

COMMENTS RECEIVED FROM PRICEWATERHOUSECOOPERS

OECD REVISED DISCUSSION DRAFT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS - PART III (ENTERPRISES CARRYING ON GLOBAL TRADING OF FINANCIAL INSTRUMENTS)

This letter provides the comments of the Electronic Commerce Tax Study Group (“ECTSG”)¹ on the recently released paper captioned *Discussion Draft on the Attribution of Profits to Permanent Establishments: Part III (Enterprises Carrying on Global Trading of Financial Instruments)*. None of the members of the ECTSG is engaged in the business of global trading of financial instruments. Accordingly, our comments do not seek to address comprehensively the many issues arising in the context of applying the Working Hypothesis to businesses engaged in such global trading activities. However, we believe that certain provisions of Part III of the Discussion Draft have implications that extend well beyond the context of global dealing businesses, and that may affect the administration of international tax law for many different types of companies, including the members of the ECTSG.

Specifically, we are concerned about the implications of the provisions of Part III of the Discussion Draft relating to the attribution of income to so-called dependent agent permanent establishments. In providing these comments we wish to elaborate on the matters raised in ECTSG’s earlier comments on Part I of the Discussion Draft relating to the attribution of income to dependent agent PEs.²

Discussion Draft Position With Regard to Dependent Agent PEs

Part III of the Discussion Draft asserts that it is quite common for entities engaged in a global dealing business to conduct that business through an associated enterprise, often a wholly owned subsidiary, which concludes contracts in the name of the booking entity. The Discussion Draft then asserts that in such situations, it is appropriate to attribute income to the jurisdiction in which the dependent agent operates in amounts that exceed an arm’s length level of compensation for the functions performed by the dependent agent in that jurisdiction.

The rationale supporting this assertion is set out in paragraph 260 of Part III of the Discussion Draft, which states:

It may happen in global trading cases for the dependent agent enterprise to be paid a service fee by the non-resident enterprise on whose behalf the dependent agent enterprise acts. *Issues arise as to whether there would be any profits to be attributed to the*

¹ The Electronic Commerce Tax Study Group was formed in 1996 to study international tax issues relating to electronic commerce and to foster a constructive dialogue on these issues between business and tax authorities around the world. The member companies of the ECTSG include Amazon.com, AOL Time Warner Inc., Cisco Systems, Inc., Hewlett Packard Company, International Business Machines Corporation, Microsoft Corporation, Sun Microsystems, Inc., and The Thompson Corporation, Inc. PricewaterhouseCoopers LLP acts as advisor to the ECTSG.

² See, letter to Jeffrey Owens, June 6, 2001.

dependent agent PE after an arm's length service fee has been paid to the dependent agent enterprise. The service fee should provide the appropriate remuneration for the functions performed (taking into account the assets used and risks assumed) by the dependent agent enterprise in its own right. However, a functional analysis of a transaction may show that the ability to assume the risks arising from the transaction is not found in the dependent agent enterprise, for example because it has insufficient capital to support the risks assumed. Rather the ability to assume the risks is generally found in the non-resident enterprise in whose books the transaction – and the resultant risk – appears. These risks, and therefore the capital needed to support them, will be attributed to the dependent agent PE to the extent that they arise from functions performed by the dependent agent or by the non-resident enterprise in the PE jurisdiction. In short, when attributing profits to the dependent agent PE, there are likely to be profits (or losses) over and above the arm's length service fee paid to the dependent agent enterprise. (Emphasis added)

We are concerned that these brief and innocuous sounding words, buried near the end of a lengthy, specialized paper that many will believe has application only to financial institutions, contain the seeds of tax controversy and systemic double taxation that could plague the international tax system for years to come. We urge the OECD to reconsider its approach to these issues, and particularly to focus energy and attention on the issues relating to dependent agent PEs in a broader context, not simply as those issues arise in a specialized industry.

Allocating More Income to a Jurisdiction Than That Attributable to the Functions and Risks Undertaken By a Dependent Agent is Not Sound International Tax Policy

It is the experience of members of ECTSG that numerous countries are increasingly asserting in tax audits that a local affiliate constitutes a dependent agent PE of either its parent or some other affiliated company. While such assertions of jurisdiction to tax have resulted in highly publicized judicial decisions in some cases,³ more often these assertions appear to be initiated to create negotiating leverage in transfer pricing examinations and may often be resolved administratively.⁴ Such assertions are no longer limited to those few countries that have taken unusually aggressive positions with regard to permanent establishment issues for a number of years. We note that public comments of the competent authorities of some countries, including the United States, have specifically identified the increasing prevalence of permanent establishment cases in the competent authority caseload and have also noted the difficulties involved in resolving such cases through the competent authority process.⁵

In structuring their business operations, multinational industrial enterprises have rarely chosen to conduct even limited business operations in a country without organizing a local entity.⁶ At least one strong motivation for such an approach has been the uncertainty over tax liability that arises in connection with the attribution of income to PEs. The OECD's project on the attribution of income to PEs provides ample testimony of the uncertainty that has existed in this area. The fact that the OECD's working hypothesis admittedly diverges in several respects from the local law rules of many countries, and from certain

³ See, e.g. the decision of the Italian Corte de Cassazione in a case involving a subsidiary of Philip Morris.

⁴ We note in this regard the recent report suggesting that Australia may assert the existence of a dependent agent permanent establishment and attribute income to that permanent establishment in every case involving the conversion of a buy-sell distributor to a commissionaire structure. BNA Transfer Pricing Report, March 19, 2003 at 957.

⁵ See, BNA Transfer Pricing Report, January 8, 2003 at 748.

⁶ Obviously industries like banking, with special regulatory concerns, are an exception to this general rule.

provisions of both the OECD Model Treaty and most bilateral tax treaties in force, bears further witness of that uncertainty.

While organizing a local subsidiary clearly subjects that local entity to source-based taxation in the host jurisdiction, and often to some transfer pricing exposure, the attendant risks have almost always been deemed to be less onerous than dealing with the uncertainties created by the application of subjective PE thresholds and ill-defined PE income attribution rules. The attendant dispute resolution mechanisms that have grown up, including the competent authority process, the promulgation of the Transfer Pricing Guidelines, and proliferating transfer pricing documentation rules have usually functioned well enough to keep the risk of double taxation at acceptable levels.

The subsidiary corporations organized to assist in carrying the business of the multinational enterprise into local markets often provide only limited, service provider - type functions. They may act as local market commission agents, commissionaires, providers of limited logistical services or local market information gathering services, providers of contract research or limited administrative services, or in other ways provide a focused and limited service to the global business organization. In the context of a global dealing enterprise, the functions of the local entity could be limited to marketing and promotion, limited administrative support or other service functions. Many companies are careful to define the limited functions and limited risks assumed by these entities in written intercompany agreements and the Transfer Pricing Guidelines suggest that when such agreements comport with the substance of business operations they should be respected.⁷

In conformity with the Transfer Pricing Guidelines, such service providers earn levels of income, on a guaranteed or near-guaranteed basis, that reflect the limited business risk and the limited assets and functions of these entities. The greater business risks associated with product development and production, the concentration of the assets of the enterprise, the assumption of the entrepreneurial risks of the business, and the creation of intangible property, are not assumed by these local service provider affiliates and the economic rewards or losses associated with these activities should therefore have no bearing on the determination of the local tax liability of the limited risk service provider. This result is appropriate, since by any reasonable measure those functions, assets and risks undertaken by the principal company, have very little or nothing to do with the geographic jurisdiction in which the dependent agent operates.

The suggestion in Part III of the Discussion Draft that the functions of such local service providers may draw into the local tax net not only an amount of income appropriately attributable to the functions, activities and risks undertaken by the local entity in the host country, but also some undefined additional amount to be attributed to a PE of the parent or other principal company, certainly runs counter to the expectations of most multinational enterprises.

It is beyond the scope of this comment letter to address the ongoing discussions at the OECD regarding the PE definition. It must be recognized however, that the assertion of Part III of the Discussion Draft, quoted above, puts enormous pressure on the definition of a dependent agent PE, causing highly material tax consequences to turn on the very narrow and factually difficult question of whether an entity has and habitually exercises the ability to contract on behalf of a related party. It will put the competent authorities in the unenviable position of seeking to resolve cases that the competent authority process is not well-equipped to address. Such cases are not readily susceptible to compromise, but require resolution of a yes or no question (the existence and habitual use of contracting authority and thus the existence of a dependent agent PE) that potentially can have (under the approach espoused in Part III of the Discussion Draft) extremely large revenue consequences. We do not believe that the creation of such extreme

⁷ See OECD Transfer Pricing Guidelines, paragraphs I-28 and I-29.

pressures on the resolution of all or nothing questions through the competent authority process constitutes sound tax policy.

The Economic Argument Supporting the Allocation of More Income to a Jurisdiction Than That Attributable to the Functions and Risks of the Dependent Agent is Highly Questionable

The tax policy implications of the assertions regarding dependent agents in Part III of the Discussion Draft are made more questionable still when the economic assumptions underpinning the Discussion Draft are carefully examined. Essentially, the argument proceeds according to the following syllogism. First, it is argued that within a single corporate entity, a close factual analysis can identify the geographic location of key business functions. Next it is contended that assets of a business should be attributed to the geographic location of the functions giving rise to those assets. Third, it is asserted that the capital of the business should be allocated to the various jurisdictions in which the entity operates by reference to where those assets have been allocated. Fourth, it is argued that the geographical situs of the risks of the business follow the geographic location of its functions, assets and capital – i.e., that risks should be deemed to reside geographically in the jurisdiction in which the functions of creating and managing risks are carried out. And finally, it is observed that in a dependent agent context, at least in the context of a global dealing business, risks created by functions carried out by the dependent agent should be allocated to and compensated in the jurisdiction where the dependent agent acts.

We do not provide specific comment on the degree to which this intellectual construct provides a necessary, a practical or a workable foundation for the taxation of financial institutions. However, we strongly take issue with the implied consequences of this line of thought for non-financial enterprises.

It is a fundamental principle of the Transfer Pricing Guidelines that business risk should not be deemed to have its situs in an entity or a jurisdiction where the business lacks the assets or management skills to bear and manage the risk.⁸ In the typical service provider, dependent agent PE situation, it is quite clear that the principal company has no assets and no functions in the jurisdiction other than the functions carried out by and the assets owned by the dependent agent itself. In such a case, the principal company is most unlikely to have its own employees in the jurisdiction to manage risks, it is most unlikely to maintain its own inventory, bank accounts, or physical assets of any kind in the jurisdiction to support the assumption of risk, and it certainly is unlikely to engage in activities in the jurisdiction that result in the creation of intangible property. A ring fence that excludes the functions and assets of the alleged dependent agent, and also excludes the functions, assets and other substantive business activities of the principal company outside the host jurisdiction, is virtually certain to contain no business functions and no business assets at all. Attributing risk, and therefore income, to the business functions taking place inside that empty circle runs directly contrary to the provisions of appropriate transfer pricing practice that require a confluence of business substance and transfer pricing result.

The intellectual construct propounded in Part III of the Discussion Draft gives rise to the attribution of income to a notional PE separate entity that is completely lacking in its own assets, employees, functions and business risks. We believe that such a result is manifestly contrary to both sound economics and sound tax administration. It will lead to endless dispute over the existence of such a dependent agent PE, and the measure of the income appropriately associated with the reward for the assumption of risk. The reasoning that leads to that conclusion should be reconsidered in the context of those non-financial business operations where it is likely to have its greatest impact. We believe that such a reexamination should lead to the conclusion that once the dependent agent has been appropriately compensated for its functions risks and activities, those same functions risks and activities cannot be determined to attract any additional income to the jurisdiction.

⁸ See e.g. Transfer Pricing Guidelines at para 1.36 – 1.38; US Treas Reg. section 1.482—1(d)(3)(B).

Intangible Property

Part III of the Discussion Draft does not focus attention on the issue of the situs of intangible property in the context of a dependent agent PE. Such issues are reserved for the forthcoming redrafting of Part I of the Discussion Draft.

We reiterate in this regard that income attributable to intangible property should in all cases be allocated to the entities and business functions that create and fund the creation of intangible property. In a dependent agent PE fact pattern, as noted above, the PE is devoid of business activity, functions and assets other than those of the dependent agent. That PE does not bear the cost or the risk of developing intangible property. Since, viewed as a separate entity, the PE will typically have no employees in the jurisdiction, the PE cannot be said to manage the creation of intangible property. Such a PE should, under no circumstance be deemed to own and be entitled to a return on intangible property.

In our earlier comment letter on Part I of the Discussion Draft, we noted that certain statements in the original Part I tended to geographically locate intangible property at the situs of its actual or anticipated use. We continue to believe that such an approach is both inappropriate and inconsistent with the transfer pricing guidelines. It would be particularly inappropriate to argue that intangible assets should be deemed to be owned by a dependent agent PE because those assets are in some way used by the dependent agent in carrying out its limited functions. Indeed, we can see no basis in the typical dependent agent PE situation for attributing intangible related income to the alleged PE.

If a dependent agent is the owner of intangible property, it should be compensated for the use of such intangibles. If the dependent agent itself is not the owner of an intangible, then intangible related income should not be taxed in the jurisdiction in which the dependent agent operates since, by definition, there are no other business activities in that country which could have given rise to the creation of the intangibles in question.

Conclusion

We appreciate the consideration given by the OECD to these important topics. We urge that the foregoing comments be carefully weighed in the process of further revising the various parts of the Discussion Draft. We stand ready to discuss these comments with appropriate persons at any time.