

PUBLIC COMMENTS RECEIVED ON THE DISCUSSION DRAFT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS – PART I (GENERAL CONSIDERATIONS)¹

Institute of Directors²

Attributing profits

The basic rules

1. Once a business's permanent establishments have been identified, each state hosting a PE can tax its profits. But it can only do so if it can work out the PE's profits. That has never been easy, and e-commerce is making it harder.

2. The current rules are set out in Article 7 of the Convention. Roughly, Article 7 says that one should think of the PE as if it were a separate enterprise and work out what profits that separate enterprise would have made. We assume that in its dealings with the business of which it is a PE, it acts as if it were independent. There is an existing commentary on this article, explaining how it should be applied.

3. In February 2001, the OECD published two relevant documents. *Discussion Draft on the Attribution of Profits to Permanent Establishments* discusses the attribution of profits in general, not just in the context of e-commerce. It is referred to here as the general paper. *Attribution of Profit to a Permanent Establishment Involved In Electronic Commerce Transactions* discusses the problem in the context of e-commerce. It is referred to here as the e-commerce paper.

4. The general paper is available at www.oecd.org/daf/fa/tr_price/peprofit_english.pdf, and the e-commerce paper is available at www.oecd.org/daf/fa/e_com/ec_3_attribution_eng.pdf.

5. Article 7 gives the basic rules as follows:

Paragraph 1: If an enterprise carries on business [through a PE], the profits of the enterprise may be taxed in [the state hosting the PE] but only so much of them as is attributable to that PE.

Paragraph 2: Subject to the provisions of paragraph 3, ... there shall in each contracting state be attributed to the PE the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a PE.

1. Please note that comments received on the "Discussion Draft on the Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions" are *also* included in this document, as these comments may also be of interest when examining Part I of the Discussion Draft on the Attribution of Profit to a Permanent Establishment.

2. The following is an excerpt from a report by Mr. Richard Baron, "Taxing Profits from E-commerce: Challenges for the OECD", June 2001.

Paragraph 3: In determining the profits of a PE, there shall be allowed as deductions expenses which are incurred for the purposes of the PE, including executive and general administrative expenses so incurred, whether in the state in which the PE is situated or elsewhere.

Difficulties with the basic rules

6. The basic rules might seem to amount to a straightforward rule that we should regard a PE as if it were a separate business and simply draw up a profit and loss account for it. But in fact there is considerable room for argument about what the rules mean.

7. Article 7, paragraph 1 states that only so much of the enterprise's profits as is attributable to the PE should be taxed in the state hosting the PE. It is not clear how to apply this if the PE makes a profit of £10,000 but the rest of the enterprise makes a loss of £4,000, giving a total profit of £6,000. Can £10,000 be taxed in the state hosting the PE, or can the amount taxed there be only a portion (perhaps all) of the enterprise's £6,000 profit? If £10,000 were taxed, then over-taxation of the enterprise as a whole would be the likely result because relief for the £4,000 loss might well not be available anywhere else. If only £6,000 were taxed, then one would be accepting an integration of the PE into the wider enterprise, going against the "distinct and separate enterprise" rule in Article 7, paragraph 2.

8. (Note, however, that in practice states have not integrated PEs' results into the results of an entire enterprise. Rather, they have integrated them into the results of the enterprise's conduct of the business in which the PE is involved. Thus if an enterprise had a PE engaged in food sales which made a profit of £10,000, another food sales division which made a loss of £3,000 and a computer software division which made a loss of £1,000, even an integrationist state would arrive at a profit for the PE of £7,000, not £6,000.)

9. More generally, different states have adopted a range of interpretations of the "distinct and separate enterprise" rule. Some take it literally, and look at the PE entirely separately from the rest of the enterprise and its results. Others look at the PE much more as part of the wider enterprise. This range of interpretations is unsatisfactory, because if an enterprise is based in state X, which takes one view, and has a PE in state Y, which takes a different view, then the worldwide result is likely to be tax on either more or less than the profits of the enterprise as a whole.

The general paper's proposal

10. The general paper was produced as a response to this problem of conflicting approaches. It puts forward a "working hypothesis" as the approach to be adopted by all states. The proposal is to treat the PE separately, so that in the above examples £10,000 would be taxed.

11. The proposal is made more precise by saying that a PE is to be regarded as a functionally separate entity. This means that profits are to be attributed to a PE by first identifying the business functions it performs and the conditions under which it performs them, then working out how those functions would be rewarded if it were a separate business operating under those conditions. A PE may take on assets and risks in order to perform its functions: the computation of its profits should take account of those assets and risks. But no account should be taken of assets and risks unrelated to the PE's functions.

12. The general paper, paragraph 26, acknowledges that the proposal may not be justified on the basis of the current wording of Article 7 and its commentary. If this were a problem, and states wished to adopt the general paper's proposal, then Article 7 and/or its commentary would have to be re-worded.

13. However, the general paper does lean heavily on one aspect of the current Article 7 and its commentary. This is the view that in working out the profits of the functionally separate entity, one should apply the same assumption of dealing at arm's length which is currently used to determine the profits of companies under common control when they have transactions with each other. If one company in a group sells something to another group company for £2,000, when the price between independent companies dealing at arm's length would have been £3,000, the arm's length price of £3,000 is substituted for the actual price for tax purposes. Thus the seller's profit is increased by £1,000 and the buyer's profit is decreased by the same amount. This approach is set out in rules on transfer pricing, and the OECD publish extensive guidance on the rules.

14. The general paper states that these rules should be applied by analogy. They can only be applied by analogy, not directly, because the transfer pricing rules apply when there are transactions between two legally separate entities, the two group companies, and assets really change their legal ownership. Where an enterprise has a PE, the PE is part of the same legal entity as the rest of the enterprise. Dealings between the PE and the rest of the enterprise may change which part of the enterprise uses an asset, but they do not change the asset's legal ownership: it is not legally possible for a company to sell an asset to itself, or to lend itself money. This fact can make it harder to work out the profits of a PE on the arm's length principle than it would be to work out the profits of a subsidiary on the same principle, as we shall see below.

Applying the proposal to e-commerce

15. The e-commerce paper explains how to apply the working hypothesis to electronic retailing. It considers one basic business and three variations. It acknowledges that there are other forms of e-business, but suggests that the same approach could be extended to them (e-commerce paper, paragraph 15).

The basic business

16. The basic business, which the OECD call Starco, is a retailer of music and films. They are available both in physical form (CDs and DVDs) and in digitised form allowing them to be downloaded over the Internet. Starco has a web site on a server in a state, and the server is such as to give it a PE in that state. Despite the tendency not to let web sites constitute PEs, it is still possible for a server to be a PE. The web site shows customers what products are available, accepts their orders and credit card details, obtains payment authorisation from credit card companies, instructs a warehouse (outside the PE's state) to despatch physical goods and allows downloading of digitised products from the PE server itself.

Functions

17. Analysing the functions is straightforward. The PE establishes Internet connections with customers, displays Starco's wares, takes orders, arranges for payment, instructs delivery of physical goods and delivers digitised products.

Assets

18. The assets that the PE uses in these functions include the server, the software to run the web site, some of the value of the Starco brand and the value of good web site design and content (making the web site attractive and easy to use). The assets also include the files of digitised products and some intellectual property rights in the content of those files, though curiously the e-commerce paper does not list either of these assets along with the others in paragraphs 49 and 50.

19. However, paragraph 51 of the e-commerce paper cautions against simply listing the assets and attributing profit to the PE on the basis that the PE uses them. With the intangibles (the value of the Starco brand, the value of good web site design and content, and presumably also the unmentioned files of digitised products and intellectual property rights in the content of those files), we must determine which part of the enterprise is entitled to benefit from their use. Paragraph 51 states that the reward associated with 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

20. The risks that Starco assumes are analysed into three categories:

Credit risk is the risk of not getting paid, which would normally only arise when Starco had not had a transaction authorised by a credit card company. Paragraph 55 of the e-commerce paper leaves it open whether this risk is assumed by the PE or by the rest of Starco.

Market risk is the risk of being left with unsold inventory which cannot be returned to suppliers for a refund.

Technological risk is the risk of technological failure affecting sales. This may be due either to internal failure or to attack by hackers. Paragraph 60 suggests that hacker risk should be treated as assumed by the PE because the PE's activities (running a server which may be hacked) are the source of the risk. It is not at all clear that this is correct: the source of the risk and the person assuming the risk are only guaranteed to be the same person if there is a legal system in which the source of the risk can always be sued for the damage caused when the risk is realised. Most legal systems are far from that ideal.

Paragraph 61 pursues the attribution of risk to source in relation to internal failure risk. Internal failure leads to lost sales, but the physical inventory is not carried by the PE so the risk should not be wholly attributed to it. The argument here is that the carrying of inventory is a source of risk because it might become unsaleable: CDs are not perishable stock like vegetables, but some of them are only saleable at a good price when they are in the current week's pop charts, and even if they remain saleable a delay in sale increases storage and working capital costs. However, as paragraph 61 says, the PE would still be one source of the risk, because it would be its failure that would delay or lose sales.

The OECD conclusion

21. The OECD conclude that Starco's PE should be regarded as a mere provider of services to the rest of Starco, because the head office does most of the work that one would normally expect a retailer to do and assumes most of the risks.

22. However, the OECD acknowledge that this conclusion is not a complete answer. There are two main different types of service provider. The first type is an independent service provider, which owns its computer systems and expects to earn a profit on its investment in equipment. The second type is a contract service provider, which merely operates its customers' systems. If Starco's PE is like an independent service provider, then one should regard Starco's equipment as transferred to the PE, assume that the PE should bear the cost of that equipment and earn a profit, and compute the PE's profit accordingly. If, on the other hand, the PE is like a contract service provider, one should simply establish an appropriate fee for the work which it does using equipment which is regarded as remaining the property of the head office.

23. To decide which category of service provider Starco's PE falls into, we would have to decide which risks related to the computer equipment the PE bears. On the facts, the OECD conclude that "one could credibly characterise" the PE as similar to a contract service provider (e-commerce paper, Paragraph 70). But credible characterisation is not enough to give the certainty needed to forecast tax liabilities with confidence.

24. Once one has got over this difficulty and characterised the PE appropriately, the attribution of profit raises few new issues. It is covered in the e-commerce paper, paragraphs 72 to 110. Naturally some

assets are hard to value, and it is not always easy to work out what rights in assets should be regarded as transferred from the head office to the PE; but these are secondary difficulties.

25. One new issue raised by the functional analysis approach to PEs is the contrast, in the current rules, between the treatment of intangible assets transferred to a subsidiary and the treatment of intangible assets transferred to a PE. A subsidiary can expect to be deemed to pay a price which reflects the value of the intangible assets. A PE can expect to be deemed merely to bear a share of costs. But the functional analysis approach is supposed to treat PEs on an analogous basis to independent companies – the same approach as should be used for subsidiaries – so PEs and subsidiaries should not be treated differently. The e-commerce paper, paragraphs 83 to 88, explores this tension and suggests, perfectly reasonably, that the difference in treatment between PEs and subsidiaries should be eliminated by changing the commentary on Article 7 of the Convention (the transfer pricing article). Paragraphs 106 to 110 expand on this issue, but the obvious remedy remains the same: amend the commentary on Article 7.

Difficulties with the OECD analysis

26. As noted above, the key difficulty is the appropriate characterisation of the PE. The fact that the transfer pricing issues which arise beyond that point are relatively straightforward should not lead us to overlook the size of the difficulty.

27. We can focus the issue by noting that in discussing the attribution of risk, the e-commerce paper, paragraph 61, does not give us a way of dividing the risk between the PE and the rest of the enterprise. We could for example work out the PE's share on the basis that it was a mere contract service provider, by considering what the liabilities of an independent contract service provider would be, but we could only do that after we had decided that the PE was a contract service provider. There is a danger of circularity here. The functional analysis tells us what risks the PE assumes, and therefore what role it plays and which independent businesses it should be compared with. But the analysis can only tell us what risks the PE assumes when we have decided what role the PE plays.

28. There is another hint of circularity. Paragraph 61 includes the argument that inventory risk could only be treated as entirely assumed by the PE if the financial position of the rest of Starco were unaffected by an internal failure at the PE. This would not be the case, because the physical inventory was carried by the rest of Starco. But pushing that approach to its logical conclusion, no risk could ever be entirely attributed to the PE because any diminution in the worth of the PE would automatically affect the financial position of Starco as a whole. That would happen because the PE was simply a branch of Starco.

29. Starco cannot in reality be valued as two separate components, the PE and the rest. We can only value the PE and the rest separately, and therefore use the question "Whose financial position is affected by a failure?" to allocate risks and determine the conditions under which the hypothetical functionally separate entity performs its functions, if we first decide what kind of separate entity the PE is to be assumed to be. This is something we should not do so early, because the risk analysis is supposed to steer us towards picking the relevant kind of separate entity, that is, one which is operating under the same conditions. So once again, circularity threatens.

30. These fears of circularity must not be exaggerated. An analysis does not have to proceed linearly from one set of conclusions (about functions and risks) to another set of conclusions (about the type of entity) in order to be useful. One can juggle functions, risks and type of entity in order to reach an equilibrium set of conclusions on all points, which we are satisfied does not clash with any of the empirical evidence. But if that is how functional analysis works, we must not assume that it will always deliver unique solutions. There might sometimes be two or more conflicting equilibrium sets of

conclusions. In the Starco example, we could imagine giving the PE more tasks and the head office fewer tasks, until we reached the point where the OECD analysis that the PE was a service provider became no more plausible than an alternative view, that the PE was the real locus of the main business and the head office was a mere warehouse for physical inventory.

31. We should also be concerned that the approach of iteratively searching for an equilibrium may not stick closely enough to the requirements of Article 7 of the Convention. That article may license functional analysis, and it may license the alternative “relevant business activity” approach, which limits a PE’s profits to those made by the enterprise from the business activity in which the PE engages. It is not clear that it licenses groping for an equilibrium.

Variations on the basic business

32. The basic Starco business considered so far is Variation 1 in the e-commerce paper. The paper also discusses variations 2, 3 and 4.

Variation 2: multiple PE-servers

33. Variation 2 involves the same business model as variation 1, but there are several servers in different states, each constituting a PE. One of these servers takes the initial approaches from all customers, and then allocates each customer to a server to ensure the best response to all customers.

34. As the OECD point out, this variant does not raise any fundamentally new issues: it just makes the tax compliance work harder in practice because there are several head office – PE relationships to deal with.

Variation 3: technical support staff at the PE

35. This variation assumes that there are Starco personnel at the PE who maintain the server, deal with any web site problems and help customers and web site visitors who run into difficulties.

36. As the OECD say, this changes the relationship between the head office and the PE. One needs to look again at the functions performed by the PE. The OECD acknowledge that the new functions taken on by the PE might make it analogous to a retail outlet running its own free-standing business of buying goods from head office and selling them on. However, the OECD think it more likely that the PE should still be seen as simply providing services to the head office.

37. The basis for this conclusion is that the PE would not earn additional revenue for Starco as a whole directly from the provision of services (although good service would increase revenue indirectly, by getting Starco a good reputation), nor would the PE bear significant additional risk from its expanded activities. But it is easiest to reach this conclusion by starting from the basic Starco with its very limited PE, and then moving to variation 3 and deciding that there is little reason to change the conclusion in the basic case. If one started with variation 3 as the basic case, one might be more inclined to regard the PE as a full-blown retail outlet.

Variation 4: web site fully developed at the PE

38. In variation 4, the PE itself is assumed to have developed the web site. And having done so, it operates as in variation 3: there are maintenance and customer assistance staff at the PE.

39. The big difference from the other variations is that the PE can be assumed to own the intangible assets which it created. There will be no question of regarding it as having acquired these assets from the head office for a price which must be taken into account in computing the PE's profits. Instead, the PE should be regarded as having borne the commercial risk of developing the web site, and the PE should also be regarded as having the right to exploit the web site commercially. It does so by supplying e-commerce services to the head office. The PE's profit will be simply the arm's length charge for those services, less the PE's development and running costs.

40. Having said that, the head office should be regarded as having supplied the PE with the resources with which it developed the web site, and that would need to be taken into account in computing the PE's profits.