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

Ernst & Young[2]

Comments on the Discussion Draft on the "Attribution of Profits to a Permanent Establishment Involved in Electronic Commerce Transactions"

Overview

1. Ernst & Young submits the following comments in response to the OECD's Discussion Draft on the "Attribution of Profits to a Permanent Establishment Involved in Electronic Commerce Transactions" (the "OECD Draft"). The discussion includes both overall commentary and a paragraph-by-paragraph critique of the OECD Draft.

2. Ernst & Young commends the work of the Business Profits TAG in analysing the application of the Model Treaty Business Profits Article of the OECD Model Tax Convention ("Article 7") to the transfer pricing issues arising in attributing profits from retail e-commerce activities to a permanent establishment ("PE"). Ernst & Young supports the stated goal of the Committee on Fiscal Affairs to develop a common interpretation of Article 7 that is in accordance with the articulation of the arm's length principle found in the OECD Transfer Pricing Guidelines (the "Guidelines").[3]

Basis for Existence of Permanent Establishment

3. On December 22, 2000, the OECD adopted a change to Article 5 of the Model Tax Convention (the Treaty) Commentary on the definition of PE in the context of e-commerce, thus effectively ending the debate as to whether human intervention was required to create a PE.[4] The Committee on Fiscal Affairs

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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 . By Robert E. Ackerman, Elizabeth Danziger, Christopher Faiferlick, Lisa C. Lim, and Kenneth Wood, of Ernst & Young in the United States.

3 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (originally issued in 1995 and updated in 1999).

4 According to the Clarification on the Application of Permanent Establishment Definition in E-Commerce:

> Changes to the Commentary on the Model Tax Convention on Article 5 ("Article 5 Commentary"), issued by the OECD Committee on Fiscal Affairs, an Internet web site does not, in itself, constitute tangible property and therefore cannot be considered a "place of business" within the meaning of Article 5. In contrast, the server on which the web site is stored, and through which the web site may be accessed, is equipment having a physical location which may constitute a "fixed place of business" of the enterprise that operates the server.

(the "CFA") concluded that the mere presence of a server may be sufficient to create a PE in the server locale, *i.e.*, no human intervention is required. Proceeding under this assumption, the Business Profits TAG issued the OECD Draft, which analyses the attribution of business profits under Article 7 from cross-border e-commerce transactions under four different scenarios: 1) stand-alone server, without the presence of personnel; 2) multiple servers performing identical tasks; 3) personnel present to provide online services and maintain the server; and 4) hardware and software used in the server locale entirely developed in that locale.

The OECD Draft

Inter-Branch Dealings

4. The Working Hypothesis (WH) includes the comparability analysis described in the Guidelines for determining the profits attributable to the PE. Dealings between the PE (the server locale) and the enterprise which operates the web site are taken into account for purposes of profit attribution where the dealings are relevant to the functions performed by the PE, taking into account assets used and risks assumed. Profit is attributed in the same manner as would be the case in comparable transactions between unrelated enterprises. Dealings are recognised where they have economic substance and relate to a "real and identifiable event." Ernst & Young supports this approach, but disagrees with the OECD Draft that an "actual event" is necessary to the finding of a real and identifiable event. While evidence of a dealing actually undertaken between the PE and another part of the enterprise may establish a dealing for purposes of profit attribution, the inference of risk allocation may be appropriate in some circumstances where the conduct of the parties indicates that risk has been assumed, even though there may be no single event which alters the relationship between the PE and the enterprise which operates it. The OECD is encouraged to address this issue in more detail.

5. The OECD Draft addresses the issue of the allocation of inter-branch services at cost, stating that some countries interpret Article 7 to require an allocation of costs without mark-up. While the OECD Draft stops short of supporting a mark-up on services, it asserts that costs undertaken by the PE should not be disallowed for inappropriate reasons, such as the costs having been incurred outside the jurisdiction of the server locale. Ernst & Young believes that the allocation of services at cost is inconsistent with the WH. In the same manner in which the PE would be expected to charge a mark-up on costs for services performed for unrelated parties, so too should the PE ordinarily charge a mark-up on services provided to related parties. The OECD is encouraged to address this issue in more detail.

Functions Performed

6. Ernst & Young agrees with the statement in the OECD Draft that states, "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 PE, and to what extent."[5] However, as discussed below, we disagree with some of the conclusions drawn from this general principle.

Assets Used

5 Par. 28 of the OECD's Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions.

7. In a manner consistent with traditional transfer pricing analysis, the OECD proposes an approach that analyses the functions performed at the PE, taking into account the assets used. Ernst & Young agrees that such an analysis should be based on the facts and circumstances. We also agree that only those assets used by the PE should be used to reward the functions of the PE. Ernst & Young suggests that some clarifications be made in this regard.

8. We suggest that the functional analysis with respect to the use of assets should take into account the legal ownership of the assets. The OECD Draft explicitly rejects the incorporation of legal ownership into the analysis of asset use. Ernst & Young contends that legal ownership is relevant to the risk associated with asset use; such legal ownership impacts the return required and, therefore, a fact-specific analysis is warranted. Ernst & Young believes that a fact-specific approach is more consistent with the arm's length principle, which contemplates the attribution of profits according to the functions performed, assets used, and risks borne in each jurisdiction. For example, the software owner may choose not to charge the PE server locale for the use of the software, since such a charge would merely be included, presumably on a marked-up basis, back to the owner in conjunction with other functions provided by the PE.

9. The OECD approach takes into consideration the ownership or development of intangible assets employed in calculating the attribution of profits, but does not specifically address the relationship of ownership of intangible assets as related to risk and return. Ernst & Young suggests that the OECD consider providing more detailed guidance on how to account for the assets of all members of the enterprise related to the development, maintenance, and ownership of the server and the web site.

10. Further with respect to economic ownership of intangibles, parties that fund activities may become the economic owner of a portion of an enhanced or newly developed intangible. However, this is not always the case. For example, when a distributor incurs advertising costs to distribute a product, it does not become the owner of the enhanced trademark resulting from the advertising. The distributor will have typically earned its return from the advertising expenditures on the increased sales resulting from its advertising efforts. In that case, the advertiser would not be an economic owner of any portion of the trademark intangible. Our concern regarding intangible ownership is consistent with our suggestion that legal ownership be considered, because the two together affect which party bears the risk associated with intangibles. If legal ownership of an intangible does not reside with the PE, it should not be deemed to bear the risk that goes with such intangible. Ernst & Young suggests that the OECD distance itself from the developer-assister rules promulgated by the U.S. Treasury which discount the relevance of legal ownership, and instead, move towards a concept of legal ownership as being a relevant factor for intangible transfer pricing analysis.[6]

11. On a general basis, the assets used in the PE consist primarily of hardware and software. Ernst and Young agrees with the OECD Draft that, in general, an arm's length charge for the use of hardware is appropriate. However, it is foreseeable that hardware may be supplied without charge where any use by the service provider is exclusively for the benefit of the owner of the hardware. Further, Ernst & Young agrees that, if the PE were an independent service provider, an arm's length charge for the use of software would be appropriate. However, we question whether an "independent service provider" characterisation is proper in the context of a server locale with no personnel to maintain or enhance the assets.

12. Ernst & Young agrees with the OECD Draft that the attribution of profit to the PE in connection with software must be based on more than mere use, but rather on an inquiry into which part of the enterprise will benefit from the use of the software. This inquiry will typically lead to the attribution of profits to the developer of the software, rather than to the PE, unless the software was acquired by or

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6 See Treas. Reg. § 1.482-4(f)(3).

developed in the PE server locale. The same principle should apply with respect to other intangibles, *i.e.*, that the entity that developed the value of intangibles should be attributed the returns from these intangibles. Such an inquiry may lead to the attribution of profits to the initial developer or contributor of the intangibles or, in appropriate cases, to the PE.

13. While we agree that some circumstances may warrant a deemed transfer of software or marketing intangibles to the PE, Ernst & Young believes that such a transfer should only be deemed where unrelated parties would structure the same or similar transaction in like fashion. Generally, as between unrelated parties, a transfer of software would not occur unless the transferee (*i.e.*, the PE server locale) was in a position to maintain and enhance the software. If there were no personnel in the PE server locale, such a transfer would not occur, since the PE would not be in a position to perform the functions required to support the software. Ernst & Young submits that the same is true with respect to a deemed transfer of marketing intangibles. It is foreseeable that the owner of marketing intangibles would enter into an agreement with an unrelated service provider to supply these intangibles for the use of the service provider, where the intended use is for the exclusive benefit of the owner. The service provider would be compensated for its services and activities but there would be no deemed royalty paid to the owner of the intangibles, and the service provider would accrue no interest in the intangibles. We agree that, if the PE bore a significant share of costs of developing intangibles, maintained an ownership interest in the intangibles, and local law did not preclude ownership attributable to improvements by licensees, an allocation of profits attributable to the PE may be appropriate.

14. Finally, to the extent that the ownership of assets is attributed to the PE server locale, the OECD should address how the associated costs to develop these assets should be apportioned in order to preclude related entities from being effectively charged twice for the use of an asset.

Risks Assumed

15. The OECD Draft does not define risk and addresses only some of the types of risk associated with typical e-commerce transactions. For example, the OECD Draft attributes credit risk to the PE on the basis of functions performed, even where the server contains no personnel. Ernst & Young strongly disagrees with this analysis. The sale of a product on the Web does not occur at the site of the PE server locale. Rather the sale occurs in cyberspace and the server is merely compensated for processing the order. Instead, risk of loss should be borne by that entity which has agreed to bear the credit risk, assuming that it has sufficient resources to do so.

16. Ernst & Young also disagrees with the assertion in the OECD Draft that technological risk should be borne by the PE. The failure of the software, for example, should, in most instances, be attributable to the software developer, rather than the operator of the server. In contrast, the economic consequences from hardware failure may properly be attributed to the PE as the operator of the hardware, assuming it has agreed to undertake this risk and it has the economic wherewithal to bear such risk. Notwithstanding whether the technological risk is associated with software or hardware, the agreement between the parties should ultimately control the allocation of risk and, therefore, the related attribution of profits.

17. The OECD Draft takes the position that the PE will be considered to be acting as an independent service provider where the server locale is deemed to have (i) acquired the hardware and software required for the provision of services and (ii) assumed the associated risks. Although we agree that this characterisation may be appropriate in some circumstances, we disagree that an independent service provider would necessarily assume the risks associated with operating a web site from a computer server.

18. In the case of a stand-alone server, where risks are likely to remain with the head office, the OECD Draft suggests that, irrespective of whether there are few dealings between the head office and the PE server locale (described by the OECD Draft as the "contract service provider model"), or a number of dealings with different members of the enterprise (described by the OECD Draft as the "independent service provider model"), electronic distribution activities do not warrant the allocation of a substantial share of profits attributable to activities conducted through the server. Ernst & Young agrees with this approach, but suggests that independent service providers may also be insulated from risk-bearing activities associated with the distribution activity conducted on the server, which should impact the allocation of profits to the PE server locale. Unrelated parties enter into various transactions for the provision of software by web site owners to server operators, including the use of the software on a royalty-free basis. Further, under arm's length dealings, credit and technological risks associated with software would typically not be attributed to the server locale if it did not develop the software. The server operator may also be incapable of bearing significant loss, especially if risk events occur at the start-up stage of the server function. Risks arising from use of the hardware should be low if the home office conducted significant testing before agreeing to a service contract with the server operator. The risk analysis should be conducted on a "facts and circumstances" basis. Ernst & Young suggests that the PE will usually be more properly viewed as a type of service provider, earning routine returns for the performance of functions and the assumption of little, if any, risk.

Other Forms of E-Commerce

19. Because the assumptions on which the analysis is based are not without objection, Ernst & Young encourages the OECD to entertain further discussion before applying the principles outlined in the OECD Draft to other forms of e-commerce.

Conclusion

20. In light of the stated goal of the CFA to develop an interpretation of Article 7 that is consistent with the articulation of the arm's length principle found in the Guidelines, Ernst & Young would urge the OECD to consider further the deference to be accorded contractual terms (to the extent such terms are documented) associated with dealings between the PE and the other members of the enterprise, including the head office. So long as they have economic substance, and are consistent with the conduct of the parties, agreements between or among the parties can be the best evidence of the allocation of functions and risks, and should be respected as consistent with the arm's length method.

21. Again, Ernst and Young commends the work of the Business Profits TAG in analysing the application of Article 7 to the attribution of profits from e-commerce activities to a PE. We encourage further discussion in connection with those issues identified in the OECD Draft, as well as those issues raised by transfer pricing practitioners.

22. Below are the specific comments submitted by Ernst & Young for each paragraph in the OECD Draft.

Paragraph-by-paragraph comment on OECD proposed guidance on attributing profits from cross-border e-commerce transactions between related parties.

Foreword

23. Par. 1. Ernst & Young accepts, for arguments' sake, that a computer server constitutes a PE for purposes of providing comments to the attribution of profits arising from such activity.

24. Par. 2. Ernst & Young agrees that the allocation of business profits attributable to a PE would be determined under Article 7, par. 2, of the OECD Model Tax Convention.

25. Par. 3. Ernst & Young is concerned about the lack of consensus among the members of the Business TAG. If international trade is to flow as smoothly as possible, pragmatic taxation rules accepted by all countries must be adopted. If the lack of consensus involves the issue of whether a computer server can constitute a PE, this threshold issue should be revisited. If the issue is whether a separate enterprise approach is the best model to attribute profits, Ernst & Young contends that there is no other pragmatic approach than the arm's length approach that would apply had the PE been a separate enterprise.

26. Par. 4. This paper constitutes the comments of Ernst & Young. These comments are the comments of members of Ernst & Young and do not represent the opinions or comments of any of its clients. This paper is being submitted on September 4, 2001 because the deadline was extended from the original due date of June 30, 2001.

Executive Summary

27. Par. 5. No comment.

28. Par. 6. No comment.

29. Par. 7. No comment.

30. Par. 8. Ernst & Young generally agrees with the summary. However, Ernst & Young has specific comments about its application specifically raised later in these comments.

31. Par. 9. Ernst & Young clarifies that independent service providers may be insulated from risk bearing activities associated with the economic activity on the computer servers, and if so, an arm's length charge must be calculated accordingly. Regarding the in-house development of the server and web site, a determination of economic ownership must consider all efforts provided by related parties other than the PE, and either appropriate setoffs must be calculated, or joint ownership of the tangibles and intangibles must be determined.

32. With respect to economic ownership, parties that fund activities may be the economic owner of a portion of an enhanced or newly developed intangible. However, this is not always the case. For example, when a distributor incurs advertising costs to distribute a product, it does not become the owner of the enhanced trademark resulting from the advertising. The distributor earned its return from the advertising expenditures on the increased sales resulting from the advertising. In that case, the advertiser would not be an economic owner of the intangible.

33. Par. 10. Ernst & Young suggests clarification of the phrase "could warrant further work." For example, does this phrase mean new guidance for a different business model is forthcoming? If not, in what instances may these principles be extended? Although the OECD Draft states that these issues are currently being examined, Ernst & Young suggests concurrent issuance of these rules, in order to provide additional insight into the proposals.

34. Par. 11. No comment.

Introduction

35. Par. 12. Ernst & Young reiterates its general comments at Par. 1.

36. Par. 13. Ernst & Young agrees with the use of a separate enterprise approach of Article 7, par. 2 as used in the context of Article 9. Such an approach is essential in fostering uniform international tax administration.

37. Par. 14. No comment.

38. Par. 15. Because many of the premises and conclusions set out in the OECD Draft are not without objection, Ernst & Young discourages the application of these principles to other forms of e-commerce. For example, the business models of B2B, auctions, and web hosting, all to one extent or another, rely heavily on the creation of a network intangible. Which entity should be attributed profits from the development of such an intangible is highly complicated and is not adequately addressed in this draft.

39. Par. 16. Ernst & Young suggests that compliance issues should be considered, consistent with the policy consideration articulated in the commentary to the OECD Model Treaty that "it is desirable to clarify, standardise and confirm the fiscal situation of taxpayers who are engaged in commercial, industrial, financial or any other activities in other countries...."[7] A key element of whether proposed rules are appropriate is whether they are administrable in other tax contexts besides transfer pricing.

General Principles for the Attribution of Profit to a PE

40. Par. 17. Ernst & Young reiterates its prior comments regarding the need for consensus.

41. Par. 18. Ernst & Young is submitting separate comments for attributing profits to banking enterprises.

42. Par. 19. No comment.

43. Par. 20. No comment.

Article 7(1): Calculating Profit to be Allocated to a Permanent Establishment

44. Par. 21. Ernst & Young agrees that the OECD Model Tax Convention precludes the attribution of profits of a non-resident enterprise to activities associated with, for example, a server locale, that are not attributable to the PE.

45. Par. 22. Ernst & Young suggests that the OECD provide guidance to reduce the inconsistent application of the separate enterprise approach. In order for the WH to be properly applied, single entity analysis cannot be selectively applied to certain concepts. For example, if an independent service provider that bears no risk would always earn a routine return for the functions it performs, then it should earn this profit irrespective of the overall financial results of the single enterprise.

46. Par. 23. Ernst & Young reiterates its general comments at Par. 21. Ernst & Young resists any WH that is a departure from how profits would have been attributed to the PE had it been in fact a separate

7 OECD Model Tax Convention, commentary at Introduction, Par. 2.

enterprise. The use of the term "functionally separate entity" may suggest to some taxing authorities a standard different from separate enterprise. To avoid such confusion, the OECD should consider using only the term separate enterprise.

47. Par. 24. Ernst & Young reiterates its general comments at Par. 21. The U.N. Model Convention is used most often in treaty negotiations where an emerging country is a contracting state. The extension of source country tax jurisdiction under the U.N. Model is to foster economic development in a particular contracting state.

Article 7(2) of the OECD Model Tax Convention

48. Par. 25. Ernst & Young strongly supports the use of Paragraph 2 of Article 7 as the guiding principle in attributing profit to a PE. The use of this standard will reduce the cost of tax compliance, administration, and controversy, because economic activity in a particular jurisdiction will be taxed in the same manner irrespective of the corporate form under which a business enterprise chooses to operate.

49. Par. 26. Ernst & Young supports the full use of Article 9 principles in attributing profits under Article 7, paragraph 2. Ernst & Young agrees that the term "dealing" is useful in distinguishing interbranch activities from activities between separate enterprises. However, Ernst & Young would oppose any substantive differences in how profits would be attributed to a PE or a separate enterprise.

50. Par. 27. Ernst & Young supports this general approach.

First Step: Determining the Characteristics and Functions of the Hypothesised Distinct and Separate Enterprise

51. Par. 28. Ernst and Young agrees.

52. Par. 29. Ernst & Young disagrees that the use of assets should be taken into account without regard to legal ownership of these assets. Legal ownership is relevant to risk and should be analysed under the facts and circumstances. Parties at arm's length typically provide for how modifications to intangible property are to be treated. Frequently, the licensor continues to be the owner of derivative works of its intellectual property. The possibility that the PE would not have any property interests in modifications to intellectual property it uses should be an option under the WH.

53. As currently drafted, a tax administration could conclude that some profit must be attributed whenever a PE uses an asset provided by another member of the business enterprise; this should not always be the case. For example, an e-tailer may request that the PE use software provided by the e-tailer to run the server. The e-tailer as the owner of the software would license the software to the PE (hypothetically an independent enterprise) on a royalty free basis so that its web site could be displayed in cyberspace. At arm's length, a licensor of software would not expect to charge for the use of its software only to have it charged back on a marked up basis. Accordingly, the WH should make it explicitly clear that the use of assets by the PE may not always result in an arm's length charge.

54. Par. 30. Ernst & Young agrees that risks may be assumed by the PE based on the functions it performs. Nonetheless, Ernst & Young suggests that these risks may be contractually rearranged, and encourages the OECD to add a provision that the tax authorities should respect the terms of contracts between parties that are consistent with economic substance.

55. Par. 31. Ernst & Young supports the general conclusion.

Second Step: Determining the Profits of the Hypothesised Distinct and Separate Enterprise Based upon a Comparability Analysis

56. Par. 32. Ernst & Young supports the consistent application of the transfer pricing methods in the Guidelines to the PE as if it were a separate enterprise.

57. Par. 33. Ernst & Young supports the use of the comparability analysis of the Guidelines in determining the amount of profit that should be attributed to the PE.

58. Par. 34. Ernst & Young recognises the difficulty in deeming an interbranch dealing to have occurred. However, we are concerned that tax administrations may be given too much discretion to deem interbranch dealings which have not substantively occurred. Our concern is all the more reason to include a provision that documented inter-branch dealings, such as the allocation of risk, should be respected by the tax administrations.

59. Par. 35. Ernst & Young suggests that additional guidance be provided to illustrate the concept of a "real and identifiable event." As it stands, too much discretion is left with the tax administrations to deem whether a real and identifiable event has occurred. It bears repeating that the allocation of risk bearing activity cannot be readily discerned from a functional analysis. An internet service provider ("ISP") operating at arm's length could provide the same services to a customer, irrespective of whether it assumes the risks resulting from such activities. It does not follow that the mere performance of server related activities implies that risks from these activities should be attributed to the PE server locale. More guidance on this matter should be provided including a provision that recognises interbranch allocations of risk for transfer pricing tax purposes only.

60. Par. 36. Ernst & Young supports attributing profit from transactions based on their economic substance.

61. Par. 37. Ernst & Young supports the principles in the draft WH that no other tax consequences result from treating the PE as a hypothetical separate enterprise.

62. Par. 38. Ernst & Young contends that a cost contribution arrangement ("CCA") should not be deemed to exist, unless in fact the related parties have so structured such an arrangement. Deeming a CCA might inappropriately treat a value added function as a cost centre when in fact the function is a very important part of the business enterprise that should receive appropriate arm's length compensation. Ernst & Young is deeply concerned that this paragraph as written provides too much discretion to tax administrations with the likely result of inconsistent tax consequences arising in the form of double taxation.

Article 7(3) of the OECD Model Tax Convention

63. Par. 39. Ernst & Young contends that these are two important issues that needs further analysis and discussion. First, the allocation of some inter-branch services at cost, i.e. without a mark-up, is fundamentally at odds with the WH. Just as the PE would be expected to charge (and thus earn) a mark-up on services it provides, so too, should other related parties generally expect to receive an arm's length mark-up on the services they provide to the PE.

64. Ernst & Young suspects that, in the context of a situation where activity occurs within three separate taxing jurisdictions, one of the taxing authorities will expect profit to be earned by the entity in its jurisdiction. For example, entity Alpha in Country A provides services to branch Beta, a PE in Country B,

which in turn provides e-commerce services to entity Charlie in Country C. Many taxing authorities will require Alpha to earn a mark-up on its services.

65. Regarding the threshold issue of whether service performed outside the branch should be allocated, we agree that Article 7(3) of the Guidelines should be the working standard. We think this is particularly important in the context where the branch is deemed the owner of an asset which it did not develop. In such cases, some type of mechanism must be in place to compensate the developing entity, *e.g.*, a royalty.

Special Considerations in Attributing Profit to a Permanent Establishment in an Electronic Commerce Environment

Server Creates a Permanent Establishment

66. Par. 40. No comment.

Variation 1: Single Server

67. Par. 41. No comment.

68. Par. 42. Ernst & Young points out the difference between ordering a physical copy of the product and downloading a digitised version of the product, which will affect the functional analysis and the characterisation of the "dealing." Ernst & Young suggests that guidance be provided addressing the situation in which Starco Inc.'s only channel of distribution is online.

69. Par. 43. Ernst & Young suggests that the perspective of the customer must also be considered. In this light:

- the Starco web site is viewed in cyberspace on the customers personal computer ("PC");
- purchases are made by the customer from her PC in cyberspace;
- orders are communicated among the customer, the vendor, and the customer's bank in cyberspace; and
- digital products are received by the customer through cyberspace.

The customer usually does not know or think about the location of the server.

70. Par. 44. Ernst & Young suggests that these conditions are fundamentally the same as if the customer had purchased products from a foreign-based company. For example, customer resides in Country C, a sales agent (automated or live) is located in Country A, catalogues are mailed to the customer from a warehouse in Country B, and products are also shipped from Country B. Although the allocation of profit may vary because the costs of the factors of production vary, the fundamental analysis should ultimately be the same.

71. Par. 45. No comment.

72. Par. 46. Ernst & Young reiterates its general comments at Par. 1.

General Considerations

73. Par. 47. No comment.

First Step: Determining the Conditions of the Hypothesised Distinct and Separate Enterprise

Functions Performed

74. Par. 48. No comment.

Assets Used

75. Par. 49. No comment.

76. Par. 50. Ernst & Young generally agrees with the paragraph. Ernst & Young suggests that the promotion of a company's marketing intangibles on a web site via a server does not necessarily provide the PE with any interest in these intangibles unless it undertakes activity more significant than what is typically provided by an ISP.

77. Par. 51. Ernst & Young supports the conclusion that any profit attributable to the software - in those cases where it was not developed in the server locale - is attributable to the entity that developed the software, not the PE. Under the OECD approach, the equivalent of a charge for the use of the hardware, which is relatively minimal, would be attributed to the server locale.

Risks Assumed

78. Par. 52. No comment.

79. Par. 53. No comment.

Credit Risk

80. Par. 54. No comment.

81. Par. 55. Ernst & Young contends that credit risk is generally considered borne by the entity that explicitly accepts the risk and which is financially capable of bearing the risk. Credit risk should not be simply attributed to the place where the sale may have occurred, nor to the entity that executed the sale, whether automated or not. The sale occurred in cyberspace between the customer and Starco Inc; it did not occur at the computer server. The computer server processed the sale, a function for which it could be compensated under the WH without accepting any credit risks.

82. The sale was ultimately processed by the software which has been programmed with the criteria of when to accept or reject an order. If there is a default credit risk holder, it should be the software owner which defined the parameters for the acceptance of a customer order, not the computer server owner. In

any event, the proper analysis should consider which entity has agreed to accept the risk, assuming it has sufficient resources to bear the risk. The OECD should recommend that the branch and head office execute a contract specifically allocating risk to reduce tax controversy that may otherwise arise if such risk must be determined by the interbranch dealings.

Market Risks

83. Par. 56. Market risks also include the loss of goodwill resulting from defective products being returned by customers.

84. Par. 57. E-tailers face the risk that their digitalised products may be illegally copied or that a customer "returns" a product but keeps a copy for himself. This market risk results in lost sales to the e-tailer. This risk is unique to digital products distributors.

85. Par. 58. Ernst & Young suggests that market risk may be more than suggested in this paragraph as discussed above.

86. Par. 59. Ernst & Young contends that fraudulent use of a credit card which is authorised is a risk generally borne by the approving bank, not the e-tailer.

Technological Risks

87. Par. 60. Ernst & Young generally agrees that the activities of the computer server create technological risks. Ernst & Young disagrees that the PE should necessarily be attributed this risk. For example, successful hackers penetrate web sites through inadequacies in the software, not the hardware. Similarly, software failures should not be attributed to the operator of a computer server, if it did not develop the software. Hardware malfunctions are most likely to be the responsibility of the operator of the computer server.

88. Even if all technological risks arise from operation of the computer server, an operator at arm's length might not be willing to undertake such risk and require the web site owner to bear such risks. Accordingly, the contractual relationship of the parties should be controlling.

89. Par. 61. No comment.

Implications of the Functional Analysis

90. Par. 62. Ernst & Young generally agrees with this paragraph.

91. Par. 63. Ernst & Young generally agrees with the paragraph except the last sentence. As previously discussed, credit and technological risks associated with software should not be attributed to the PE if it did not develop the software.

92. Par. 64. Ernst & Young agrees that a low-risk service provider is the best description of the PE's functions in this example.

93. Par. 65. Ernst & Young reiterates that risks arising from the software should not be necessarily attributed to the PE. Regarding risks arising from the hardware, this risk may be low if Starco Inc. conducted extensive testing on the server before agreeing that the PE would provide it with services.

94. Par. 66. Ernst & Young contends that the PE should rarely be viewed as an independent service provider when there are no personnel at the site. The software to run the computer server will have to be frequently updated and modified. The PE cannot perform this function nor decide when it is needed.

95. Par. 67. Ernst & Young agrees that the most likely scenario is that the PE should be treated as a contract service provider which performs limited functions and assumes little, if any, risk. The risk of inadequate compensation should be minimal if arm's length comparables are used. With regard to both the independent service provider model and the contract service provider model, the profits attributed to the PE should be comparable to that earned by third-party providers of web-hosting services, *i.e.*, application service providers ("ASPs") and ISPs. Ernst & Young believes that the returns to ASPs and ISPs in the current marketplace would appear to indicate a minimal return, because these third-party providers have no ownership in the assets employed.

96. Par. 68. Ernst & Young agrees that this is consistent with the OECD Guidelines. However, Ernst & Young contends that a functional analysis based on the contractual allocation of risks between the parties will most likely support a determination that the PE is a contract service provider. Ernst & Young is concerned that in instances where a PE is treated as an independent service provider and it incurs losses at the outset because of the occurrence of risk events, that the taxing authorities in the PE will contend that the PE should have been characterised as a contract service provider, which is incapable of bearing significant loss.

Conclusions

97. Par. 69. Ernst & Young disagrees that the PE would ever be an independent service provider without some form of human intervention. Ernst & Young agrees that it is more likely that the PE will be a contract service provider earning routine returns on functions performed with the assumption of little, or no, risk.

98. Par. 70. Ernst & Young agrees with the conclusions of this paragraph and strongly suggests that this is the default for viewing computer servers without human intervention.

99. Par. 71. No comment.

Second Step: Determining the Profits of the Hypothesised Distinct and Separate Enterprise

100. Par. 72. Ernst & Young contends that the legal aspect implicitly provides for an attribution of risk which is consistent with the WH.

101. Par. 73. Ernst & Young reiterates its general comments at Par. 69. The determination that the PE is a retail outlet will depend on the facts and circumstances.

"Contract Service Provider" Model

102. Par. 74. Ernst & Young agrees with the general conclusions of the paragraph. Ernst & Young suggests that the license of software on a royalty free basis by the head office would be consistent with what parties at arm's length might arrange. The economic substance remains the same, yet it recognises that the PE uses the software, but doesn't own it.

“Independent Service Provider” Model

103. Par. 75. No comment.

104. Par. 76**.** Ernst & Young disagrees that an independent service provider would necessarily acquire the rights to software necessary to run a web site on a computer server. Unrelated parties enter into various transactions; in some instances the web site owner is responsible for creating and providing software to the computer server operator under a royalty free license, in others the computer server operator is expected to use standardised software to provide web-hosting services. Even in the latter circumstance, there is no necessary requirement that the operator of the computer server except risks associated with standardised software. The analysis must be conducted under a facts and circumstances basis and the OECD should reject a one-size-fits-all approach to classifying independent service providers.

105. Similarly, with respect to digitised products, the PE does not necessarily need to own all these assets. The independent service provider could act partly like a contract service provider with respect to the performance of some functions, the assumption of some risks, or the ownership of some assets. Again, a facts and circumstances analysis would be the proper approach.

106. Par. 77. No comment.

Software

107. Par. 78. Ernst &Young agrees that, under some circumstances, the profits attributable to the activities in the PE should be reduced - in effect - for a royalty equivalent to the home office for the right to use the software, *i.e.*, a license, if and only if this is how unrelated parties structure their transactions. This royalty would be a declining royalty if the PE undertook efforts to maintain and enhance the software to account for the value added by the PE, irrespective of whether the PE acquires a property interest in the software. Nevertheless, if unrelated parties operate under royalty free licenses, a head office and its PE should be able to structure its relationship in this manner.

108. In order for the transfer of software to have any economic effect, the independent service provider would eventually be required to maintain and enhance the software. If the independent service provider cannot perform these activities, the head office would not have any incentive to transfer software to the independent service provider under an arm’s length scenario. If the PE has no personnel, Ernst & Young believes the PE could not even notionally acquire interests in the software.

Marketing Intangibles

109. Par. 79. Ernst & Young contends that the notional sale of marketing intangibles is not required under the service provide situation. A service provider does not have to acquire interests in intangibles in order to assist the intangibles owner in exploiting these intangibles. Again, the relevant inquiry should be what unrelated parties would do in similar situations. Ernst & Young submits that unrelated parties would enter into an arrangement under which the service provider would use the intangibles under certain conditions for the exclusive benefit of the intangibles owner. The intangibles owner would compensate the service provider for its efforts in promoting the intangibles. The service provider would acquire no equitable interests in the intangibles, including any enhanced value arising from the services, and the service provider would not pay the intangibles owner any royalty resulting from its exploitation of the intangibles on behalf of the owner.

110. It is possible that an electronic retail outlet might acquire an interest in the trademark of the retailer. Ernst & Young suggests that this situation may be most likely where the retailer has already established a physical distribution network and is looking to expand its retail operations into another distribution channel (e-commerce). In this situation, if the PE undertakes significant efforts to develop the web site and the supporting software and hardware, the PE should be deemed to have rights in the electronically based marketing intangibles.

111. Par. 80. Ernst & Young contends that if the service provider does not have any ownership interest in the intangibles, it cannot be considered to have co-developed the intangibles, and hence, should not be attributed any value from the increase, if any, of value in the intangibles. In the case where the service provider has acquired a partial interest in the marketing intangibles, we agree that various factors must be considered in determining whether the server could be considered to be a part developer of the marketing intangibles, *e.g.*, whether the server locale bore any costs of development, and the amount of managerial and operational control that Starco had over the server locale with respect to further development of the intangibles. Such factors would include local law and contractual provisions of the parties. For example, the courts of many jurisdictions, including Canada and the United States, recognise that improvements made to intangibles by licensees become property of the licensor only. Again, a facts and circumstances analysis would be the best approach to adopt.

112. Par. 81. Ernst & Young suggests that the computer server is not the primary component that creates an e-commerce marketing intangible. This intangible is created through the collective perceptions of customers in the market. The success or failure of the web site is not dependent on hardware but on the design of the web site and the functionality of the software (*e.g.*, the ease to buy items on-line), as well as any pre-existing marketing intangibles (an established retailer is more likely to generate electronic server traffic in the beginning than an unestablished retailer). Much of the value should be attributed to the software owner and the entity that performs the marketing function outside of the server locale. Even if the hardware contributes to the creation of these intangibles, the software owner could insist on a contract, on arm's length terms, that it is the owner of all subsequently developed intangibles.

113. Par. 82. Ernst & Young agrees that the server locale would have no economic interest in the products it distributed, as is frequently the case with many distributors in a brick and mortar context.

Application of Article 7 in the Case of Intangible Property

114. Par. 83. Ernst & Young contends that, to the extent that such a dealing is required to be recognised, the Commentary should be modified to provide for an allocation of costs with a mark-up, if appropriate. Otherwise, the WH will not be consistently applied if such modification is not made.

115. Par. 84. Ernst & Young agrees that the result is not at arm's length. Intangibles, if transferred for arm's length consideration, should not be done at cost, but at fair market value. Ernst & Young believes that the PE will infrequently need to acquire such property.

116. Par. 85. Ernst & Young suggests that the concern described is often inherent in the valuation of intangibles and that the current Guidelines are sufficient to deal with these issues.

117. Par. 86. Ernst & Young agrees that the application of transfer pricing principles to a PE should be consistent with the application of transfer pricing principles to a subsidiary. However, Ernst & Young reiterates that the intangibles do not have to be transferred under a situation where the PE must pay for their use. Unrelated parties often provide service providers with intangibles without charge to perform a particular service for them.

118. Par. 87. Ernst & Young reiterates its general comments at Par. 86.

119. Par. 88. Ernst & Young contends that a cost contribution arrangement ("CCA") should not be deemed to exist, unless in fact, the related parties have so structured such an arrangement.

Hardware

120. Par. 89. Ernst & Young suggests consideration of the alternatives that might be available to independent parties in similar circumstances. Besides a sale, lease or license, it is possible that parties at arm's length would agree to transfer property to the service provider without charge under the premise that the property is to be used solely for the benefit of the property owner in providing specified services. This result occurs in some specialised industries where highly expensive and critical components must be provided to contract researchers in order for them to perform their services. Under such arrangements the contract researchers charge for their services and other physical assets, but not for the contributed assets. This situation should be a possibility under the WH.

121. Par. 90. Ernst & Young agrees that if the PE is an independent service provider, arm's length principles should be used to attribute profit to the PE. Ernst & Young reiterates its concern that a PE without human personnel could rarely, if ever, constitute an independent service provider because it could not undertake the activities to maintain and enhance itself over time nor could it consciously assume the risks from such activities.

122. Par. 91. Ernst & Young reiterates its prior comments about the likelihood that an independent service provider can ever be applicable and thus disagrees that the first sentence of this paragraph would always be the proper characterisation to draw. Ernst & Young further suggests that the phrase "initial provision of tangible and intangible property to the PE in order to enable the PE to provide a service to the rest of the enterprise" be clarified. The provision of such property could be structured such that the PE bears minimal risk, *i.e.*, the PE does not pay for use of the property but uses it exclusively for the benefit of the head office in providing services, particularly in circumstances where it cannot maintain or enhance the property. Thus, only the value of the services are charged out at arm's length prices.

123. On the other hand, if the PE is undertaking risks associated with the use of assets, an arm's length charge would be required for the initial transfer of the assets. In the future, the PE would be able to charge back the head office for use of these assets plus any arm's length mark-up. Ernst & Young agrees that traditional transfer pricing rules should be applied to determine the value of all dealings between the head office and the PE.

Application of Transfer Pricing Methods

"Contract Service Provider" Model

124. Par. 92. Ernst & Young agrees that a contract service provider would only charge for the services it performs.

125. Par. 93. Ernst & Young contends that CUPs exists for ISP services similar to what a PE would provide to other parts of a single entity.

"Independent Service Provider" Model

126. Par. 94. Ernst & Young agrees that if the PE acquires assets that it must pay appropriate arm's length charges. Such an arrangement should only be deemed to exist if the related parties in fact entered into an agreement providing for such an arrangement. Ernst & Young disagrees that a PE should always be deemed to have received hardware and software if that is contrary to the substantive dealings between the PE and the head office.

127. Par. 95. Ernst & Young agrees with this statement and reiterates its general comments at Par. 94.

128. Par. 96. Ernst & Young reiterates its general comments at Par. 94.

129. Par. 97. Ernst & Young contends that which entity bears indirect costs may have an effect on the profit attributable to the PE. If the PE were deemed to have incurred these expenses, it would arguably price its services to the head office to cover these expenses plus a mark-up for the risk inherent in committing itself to these resources.

130. Par. 98. Ernst & Young believes that CUPs may be available from ISPs that provide comparable services to unrelated parties. To the extent a cost plus method must be used, Ernst & Young agrees that if the PE has functionally acquired intangibles from the head office, these costs must be included in the cost basis. Of course, such charge would require a setoff for the value of the notionally transferred assets under the independent service provider model.

131. Par. 99. Ernst & Young agrees that a TNMM may be a feasible method and should not be considered a method of last resort.

132. Par. 100. No comment.

Conclusion

133. Par. 101. No comment.

134. Par. 102. No comment.

135. Par. 103. Ernst & Young generally agrees with the conclusions of this paragraph.

136. Par. 104. Ernst & Young generally agrees with the conclusions of this paragraph.

137. Par. 105. Ernst & Young agrees that the attribution of profit to country B may be minimal in comparison with the value of transactions processed through the server, and contends that this is consistent with arm's length principles.

138. Par.106. Ernst & Young contends that the general principles of Article 7, paragraph 2, provide the proper approach, *i.e.*, a hypothetical separate enterprise analysis under Article 9. Ernst & Young does not believe the Commentary to the Model Treaty should undermine the clear language of Article 7, paragraph 2. To the extent the Commentary is inconsistent with the application of the separate enterprise principles to a computer server in a foreign locale, the language should be changed or supplemented to allow for separate enterprise treatment.

139. Par. 107. Ernst & Young agrees with the paragraph as stated; however, we disagree that Article 7, paragraph 3 would preclude the deduction of such expenses. There is no language within the Model Treaty itself which limits such deductions. Deductions for acquisitions of intangibles should be allowed on the same basis as for tangible property. Accordingly, the OECD should make it clear that for the WH to be

applied consistently, if the independent service provider has acquired such property on a notional basis, then profits attributed to the PE must be based on all costs being properly allocated to the independent service provider.

140. In addition, Ernst & Young agrees that, if a PE exists that has the right to use the software and marketing intangibles, there is inherent value in such a right and that value should be reflected in comparables for the provision of services to the head office.

141. Par. 108. Ernst & Young agrees that if a cost based approach is used to value transferred assets, the PE may earn more or less income than it otherwise should. As a result, Ernst & Young supports the use of fair market value as the basis to value transferred assets to the PE.

142. Par. 109. Ernst & Young reiterates that all deductions should be allowed for transfers of any property to the PE. Ernst & Young agrees that comparables should be adjusted for the use of the relevant intangibles in the event that not all deductions are allowed.

143. Par. 110. Ernst & Young agrees that the application of transfer pricing principles to a PE should be consistent with the application of transfer pricing principles to a subsidiary. Any variations from Article 9 provisions should be strongly discouraged and rectified where at all possible.

Variation 2: Multiple Servers

144. Par. 111. No comment.

145. Par. 112. No comment.

146. Par. 113. Ernst & Young generally agrees with the benefits from multiple servers except we disagree that risk from hackers is reduced through the use of multiple servers.

147. Par. 114. Ernst & Young agrees that multiple servers minimise the risks associated with the failure of server technology in any particular location.

148. Par. 115. Subject to our comments to Variation 1, Ernst & Young agrees that the principles of Variation 1 should be extended to the multiple server context. The WH does not suggest how the attribution of profits should be adjusted for the multiple server scenario. For example, if each server has one-fourth of the capacity in Variation 1, should the profit attributed to each server be twenty-five percent of the single server profit? Under a contract service provider model, since risk is not being assumed, the benefits of risk reduction with multiple servers should be attributed to the head office.

149. Ernst & Young suggests that an independent service provider model is not applicable for all four servers. All four servers cannot be independent service providers if the servers are working together to route traffic efficiently. Possibly, one server could be an independent service provider and it distributes internet service responsibilities to the remaining three servers.

150. Par. 116. Ernst & Young contends that if the home office splits the functions of one “high-performance” server between four different jurisdictions, this illustrates the high degree of mobility of the functions and should preclude the treatment of all the server locales as four separate PEs.

Server is Part of an Existing PE

151. Par. 117. No comment.

Variation 3: Technical Support Staff in PE

152. Par. 118. No comment.

153. Par. 119. No comment.

General Considerations

Functional Analysis and Conditions of the Hypothesised Distinct and Separate Enterprise

154. Par. 120. Ernst & Young agrees that moving people from the head office to the PE changes the location of functions performed under Variation 1.

155. Par. 121. Ernst & Young disagrees that the conclusions of this paragraph must follow in every situation. The PE could still be treated as a contract service provider even though there are humans providing support for the computer server in the PE. The head office could still provide software on a royalty-free basis to the PE for the sole purpose of providing internet services to the head office. The PE's need to own assets is not necessarily affected by whether human technicians work at the PE.

156. Par. 122. Ernst & Young contends that the services provided by the personnel in the PE do not give rise to the co-development of marketing intangibles under the contract service provider or independent service provider models. Under either model, the PE is providing service at the behest of the head office. It has no ownership interest in any developed intangibles. To the extent that this is not clear, the parties could enter a contractual arrangement that provides that all developed and enhanced intangibles arising from service efforts of the PE inure to the benefit of the head office. Moreover, if the services are charged back to the head office, the PE should not be deemed to acquire an interest in any e-commerce intangibles.

157. Par. 123. No comment.

158. Par. 124. Ernst & Young agrees that the retail outlet model is inappropriate to variation 3.

159. Par. 125. Ernst & Young agrees that Starco bears the market risk associated with poor service.

160. Par. 126. Ernst & Young agrees that the most appropriate model to use is the contract service provider model. The independent service provider is a possibility since there are humans available to assume risks, modify assets, and make other relevant business decisions.

Application of Transfer Pricing Methods

161. Par. 127. Ernst & Young generally agrees with this paragraph. Ernst & Young requests clarification of whether stock options provided to the employees should be included in the cost base.

162. Par. 128. Ernst & Young generally agrees with the paragraph, if in fact the independent service provider model is truly applicable.

Variation 4: Web Site Fully Developed in PE

163. Par. 129. No comment.

General Considerations

164. Par. 130. Ernst & Young agrees that the place where the development activities occurred has changed.

165. Par. 131. Ernst & Young agrees that this example is unrealistic. Ernst & Young disagrees that the only conclusion in hypothetical terms is that the PE is the owner of the developed intangibles. Parties at arm's length frequently enter into software development arrangements where Party A will fund the development costs of Party B to create a software package for Party A. Party A assumes all risks of development, except fraud and malfeasance, and it also obtains all rights in the software. A head office and PE could contract for the development of software under similar conditions.

Functional Analysis and Conditions of the Hypothesised Distinct and Separate Enterprise

166. Par. 132. Ernst & Young agrees that this paragraph is one possible scenario. However, we disagree that it is the only one, as illustrated in par. 131 above.

167. Par. 133. Ernst & Young agrees that this paragraph is one possible scenario. However, we disagree that it is the only one, as illustrated in par. 131 above.

168. Par. 134. Ernst & Young agrees that this paragraph is one possible scenario. However, we disagree that it is the only one, as illustrated in par. 131 above.

169. Par. 135. Ernst & Young agrees that this paragraph is one possible scenario. However, we disagree that it is the only one, as illustrated in par. 131 above.

170. Par. 136. Ernst & Young agrees that this is another possible scenario.

Application of Transfer Pricing Methods

171. Par. 137. Ernst & Young disagrees that the PE would necessarily earn a higher profit than the ISP under this scenario. If economic conditions were poor, one would expect at arm's length that a risk bearing ISP would earn less than an ISP that is acting as a type of service provider.

172. Par. 138. No comment.

Conclusions

173. Par. 139. Because many of the premises and conclusions set out in the OECD Draft are not without objection, the application of these principles to other areas may be controversial. Ernst & Young suggests that the extension of these principles to other e-commerce models is inappropriate at this time.

174. Par. 140. Ernst & Young agrees that, under the facts of variations 1 and 2 of the example, the bulk of Starco's profits associated with the exploitation of marketing intangibles, and the use of the hardware and software owned by the head office, should be attributable to the head office rather than to the server locale.

175. With respect to variation 3 of the example, Ernst & Young agrees that profit associated with the PE would be largely attributed to the head office, but that the PE would earn additional profit for additional functions performed by the technicians.

176. With respect to variation 4, Ernst & Young reiterates that this model is not the only plausible alternative; a facts and circumstances test should be used to determine what ownership interests the PE and head office have agreed to fund.

177. Par. 141. No additional comment.

178. Par. 142. No comment.

179. Par. 143. No additional comment.

180. Par. 144. No comment.