AN ANALYSIS OF THE ATTRIBUTION OF PROFITS TO A PERMANENT ESTABLISHMENT INVOLVED IN E-COMMERCE TRANSACTIONS ON THE BASIS OF THE REPORT OF THE TECHNICAL ADVISORY GROUP OF THE OECD

(A Thesis submitted in partial fulfillment of the course requirements for the grant of Master of Laws Degree)

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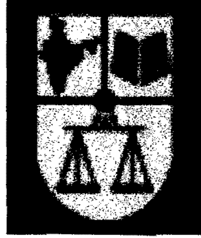

CERTIFICATE

This is to certify that this dissertation entitled "AN ANALYSIS OF THE ATTRIBUTION OF PROFITS TO A PERMANENT ESTABLISHMENT INVOLVED IN E-COMMERCE TRANSACTIONS ON THE BASIS OF THE REPORT OF THE TECHNICAL ADVISORY GROUP OF THE OECD" is the result of bonafide work done by Ms. Annie Varghese under my guidance for the award of the Degree of Master of Laws and that this dissertation was not previously the basis for the award to the candidate, of any degree, diploma, fellowship or similar title.

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DECLARATION

I, Annie Varghese hereby declare that the outcome of this research endeavor entitled 'AN ANALYSIS OF THE ATTRIBUTION OF PROFITS TO A PERMANENT ESTABLISHMENT INVOLVED IN E-COMMERCE TRANSACTIONS ON THE BASIS OF THE REPORT OF THE TECHNICAL ADVISORY GROUP OF THE OECD" has been written under the guidance and supervision of Professor K.C. Gopalakrishnan, during my Post-Graduate study at the National Law School of India University, Bangalore.

It is declared that the work is original, except for such help taken from such authorities which have been sincerely acknowledged at the respective places.

It is also declared that this dissertation in part or in whole has not been submitted to any institute or university for the grant of any degree, diploma, fellowship or any such title.

Place: Bangalore

Date: 9.11.2002

Annie

(Annie Varghese)

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I hope this thesis is indicative of my efforts and hard work.

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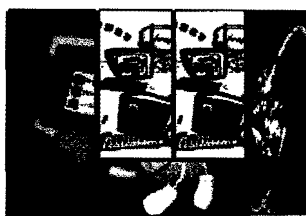

I. INTRODUCTION

New Technologies are at the forefront of global economic interaction. The recent great strides in technology especially communications technology and e-commerce, particularly has galvanized global interaction on an unprecedented scale.

New technologies bring with them social changes and new ways of doing business. However, the innate nature of these developments is that they tend to blur national borders and the source and character of income. Consequently, significant issues often arise regarding how the income arising from transnational transactions utilizing these technologies should be treated under current rules. Since these transactions tend to affect the interests of several different countries, it is possible that countries will claim inconsistent taxing jurisdiction, with the attendant possibility that taxpayers will be subject to international double taxation. If these technologies are to achieve their maximum potential, this must be avoided.

These technological developments particularly e-commerce has drastically changed the manner of doing business by making physical presence and physical delivery of goods and services nearly obsolete which were the very basics of conducting traditional business. Physical presence being immaterial, commercial transactions are no longer defined by geographical situations.

National boundaries therefore lose their significance in the context of e-commerce, creating myriad, unexpected and highly complex problems for the Governments of various countries in the context of their duty and need to bring the income generated by e-commerce into the tax net. The ability to conduct e-commerce from virtually any location challenges the application of traditional tax schemes. Several characteristics of the Internet contribute to this: its absence of central control, its lack of dependence on physical location, its absence of registration for use and its lack of proof of identity requirements *et al.*

To ensure that these technologies are not impeded, the development of substantive tax policy and administration in this area should be guided by the principle of neutrality. Neutrality rejects the imposition of new or additional taxes on electronic transactions and instead simply requires that the tax system treat similar income equally, regardless of whether it is earned through electronic means or through existing channels of commerce.

The amorphous nature of e-commerce has given rise to a plethora of issues that relate to the interpretation and application of traditional principles of taxation. In recent times, the following aspects of e-commerce transactions have been extensively scrutinized by the OECD as well as the tax authorities in individual countries.

- The Permanent Establishment (hereinafter PE) concept in e-commerce transactions,
- The attribution of profits on the basis of source of such income and
- The characterization of income arising from e-commerce transactions.

These issues are fundamentally related to the equitable allocation of taxing rights between jurisdictions.

The objective of this paper is to analyze the concept of PE and the issues concerning the attribution of profits with special emphasis on the Report of the Technical Advisory Group of the OECD and the Report of the Indian High Powered Committee of Central Board of Direct Taxes (CBDT).

In the course of the study the researcher has sought to address certain specific issues and to bring the study into focus, the following research questions were framed:

- What constitutes a PE in cross border e-commerce transactions?
- Whether a website or a server constitute PE in the source country?
- How to allocate business profits between the PE and the Head Office?
- Whether the present Transfer Pricing methods are applicable in attributing profits in the e-commerce scenario?

The method of research adopted is a combination of the descriptive and analytical methods. Albeit the reports of the Technical Advisory Group (TAG) and the Committee of the Fiscal Affairs (CFA) of the OECD on various aspects of e-commerce taxation forms the basis of the study, an analysis of the conclusions with specific reference to India has also been attempted. The sources of data used are primarily secondary sources. In addition, number of books and articles written by eminent authors relating to the subject matter of the research have been used. A uniform mode of citation is used wherever needed.

E-commerce obviously as ramifications beyond merely the attribution of income to a PE including the current trend to de-emphasize traditional concepts of source-based taxation, increasing the importance of residence-based taxation, the classification of income arising from transactions in digitized information, such as computer programs, books, music, or image, the distinction between royalty, sale of goods, and services income, tax administration and compliance issues and the potential for anonymous and untraceable transactions. Another significant category of issues involves identifying parties to communications and transactions utilizing these new technologies and verifying records when transactions are conducted electronically. However, these fall outside the scope of the research endeavor.

This paper does not offer the definitive answer to the question of the attribution of profits to the type of PEs examined therein. The paper is also limited to an analysis of transfer pricing issues and does not address issues of characterisation of income, compliance or other administrative aspects.

* to avoid either double-taxation or non-taxation; and
* to avoid disparate treatment of off-line versus on-line transactions.[1]

However, any consideration of the substantive tax policy, tax administration and compliance issues that arise with regard to e-commerce must be guided by basic tax policy principles and must also take into account the technical and scientific characteristics of the Global Information Infrastructure, including the Internet.

The key principles for the taxation of e-commerce were agreed to at the OECD[2] Ministerial Conference in Ottawa in 1998.The OECD concluded that the taxation principles that guide governments in relation to conventional commerce should also guide them in relation to electronic commerce. The Committee on Fiscal Affairs (hereinafter CFA) set up by the OECD has recommended following five aspects as key to formulating tax policy relating to e-commerce:

- Neutrality;
- Efficiency;
- Certainty and simplicity;
- Effectiveness and fairness; and
- Flexibility.

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[1] **Taxation of E-Commerce,** Global Internet Policy Initiative, December 2001 <http://www.oecd.org/oecd/pages/home/displaygeneral/0,3380,EN-document-101->

[2] The Organisation for Economic and Cultural Development (OECD) is an organisation composed of the world's developed countries. The OECD provides an important role in international taxation by providing a forum for discussing and coordinating international tax policies. The OECD's Model Tax Convention serves as the basis for most of the tax treaties around the world.

(a) Neutrality

The focus is on neutrality of taxation of e-commerce with respect to commerce carried on in traditional manner. This is necessary in the context of equity as well as administrative simplicity. The Committee endorsed this principle as an essential part of the policy relating to taxation of e-commerce.

(b) Efficiency

This is the basic principle of any taxation be it direct or indirect, levied on e-commerce or traditional commerce. The emphasis has to be to minimize distortions in business decisions and to ensure that compliance and administrative costs are minimum.

The complexity created in the manner of doing business though Internet or other networks may require new principles being put in place. These would certainly require new measures to take care of enforcement issues. The Committee is of the view that while formulating new principles or enforcement strategies to meet the new challenges the effect on compliance costs for the taxpayer and the cost of administration must be kept in view.

(c) Certainty and Simplicity

Taxpayer should be able to anticipate the tax consequence of every transaction as it is crucial to business decisions. The Committee agrees that the approach to taxation of e-commerce should ensure such clarity even in the interim while the process of reaching international consensus on issues specific to e-commerce is being attempted.

(d) Effectiveness and Fairness

Emphasis is on raising right amount of tax at right time and the need to minimize evasion and avoidance opportunities. E-commerce offers new avenues for evasion and avoidance. The Committee agrees that this has to be kept in view while formulating new rules and devising enforcement strategies.

(e) Flexibility

Clearly in a scenario of fast developing technologies and changing manner of doing business, the policies which are formulated have to be flexible and need to keep pace with changes in the manner of doing business as a result of advances in technology. The Committee also endorses this view.

Albeit, the OECD framework on tax policy provides that the present international norms are capable of being applied to electronic commerce, some clarifications should be given as to how these norms, and in particular the Model Tax Convention, applies.

In the area of consumption tax, particularly, the framework provides that taxation should occur in the jurisdiction where consumption taxes place, and that the supply of digitized products should not be treated as a supply of goods.

In addition to the above, the OECD provides that with regard to tax administration, information reporting requirements and tax collection procedures should be neutral and fair, so that the level and standard is comparable to what is required for traditional commerce. **However, due credence is given to the fact that different means may be necessary to achieve those requirements.**

OECD GUIDELINES ON THE PRINCIPLES GOVERNING TAXATION OF E-COMMERCE

The same principles that governments apply to taxation of conventional commerce should equally apply to e-commerce, namely:

- **Neutrality** – taxation should seek to be neutral and equitable between forms of e-commerce and between conventional and electronic commerce, so avoiding double taxation or unintentional non-taxation.

- **Efficiency** – compliance costs to business and administration costs for governments should be minimized as far as possible.

- **Certainty and simplicity** – tax rules should be clear and simple to understand, so that taxpayers know where they stand.

- **Effectiveness and fairness** – taxation should produce the right amount of tax at the right time, and the potential for evasion and avoidance should be minimized.

- **Flexibility** – taxation systems should be flexible and dynamic to ensure they keep pace with technological and commercial developments.

The Committee on Fiscal Affairs believes that these principles-

- Can be applied through existing tax rules, and
- Therefore any new or revised administrative measures in the framework of those rules should be directed toward the application of existing taxation principles, and
- Should not be intended to impose a discriminatory tax treatment on commerce
- The process of implementing these principles should involve an intensified dialogue with business, with non-business taxpayer groups, and with non-OECD member economies.

Source-Based and Residence-Based Taxation Principles

The international tax environment has relied on the principles of source and residence-based taxation over the years. A source-based approach (sometimes referred to as a territorial approach) entitles the "source" country to tax the income of nonresidents that is earned within its borders. In contrast, under a residence-based system, a country asserts jurisdiction to tax the worldwide income of its residents, regardless of source. Most countries assert jurisdiction to tax based on principles of both source and residence.

The policies of the various countries - whose constituents engage in international trade - regarding source and residence-based taxation may create the potential for the double taxation of certain cross-border flows of income. Double taxation comes in three basic forms: (1) residence-residence double taxation; (2) residence-source double taxation; and (3) source-source double taxation. Residence-residence double taxation occurs when a taxpayer "is deemed a resident of more than one nation" and each asserts the right to tax on a residence basis. Residence-source double taxation arises when one nation seeks to tax income on a residence basis and another country asserts the right to tax the same flow of income on a source basis. Finally, source-source double taxation exists when each of two nations that tax on a source basis considers a particular flow of income to have a domestic source. [3]

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[3] John K. Sweet, "Formulating International Tax Laws In The Age Of Electronic Commerce: The Possible Ascendancy Of Residence-Based Taxation In An Era Of Eroding Traditional Income Tax Principles" <http://www.lexis.com/research/retrieve?_m=f5fcfc55dd564c46143c73153c5cdabb&docnum=8&_fmtstr=FULL&_startdoc=1&wchp=dGLbVlb-lSllW&_md5=d9982e12c6831834004db7f2e8b93b50>

To avoid double taxation, "one principle must yield to the other." A common bilateral tax treaty solves the double taxation problem by restricting the taxing rights of the source country, which correspondingly increases the taxing jurisdiction of the residence country. Where a source country retains its rights to tax a particular flow of income, the country of residence may avoid double taxation on that income in one of two ways: (1) by granting a credit to its resident taxpayers for taxes paid to the foreign jurisdiction; or (2) by exempting the foreign source income from the taxable income base of its taxpayers.

The source-source situation also carries with it the risk of tax evasion. A tax avoidance opportunity could arise when each of two countries considers an income flow to have a foreign source, and neither country asserts jurisdiction to tax on a residence basis. Since most countries employ both residence- and source-basis taxation, this tax avoidance scenario should not arise too often. Nevertheless, because the source-source situation creates the potential for double taxation without any corresponding relief from foreign tax credit provisions, it remains particularly problematic. [4]

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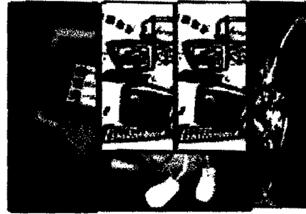
[4] *Ibid.*



3. PERMANENT ESTABLISHMENT

The whole system of international taxation is pivot on the principle of 'Permanent Establishment'. While the concept of PE has a history as long as the history of double taxation conventions, in the context of radical changes caused by the prolific growth of e-commerce, it requires serious reconsideration. Currently, the international tax principles for attributing profits to a PE are provided in Article 7 of the OECD Model Tax Convention[1] on Income and on Capital, which forms the basis of the extensive network of bilateral income tax treaties entered into by the OECD member countries and also the non-member countries.

The principle that a country has the right to tax the business profits of a resident of another country only if that person has a PE in that country, is one of the primary legal principles in international tax law and is a vital provision in international tax treaties. The concept of permanent establishment is essentially a trade-off between source state and residence state jurisdiction to tax.[2] Most international tax treaties incorporate the PE concept, usually defined as a "fixed place of business through which the business of an enterprise is wholly or partly carried on." Under the typical treaty, a contracting state gives up its right to tax

[1] The OECD Model Double Taxation Convention was adopted on April 29, 1977 and revised on July 23, 1992

[2] Jinyan Li, "E-commerce Tax Policy in Australia, Canada and United States", (2000) 23(2) UNSW Journal 313

"business profits" earned within its borders (source income), unless those profits are attributable to a PE located in that state. Thus the PE concept depends on the applicability of source-based taxation principles. A PE represents a taxing threshold that allows source-based taxation principles to operate once it is crossed.

3.1 History

Historically, the concept of PE answered the internationally felt need for a quantitative criterion for ascertaining the taxability or otherwise of foreign commercial activity in the source state. The PE principle provided sufficient evidence that a foreign company's business within the source country was substantial enough to justify the imposition of fiscal compliance burdens on the foreign company in that country.

The concept of PE was originally developed under Prussian domestic legislation and developed a narrower meaning as the necessity of prevention of double taxation grew among German States. By the end of the 19th century the PE principle had been adopted into bilateral international tax treaties between German and other European States. Between 1927 and 1946, a number of draft tax treaties, which included variations of the PE principle, were introduced by the League of Nations but no commonly accepted definition of PE was established. In 1958, the Fiscal Committee of the OECD published its first report with a draft definition of PE. This draft definition formed the basis for Article 5 of the OECD Model Convention and, with some modification, was also used for Article 5 of the UN Model Convention of 1980. Article 5 of the OECD Model

Convention has not changed significantly since it was introduced in 1958, although it has been expanded and refined over the years. [7]

PE satisfied the requirement of certainty and predictability of tax law in that it provided multinational companies with relatively clear rules to determine in advance whether and in what way their activities abroad would be taxed by foreign tax authorities. Furthermore, the PE principle presented states with an internationally equitable rule for sharing the benefits of cross-border commerce - source country taxation rewards importing countries for opening to foreign businesses the commercial opportunities available within their markets, while net-exporting countries obviously reap the benefits of taxing value added at the production stage.

3.2 Permanent Establishment under the OECD Model Tax Convention

The concept of permanent establishment was developed in the brick-and-mortar economy. The international organization entrusted with setting the standard for international tax treaties, the OECD, has drafted language amending the provision in its Model Tax Convention on Income and on Capital concerning its conceptualization of a permanent establishment.

Article 5 of the OECD Model Tax Convention defines permanent establishment. Article 5.1 is a descriptive definition, which indicates that a PE is a fixed place of business through which the business of an enterprise is wholly or partly carried on. Article 5.2 is an inclusive definition, which includes a place of management, a

[7] Gloria J. Geddes, "Rethinking the concept of permanent establishment in the light of an e-commerce driven international corporation", <http://www.smithlyons.ca/practicearea/Tax/Shore_North_America_2001_Conference/Rethinking_The_Concept_Of_Permanent_Establishment_In_The_Light_Of_An_E-Commerce_Driven_International_Corporation>

branch, an office, a factory, a workshop, or a min, an oil or gas well, a quarry or any other place of extraction of natural resources, as a PE. The article also stipulates that a building or construction or installation project constitutes a PE only if it lasts for more than 12 months.

Article 5.4 is an excluding provision. It excludes from the ambit of PE the use of facilities solely for the purpose of storage, display or delivery of goods, the maintenance of a stock or goods for the purpose of processing by another enterprise, the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, the maintenance of a fixed place of business solely for the purpose of carrying on the activity of a preparatory or auxiliary character, or a combination of the above factors, as long as the overall activities from the fixed place of business result in something which is only preparatory or auxiliary in character.

Article 5.5 deems the existence of a 'dependent agent', who acts on behalf of the enterprise, and who has habitually exercised an authority to conclude contracts in the name of the enterprise, to constitute a PE.

Article 5.6 excludes the presence of independent agents from being construed as a PE provided that such persons are acting in the ordinary course of their business.[8]

PE is clearly defined in each bilateral tax treaties and is more or less in consistence with the above-mentioned Article of the OECD Model Convention. But as a thumb rule one could make a generalization that according to most treaties, the PE is a place of relative permanence from where the foreign enterprise carries on the business of the enterprise on the host soil. Most treaties

[8] See Rodney D.Ryder, *Guide to Cyber Laws* (Nagpur: Wadhwa, 2001) at p. 126

include 'a place of management' as a PE. In addition, if the foreign enterprise also carries on the same or similar business, independent of the PE, what is known as the force of attraction rule comes into play in certain treaties. While the principles of applying the principle of PE in the case of the conventional method of transactions have been fairly established, those for the e-commerce transactions pose considerable difficulties.

Primary Rule

The definition of PE provided by article 5.1 of the OECD Model Convention contains three conditions:

a) the existence of a "place of business", i.e. a facility such as premises or, in certain instances, machinery or equipment;
b) this place of business must be "fixed", i.e. it must be established at a distinct place with a certain degree of permanence;
c) the carrying on of the business of the enterprise through this fixed place of business;
d) and the activities must be a "core" business activities (that is, not preparatory or auxiliary.)[9]

3.3 The Challenge of E-commerce

With the advent of the Digital Age, the international tax community saw the PE concept face its first major challenge- Disintermediation.

Removal of Physical Intermediaries and consolidation

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[9] Nandan kamath, *Law Relating to Computers, Internet and E-commerce,* (Delhi: Universal Law Pub. Co., 2000) at 361

Traditionally, multinational corporations have sought to penetrate foreign markets by setting up physical intermediaries within the targeted markets. These physical intermediaries often constituted PEs under tax treaties, triggering source-based taxation.

The picture changes with the availability of e-commerce opportunities. E-tailers effect the greater part of their market research, advertising, marketing and sales through a web site. Thus, the Internet can be seen as an "agent of disintermediation" because it removes the necessity for certain intermediaries.

For the multinational corporation, disintermediation means shifting part of their business operations from their physical intermediaries in source countries to their e-commerce base in the country of residence, thereby centralising their administrative, sales, marketing and after-sales operations and outsource non-essential functions to foreign affiliates. For source countries, this means a loss of source-generated taxable profits and, as long as international tax rules insist on the physical presence requirement, their tax base will suffer further erosion.[10]

Removal of Human Intermediaries

The present day internet technologies can perform those tasks traditionally carried out in source countries by dependent agents or employees employed by multinationals. The removal of dependent agents habitually concluding contracts in the source state means that a PE may no longer be present under most tax treaties. The same result can be achieved by replacing dependent agents with independent agents acting on instructions to perform the same

[10] Thomas A. O'Donnell et al., "International Tax Issues For Cyberspace Transactions", <http://www.bmck.com/ecommerce/cyber.doc>

tasks. Under the current international tax regime, no tax can be chargeable by the source state for the corporation's activities in its market.[11]

In an e-commerce environment, the issue has arisen as to how far Article 5 of the OECD Model Tax Convention applies to the e-commerce situations. Whether the existence of a website and/or server in a foreign country will constitute a PE with the consequence that the foreign country will have taxing rights in relation to profits attributable to the activities of that PE.

3.4 OECD Findings

The application of existing tax rules to e-commerce

All the OECD member countries, including the US, represented at the Ottawa Conference agreed with the Committee on Fiscal Affairs' recommendations that "the taxation framework for e-commerce should be guided by the same taxation principles that guide governments in relation to conventional commerce." Any new administrative measures should be directed toward the application of existing taxation principles and should not be intended to impose a discriminatory tax treatment on e-commerce "at this stage of development in the technological and commercial environment". Likewise, it was agreed that the canons of taxation generally applicable to taxation of conventional commerce should equally apply to e-commerce, namely: neutrality, efficiency, certainty, simplicity, effectiveness, fairness, and flexibility.

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[11] *Ibid.*

Clarification on the Application of the PE Definition in E-Commerce[12]

The Draft Commentary on Article 5 concerning the application of the current definition of PE the context of e-commerce, issued by Working Party No. 1 on Tax Conventions and Related Questions, was adopted by the CFA on 22 December 2000.

Web sites and servers

The approved changes to the commentary on Article 5 distinguish between web sites and servers for PE purposes so that web sites stored on a server should not constitute a PE. On the other hand, "the server on which the web site is stored and through which it is accessible is a piece of equipment having a physical location. Such a location may constitute a 'fixed place of business' of the enterprise that operates that server" as long as the server is fixed at a certain place for a sufficient period of time. The permanence test looks at whether the server has actually been moved, irrespective of whether it can or cannot be moved.

A distinction is also made between the web site operator and the server operator, who may or may not be the same person. The former enterprise "carries on business through the web site' but does not necessarily operate the server. In the case of web hosting arrangements, the enterprise's web site is hosted on a server operated by an ISP. A PE may only arise where the server is

[12] OECD, Clarification On The Application Of The Permanent Establishment Definition In E-Commerce: Changes To The Commentary On The Model Tax Convention On Article 5, 2000 <http://www.ecommercetax.com/Official_docs/OECD%20-%20web%20server%20as%20PE.pdf>

at the disposal of the online enterprise who owns or leases it, and can never arise in the case of ISP hosting.

ISPs, web sites and agency

Paragraph 42.10 makes it clear that ISPs cannot constitute dependent agents because they do not have authority to conclude contracts in the name of the enterprise, because they do not do so regularly or because they "constitute independent agents acting in the ordinary course of their business, as evidenced by the fact that they host the web sites of many different businesses." Neither can a web site constitute a dependent agent as it is not itself a 'person' in the sense of Article 3 of the OECD Model.[13]

Core functions

However, this requires that the functions performed at that place be significant as well as an 'essential' or 'core' part of the business activity of the enterprise:

Where [the server] functions form in themselves an essential and significant part of the business activity of the enterprise as a whole, or where other core functions of the enterprise are carried on through the computer equipment ... there would be a PE.

The new additions to the Commentary on Article 5 provide an indicative list of examples of core functions in the case of e-tailers. These "depend on the nature of the business carried on by the enterprise" and need not all occur in any given case: "the conclusion of the contract with the customer, the processing of

[13] *Ibid.*

the payment and the delivery of the products," all of which are performed automatically online.[14]

Preparatory or auxiliary activities

An indicative list of activities generally considered preparatory or auxiliary includes providing a communications link, advertising goods or services, relaying information through a mirror server, gathering market data or supplying information. Whether these or other server activities should be characterised as auxiliary or preparatory in nature "needs to be examined on a case-by-case basis having regard to the various functions performed by the enterprise through that equipment." Thus online advertising, the provision of an online catalogue or the provision online of information to prospective customers by an e-tailer does not create a PE. On the other hand, an online advertising agency's online adverts or the online research activities of an online market analyst are likely to constitute core activities and this contribute to establishing a PE.[15]

Human intervention

The new Commentary also indicates that servers can constitute PEs even if no on-site human intervention is involved or necessary, in the same way as automatic pumping equipment used in the exploitation of natural resources can make up a PE. The CFA's decision to allow the taxation of business profits generated by servers seems to have precedent. By analogy, servers may be compared to "automatic equipment" such as vending and gaming machines which thought to suffice for the purpose of a PE. On the other hand, it is not

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[14] *Ibid.*
[15] *Ibid.*

unknown for tax treaties to contemplate 'fictions' which favour source country taxation despite the absence of any real PE, as in the case of foreign athletes or artists generating earnings without a PE. Such precedents support arguments that source countries should tax e-commerce profits from sales within their jurisdictions even in the absence of a PE.[16]

3.5 Summary of requirements for a Server-PE

For a server to constitute a PE, it has to meet the following requirements:

1. The server on which web site is hosted and its location have to be at the foreign enterprise's disposal - owned / leased and operated by the enterprise - not web hosting;

2. The server must be is located in the taxing state - a "fixed place of business";

3. Core business activities have to be performed through the server, as opposed to preparatory or auxiliary functions, without the need for human intervention.

3.6 Conclusion: Problems solved?

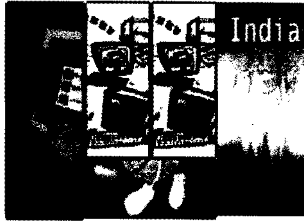
The problems posed by the technology of the New Economy seem insurmountable. It is debatable whether the OECD's clarification of the definition of a PE has helped restore the equitable sharing of tax revenues between residence and source countries, and this for a number of reasons.

[16] *Ibid.*

Servers are highly mobile and flexible in nature. A server need not have any geographic connection either to the source country or to the residence country. Therefore e-businesses may own or lease a server located anywhere in the world and can conduct its business activities via this server in such a way as to ensure that their profits will either be taxed exclusively by the residence country or by some low tax jurisdiction. Moreover, servers can transfer their programs almost instantaneously to a server in a different jurisdiction as necessary. Furthermore, the server can be maintained or programmed remotely by employees located outside of the source country or serviced by experts in the server state.

A flaw of the OECD's position is that it ignores the possibility of e-commerce functions being transferred to the end consumer's computer. Web servers often plant small programs or applets in the user's computer which then performs a portion of the processing itself. Alternatively, e-commerce functions can be decentralised via peer-to-peer networking where users trade digital products without resorting to any centralised server location. All these possibilities render the task of determining the location of a PE very difficult, if not impossible. Ultimately, networking technologies have created a breading ground for tax planning opportunities which encourage the relocation of servers across borders. The current PE rules can easily be circumvented either by carrying on only preparatory or auxiliary activities in the source state, or by using the server of a local ISP to carry on the core business activities of the foreign enterprise, or by positioning the server and establishing a PE in low or no tax jurisdictions. Similarly, domestic vendors too can very easily create a PE in lower tax jurisdictions elsewhere.

Another problematic matter is that of enforcement and administration. How can tax authorities determine the income attributable to software functions within servers, to a server or web site? How about the significant compliance costs that could burden multinational businesses having to comply with fiscal obligations in every jurisdiction where their servers are located? These are the questions that face the international fiscal order in the years to come.



4. THE INDIAN POSITION

In India, any person, whether resident or not, is chargeable to tax in respect of his income accruing, arising, or received, or deemed to accrue, arise, or to be received in India. Thus, even if the income was not actually received in India but is deemed to accrue or arise in India, it would be taxable in India. Residents are taxed on their worldwide income, whether it accrues, arises, or is received outside India. Nonresidents are taxed on their Indian-source income. The determination of a person's residential status becomes essential because taxability of a particular income and the rates at which it is taxed vary according to this status.

4.1 Residence Rule

Any company incorporated in India is deemed to be resident in India even if its control and management are situated wholly or partly abroad. A non-Indian company is deemed to be resident in India only if its control and management are situated wholly in India. Thus, most foreign companies fall under the category of nonresident.

The expression "control and management" means, de facto, control and management, and not merely the right or power to control or manage. Even if a part of the management and control is outside India , the company won't be

considered resident in India. Thus, in one year, a company may be "resident" in India and in another, it may be "nonresident."

Control and management is different from carrying on business operations of a company. It does not refer to control and management of the day-to-day affairs of the company's business, which is conducted by agents, employees, and servants. It's not situated where the shareholders meetings are held even if a single shareholder, by reason of his majority shareholding, has a decisive voice in matters relating to the company's affairs. It is situated where the central management and control actually resides. A company can have dual residence.

4.2 Source Rule

Section 9 of the Indian Income Tax Act, 1961

Section 9 of the Income Tax Act specifies various types of income that would be regarded as deemed to accrue or arise in India and, therefore, becomes taxable in India. The income is covered under this section when it isn't chargeable on the basis of its receipt. This principle is applicable to both residents and on residents. For nonresidents, unless the place of accrual or receipt of the income is within India, they cannot be subject to taxation in India.

4.3 Business Income

Foreign enterprises are taxed in India on the basis of 'income accruing or arising or deemed to accrue or arise in India'. Income accruing directly or indirectly from any 'business connection' or through property or assets or source of income

in India or through transfer of capital asset situated in India is 'deemed to accrue or arise in India'.

Section 9(1)(i) of the Income Tax Act deals with the source rules for business income in India. Any direct or indirect income is deemed to accrue or arise in India so long as it is derived through or from:

- any property in India;
- business connection in India;
- any asset or source of income in India; or
- transfer of a capital asset situate in India.

If not all operations of a business are carried out in India, then only the part of income that is attributable to Indian operations would be regarded as income accrued or arisen in India.

The expression "business connection" has a wide but uncertain meaning. The expression isn't defined under the Income Tax Act. The concept of "business connection" is similar to but much wider in meaning than the concept of PE. The meaning of this expression is also not restricted to the definition of "business." The judicial precedents on the subject have evolved a meaning for this term, which could be summarised as follows:

A business connection involves a relation between a business carried on by a nonresident that yields profits or gains and some activity in India that contributes directly or indirectly to the earning of those profits or gains. Thus, to establish a business connection, an element of continuity should exist between the nonresident's business and the activity in India.

A business connection may exist even without any regular agency, branch, or other definite organization. The mere fact that a substantial part of the nonresident's output is sold in Indian markets, or is sold directly or through brokers to Indian consumers, or rendering of services outside India, per se, to a person carrying on business in India, would not amount to a business connection in India.

Thus, if it is established that a nonresident has a business connection in India, then its income would be subject to Indian taxation under section 9 of the Income Tax Act. However, the tax would apply only to the income that is attributable to its activity in India. The tax rate applicable to business income of a foreign entity in India would be 48 percent, subject to the applicable tax treaty.

4.4 DTAs v. Income Tax Act

Further, section 90(2) of the Income Tax Act provides that the provisions of the act will apply to an assessee only to the extent that they are more beneficial to the assessee as compared to the relevant double taxation avoidance agreement. The effect of section 90 is to incorporate treaty law into domestic tax law. In the case of a conflict between the two, the treaty would override the domestic tax law to the extent that it is more beneficial to the taxpayer. Hence, although the term "business connection" is much wider, in a situation when the nonresident comes from a treaty country, the definition and meaning of PE would be relevant in determining its tax liability in India. Similarly, the nonresident could also avail the benefit of the restrictive definitions in the applicable double taxation avoidance agreement of the terms "royalty" and "fees for technical services," respectively.

It's clear from the above that technology transfers are already subject to tax under the current provisions of the Income Tax Act. As we observed from the earlier discussion, e-commerce is merely a different form of doing business. There is, therefore, nothing sacrosanct about taxing e-commerce. It should be treated in the same manner as any other business, and the existing laws should be adopted and adapted to enable the taxation of e-commerce transactions while maintaining neutrality. The principle of neutrality requires that the e-commerce transactions be treated at par with the conventional way of doing business. This means that they should neither escape taxation all together, nor be subject to taxation if a similar transaction under conventional means would not have been taxed.

4.5 Report Of The Indian High Powered Committee On E-Commerce Taxation

The Indian High Powered Committee on E-commerce Taxation[17] carefully considered the views of the OECD and agreed that the views taken are consistent with the existing rules and principles. However, the Committee was constrained to point out that treating the server which hosts the website, which is at the disposal of the enterprise and performs 'core business functions' of the enterprise as PE will not address the crucial issues arising from growth of e-commerce. **Treating the server as PE will not create certainty of tax burden or ensure maintenance of the existing equilibrium in revenue sharing between countries of residence and source.**

[17] Report of the High Powered committee of Ministry of Finance, India, "Taxation and E-Commerce". Available at the website of the Ministry of Finance <http://finmin.nic.in/fdrev.htm>

The report further pointed out that since more than one server may be used by the enterprise making the location of the server actually performing specific functions in the source country difficult to determine, the location of the server would be easy to manipulate. That there is nothing to prevent it being located in a low tax jurisdiction or a tax haven and not in the source country. Even if the server is located in the source country, in e-commerce huge volume of transactions can be conducted without any requirement of office and staff in the source country.

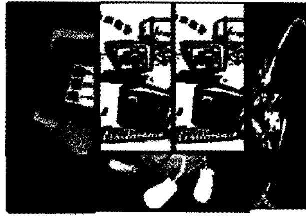
The Committee is of the view that applying the existing principles and rules to e-commerce situation does not ensure certainty and reasonable allocation of revenues between residence and source countries. The Committee is also firmly of the view that there is no possible liberal interpretation of the existing rules, which can take care of these issues, as suggested by some countries. **The Committee, therefore, supports the view that the concept of PE should be abandoned and a serious attempt needs to be made within the OECD or the United Nations to find an alternative to the concept of PE.**

"The PE concept emerged in traditional commerce as it was not possible to carry on business of any significant size without having physical presence in the source country. Where there was no physical presence the level of business was too low to be of concern for taxation purposes. The revolution in telecommunication technology changed that. And now, with the Internet it is possible to transact huge business without moving out of the country of residence. The argument that in such a situation there is 'no PE' and therefore no value addition in the source country and hence no source taxation is being questioned. It can be argued that the supply side alone does not create value without there being demand. The existing rule which makes the right to tax, by

the source state, dependent only on the existence of PE has, therefore, no rational basis in the era of e-commerce."[18]

The Committee is also of the view that pending the new consensus it will be meaningless to amend the Act or the DTAs to provide for definition of what constitutes a PE in an e-commerce situation. There will be too many possibilities of manipulation and too many qualifications to be administratively feasible to implement. The Committee also recommends that interaction at the international level should be made regular and structured.

[18] Extract from the Report of the High Powered committee of Ministry of Finance, India, "Taxation and E-Commerce".



5. ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENT

Once the concept of PE in e-commerce taxation is confirmed, at least in respect of the application of the existing rules, what is to be determined is to what profits can be attributed to e-commerce activities that have passed the threshold of Article 5 so that a PE is held to exist. The allocation of the taxing rights between the jurisdiction of the enterprise and the jurisdiction of the PE need to be determined. Under the OECD Model Tax Convention, Article 7 provides for the same.

5.1 Article 7 OECD Model Tax Convention

Article 7(1) - Calculating profit to be allocated to a permanent establishment

Article 7 of the OECD Model Tax Convention sets out the rules for allocating profits to a PE. Article 7(1) provides that only so much of the "profits of an enterprise" as are attributable to a PE in a country may be taxed in that country. This limits the taxing rights of a host country so that profits of a non-resident enterprise that are not attributable to the PE.

Article 7(2) of the OECD Model Tax Convention

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 PE. It states that the profits to be attributed to a PE 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.

5.2 The Arm's Length Principle

Traditionally the allocation of income among different jurisdictions has relied on the arm's length principle. The underlying assumption is that members of a multinational enterprise[19] group are separate accounting units and deal with each other at arm's length. The norm, by extension, is that each unit of the MNE is expected to declare, for tax purposes, the profits that it would have made had it been a distinct and separate enterprise operating at arm's length from its parent and sister affiliates.[20] Thus, allocations of income among related entities are evaluated in accordance with the way that unrelated parties transacting business with one another would structure their transactions.

The OECD in Article 9 of the OECD Model Tax Convention[21] defines the arm's length principle as when

"Conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would but for these conditions, have accrued at one of the enterprises, but, by reason of those

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[19] Hereinafter "MNE".

[20] L. Eden, "The Arm's Length Standard in North America" 2000, Tax Notes International at 673 and 674.

[21] Organisation for Economic Co-operation and Development, Model Tax Convention on Income and Capital (Paris: OECD, 1992).

conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly."[22]

The US tax authorities have defined the arm's length standard by calling a controlled transaction as arm's length if "the results are consistent with the results that would have been realised if uncontrolled taxpayers had engaged in a comparable transaction under comparable circumstances. Canadian tax authorities state that, "non-arm's length parties must conduct their transactions under terms and conditions that would have prevailed if the parties had been dealing at arm's length with each other."[23]

Transfer pricing is the appropriate valuation of cross-border transaction among related parties so as to ensure that income and expenses are properly allocated among jurisdictions for tax purposes. It operates through the arm's length principle. Its aim is to prevent MNEs from reducing their tax burdens by shifting taxable income or assets, especially intellectual property, to subsidiaries situated in tax havens or low tax jurisdictions. In layman's terms, transfer pricing goals are achieved by considering each unit of a MNE as a separate business entity and thus, treating any transfer of assets, production capacity or taxable income as being transferred among different business pricing, different subsidiaries of MNE are considered as separate business entities.

The US transfer pricing guidelines are set out in section 482 of the Internal Revenue Code. Under this section, the US Secretary of Treasury is granted

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[22] *Ibid.*

[23] Department of Finance Canada:< http://www.fin.gc.ca/news95/95-059_1e.html>

extensive power to make appropriate adjustments to an entity's reported income, expenses, credits, allowances, and so on, in reference to transactions of tangible or intangibles, in order to prevent evasion of taxes or to more accurately reflect real income. The official state purpose of section 482 is to ensure that taxpayers clearly reflect income attributable to "controlled transactions" and to prevent avoidance of taxes with respect to such transactions. The Canadian transfer pricing rules are outlined in section 247 of the Canadian Income Tax Act and follows similar principles.

5.3 Transfer Pricing Methods

OECD member countries and the United States usually achieve their transfer pricing objectives through a variety of methods. These methods can be broadly divided into three classes: the traditional transaction methods, the transactional profit methods, and global formula apportionment. These three classes together form the spectrum of transfer pricing methods.[24] The first two classes will be discussed in this section of the paper.

1. **Traditional Transaction Methods**: The three methods that fall under this category are:

   a. Comparable Uncontrolled Price Method
   b. Resale Price Method
   c. Cost Plus Method

[24] R.S. Avi-Yonah "The Rise and Fall of Arm's Length: A Study in the Evolution of U.S.International Taxation", 15 Virginia Tax Review 89.

a. *Comparable Uncontrolled Price Method* - Prime among the traditional transaction method is the comparable uncontrolled price method. This method compares the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.[25] Any difference between the two prices may indicate the conditions of the commercial and financial relations of the associated enterprises are not arm's length, and that the price in the uncontrolled transaction may need to be substitute for the price in the controlled transaction.[26] Any difference in prices between the compared transactions will reflect on the need to adjust prices of the transactions between associated enterprises. The OECD deems that an uncontrolled transaction can be compared to a controlled transaction if one of two conditions are met: 1) none of the differences (if any) between the transaction being compared or between the entities undertaking the transactions could materially affect the price in the open market; or 2) reasonably accurate adjustments can be made to eliminate the material effects of such differences. In considering whether controlled and uncontrolled transactions are comparable, regard should be had to the effect on price of broader business functions other than just product comparability. [27]

b. *Resale Price Method* -The OECD also suggests the use of the resale price method. This method begins with the price at which a product that has been purchased from an associated enterprise is resold to an individual

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[25] Organisation for Economic Co-operation and Development, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators (Paris: OECD, 1995)

[26] *Ibid.*

[27] Aaron Lukas, *Tax Bytes: A Primer on the Taxation of Electronic Commerce,* <http:/S/www.freetrade.org/pubs/pas/tpa-009es.html>

enterprise. The price (the resale price) is then reduced by an appropriate gross margin (the resale price margin) representing the amount out of which the reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed, make an appropriate profit. What is left after substracting the gross margin can be regarded, after adjustment for other costs associated with the purchase of the product, as an arm's length price for the original transfer of property between the associated enterprises. The resale price margin of the reseller in the controlled transaction may be determined by reference to the resale price margin that the same reseller earns on items purchased and sold in comparable uncontrolled transactions.[28] Thus, the arm's length price under the resale price method bases the transfer price on the gross profit margin of sales in uncontrolled transaction.

c. *Cost Plus Method* – The third transfer pricing method suggested by the OECD is the cost plus method. This method looks at whether the gross profit mark-up realized in comparable uncontrolled transactions is similar to the mark-up realized in the controlled transaction. The method begins with the costs incurred by the supplier of property in a controlled transaction for property transferred or services provided to a related purchaser. An appropriate cost plus mark-up is then added to this cost, to make an appropriate profit in light of the functions performed and the market conditions. What is arrived at after adding the cost plus mark-up to the above costs may be regarded as an arm's length price of the original controlled transaction. The cost plus mark-up of the supplier in the

[28] *Ibid.*

controlled transaction should ideally be established by reference to the cost plus mark-up that the same supplier earns in comparable uncontrolled transactions. Once again the same two conditions used in the Comparable Uncontrolled Price method for comparing a controlled transaction to an uncontrolled transaction apply here. The Resale Price Method and the Cost Plus Method basically operate in the same manner as the Comparable Uncontrolled Price method. The difference is that the former methods focus on the gross margins from controlled and uncontrolled transactions to determine whether the terms and conditions between associated enterprise meet the arm's length principle. American and Canadian authorities accept these three methods as the prime methods for achieving their transfer pricing guidelines.

2. **Transactional Profit Method** - The OECD also suggests the use of other approaches that might be used to approximate arm's length conditions when traditional transaction methods cannot be reliably applied or applied at all. These methods are collectively referred to as the "transactional profit methods" i.e. methods that examine the profits that arise from particular transaction among associated enterprises. Two methods that fall under this category are the "profit split" method and the "transactional net margin" method.

a. *Profit Split* - where transactions are highly integrated it might not be possible to evaluate them on a separate basis. Under these circumstances, the profit split method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction by determining the division of profits that independent enterprises would have expected to realize from engaging in the transaction. This method first identifies the

profit to be spilt for the associated enterprise from the controlled transactions in which the associated enterprises are engaged. It then splits those profits between the associated enterprises on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length. There are two basic approaches to the profit split method – a "comparable profit split analysis" and a residual profit split" analysis. In a comparable profit split the profit allocation is determined by analysing the operating profits or loss among uncontrolled taxpayers performing similar activities under similar circumstances. The residual profit split analysis allocates profits by attributing normal market returns to the routing contributions made by each of the related parties.

b. *Advance Pricing Arrangements* – The OECD, the United States, the Canada have all suggested the setting up of or set up a system known as Advance Pricing Arrangements[29] to alleviate some of their concerns with the proper application of the transfer methods. An APA is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (eg. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time. An APA is formally initiated by a taxpayer and requires negotiations between the taxpayer, associated enterprises, and tax administrators. It is intended to supplement the traditional administrative, judicial, and treaty mechanisms for resolving transfer pricing issues. The OECD guidelines identify an APA as a non-adversarial and efficient process through which

[29] Hereinafter "APA".

a taxpayer can enhance the predictability of the tax treatment of its international transactions.[30] A successful APA can prevent costly and time-consuming examination and litigation.[31] More importantly, it can provide a degree of certainty that may otherwise be unavailable in transfer pricing. APAs also foster co-operation among taxpayers and administrators and reduce the possibility of double taxation of non-taxation. As mentioned previously, countries like Canada and the United States have enacted APAs within their transfer pricing guidelines. These countries developed their respective programs mainly to address the uncertainties of inter-company transfer pricing and hazards of double taxation or non-taxation. The US APA procedure is designed to produce agreements between the taxpayer and the Internal Revenue Service on three issues: a) the factual nature of the inter-company transactions to which the APA applies, b) an appropriate transfer pricing method to apply to these transactions, and c) the expected arm's length range of results from the application of the transfer pricing method to these transactions. The Canadian system follows similar principles and is outlined in a 1987 Information Circular (87-2), "International Transfer Pricing and Other International Transactions."[32] The taxpayer is given the option of seeking a unilateral, bilateral or multilateral APA. The APA system is a relatively new addition to the controversy surrounding the application of various transfer pricing methods to non-arm's length transactions. The system has definitely reduced some of the uncertainty related to the application of the arm's length approach. However, it

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[30] R.S. Ackerman, "Negotiating Advance Pricing Agreements for Financial Institutions" 1998 Tax Notes International 1713, at 1717.

[31] *Ibid.*

[32] S. Shaughnessy, "Spotlight on APAs in Canada" 1995 Tax Notes International 232 at 233.

remains to be seen whether APAs can be as useful when applying the current transfer pricing methods to e-commerce transactions.

5.4 Transfer Pricing in India

The Union Budget of India for the financial year 2001-2002 introduced comprehensive transfer pricing regulations to the Indian legal and tax paradigm. The Finance Act 2001 has replaced the earlier Section 92 of the Indian Income-tax Act, 1961 (the "Act") which addressed transfer pricing in a very restricted manner. The current provisions have been moulded to a large extent by the OECD guidelines, which were first published in 1979 and the Union Nations' Guidance Report. These provisions came into effect on April 1, 2001.

The Central Board of Direct Taxes ("CBDT") have recently announced the rules that list the various methods of transfer pricing and also describe the selection and application of such methods to the transaction in question.

The provisions recently introduced, like their global predecessors, are principally concerned with ascertaining the jurisdiction in which taxes are payable rather than the possibility of tax evasion. The thrust of the provisions is on the definition of an associated enterprise in the context of an international transaction. The provisions do not apply to purely domestic transactions entered into between two residents. One of the pre-requisites for any transaction to fall within the scope of the provisions is that at least one of the parties to the transaction should be a non-resident. In order to understand and appreciate the scope of the aforementioned provisions it is necessary for one to deal at length with the following terms:

i. Arm's Length Price

The term *'arm's length price'* has been defined under Section 92F(ii) of the Income Tax Act as, '*A price, which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions*'.

As is apparent from the earlier definition, in order to understand the meaning of transfer pricing it is necessary for one to know what the meaning of 'enterprise' is. The term "enterprise" would include a permanent establishment of the enterprise[33]. Thus, transfer pricing provisions will apply to transactions between the head office and branch of the same entity. Therefore, the expenses and interest payable by / to a head office of an enterprise to / from its branch office would also fall within the purview of these provisions.

ii. Associated Enterprise[34]

The definition of an 'associated enterprise' consists of two parts; the first part deals with the concept of an associated enterprise *per se*, whereas, the second part exhaustively lists down the circumstances in which two enterprises are *deemed* to be associated enterprises.

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[33] Section 92F(iii) of the Act

[34] As per section 92C of the Act, an associated enterprise means:

(a) an enterprise which participates - directly or indirectly - or through one or more intermediaries, in the management or control or capital of another enterprise; or

(b) an enterprise in respect of which one or more persons who participate - directly or indirectly - or through one or more intermediaries in the management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management, capital or control of the other enterprise.

This definition contemplates a situation where, there is either a common person /groups of persons controlling the enterprise under scrutiny and the other enterprise with which it has transacted, or where one enterprise itself controls another enterprise with which it has transacted business. The concept of control in terms of the capital and management has been elaborated upon in the deeming provisions.

These provisions envisage thirteen situations in which two enterprises are deemed to be associated for the purpose of transfer pricing, which principally relate to percentage of equity ownership or common equity holding in excess of the prescribed limits, the grant or guarantee of loans or borrowings by one enterprise for another enterprise in excess of the prescribed limits, business interdependence, and so on. These deeming provisions are unique to India, since existing transfer-pricing norms in other jurisdictions do not enumerate such detailed and explicit criteria.
This clause under the transfer pricing provisions spawns problems of unpredictability of the application of these provisions by the tax authorities.

iii. Methods of Transfer Pricing

Under the Income Tax Act, *arm's length price* in relation to an international transaction between two or more associated enterprises may be determined by any one of the following methods:
(a) comparable uncontrolled price method;
(b) resale price method;
(c) cost plus method;
(d) profit split method;

(e) transactional net margin method; or

(f) such other method as may be prescribed by the CBDT.

The taxpayer has an option to select the most appropriate method, which is applicable to his transaction. The rules for transfer pricing, announced by the CBDT, elaborate upon the manner in which such method is to be applied and consequently, how the appropriate price is to be arrived at. As seen previously, under the OECD model, the first three methods are popularly understood to be transaction-based methods, whereas the methods mentioned in items (d) and (e) hereinabove fall under the category of transactional profit methods. The aforementioned rules of the CBDT favour the former category of methods, which is in accordance with the prioritization of methods under the OECD guidelines. However, where more than one price may be determined by the most appropriate method, the *arm's length price* is to be taken to be the arithmetic mean of such prices. This provision is peculiar to Indian legislation and has been the cause of much public outcry. The Indian tax regime has so far not provided for an advance pricing mechanism under the provisions, which would enable a party involved in an international transaction to ascertain whether or not his method of pricing would be acceptable to Indian tax authorities, and thereby minimize the risk of litigation in the future.

Transfer pricing provisions in India are at a nascent stage at the moment, but would benefit greatly from relying on and learning from international experience in this regard.

In India, it seems to be the general consensus amongst eminent jurists that, the existing principles for allocating income of various units of a globally integrated

business could perhaps be applied to electronic commerce. As per domestic Indian law, only income attributable to operations carried on in India can be taxed in India.

The Indian law provides a choice of allocation methods to be applied at the discretion of the income tax officer. If the officer disagrees with the accounts maintained by the taxpayer, the tax officer may adopt any of the following three allocation methods:

- a percentage to the turnover;
- a global profit split (including allocating global profits to India based on relative turnover realized in India); or
- any other manner that the tax officer considers suitable.

5.5 Application Of Article 7 To 'PE' In E-Commerce Transactions

The Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits[35] brought out a discussion paper[36] which provides a detailed analysis of the transfer pricing issues arising in attributing profit to a PE involved in e-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 PE under Article 7 of the OECD Model Tax Convention.

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[35] Hereinafter "Business Profits TAG/BP TAG Paper"

[36] Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions, released February, 2001. Available at <http://www.oecd.daf.fa>

The CFA Paper[37] posits a working hypothesis ("WH") whereby a PE is treated as a hypothetical distinct and separate enterprise. Under the WH, a functional analysis is made to identify all of the functions performed, assets used, and risks assumed by the PE. Having identified these functions, assets and risks, "dealings" between the PE and head office are recognized reflecting the various arm's length transactions that the PE would have had to transact with the head office (or other part of the enterprise) to shift the identified assets, risks and/or functions from the head office (or other part of the enterprise) to the PE. The crux of the BP TAG E-Commerce PE Attribution Paper is an application of the WH to a PE carrying on retail e-commerce activities.

With respect to the e-tailer model, the BP TAG Paper provides that an analysis of the functions and risks assumed by a stand-alone computer server "is likely to show that the PE is performing only routine functions" and that the PE's activities "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." Absent personnel, the "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 PE the profits associated with the physical operation of the computer server." These profits would likely be determined "by reference to a cost plus calculation performed on the basis of the direct operating costs incurred in the PE. Therefore, the computation of the compensation attributable to the PE

[37] Discussion Draft on the Attribution of Profits to Permanent Establishment, <http://www.ecommercetax.com/Official_docs/OECD%20-%20attribution%20of%20profit%20to%20PE.pdf>

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."

Identifying the various decision-making functions required of a retail outlet, the BP TAG Paper rejects the "retail outlet" business model as comparable to a stand-alone e-tailer server. Depending on the functions performed and risks assumed, the stand-alone server could be considered the comparable of an independent service provider. In that case, dealings between the PE and head office would have to be recognized to reflect the head office's transfer of rights to the PE to use the hardware and software "belonging" to the head office on its own behalf. Substantially all of entrepreneurial reward from the hardware and software supporting the web site would accrue to the head office under this model as well: ... given the need for the PE to recognize, 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.

Given that the PE did not develop any of the hardware or software being used, it would be probably "fair to say that the profit accruing to a typical internet service provider would exceed the profit accruing to the PE" because in the hypothetical given "the head office has provided the PE with all software, including that needed to establish a portal into the internet."

Additional profits could accrue to the PE, however, from its exploitation of "e-commerce marketing intangibles" in the host jurisdiction. Such intangibles are described as those "related to the operations of the web site." With respect to other marketing intangibles such as brand, the BP TAG Paper provides that substantially all of the profits of exploiting such assets would accrue to the head

office provided that the intangibles were "owned" by the head office. Ownership would require the head office or other parts of the enterprise other than the PE to have developed or obtained the intangibles without any material involvement of the PE.[38]

Where in addition to locating a server in the host jurisdiction, the foreign enterprise has personnel in the host jurisdiction as well to perform maintenance and on-line customer support services, the PE would earn an additional quantum of profit commensurate with what independent service providers would be expected to earn in similar situations. Here too, e-commerce marketing intangibles could be created (and possibly owned by the PE) arising from the presence of in-jurisdiction maintenance personnel.

More substantial profits would be attributed to a PE which was responsible for the in-jurisdiction development of the software for the server, and for the continued improvement of the web site. In that case, the PE would accrue the entrepreneurial profits of the e-commerce activities "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." [39]

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[38] Gary D. Sprague & Rachel Hersey, "Attribution of Profits to Permanent Establishments Generally and to Permanent Establishments Involved in E-Commerce",
<http://www.bakerinfo.com/NR/rdonlyres/eukx6dgf2bweoqozfuvtjujp2brnatkencsc7ihqg5j7j572dxwvxjkerlh37u4jd6rbgvbpe7a4fc/Attribution+of+Profits+to+Permanent+Establishments.PDF

[39] *Ibid.*

5.6 The Business Profits Tag E-Commerce Pe Attribution Paper[40]: An Overview

The Case of Starco, Inc., an E-Commerce Retailer - Variation 1

Stand alone server with no personnel

The BP TAG PE Attribution Paper's analyzes the application of the WH to e-commerce by hypothesizing an on-line distributor of music and video products worldwide, Starco, Inc. ("Starco"). 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. Under the example presented, Starco is a resident in country A, and its web site is hosted on a single server in country B. Under the hypothetical, Starco's "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."[41]

Under the first hypothetical, no personnel attend the server. The server is 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 digitized products;

iv. hold a digitized copy of all available products; v. transmit digitized products on-line to the computer of customers.

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[40] *See*, Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions, available at
<http://www.ecommercetax.com/Official_docs/OECD%20-%20attribution%20of%20profit%20to%20PE-server.pdf>

[41] The BP TAG PE Attribution Paper at 14.

A customer orders goods by specifying the items and method of delivery desired and provides a credit card number as a means of purchase. Within two minutes of the order, the customer will receive confirmation that the order has been received and that the credit card company has accepted the transaction. In the course of a typical order, Starco's server would execute software that effects the following transactions:

1. The specified credit card company is contacted by phone to secure immediate payment for the product purchased. On acceptance of the transaction, the credit card company will make a payment directly to a Starco bank account in country A. If the credit card company does not authorize payment, the server will notify the customer that the transaction cannot be completed.[42]
2. If the customer requested physical delivery, the server will send a message to Starco's central warehouse in country A requesting that the product(s) be delivered. The head office performs the actual shipping.
3. If the customer requested a digitized delivery, the customer is authorized to download a copy of the product immediately.

Determining the profits attributable to the PE

The BP TAG Paper next applies the two-step process identified under the WH to determine the profits allocable to the PE:
Step 1. Identify the functions, assets and risks assumed by the PE.

[42] Payment validation is not performed always systematically. For example, where single payments are of a low monetary value, Starco would assume the credit risk in respect of these transactions.

Step 2. Apply the Guidelines to determine an arm's length return for the PE's functions, taking into account assets used and risks assumed. In so doing, apply the Guidelines to determine arm's length fees between the PE and other parts of the enterprise for any dealings (deemed or otherwise) between the parties.
As in the CFA Paper, these dealings "are postulated solely for the purpose of attributing the appropriate amount of profit to the PE."[43]

Step 1

Functions performed:

- The establishment of an internet connection to the customer through "an interface created by the joint operation of the permanent establishment's hardware and software, the web site;"[44]
- Presentation of information (including Starco's products, instruction on how to enter into a transaction, phone numbers for customer service, etc.);
- Processing of customer orders which includes the immediate validation of payments with credit card companies; the immediate approval or refusal of an on-line order; processing instructions for physical delivery of the product(s); on-line transmission of digitized product(s); and on line trouble-shooting if the customer is having problems with the transmission.

Assets used

Starco's PE requires hardware and software to perform its functions. The software, which is intangible property, encompasses the product resulting from the development work necessary for the creation and operation of Starco's web

[43] The BP TAG PE Attribution Paper at 10
[44] *Ibid.* at 13.

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 PE.

The PE would also use other Starco intangible assets such as the marketing intangible associated with the enterprise, the main component of which "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 PE."[45] There may also be an e-commerce marketing intangible that would relate directly 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.[46]

With respect to the PE's use of such intangibles, it is necessary to determine which part of the enterprise developed or otherwise contributed the intangible to the PE in order to determine who is entitled to the benefits associated with the use of the intangibles by the PE.

Risks assumed

Under the WH, a functional and factual analysis is used to determine the risks assumed by the PE. Under the WH, the PE is treated as bearing any risks inherent in the functions that it performs or that relate thereto.

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[45] *Ibid.* at 14.

[46] *Ibid.*

Credit risks

No risk is assumed in those cases where the PE requires a confirmation number from the credit card company before proceeding with the transaction. Risk, however, is assumed for low monetary value transactions that the PE may process without validation.

The BP TAG Paper questions whether a computer can assume risk alone or whether some human intervention is required. It therefore leaves open the question of whether the risk assumed in these low value monetary transactions would be the PE's, the entity who accepted the customer order, or if it would be the head office because it provided the software that enabled the PE to accept the order.

Market risks

Assuming that for both digital and physical products, a payment is made to suppliers each time a product is purchased by a customer, market risks would include the transactional costs associated with need to replace a defective product - the cost of the defective product itself being borne by the supplier generally. The cost of the marginal physical support in the case of a digitized transmission of product is infinitesimal. Accordingly, the risk in this area would be limited to the cost of having to replace a defective digitized product which cost would depend on the arrangement with Starco's suppliers when the customer is allowed to download again. In the case of a physical delivery which fails (e.g., the product is defective), there will be the added costs of physically obtaining and shipping another product to the customer. Similarly, Starco's

market risks from holding inventory will depend on the nature of its agreements with its suppliers.
The BP TAG Paper refers to these risks as Starco's and does not mention the PE in this discussion.

Technological risks
The BP TAG Paper identifies two broad categories of technological risks an e-tailer faces: (i) risks affecting customer volume such as those due to a malfunctioning of hardware or software; and (ii) risks associated with the PE's performance of its everyday functions, e.g., a customer's credit card number is obtained from the site and used fraudulently; a hacker uses the server to spread defamatory material about one of the artists featured on the site.

The first category would be allocated between the head office and PE. The head office would bear some of the risk since the loss of business by the PE is a revenue loss for the head office. This is not a case where a PE holds inventories of perishable goods and assumes the entire inventory risk. Digitized products on a hard drive are not "inventory" and the PE does not have any inventory of physical products. A limited amount of the market risk is allocated to the PE because "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."[47] The PE is allocated all of the second category of risk because "arguably, the activities of the PE create this second category of risks."[48]

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[47] *Ibid.*
[48] *Ibid.*

Business Model Classification

Comparing the functions performed by the PE, the assets it uses, and the risks it assumes against the functions, assets, and risks that would be assumed by an independent enterprise functioning as (i) a retail outlet; (ii) a contract service provider; or (iii) an independent service provider, the paper concludes that the latter two are the better comparables..

Retail Outlet

The BP TAG PE Attribution Paper rejects the possible analogy of Starco PE to a retail outlet finding that Starco PE does not perform many of the core functions of most retail stores: (i) decision-making regarding the ordering of inventory and the level of inventory to be held; (ii) negotiations regarding terms with suppliers; (iii) decisions on product pricing, (iv) marketing and promotion; (iv) credit control, including decisions on credit arrangements for customers; and (v) the management of incoming funds, among others.[49]

The lack of *human or artificial intelligence* in the PE 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 PE server as 'inventory.' ...
The factual and functional analysis would show that the PE could not be considered to notionally hold title to physical products sold through its server.[50]

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[49] Other retail outlet functions identified include concluding contracts with customers, the physical distribution of goods, and accounting functions such as cash flow control.

[50]The BP TAG PE Attribution Paper at 17. This leaves open the possibility that execution of software, albeit "artificially intelligent," could be treated as the equivalent of human decision making for purposes of profit attribution. In addition, the paper does not preclude the possibility

Independent Service Provider

Under this business model, the PE is considered to have acquired at arm's length prices the hardware and software necessary for the provision of services and, crucially, to assume the risks usually associated with the operation of such an enterprise.

Contract Service Provider

Under this model, the head office is considered to retain control ("economic ownership") of all the property (both tangible and intangible) transferred to the PE. Thus, all risks associated with the use of such properties would remain with the head office.

Step 2

Step 2 is the determination of the amount of profit the PE would earn, in similar circumstances, if it were dealing at arm's length with the rest of Starco, under the relevant business model. Identifying the relevant business model (e.g., retail outlet, independent service provider, or contract service provider) is required to establish whether "*dealings*" (requiring arm's length remunerations) occurred between the PE and the rest of the enterprise.

Contract Service Provider Model

This characterization is treated as most likely given Starco PE's limited functionality due to its lack of personnel. For purposes of determining an appropriate profit allocation, the head office is treated as retaining control and

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that a functional and factual 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."

'economic ownership' of all properties transferred to the PE, in addition to bearing most of the responsibilities, risks and benefits of the service arrangement. Under this model, a *dealing* recognizing a transfer of the equipment (hardware and software) to the PE would not be required.

A *dealing* reflecting an arm's length charge for Starco PE's provision of services to the head office which would take into account the relatively riskless nature of the arrangement between the head office and PE would be required. The fee should be determined using a CUP (i.e., by examining transactions undertaken by independent contract services providers), if possible. Otherwise, the cost plus transfer price method could be used, taking into account all direct and indirect costs incurred in the PE (rent, insurance, electricity, communications lines, etc.), but not including any capital costs associated with the tangible and intangible assets used by the PE.

Independent Service Provider Model

If an examination of the conduct of the PE were to demonstrate that the PE was performing functions, using assets and assuming risks in a manner comparable to a full service provider, the *dealings* between the PE and head office would include the head office's transfer of hardware and software to the PE. Accordingly, in computing its profits, Starco PE would take into account an arm's length compensation to the head office in consideration for the provision of such property, in addition to its other expenses such as rent, insurance, electricity, communications lines, etc.

The BP TAG Paper posits that web-hosting enterprises may make use of similar

hardware and software, and that accordingly, internet service suppliers would be an obvious source of either a CUP or comparable gross margin for similar service arrangements, provided adjustments are made to take into account any differences. Under the independent service provider model, the cost base would include the PE's notional expenses associated with its acquisition of rights with respect to the tangible and intangible property owned by the head office. If a traditional transaction method cannot be applied, the use of a profit method, especially a transaction net margin method (TNMM), should not be overlooked.[51]

As with the contract service provider business model, under the independent service provider model, as hypothesized above, Starco PE would be allocated:

... a quantum of profit that is insignificant relative to either the value of transactions processed ... 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.... Under this fact pattern, the PE 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.

Hardware

The arm's length compensation for any supplied hardware (i.e., for the server) will depend on the nature of the *dealings* between the parties as evidenced by the facts and circumstances (including any internal documentation) and conduct of the parties with respect to the division of the risks and responsibilities of ownership with respect to the hardware. Characterized as a lease, a notional

[51] BPt TAG PE Attribution Paper at 24

arm's length lease payment would be deductible in computing Starco PE's profit. Characterized as an outright sale, a capital cost allowance in accordance with the depreciation system of country B would be deducted in computing Starco PE's profit. Basing characterization on the conduct and intent of the parties (pursuant to the guidance under the WH) would be limited in this case to the intent of the head office given the lack of personnel in the PE.

Software

Starco PE should be allowed to deduct an amount that represents what arm's length parties would pay for the rights acquired by Starco PE in the software. In the instant case, these rights would be limited: ... the PE has clearly not acquired the right to resell or modify the software, given the nature of the activity of the PE (and *a foritiori* because of the *lack of human or artificial intelligence* at the location of the PE).

Marketing Intangibles

It would be appropriate to consider the head office (rather than the PE) as exploiting marketing intangibles used on the web site hosted on the PE's server (for example, the brand name) because:

... 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.

Accordingly, under the independent service provider model, it is not clear that a *dealing* with respect to the intangible would be appropriate, although it would be

appropriate to assume that the PE had acquired the notional right to use Starco's marketing intangible if it had been viewed as the equivalent of a retail outlet.

Assuming the existence of a *dealing* for marketing intangibles, it would need to be determined whether the PE's activities could be said to increase the value of the marketing intangible provided by the head office so as to entitle the PE to some of the entrepreneurial profit associated with the use of such an intangible. Also at issue would be the question of who "owns" intangibles (such as customer lists) that are created in the host jurisdiction. Would a *dealing* be required if other parts of the enterprise used such lists?

With respect to the current Commentary's allocation of the costs of creating intangible rights between the various parts of an enterprise without any mark-up for profit or royalty, the BP TAG Paper is in accord with the recommendation made by the CFA in the CFA General PE Attribution Paper that the Commentary should be revised to allow for a mark-up on the transfer of intangibles between the PE and other parts of the enterprise. The BP TAG Paper notes that transfers of intangibles "are likely to be greater and more frequent in the e-commerce context because of the prevalence of intangibles, especially those based on ideas." A cost contribution arrangement may be appropriate where the PE is in existence at the time of the development of the intangible and the enterprise intends to have the PE make use of the intangible, when and if developed.

In conclusion then, under the independent server provider model, the profit margin of the PE is computed as the difference between the arm's length compensation that can be charged on the market for the services provided to the

head office and the arm's length charge that must be recognized for the PE's use of the tangible and intangible property contributed by the head office.

The Case of Starco, Inc., an E-Commerce Retailer - Variation 2
Multiple servers - no personnel

The facts are the same as in variation 1 except Starco's web page is hosted on four different servers located in four different countries. Customers are connected to Starco's web sites according to a predetermined procedure, programmed on and managed by the server located in country B that takes into account the location of the user and the traffic on each server. Once a customer is connected to a given server, all aspects of the transactions are performed on that server.

Under this variation, the functional analysis remains pretty much as before except that the four servers are now responsible for the total customer volume and functions to be performed. The range of functions performed by any one server once a customer is hooked up with that server remains the same as before. Having multiple servers performing identical functions would reduce the risks associated with the operation of any given server. Accordingly, an additional functional and factual analysis would have to be made in this case to determine whether and to what extent the *de facto* pooling of risks among the separate servers would affect the quantum of reward attributable to each PE. *Dealings* between the separate servers would only be necessary if different steps of a transaction with a single customer were handled by different servers.

The Case of Starco, Inc., an E-Commerce Retailer - Variation 3

Maintenance personnel

The facts are the same as in variation 1 except that maintenance personnel responsible for the following functions are situated in the PE in country B rather than in the head office:

- installing the hardware and software created by the head office;
- ensuring the maintenance of the server;
- performing repairs to the hardware and addressing any problems affecting the operation of the web site;
- handling trouble-shooting with customers or web site visitors;
- providing after-sales services and support to customers, either on-line or, exceptionally, on the telephone.

The cost of the services provided are internalized in the product price (i.e., no additional revenue is generated by the provision of services). The PE TAG Paper posits that locating the maintenance personnel in the host jursidiction will require additional *dealing*s between the head office and PE in that a functional and factual analysis would likely reveal that the personnel are required to use both tangible (for example, computers) and intangible assets (for example, software) in the jurisdiction in order to provide technical services to customers.

The PE TAG Paper also posits the possible creation and/or enhancement of an e-commerce marketing intangible by the presence of in-jurisdiction maintenance personnel: ... 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 PE* and thereby lead to the creation of an e-commerce marketing intangible.[52]

As under variation 1, the head office is treated as bearing the full market risk associated with the possible loss of business due to a failure to help would-be customers.

A contract service provider or independent server provider are again presented as the most likely comparables to Starco PE under this variation, rather than a retail outlet, based on the functions and risks undertaken by the PE. *Dealings* in either case must include an arm's length fee to the PE for services rendered to, or on behalf of, the rest of the enterprise. As under variation 1, additional *dealings* between the PE and head office would be required to reflect the independent service provider's acquisition of the software and hardware needed to run and maintain the web site in the host jurisdiction.

With respect to remuneration, the contract service provider's allocable profits would have to be increased to reflect the additional maintenance service it is providing to, or on behalf of, the head office. If remuneration were based on a cost plus method, the PE's costs would include all direct and indirect costs including employee compensation, and the applicable arm's length margin would need to be increased to reflect the different nature of the functions performed in the PE. A CUP would be the best comparable under the independent service provider model.

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[52] BP TAG PE Attribution Paper at 29

The Case of Starco, Inc., an E-Commerce Retailer - Variation 4
Maintenance personnel and owner of hardware & software

The facts are the same as in variation 3 except that this variation assumes that the full development effort and costs toward the development of the server and the web site were incurred by Starco personnel situated in the host jurisdiction, country B. Pursuant to the WH, Starco PE would be treated as the economic "owner" of the intangibles. As such, no *dealings* with respect to a transfer of hardware and/or software from the head office to the PE are required. Starco is treated as having capitalized Starco PE 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.

Because Starco PE is considered to be the economic "owner" of the web site, the economic benefit derived from the commercial exploitation of the web site will accrue to Starco PE. Its allocable profit therefore would be an arm's length compensation for the service provided to the head office net of its costs to develop the software.[53] A CUP would be the best method to determine the head office's service fee to Starco PE. The paper posits that the reward to Starco PE under this variation would likely exceed the reward earned by a typical internet service provider given that Starco PE provides not only a portal into the internet but also would have developed the actual "customer" software being hosted.[54]

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[53] If the head office and PE jointly developed the software, appropriate proportions of the profit directly associated with the commercial exploitation of that software would be attributed to the head office and to Starco PE. The appropriate proportion would reflect the relative value of the contribution made by the PE and head office towards the development of the software.

[54] Gary D. Sprague and Rachel Hersey, "Attribution of Profits to Permanent Establishments Generally and to Permanent Establishments Involved in E-Commerce."

5.7 Critique

The TAG paper's explanation for assuming a routine function of a "server-only-PE" is basically the lack of personnel. However, under the separate entity principle the allocation of assets, personnel and risks has to follow the function performed (functional allocation). Consequently, if a function that requires personnel, is found to be performed by a PE, the personnel engaged in activities necessary for the PE's functions (together with the assets required for the PE's function) have to be allocated to the PE, even if they were physically located in the head office or any other location (principle of functional allocation as laid down in Art. 7 para. 3 OECD model agreement).

This follows from the separate entity approach, requiring the necessary "endowment" of a PE as a separate and distinct enterprise with the assets necessary for its functioning - such as adequate endowment capital has to be provided by the head office without any charge for remuneration by the PE.

Following the wide economic approach in the determination of server functions would thus invariably exclude the possibility to determine the server PE functions as mere "routine functions" that could be remunerated by a modest cost-plus mark-up. The TAG paper tries to correct this consequence by charging deemed payments by the PE to the head office for the use of intangibles stored on the server PE. This however seems to be incompatible with the endowment requirement described in the preceding paragraph.

Hence a premature endorsement of the TAG paper on attribution of income without significant amendments would result in a contradictory treatment of

server PE's and conventional PE's. The application of the narrow "technical" approach for the determination of a server's function could avoid this contradiction.

5.8 Potential Difficulties In Applying Transfer Pricing Methods To E-commerce

The task of locating appropriate comparable transactions is perceived to be the most difficult transfer pricing challenge arising from new market transactions. This arises from the nature of the business models being adopted in the new economy. In general, the evolution of business models towards greater integration of transactions among related entities, and greater specialization of functions all could make identification of comparables more difficult.

For instance, a multinational enterprise may be established in different jurisdictions based on optimization of costs, regional headquarters, research and development facilities, administrative or back-office functions, customer support, manufacturing, local or regional sales and marketing, all of which network with each other, yet, ultimately are managed by a global corporate headquarters located in a third jurisdiction. These operations are tied together electronically through the global communications infrastructure, which allows the global enterprise to operate across borders efficiently and effectively in unique ways. This structure may contrast with more traditional organizations, which frequently concentrated the most important functions in a single jurisdiction, in order to facilitate management of all aspects of the enterprise. As decentralization of organizations takes place, the provincial locations may not

necessarily support or report solely to the corporate headquarters in the home jurisdiction.[55]

To the extent that a global enterprise distributes more functions across more jurisdictions than has been typical in the past, the mere multiplicity of locations has created related party transactions, which are being tested. Also, the differences in national transfer pricing law in this new economy environment, would go on to provide another ground to raise controversies.

Jurisdictions, which accept transfer pricing methods based on profit-based measures, would encounter the task of identifying comparable entities performing such functions. Where services are transferred between the specialized entities via the internet/intranet there are possible transfer pricing issues that are involved.

A further difficulty that arises in identifying comparable transactions or comparable entities is when the e-commerce entity is engaging in business activities that do not have an accurate economic parallel in traditional commerce. For example, two types of enterprises standing at the core of the e-commerce infrastructure are the Internet Service Providers and Web Portal Companies. It may be relatively straightforward to identify comparable transactions for an Internet Service Provider, at least if the taxpayer is able to identify other transactions involving the provision of services utilizing sophisticated equipment which the provider must maintain. The business model of the web portal

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[55] Nishith M. Desai, Impact of Transfer Pricing Regulations on E-Commerce <http://www.nishithdesai.com/FINAL%20Tranfer%20pricing-%20FICCI.pdf>

company, however, is completely novel, and valuing the various economic inputs to that business will provide transfer pricing challenges.

A) Difficulties identified by the OECD in the allocation of profits area

In the discussion Paper on Taxation Issues of the OECD, five of the most significant potential difficulties in the mater of transfer pricing in e-commerce were identified as:

i. applying the transactional approach;

ii. establishing comparability and carrying out a functional analysis;

iii. applying traditional transaction methods;

iv. the tax treatment of integrated businesses;

v. determining and complying with appropriate documentation and information reporting requirements.

Since, the concept of transfer pricing has evolved in most economies just recently, the experience amongst tax administrations in dealing with transfer pricing matters in the field of e-commerce is fairly limited so far. The OECD has noted that it may be difficult for tax administrations to perform a detailed examination of the factual background at such an early stage in the development of the business of electronic commerce.

OECD Committee on Fiscal Affairs preliminary concluded that the existing guidance in the transfer pricing guidelines[56] is capable of being applied to the special factual circumstances of multinational groups conducting their business through electronic commerce. As a result, traditional transaction methods are still to be preferred as a means of establishing arm's length prices. However, the

[56] OECD: Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

OECD accepts that where such methods cannot be applied reliably because there is insufficient data on uncontrolled transactions, or such data is considered unreliable, or because of the nature of the business situation, transactional profit methods could be used.

B) Intangible properties

The use of intangible properties in e-commerce businesses could set hurdles in the process of identifying appropriate comparables especially in the case of transfer between related enterprises. The distinctions between product and marketable intangibles can get blurred in e-commerce businesses, and comparables derived from traditional transactions thus are more difficult to apply. In some cases, enterprises may regard their intangible value as deriving from entirely different circumstances than those underlying traditional enterprises. The so-called "*first mover advantage*" which direct providers of goods and services to consumers, seek to establish by staking out their *forte* in the e-commerce marketplace does not have an exact counterpart in traditional commerce. Goodwill perhaps is the closest parallel.

C) Applying the transactional approach

The OECD Guidelines on Transfer Pricing for Multinational Enterprises and Tax Administrators ("OECD Guidelines") make it clear that adjustments of profits are by reference to conditions, which would have been obtained between independent enterprises in comparable transactions and comparable circumstances[57]. There can be no adjustment in the absence of a transaction. The main difficulty in the context of e-commerce that appears to challenge the transactional approach is in identifying precisely what the transaction is.

[57] Chapter 1 para. 1.6.

The OECD Guidelines indicate that, ideally in order to arrive at the most precise approximation of fair market value, the arm's length principle should be applied on a transaction-by-transaction basis[58]. However, it is noted in the OECD Guidelines that, at times separate transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis. The OECD Guidelines suggest that some transactions need to be evaluated together as a package[59].

At this point of time, it would be of great help to look at how the United Kingdom has addressed this question of defining a "transaction" in its new transfer pricing legislation. ICTA[60] 1988 Schedule 28AA Paragraph 1 requires that, a provision be made or imposed between affected persons by means of "a transaction or a series of transactions". The meaning of a series of transactions is expanded in Paragraph 3(2) of the aforesaid. This includes a number of transactions each entered into, whether or not one after the other in pursuance of or in relation to the same arrangement[61].

D) Difficulty in applying transaction based methods

It is sometimes argued that, e-commerce does not lend itself to the application of traditional transaction methods. These are the comparable uncontrolled price method, the resale price method and the cost-plus method. Each of these methods must be examined having regard to its potential applicability to the

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[58] Chapter 1 para. 1.42

[59] Chapter 1 para. 1.43

[60] Income and Corporation Taxes Act, 1988

[61] Paragraph 3(5)) of ICTA 1988 Schedule 28AA defines an arrangement is defined as any scheme or arrangement of any kind (whether or not it is or is intended to be legally enforceable)

industry sectors that are relevant to electronic commerce. Important questions as to the number of stages in the value chain involving connected parties need to be considered. This may be shortened in the context of electronic commerce.

One of the most interesting and common areas where the impacts of e-commerce on transfer pricing can be felt is, in the working of the multi national groups. Closer integration of the management of multinational groups and the sharing of services is likely to be enabled by information and communication technology developments, particularly of intranets.

One consequence of e-commerce is in relation to business relocation. The Internet may offer certain businesses' opportunities to relocate non-physical activities to different jurisdictions, particularly resulting in shifting profits out of high tax jurisdictions to low tax or no tax jurisdictions. Another aspect of this, which, is perhaps more important, is the ability to shift physical activities to low cost jurisdictions. The ability to provide services at a place other than where the recipient is located is becoming of increasing importance. Thus, a variety of services can be provided to multinational companies from remote locations. The range of possibilities will increase, both where human intervention is required and those that are provided electronically, such as help pages on the Internet or Intranets. These might include administrative services such as planning, co-ordination, financial advice, accounting, auditing, legal, factoring, computer and financial services. Typically, such services are dealt with under cost-plus arrangements or under cost-sharing arrangements.

Where cost-plus is appropriate for services of this kind and the activities are shifted to low cost jurisdictions, the profit allocation will be reduced

proportionally. The OECD Report on the Economic and Social Impact of Electronic Commerce[62] expects that, distribution costs will be cut by about 5 per cent. However, it notes that these savings will only lead to lower consumer prices if there is fiercer competition. This may mean a shift towards an increase in value of intangibles such as customer lists, which may be owned and developed relatively easily in low tax jurisdictions. If the cost savings are passed on to end-users in some form, then the overall allocation of profits may not change. Where the profitability is retained, this may mean that profits are effectively allocated to other functions. In other words, efficiency gains may properly be allocated to intangibles or other value adding functions.

Some of the difficulties in applying transaction based methods to individual transactions may be alleviated by applying the existing guidance on evaluating combined rather than separate transactions. Further, in order to be able to identify, trace, quantify and verify transactions undertaken in the course of electronic commerce, it will still be necessary to follow the existing guidance concerning appropriate documentation.

E) Transactional profit methods

Many tax jurists world-wide are of the view that the use of profit-based transfer pricing methods may become more prevalent in the context of associated entities engaged in an e-commerce business. In many jurisdictions, the profit-based methods are methods of last resort. Accordingly, methods such as the comparable uncontrolled price method, the resale price method and the cost-plus method would be preferred to methods such as, the transactional net margin method, or the profit-split method. For example, Japanese law allows the use of

[62] <http://www1.oecd.org/subject/e_commerce/summary.htm>

the profit-split method as a method of last resort when none of the comparable uncontrolled price, resale price or cost-plus methods is available.

The OECD Guidelines suggest that, transactional profit methods might be applied as a case of last resort where the traditional transaction methods cannot be reliably applied *alone* or cannot be applied at all. The guidelines state that, these cases arise only where there is insufficient data on uncontrolled transactions, or where the data exist but is considered unreliable, or due to the nature of the business situation. Tax administrations almost uniformly prefer comparables drawn from transactions involving local entities. If a global e-commerce enterprise has established a business unit in the jurisdiction, which performs functions for which there are few (if any) publicly available comparables, taxpayers and tax administrators will have difficulty applying their traditional transaction methods. The OECD Guidelines recognize that, both the profit split method and the transactional net margin method, are somewhat more forgiving and flexible when unusual circumstances exist. Even though various members of the e-commerce enterprise may make contributions of differing types (for example, services, R&D, manufacturing, and the like), the allocation should be based upon external market data and some economic assessment of the relative values of the contributions[63]. Given the need to assess market data even for profit-based transactions, therefore, it should not automatically be assumed that profit-based methods are to be applied whenever the application of traditional transaction based methods becomes difficult.

New economy enterprises will present situations to taxpayers and tax administrators where the application of any method would be difficult. While

[63] OECD Guidelines

this particular market glitch may be sorted out over the next few years, the profit model of many emerging enterprises remains unclear. A profit-based method does not provide obvious conceptual advantages over a transaction-based method when, the profit forecasts of an enterprise are unreliable. The new economy includes various emerging enterprises or even entire market sectors; it is not clear what transactions truly are comparable to those engaged in by these emerging companies. Traditional companies investing in e-commerce business models are substantially increasing their investments in technology to create business process efficiencies. It is debatable whether, this capital investment should be regarded as giving rise to the same returns as traditional investment in productive equipment or other assets.

Hence, what may result is that, the new economy itself may produce its own comparables. For example, the increase in outsourcing will produce third party hosting transactions of various sorts. Perhaps, presently we are in a transition period where the dearth of comparables will be remedied as the new business models become more established.

F) Global formulatory apportionment method

None of these issues, however, suggests that global formulary apportionment will provide a better answer. Even a multinational, functional analysis can assess the activities performed and value-added by the business units in each location. The difficulties in achieving international consensus for global formulary apportionment would be no less in the e-commerce environment than for traditional industries. It is not conceivable that, global formulary apportionment could be applied as the agreed transfer pricing methodology solely for the e-commerce sector. A separation of the economy into e-commerce and non-e-

commerce functions for purposes of applying different transfer pricing principles simply is not possible.

G) Comparability analysis

The arm's length principle is essentially based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises. In order for such comparisons to be useful, the economically relevant characteristics of these situations must be sufficiently comparable in determining the degree of comparability. An understanding of how unrelated companies would evaluate the potential transaction is required. This may give rise to particular issues as more and more businesses migrate from traditional to electronic commerce.

i. *Character of property/services*

There would be obvious differences in property/services that form commercial activities in part for their value in the open market. Comparisons of these features may be useful in determining the comparability of controlled and uncontrolled transactions. E-commerce would definitely have a great impact on this. One of the most glaring being that of dematerialization[64].

Would it be possible to compare transactions involving the physical delivery of a CD or cassette with music recorded on it, which is enclosed in a plastic package with an attractive cover and delivery of the same music by downloading it from a website onto the acquirer's computer?

[64] Dematerialisation is the adaptation of information technology to convert products that were previously supplied in physical form into digital form. Current examples include music, films and packaged software.

The conversion of tangible property to intangible property does give rise to a number of changes. Sturdiness is one factor. A CD may be used many times. Digitised products are subject to management by the supplier, for example in relation to duration. It is possible to supply music on demand for a single use. On the other hand, the ease with which digitised products may be copied, whether legally or not, may affect their value.

ii. Functional analysis

In dealings between two independent enterprises, compensation will usually reflect the functions that each enterprise performs, taking into account assets used and risks performed. As a result, in determining whether controlled and uncontrolled transactions are comparable, a comparison of the functions taken on by the parties is necessary. The functions that need to be identified will include concept design, research and development, manufacturing, assembling, servicing, purchasing, distribution, marketing, advertising, transportation, financing and management. One party may provide a large number of functions relative to that of another in the transaction. It is the economic significance, however, of these functions in terms of their frequency, nature and value to the respective parties that is important.

Functional analysis in the context of e-commerce requires a close understanding of particular business functions. The impact of e-commerce in this area will be very much dependent as a result on the use to which e-commerce is put. Thus, in the context of those using the internet to deliver content, the manner in which intangibles are delivered, whether they are subject to copyright or not, whether it is used only for advertising or for actual trading, whether it is used to provide services or to manage group facilities will be relevant.

iii. Disintermediation

An important emerging issue in the context of e-commerce is disintermediation. This is the removal of intermediaries from a system of distributing goods or services, which traditionally relies on them for collecting information and reporting. The ability of original producers of goods or services to provide them directly to customers may diminish the role of wholesalers, brokers, agents and advisors from the system. The absence of such value added activities in the chain might result in less profit overall. Where it does not, it means that a higher value will be added to other functions.

A question that will be on the minds of taxpayers and tax authorities is where this value is added. A question that would cross the mind is that since electronic distribution diminishes certain forms of intermediary, will the value of the distribution function itself ought to be downgraded?

iv. *Infrastructure providers*

In the case of infrastructure providers, there may be considerable investment tangible and intangible assets. If expensive infrastructure is relevant to the allocation of income on transactions, the extent to which there is flexibility as to where the assets are located will have a significant impact. On the other hand, rapid obsolescence and comparative vulnerability of intellectual property rights on the Internet may require a lower value to be placed on such assets.

It may also be relevant and helpful to consider risks assumed by the respective parties[65]. Assumption of increased risk should be compensated by an increase in the expected return. A question that would arise is that, are the risks in

[65] OECD Guidelines, Chapter 1 para. 1.26

ecommerce significantly different from those in the more traditional commerce? While traditional risks, such as market risks, cost and sales fluctuation, may continue; there may be particular risks associated with e-commerce at the present time, which we have not been able to identify, due to the fact that this form of commerce is in the process of development. An example of such a risk could perhaps be that of viruses infecting a particular computer system. The OECD Guidelines, however, regard the conduct of the parties as the best evidence concerning true allocation of risk. In many cases, arm's length dealings are characterised by risk borne by the party, which has relatively more control over the particular risk factors.

v. Contractual terms

In arm's length dealings, the contractual terms of a transaction should define how the responsibilities, risks and benefits are divided between the parties[66]. This will continue to be the case in the context of electronic commerce, although evidence as to what the terms of a contract are, might be difficult to ascertain.. In addition, where the parties are associated, it is necessary to examine their conduct in order to determine whether they have followed the contractual terms or not. Lack of identification may be a relevant feature of electronic commerce. Since, Internet business leaves behind no paper trail, there arises a potent difficulty of identifying transactions and even the parties.[67]

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[66] OECD Guidelines, Chapter 1 para. 1.28

[67] Nishith M. Desai, Impact of Transfer Pricing Regulations on E-Commerce <http://www.nishithdesai.com/FINAL%20Tranfer%20pricing-%20FICCI.pdf>

5.9 Other Problems

Various commentators have also identified a number of problems with the use of the arm's length approach as a transfer pricing method, some of which apply in the context of e-commerce as well. In particular, Ruebeb S. Avi-Yonah had identified four such problems with the application of the arm's length approach.[68] The first such problem is that conducting an analysis is extremely complicated under this approach and requires massive inputs by economists and accountants, as well as access to a large fund of not-easily available information.[69] This problem assumes more significance in the context of e-commerce because the high integration of e-commerce makes it more difficult to analyse transactions and to access the required information.

A second problem identified by Avi-Yonah is that the arm's length approach leaves substantial revenue to be split even after its application.[70] Therefore, one is still left with revenue that has to be divided among the constituents of a MNE, which would then have to be allocated on the basis of a different method. It would hence, be a more sensible approach to apply the alternative method initially rather than wait to apply it after the arm's length approach has been exhausted.

The arm's length approach also does not reflect economic reality. MNEs do not regard each subsidiary as a separate entity that begins with other subsidiaries at arm's length. These enterprises are usually integrated entities to which each

[68] Vic Sussman, Gold Rush in Cyberspace, *U.S. News and World Report*, Nov. 13, 1995; Evan I. Schwartz, *Advertising Webonomics* 101, Feb. 1996.

[69] *Ibid.*

[70] *Ibid.*

subsidiary contributes. The transfer prices among constituents are fully under the control of the parent. Therefore, the basic premise of the arm's length approach, i.e. the consideration of a MNE as a separate entity, is flawed.

All of these problems with the application of the arm's length principle to e-commerce transactions render its value as a transfer pricing method relatively useless. The problems identifies make it clear that the arm's length approach, as it stands today, is not suitable to meet to the specialized requirements of e-commerce. The possibility of modifying the approach to meet the needs of e-commerce though exists, and will be discussed in a later section of this paper. However, as it stands now, the arm's length principle is unsuitable as a transfer pricing method for e-commerce transactions.

5.10 Seeking an Alternative Approach

Any discussion of alternative approach to the transfer-pricing problem usually focuses on the other approaches suggested by the OECD. However, before going into discussion on any of the other methods, a general approach in seeking an alternative method should be formulated. This general approach in seeking an alternative method should be formulated. This general approach should take into account the unique characteristics and the requirements of e-commerce.

The general approach should focus on "reverse engineering" i.e. a solution should be reached by working backwards from the problem itself. First, one must take into account the special nature of the Internet and e-commerce. This would include awareness of the transient nature of e-commerce, the increasing number of transactions these days, their novelty, the decreasing number of comparables, the difficulty in functional analysis, and the problems in obtaining

adequate information. Each of these characteristics has a bearing on the alternate method. For example, the increasing number of transactions would signify the need for a system that would be able to tax companies without having to split every transaction. The novelty of the transaction signifies that the level of integration and sophistication would be higher than in traditional transactions, and so, the new method must seek to achieve its goals in spite of this integration. The decreasing number of comparables of course, points to the fulfility of applying any of the traditional transaction methods. The difficulty in conducting a functional analysis and in obtaining relevant information suggests that the new method should not be dependent on such analyses or on obtaining anything but very transparent information.

Expand Advance Pricing Arrangement

The possibility of tinkering with the arm's length principle or expanding it is not the best solution given the lack of comparable and the numerous other problems mentioned previously in this paper. However, if the traditional methods have to be maintained then the possibility of expanding APAs for the purpose of applying them to e-commerce transactions might be a solution.

The expansion of APA's as a solution to the transfer-pricing problem for e-commerce transaction is based on the premise that expanded APAs will solve the problems inherent in applying the arm's length principle to e-commerce transactions. However, APAs are not the best answer to the e-commerce problem. Although APA's are not the best answer to the e-commerce problem. Although APAs solve the uncertainties regarding transfer pricing for traditional transactions, they are as yet, not equipped to tackle the e-commerce problem.

APAs have a number of disadvantages with respect to e-commerce transactions. The primary disadvantage is that if an APA involves an unreliable prediction on changing market conditions without adequate critical assumptions, the APA would still not reflect the actual state of affairs of the entity concerned.[71] In the context of e-commerce, APA predictions are bound to unreliable, at least initially, because of lack of adequate data regarding those critical assumptions that would make the APA a success. E-commerce involves a number of innovative and new transactions for which adequate data is not yet available. Comparables also do not always exist. Hence, formulating a suitable APA may prove to be difficult task.

Further, forming an APA for every new transaction is impossible. The unique nature of e-commerce also does not permit the formulation of a standard APA procedure for all transactions. APA programs may also place a strain on transfer pricing audit resources, as tax administrators will generally have to divert resources earmarked for other purposes into the APA program[72] need to audit many more transactions in e-commerce, the strain will be even more simply because administrators will need to audit many more transactions in e-commerce than in traditional commerce. The fact that each transaction is different from the next also means that every one has to be audited, and in view of the almost exponential increase in e-commerce transactions, auditing every transaction is impossible.

Thirdly, since APAs are voluntary agreements, not all taxpayers will be motivated to enter into these agreements, and thus, the need for a separate

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[71] Aaron Lukas, *Tax Bytes: A Primer on the Taxation of Electronic Commerce,*
< http:/S/www.freetrade.org/pubs/pas/tpa-009es.html>

[72] *Ibid.*

transfer pricing arrangement to take care of taxpayers who do not initiate APAs will still be necessary.

Fourthly, APAs are costly and complicated procedures and require extensive submissions and documentation. Therefore, implementing an APA is an extremely difficult procedure for both taxpayers and administrators alike. In the context of e-commerce the complications and the costs are further heightened. Therefore, given all these disadvantages, APAs are not adequate to solve the transfer-pricing problem with regard to e-commerce.

Profit Splits

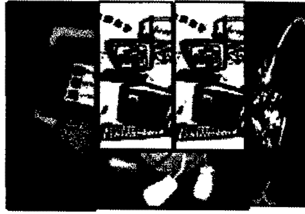
The use of transactional profit methods for e-commerce transactions, particularly the profit split is also a possibility. With this method, profits are split among business entities based on the specific facts and circumstances of each case. The approach of a profit split method is to determine an arm's length return through combined operating profit or loss in a related party transaction and then allocating that amount based on the relative economic contributions that make for the success of a venture.[73]

The profit split method can possibly be applied in the case of e-commerce because it does not require the use of comparable transactions – it looks to the value contributed by the business.[74] However, each of the two analyses under profit splits has its problems. Under the contribution analysis, which divides profits among members of a control group in relation to their functions, it might

[73] Minister's Advisory Committee on Electronic Commerce, Electronic Commerce and Canada's Tax Administration, <http://www.rc.gc.ca/ecomm>

[74] *Ibid*

be difficult to identify the functions of each control group. Thus, business entities may be encouraged to show that most functions are performed by subsidiaries in tax havens, which, given the high integration of e-commerce transactions, may be impossible to unravel. The second method, namely the residual analysis requires the presence of comparable uncontrolled data, which of course, brings one back to the predicament of the traditional transaction method. But it is possible to apply the second method, albeit not perfectly, without the help of comparable uncontrolled data. However, under those circumstances, an extended profit split method in the form of global formula apportionment is a better solution to the transfer-pricing problem.



6. CONCLUSION

The international PE concept and its taxation remain a relatively subjective and variable area. In this respect, the OECD Model Convention on PE standards has proved to be an important tool in providing a more uniform and coherent framework for analyzing the issue of foreign entity taxable presence in each respective territory. The depth of reliance on these guidelines, the level of their use, and the variability of subjective interpretations about their application to specific facts and circumstances, however, continues to produce inconsistent outcomes in each global region, each country and even each subject. Therefore, a further development and knowledge-sharing about the proper application of the PE concept to specific circumstances are both necessary and desirable.

Further understanding and knowledge of PE and attributable income issues and standards will not only benefit international taxpayers and their advisers, but should also enable local tax administrations around the world to conform their local tax rules and practices to achieve greater consistency and predictability in accordance with established international standards. After having discussed the various issues with respect to the impact of transfer pricing regulations on e-commerce, it is understood that a more viable option should be brought forth

While it is not currently anticipated the development of any significant new rules, modifications to existing domestic tax principles and international tax treaties are inevitable. These modifications, however, should be applied consistently using generally accepted principles developed with prior international consensus.

With respect to the Indian position, the government needs to provide a number of clear policy directions from the Income Tax perspective. 'E-establishments' need to know whether they are to be taxed at 'source' or 'residence', and if they require a physical presence. Jurisdictional issues regarding taxation of business profits and also the royalties, interest and license fees for data will require clarity from a double taxation perspective. Tax incentives will be required, to prevent e-businesses from shifting to tax haven countries. The Indian Government will also need to agree on double-taxation agreements from an e-commerce perspective. The methods of allocation of profits between the PE and the head office need to the clarified and there should exist an international consensus which would not hamper the developing world's interest.

E-commerce is a developing area that can be effectively negotiated only through international cooperation. To this end, the work being undertaken by the OECD is pivotal, not only to its member countries but also to all governments and revenue authorities as they grapple with the challenges of electronic commerce.

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8. APPENDIX

8. APPENDIX

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

February 2001

DRAFT FOR PUBLIC COMMENT
Deadline: 30 June 2001

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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).

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 performing 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 the 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 be 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

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

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).

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 Convention[2] 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 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.[3] 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

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

3. *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD Committee on Fiscal Affairs, Paris.

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.

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.

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" 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 then 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.

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.

Special considerations in attributing profit to a permanent establishment in an electronic commerce environment

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.

Variation 1: Single server

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.

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.

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 Starco[4], 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 property 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

4. 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.

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,[5] 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;

5. 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.

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 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 services[6] for and on behalf another part of the enterprise

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.

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

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6. 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.

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 .

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."[7]

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.

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

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 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 channelling 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.

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.[8] However, it is not denied that it may be appropriate in different circumstances.

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

8. 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.

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.[9]

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 permanent 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

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9. 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 .

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 though 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 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.

Variation 2: Multiple servers

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.[10]

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10. 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.

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.

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.

Variation 3: Technical support staff in permanent establishment

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.

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.

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 permanent 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.

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.

Variation 4: Web site fully developed in permanent establishment

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.

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.[11] 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.

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

11. 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.

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.

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.

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 though 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.

CLARIFICATION ON THE APPLICATION OF THE PERMANENT ESTABLISHMENT DEFINITION IN E-COMMERCE:

CHANGES TO THE COMMENTARY ON ARTICLE 5

Introduction

1. This document contains the changes to the Commentary on the OECD Model Tax Convention adopted by the Committee on Fiscal Affairs on 22 December 2000 concerning the issue of the application of the current definition of permanent establishment in the context of e-commerce. It follows two previous drafts which were released for comments by Working Party No. 1[1] in October 1999 and March 2000.

2. The Committee wishes to thank the individuals, organizations and non-member countries that have sent comments on the previous drafts. These comments have helped the Working Party to draft the changes to the Commentary on Article 5 which are included in this document. The comments that were received from non-member countries lead the Committee to believe that these changes reflect interpretations that have wide support both among OECD and non-OECD countries.

3. The conclusions reflected in this document have been reached after a thorough analysis of the various conditions underlying the current treaty definition of permanent establishment having regard to work done over the last few years by the Working Group on Permanent Establishments. When drafting the changes included in this document, the Working Party has taken care to ensure that its interpretation of these conditions in the context of e-commerce remained fully consistent with the views of its Member countries on the application of these conditions to more traditional business operations.

4. The Committee wishes to stress that the changes included in this document deal exclusively with the permanent establishment definition as it currently appears in Article 5 of the OECD Model Tax Convention. The Technical Advisory Group (TAG) on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits in the Context of Electronic Commerce has been given the general mandate "to examine how the current treaty rules for the taxation of business profits apply in the context of electronic commerce and examine proposals for alternative rules." The Committee looks forward to receiving the views of the TAG on the more important issue of whether any changes should be made to that definition or whether the permanent establishment concept should be abandoned. The work of that group will assist the Committee in deciding whether changes need to made to the Model Tax Convention to address this broader issue.

5. The Committee also looks forward to receiving the views of that TAG and the conclusions of the Working Party No. 6 on the Taxation of Multinational Enterprises on the issue of how much income should be attributed to electronic commerce operations carried on through computer equipment in circumstances where there would be a permanent establishment.

6. As this document shows, the Committee has been able to reach a consensus on the various issues concerning the application of the current definition of permanent establishment in the context of e-commerce (subject to the two dissenting views described at the end of this paragraph and of paragraph 14 below). This consensus includes the important views that a web site cannot, in itself, constitute a

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1. Working Party No. 1 on Tax Conventions and Related Questions is a subsidiary body of the OECD Committee on Fiscal Affairs and is responsible for drafting changes to the OECD Model Tax Convention.

permanent establishment, that a web site hosting arrangement typically does not result in a permanent establishment for the enterprise that carries on business through that web site and that an ISP will not, except in very unusual circumstances, constitute a dependent agent of another enterprise so as to constitute a permanent establishment of that enterprise. However, Spain and Portugal do not consider that physical presence is a requirement for a permanent establishment to exist in the context of e-commerce, and therefore, they also consider that, in some circumstances, an enterprise carrying on business in a State through a web site could be treated as having a permanent establishment in that State. That is the reason why Spain and Portugal look forward to the results of the work of the TAG on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits in the Context of Electronic Commerce (see paragraph 4) as regards the issue of whether changes to the definition of permanent establishment should be made to deal with e-commerce.

7. As a number of commentators and delegates have noted, it is unlikely that much tax revenues depend on the issue of whether or not computer equipment at a given location constitutes a permanent establishment. In many cases, the ability to relocate computer equipment should reduce the risks that taxpayers in e-commerce operations be found to have permanent establishments where they did not intend to. Also, in circumstances where a taxpayer would want to have income attributed to a country where its computer equipment is located, that result can be achieved through the use of a subsidiary even if no permanent establishment is considered to exist. It is crucial, however, that taxpayers and tax authorities know where the borderlines are and that taxpayers not be put in a position to have a permanent establishment in a country without knowing that they have a business presence in that country (a result that is avoided by the conclusion that a web site cannot, in itself, constitute a permanent establishment).

8. Since a large part of the draft released in March 2000 discussed a minority view that some human intervention was required for a permanent establishment to exist and since many commentators have argued that this was the case, the Committee wishes to explain the position reached on that issue and reflected in the changes that have been adopted.

9. Having further examination of the issue, the conclusion has been reached that human intervention is not a requirement for the existence of a permanent establishment.

10. There is no specific reference to human intervention in paragraph 1 of Article 5 but it has been argued that the Commentary on Article 5, in particular paragraphs 2 and 10 thereof, imply that there is a requirement of human intervention for a permanent establishment to exist. The Committee concluded, however, that the Commentary does not support this view.

11. The relevant part of paragraph 2 reads as follows:

> "The definition, therefore, contains the following conditions:
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> [...]
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> the carrying on of the business of the enterprise through this fixed place of business. This means usually that persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated."

12. Although electronic commerce is developing rapidly, this statement is still accurate, i.e. usually, enterprises that have fixed places of business carry on their business through personnel. This, however, does not, and was not intended to, rule out that a business may be at least partly carried on without personnel.

13. The same applies as regards to paragraph 10. According to the Committee, the example provided in that paragraph clearly supports the conclusion that no human intervention is required for a permanent

establishment to exist. Also, the first sentence ("The business of an enterprise is carried on mainly by the entrepreneur or persons who are in a paid-employment relationship with the enterprise (personnel)") is still an accurate statement of how business operates but, again, does not rule out that a business may be at least partly carried on without personnel. Finally, the Committee believes that a requirement of human intervention could mean that, outside the e-commerce environment, important and essential business functions could be performed through fixed automated equipment located permanently at a given location without a permanent establishment being found to exist, a result that would be contrary to the object and purpose of Article 5.

14. The changes to the Commentary on Article 5 which appear below make it clear that, in many cases, the issue of whether computer equipment at a given location constitutes a permanent establishment will depend on whether the functions performed through that equipment exceed the preparatory or auxiliary threshold, something that can only be decided on a case-by-case analysis. Some countries did not like that outcome and the uncertainty that may result from it. They suggested that, in the case of e-tailers, it would have been better to simply conclude that a server cannot, by itself, constitute a permanent establishment. In order to reach a consensus, however, most of these countries have accepted the view expressed above, noting that they will take into account the need to provide a clear and certain rule in their own appreciation of what are preparatory or auxiliary activities for an e-tailer. The United Kingdom, however, has taken the view that in no circumstances do servers, of themselves or together with web sites, constitute permanent establishments of e-tailers and intends to make an observation to that effect when the changes to the Commentary on Article 5 are included in the Model Tax Convention.

15. In order to illustrate that it is possible for functions performed through computer equipment to go beyond what is preparatory or auxiliary, an example has been included in the last sentence of paragraph 42.9. It was noted during the discussion that this example is merely illustrative and should not be considered to determine the point at which the preparatory or auxiliary threshold is exceeded since many countries consider that this could be the case even if only some of the functions described in that example are performed through the equipment.

CHANGES TO THE COMMENTARY ON ARTICLE 5

Add the following heading and paragraphs 42.1 to 42.10 immediately after paragraph 42 of the Commentary on Article 5

"Electronic commerce

42.1 There has been some discussion as to whether the mere use in electronic commerce operations of computer equipment in a country could constitute a permanent establishment. That question raises a number of issues in relation to the provisions of the Article.

42.2 Whilst a location where automated equipment is operated by an enterprise may constitute a permanent establishment in the country where it is situated (see below), a distinction needs to be made between computer equipment, which may be set up at a location so as to constitute a permanent establishment under certain circumstances, and the data and software which is used by, or stored on, that equipment. For instance, an Internet web site, which is a combination of software and electronic data, does not in itself constitute tangible property. It therefore does not have a location that can constitute a "place of business" as there is no "facility such as premises or, in certain instances, machinery or equipment" (see paragraph 2 above) as far as the software and data constituting that web site is concerned. On the other hand, the server on which the web site is stored and through which it is accessible is a piece of equipment having a physical location and such location may thus constitute a "fixed place of business" of the enterprise that operates that server.

42.3 The distinction between a web site and the server on which the web site is stored and used is important since the enterprise that operates the server may be different from the enterprise that carries on business through the web site. For example, it is common for the web site through which an enterprise carries on its business to be hosted on the server of an Internet Service Provider (ISP). Although the fees paid to the ISP under such arrangements may be based on the amount of disk space used to store the software and data required by the web site, these contracts typically do not result in the server and its location being at the disposal of the enterprise (see paragraph 4 above), even if the enterprise has been able to determine that its web site should be hosted on a particular server at a particular location. In such a case, the enterprise does not even have a physical presence at that location since the web site is not tangible. In these cases, the enterprise cannot be considered to have acquired a place of business by virtue of that hosting arrangement. However, if the enterprise carrying on business through a web site has the server at its own disposal, for example it owns (or leases) and operates the server on which the web site is stored and used, the place where that server is located could constitute a permanent establishment of the enterprise if the other requirements of the Article are met.

42.4 Computer equipment at a given location may only constitute a permanent establishment if it meets the requirement of being fixed. In the case of a server, what is relevant is not the possibility of the server being moved, but whether it is in fact moved. In order to constitute a fixed place of business, a server will need to be located at a certain place for a sufficient period of time so as to become fixed within the meaning of paragraph 1.

42.5. Another issue is whether the business of an enterprise may be said to be wholly or partly carried on at a location where the enterprise has equipment such as a server at its disposal. The question of whether the business of an enterprise is wholly or partly carried on

through such equipment needs to be examined on a case-by-case basis, having regard to whether it can be said that, because of such equipment, the enterprise has facilities at its disposal where business functions of the enterprise are performed.

42.6 Where an enterprise operates computer equipment at a particular location, a permanent establishment may exist even though no personnel of that enterprise is required at that location for the operation of the equipment. The presence of personnel is not necessary to consider that an enterprise wholly or partly carries on its business at a location when no personnel are in fact required to carry on business activities at that location. This conclusion applies to electronic commerce to the same extent that it applies with respect to other activities in which equipment operates automatically, e.g. automatic pumping equipment used in the exploitation of natural resources.

42.7 Another issue relates to the fact that no permanent establishment may be considered to exist where the electronic commerce operations carried on through computer equipment at a given location in a country are restricted to the preparatory or auxiliary activities covered by paragraph 4. The question of whether particular activities performed at such a location fall within paragraph 4 needs to be examined on a case-by-case basis having regard to the various functions performed by the enterprise through that equipment. Examples of activities which would generally be regarded as preparatory or auxiliary include:

- providing a communications link – much like a telephone line – between suppliers and customers;
- advertising of goods or services;
- relaying information through a mirror server for security and efficiency purposes;
- gathering market data for the enterprise;
- supplying information.

42.8 Where, however, such functions form in themselves an essential and significant part of the business activity of the enterprise as a whole, or where other core functions of the enterprise are carried on through the computer equipment, these would go beyond the activities covered by paragraph 4 and if the equipment constituted a fixed place of business of the enterprise (as discussed in paragraphs 42.2 to 42.6 above), there would be a permanent establishment.

42.9 What constitutes core functions for a particular enterprise clearly depends on the nature of the business carried on by that enterprise. For instance, some ISPs are in the business of operating their own servers for the purpose of hosting web sites or other applications for other enterprises. For these ISPs, the operation of their servers in order to provide services to customers is an essential part of their commercial activity and cannot be considered preparatory or auxiliary. A different example is that of an enterprise (sometimes referred to as an "e-tailer") that carries on the business of selling products through the Internet. In that case, the enterprise is not in the business of operating servers and the mere fact that it may do so at a given location is not enough to conclude that activities performed at that location are more than preparatory and auxiliary. What needs to be done in such a case is to examine the nature of the activities performed at that location in light of the business carried on by the enterprise. If these activities are merely preparatory or auxiliary to the business of selling products on the Internet (for example, the location is used to operate a server that hosts a web site which, as is often the case, is used exclusively for advertising, displaying a catalogue of products or providing information to potential customers), paragraph 4 will apply and the location will not constitute a permanent establishment. If, however, the typical functions related to a sale are

performed at that location (for example, the conclusion of the contract with the customer, the processing of the payment and the delivery of the products are performed automatically through the equipment located there), these activities cannot be considered to be merely preparatory or auxiliary.

42.10 A last issue is whether paragraph 5 may apply to deem an ISP to constitute a permanent establishment. As already noted, it is common for ISPs to provide the service of hosting the web sites of other enterprises on their own servers. The issue may then arise as to whether paragraph 5 may apply to deem such ISPs to constitute permanent establishments of the enterprises that carry on electronic commerce through web sites operated through the servers owned and operated by these ISP. While this could be the case in very unusual circumstances, paragraph 5 will generally not be applicable because the ISPs will not constitute an agent of the enterprises to which the web sites belong, because they will not have authority to conclude contracts in the name of these enterprises and will not regularly conclude such contracts or because they will constitute independent agents acting in the ordinary course of their business, as evidenced by the fact that they host the web sites of many different enterprises. It is also clear that since the web site through which an enterprise carries on its business is not itself a "person" as defined in Article 3, paragraph 5 cannot apply to deem a permanent establishment to exist by virtue of the web site being an agent of the enterprise for purposes of that paragraph."