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**DIRECTORATE FOR FINANCIAL, FISCAL AND ENTERPRISE AFFAIRS
COMMITTEE ON FISCAL AFFAIRS**

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Working Party No. 6 on the Taxation of Multinational Enterprises

CONSULTATION WITH BUSINESS ON THE OECD DISCUSSION DRAFT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS (PARTS I & II)

Case Study A: relating to the general situation (Part I): A permanent establishment is engaged in Research and Development activities leading to the development of intangible property rights . How should dealings be recognised and charaterised?

This document is FOR DISCUSSION on Thursday 11 April a.m. at the Meeting, to be held on 11 and 12 of April, 2002 at the Headquarters of OECD, 75106, Paris, Room 1, New Building.

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Case A: Relating to general situation (Part I): A permanent establishment is engaged in Research and Development activities leading to the development of intangible property rights. How should dealings be recognised and characterised?

A. Issues for Discussion

1. A number of public comments addressed the issue of the concept of “dealings” developed and used in the Discussion Draft:

2. Some requested the clarification on the concept of “dealings”, for example between events and the characterization of events for purposes of attributing profits to a permanent establishment.

3. Doubts were expressed that a functional analysis could be conclusive in the characterization of a dealing, for example to determine whether an asset used by a permanent establishment should be considered to be notionally owned, licensed or used in the context of a cost contribution arrangement. Comments on the recognition of dealings were also expressed in the context of bank permanent establishments.

4. Related to the concept of dealings is the issue of documentation. It was suggested that further guidance should developed in the Discussion Draft. Some commentators argue that taxpayers should be required to document contemporaneously the intended dealings between a permanent establishment and another part of the enterprise. Others suggested that internal “agreements”, to the extent they have economic substance, are the best evidence supporting dealings within an enterprise and should be respected for tax purposes.

5. The above issues are best illustrated by considering the case of an enterprise performing research and development activities that eventually lead to the creation of intangible property. This particular issue was itself the object of comments, including in the context of the Discussion Draft released by the Business Profits Technical Advisory Group (*Attribution of Profits to a Permanent Establishment Involved in Electronic Commerce Transactions*). Central to these comments was a request for further guidance in the Discussion Draft in order to distinguish situations where a permanent establishment engaged in R&D should be considered either (i) the “economic owner” of the intangible, (ii) a contract R&D service supplier, or (iii) party to a notional cost contribution arrangement with another part of the enterprise.

B. Example – Case A

Facts:

6. Company T, a resident of Country A, is an emerging and innovative manufacturer of telecommunication equipment. Company T has a large division in Country B organized as a permanent establishment (“PE”). Manufacturing and research and development activities take place at both locations. Products manufactured in the Head Office (“HO”) are sold mostly in North America and Western Europe, whereas products manufactured by PE are sold in Eastern Europe and Asia.

7. Research and development programs conducted at both locations are designed to be complementary, with PE's R&D focusing on the development of new telephony technology that would considerably reduce the cost of production of most of Company T's products. The cost of the R&D incurred in PE is financed out of the sales proceeds realized by PE. PE's R&D efforts eventually lead to the successful development of a new production technology for which Company T obtains a patent and which will be used by the entire enterprise.

Questions:

a) What additional facts and dealings in the above example would be required in order to conclude that:

- PE performs notional contract R&D on behalf of HO in a capacity of service provider?
- PE and HO are engaged in a notional cost contribution arrangement?
- PE is the "economic owner" of the new technology and provides it to HO under a notional licensing agreement?

b) If such additional facts were present in the example for each of the above possibilities, is it considered that the guidance currently provided in the Discussion Draft is capable or sufficient to assist taxpayers and tax administration to identify and characterize contemporaneously the nature of the arrangement that exist between HO and PE and, in particular, to assign the economic ownership of the intangible property developed by PE to a particular part of the enterprise? If not, what additional elements of guidance should be added to the Discussion Draft?

c) What would be the nature of the documentation that should be required from taxpayers in order to assist tax administrations in properly conducting the factual and functional analysis necessary to implement the guidance referred to in Question b)