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

Electronic Commerce Tax Study Group (ECTSG)

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

1. This [note] provides the comments of the Electronic Commerce Tax Study Group (ECTSG)[2] on the February 2001 Draft for Public Comment captioned "Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions" (the "TAG Draft"). The TAG Draft was prepared by the OECD Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits (the "Business Profits TAG").

2. The TAG Draft was published contemporaneously with a related but separate paper captioned "Discussion Draft on the Attribution of Profits to Permanent Establishment" which was prepared by the Committee on Fiscal Affairs (the "CFA Draft"). The CFA Draft sets out a general framework for analysis of questions related to the attribution of income to a permanent establishment ("PE"). The CFA Draft is not limited to questions arising in the e-commerce context, but is instead intended to have broad application to all businesses. The TAG Draft seeks to build on the foundation for analysis set out in the CFA Draft and to apply the CFA developed framework in the specific context of server-based PE's engaged in electronic retailing.

3. This letter provides comments on the CFA Draft only to the extent the CFA Draft bears on electronic commerce related issues. It does not seek to provide comprehensive comments on the approach taken in the CFA Draft.

Characterisation of a Server Based PE as a Contract Service Provider

4. The CFA Draft suggests, and the TAG Draft concurs, that the first step in analysing the amount of income attributable to a PE is to hypothesise the PE as a separate entity and to identify the activities,

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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. 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 AOL Time Warner Inc., Cisco Systems, Inc., Electronic Data Systems Corporation, Hewlett-Packard Company, International Business Machines Corporation, MasterCard International, Microsoft Corporation, Sun Microsystems, Inc., The Thomson Corporation, The Walt Disney Company, and VeriSign, Inc. PricewaterhouseCoopers LLP serves as advisor to the ECTSG.

risks and assets of the PE as if it were a separate enterprise.[3] This exercise of attributing activities, risks and assets to the PE is to be based on a careful functional analysis of the activities of the PE and its home office.[4] The TAG Draft considers in significant detail how such a functional analysis might be utilised to characterise the activities of a server-based PE. Four related fact patterns are considered.

5. The base case presented for analysis in the TAG Draft is a PE comprised exclusively of a server located in the source country without any supporting personnel being located in that source country. The server is posited to have the capacity to both process orders for products and download digital products to customers' computers. All of the software operating on the server is developed by employees of the home office or acquired by the home office from unrelated persons. Products sold over the web site are acquired by home office personnel from unrelated persons. The TAG Draft assumes, on the basis of the interpretation of Article 5 of the Model Treaty recently published by the CFA, that the server, standing alone, constitutes a PE in the source country.[5]

6. The conclusion of the TAG Draft with regard to the base case is that the described server-based PE should be characterised as a "contract service provider." Accordingly, a low level of profit, likely determined under a transfer pricing methodology that provides the PE with a modest mark-up on its cost of providing automated functions, should be attributed to the PE.[6] The TAG Draft further concludes that because the PE has no personnel, the mere fact that the server-PE has the capacity to process orders and digitally deliver products will not cause the PE to be characterised as a retail outlet or to have a typical retailer's return attributed to it.[7]

7. We agree with these fundamental conclusions of the TAG Draft. A server-based PE without any supporting personnel should be treated as earning only a modest mark-up on its costs.[8] It would be inappropriate to treat a server-PE, with no associated personnel, virtually no assets in the source country other than the server itself, and no capability to consciously assume business risk, as a full function retailer or distributor for purposes of allocating an appropriate arm's length return to the PE. We strongly urge that these basic conclusions of the TAG Draft continue to be reflected in the further work of the TAG and in any future OECD pronouncements on this topic.

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[3] CFA Draft at paragraph 44.

[4] CFA Draft at paragraph 45.

[5] TAG Draft at paragraphs 40 - 46. We note that reasonable persons might disagree with the assumption of the TAG that the activities described constitute a PE under the standards recently articulated by the CFA. Some OECD countries have indicated that they would be unlikely to assert the existence of a PE based on activities and functions similar to those described in the TAG Draft.

[6] TAG Draft at paragraph 105.

[7] TAG Draft at paragraph 70.

[8] The three remaining examples discussed in the TAG Draft consider other functions. In the second example, the company has additional server PE's in other countries. In the third example it has support personnel in the source country in addition to the server. The TAG concludes, and we concur, that neither of these factual variations results in a change in the basic outcome or fundamental considerations. In the fourth example, the PE has employees that perform development functions. In the TAG's opinion, this fact entitles the PE to a return on intangible property. We discuss the issue of intangible property ownership, including the issues raised in the fourth example, in greater detail below.

Issues Relating to Intangible Property

8. The TAG Draft addresses a number of issues related to intangible property. We believe that the treatment of intangible property is a critical element in the analysis of how income should be attributed between a server-based PE and its home office. We are concerned that certain of the comments on intangible property related issues contained in the TAG Draft and in the CFA Draft do not adequately reflect the economic substance of common business operations.

The Developer of Intangible Property Should Earn the Return Related to the Intangible Property

9. The CFA Draft contains a lengthy discussion of the allocation of intangible property rights between a PE and its home office for income attribution purposes.[9] With respect to internally developed intangibles, we read that discussion as supporting the proposition that a PE should be deemed to earn intangible property related income only if two prerequisites are satisfied. First, in the absence of the special circumstance of a cost contribution arrangement, intangible property related income should be attributed to a PE only if it is determined through a careful functional analysis that the PE performed the function of creating or developing the intangible.[10] Second, intangible property related income should be attributed to a PE only if the PE in fact bears the economic risk of intangible property development. These fundamental principles appear to be endorsed by some of the language in the CFA Draft and the TAG Draft. However, these basic principles should be stated much more clearly in those drafts. These principles are fully consistent with the OECD Transfer Pricing Guidelines.

10. Unfortunately, both the TAG Draft and the CFA Draft also contain certain comments that appear to be inconsistent with the general principles described above. We are particularly concerned with four aspects of the discussion: (i) the inadequate discussion of the importance of development risk in attributing intangible property related income, (ii) the references in the CFA Draft to the actual or possible "use" of intangibles as being relevant to the identification of the developer of intangibles; (iii) the specific discussion in both the TAG Draft and the CFA Draft relating to marketing intangibles; and (iv) references in both the TAG Draft and the CFA Draft to the possibility of identifying an arrangement analogous to a cost contribution agreement between a PE and its head office on the basis of functional analysis alone. Each of these points is discussed below.

Performance of Development Functions By a PE

11. As between a PE and its home office, we believe the PE should only be treated as earning a return on intangible property if (i) its personnel develop, or assist in developing, the intangible in question, and (ii) the PE, as a matter of substance, bears the economic risk associated with intangible property development. [11] The first of these requirements implies that, as a general rule, no income attributable to intangible property should be allocated to a PE unless personnel of the PE actively participate in the development or other acquisition of the intangible property. The CFA Draft and the TAG Draft both

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9 CFA Draft at paragraphs 109 - 121.

10 CFA Draft at paragraph 115. See also TAG Draft at paragraph 51 stating: "The reward associated with an intangible property does not necessarily accrue to the part of the enterprise making use of it, but rather to the part of the enterprise that developed or otherwise contributed the intangible.

11 A potential exception to this rule would exist if the PE, while not itself performing development activities, clearly agrees in advance to bear part or all of the cost and risk associated with the development activity through a cost contribution arrangement. This issue is directly addressed below.

assume as their point of departure that income attribution should be based on functional analysis. The essential function giving rise to intangible property related income is intangible property development. Absent a documented cost contribution agreement of the type described below, if an enterprise engages in no development activity in a jurisdiction where its only tax presence is premised on the existence of servers or other computer and telecommunications equipment, no intangible property related income should be allocated to that PE.

12. The TAG Draft faithfully applies this principle in analysing its first hypothetical fact pattern.

13. Under that fact pattern, the PE has no personnel. It therefore has no capacity to develop the software and other intangible property related to the function of the web site, or any of the product intangibles associated with the products sold through the web site. Under an attribution system based on functional analysis, in the absence of personnel with capacity to develop intangible property, the PE cannot be entitled to any return on the intangible property of the enterprise. The conclusions reached in the TAG Draft's analysis of the second and third fact patterns are also fully consistent with this principle. The TAG Draft is correct in supporting the conclusion that a PE which performs no development functions should not, in the absence of a clearly documented cost contribution arrangement, be treated as the economic owner of intangibles. We agree with its conclusions in this regard. We strongly urge the TAG to maintain and further clarify this position in its future work.

The Importance of Risk in the Attribution of Intangible Property Related Income

14. While PE participation in the function of intangible development should be a necessary condition for attributing intangible property related income to a PE, it is not a sufficient condition. The Guidelines make it clear that a separate entity engaging in intangible development activities may, in dealings between unrelated parties, either perform that function on its own behalf or as a service provider for others.[12] Where the entity engaging in intangible development activities is acting as a service provider to the true risk bearing developer, it is entitled only to a service fee. Where it acts on its own behalf, it is entitled to retain intangible property related income, and may have attributed to it the net losses that result from unsuccessful intangible development undertakings.

15. When a PE engages, through its own personnel, in research or other intangible development activity, it too may be acting either as a service provider or as a principal. The economic and income attribution consequences of selecting one or the other of these characterisations may be significant. It is, therefore, essential that workable income attribution rules contain mechanisms for making this distinction. We are not convinced that the CFA Draft and TAG Draft have given sufficient consideration to this issue.

16. In dealings between separate entities, whether related or unrelated, risk is often assigned through contracts. In dealings between a home office and a PE, reliance on contractual undertakings is more difficult, since a single entity cannot generally enter into binding contracts with itself.[13] Under the working hypothesis proposed in the CFA draft, it is important to look to economic substance as reflected in functional activities. The U.S. transfer pricing regulations contain appropriate suggestions of the factors one should look to in order to determine if a particular entity can, in substance, be said to bear the risk associated with a particular activity.[14] They suggest that an entity may not be said to substantively bear an

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12 Guidelines at paragraph 6.3.

13 We discuss in greater detail, below, the role that contemporaneous internal documents might play in allocating intangible related income and costs between a home office and a PE.

14 Treas. Reg. section 1.482-1(d)(3)(iii)(B).

economic risk in a situation where that entity lacks either (i) the economic resources to sustain any loss that may be associated with that risk, or (ii) the management capacity to evaluate, intelligently assume, and monitor the risk in question. Our experience is that, as a practical matter, other OECD countries follow similar principles in determining whether entities in fact assume economic risks in connection with related party dealings.

17. We believe that similar principles should be clearly stated and applied in determining whether a PE has substantively assumed real economic risk in connection with the development of intangible property. Accordingly, if a PE lacks a source of income that is sufficient to allow it to sustain the losses that may be associated with intangible property development, it should not be treated as if it were acting as a principal in connection with such development activity. Similarly, if a PE does not have personnel who are capable of and in a position to evaluate risks with respect to intangible development activity, and to make a determination on behalf of the enterprise to undertake those risks, it should not be treated as if it were acting in the role of principal in connection with development activity. Where these substantive indicators of the ability to assume and bear risk are not found in a PE, the PE should be characterised as a service provider with respect to any development function that it performs.

18. The analysis of the fourth fact pattern in the TAG Draft does not give sufficient consideration to the issue of development risk. In discussing that fact pattern, the TAG Draft seems to suggest that the mere fact that personnel of the PE perform certain development activities provides a sufficient basis to conclude that the PE is the economic owner of the intangibles. No facts are presented that would permit an evaluation of whether the PE had the financial or managerial capacity to assume that risk as a substantive matter. Without facts sufficient to demonstrate that the PE was substantively assuming the development risk, it is inappropriate to conclude that the PE is acting as a principal in the development activity, rather than a service provider. Accordingly, the conclusion that the PE is the economic owner of the intangibles in the fourth example is not supported by the facts or analysis set out in the TAG Draft. We recommend that the fourth example in the TAG Draft be revised to provide appropriate consideration of the importance of development risk in determining how income related to intangible property should be attributed between a PE and its home office.

19. A failure to revise the discussion and examples in the TAG Draft, and the discussion in the CFA Draft, to give appropriate weight to the issue of development risk will lead to confusion and a serious potential of double taxation. Those countries, like the United States, which have adopted transfer pricing rules that consider the substantive allocation of risk cannot be expected to easily concede that a PE that engages in modest development activity, but that has neither the financial or management wherewithal to assume development risk, should have full economic ownership of internally developed intangibles. To avoid significant dispute and confusion on this point, both the CFA Draft and the TAG Draft should be revised to provide greater guidance regarding the importance of intangible development risk in attributing economic ownership of intangible property to a PE.

Actual or Potential Use of Intangibles Should Not Be a Factor in Determining Whether a PE Is the Developer of Intangibles

20. Paragraph 114 of the CFA Draft purports to list factors to be considered in determining whether a PE can be said to have created intangible property. While certain of the listed factors are clearly relevant to such a determination (e.g. whether the PE directed the research and development that led to the creation of the intangibles in question, whether the PE has recorded R&D expense on its separate books for which it has not been paid a service fee or otherwise compensated), other factors listed by the CFA are not valid indicators of participation in the development of intangible property. Among these inappropriate factors are whether the PE was in business at the time the intangibles were developed and whether it has an

expectation or need to use the intangibles in its business. The confusion of the actual or potential use of intangibles by a PE with the function of creating intangible property is a fundamental flaw in the discussion of the intangibles issue contained in the CFA Draft.

21. The server-PE examples in the TAG Draft provide a basis for clarifying the existing confusion. In the TAG Draft's first example, the home office develops the software and web site design that enable the server PE to function. That development appears to take place in advance of the time when the server is placed into service and the PE comes into existence. The TAG draft appropriately concludes that the home office is the economic owner of the intangibles and entitled to the entire return on the intangible property. The PE is entitled to no intangible property related income.

22. In the fourth fact pattern, the development of intangible property takes place at a time when the PE is in existence. In the example, the PE undertakes and bears the cost of the development activity. As noted above, this example requires further elaboration regarding the issue of risk. If the facts were such that the PE could be said to have assumed the intangible development risk, however, it could be appropriate for the PE in the fourth example to share in any intangible related profit resulting from its own development activity.

23. There is, however, no example occupying the middle ground. That is, there is no analysis of the situation where the development activity occurs while the PE is in existence but where the development activity is undertaken by employees of the home office without participation from the PE. This would, in fact, be a very common fact pattern. If such an example were included, the issue presented by the CFA Draft would be clearly posed.

24. Assume, for example, that the facts in the first factual variation presented in the TAG Draft were modified slightly so that the server-PE was in existence and operational at the time development activity relating to upgraded operating software and web page design was undertaken by the home office. The PE still would have no personnel capable of performing development activity, no personnel capable of participating in a decision as to whether the risk implicit in investing in such development activity were warranted, and no personnel capable of agreeing to bear any of the costs of such development. Personnel of the home office would be responsible for all such functions. There would, however, likely be a clear contemplation that if the development activity were successful, the upgraded software would be utilised in connection with the operation of the server-PE.

25. To the extent the CFA Draft intends to suggest that under these circumstances, the PE would be deemed to be wholly or partially responsible for the development of the software, and entitled to an intangible property related return from the future use of that software, its position is clearly erroneous. In arm's length dealings, a software developer does not share the return on its development activities with any customer who might seek to utilise upgraded versions of its products. If the PE and home office were in fact separate entities and the home office undertook and paid for all intangible development activities, the Guidelines would require the home office to be attributed the profit from the intangible development. In the typical contract service provider arrangement, the home office may require the PE to use the newly-created intangible in its provision of services to the home office. This requirement does not involve the transfer of the intangible to the PE and no royalty arrangement is required – the home office is compensated by directly receiving the unrelated party revenue generated (in whole or in part) by the PE's use of the intangible to provide services to the home office. In the unusual event that home office actually transferred the newly-created intangible to the PE for use by the PE in activities other than providing services for the home office, then the PE (if it were in fact a separate entity) would be required to pay a royalty or other arm's length compensation to the developer in order to obtain access to the newly

developed and upgraded intangible.[15] The effect of such a payment would be to return to the developer the economic benefits associated with the PE's use of the intangibles in activities other than providing services to the home office. The economic result should be no different in the context of a PE that does not participate in, pay for, or assume risk with respect to the development of intangible property.

26. The fundamental principle must be that the "entity" which develops intangible property (assuming the risks, bearing the costs, and performing the functions related to such development) should enjoy the full economic return on those development functions. The mere fact that the PE is in existence at the time of the development, and may ultimately utilise any developed intangibles, should not cause the PE to be treated as a co-developer of the intangibles or give rise to any attribution of intangible related income to the PE.

27. We respectfully recommend that an example clearly delineating this principle be included in any final report prepared by the Business Profits TAG and that the principle be clearly stated in any future work on this topic by the CFA.

Issues Related to Marketing Intangibles

28. As noted above, the conclusions in the TAG Draft regarding the attribution to a PE of income related to intangible property are generally consistent with the fundamental proposition that the developer of the intangible should be entitled to the economic return from the intangible. However, there is some ambiguity in the TAG Draft as to how this proposition should be applied in the context of marketing intangibles. This ambiguity exists with respect to traditional marketing intangibles like trademarks and trade names, but is particularly apparent in connection with the discussion of so-called "e-commerce marketing intangibles."

29. The TAG Draft describes an e-commerce marketing intangible as an intangible property right related to the nature of the web site. Issues such as whether the web site is laid out clearly, is fun to use, operates efficiently to take and process orders, and has attractive content are described as comprising this e-commerce marketing intangible.[16] The TAG Draft analysis suggests that there may be reason to conclude that some or all of the value of this intangible should be attributed to the PE, even in the first fact pattern where the PE has no personnel, utilises web site designs and other software developed and economically owned by the home office, and performs no functions other than the automated communications functions performed by the server itself.[17] The only apparent rationale for such a possible outcome is that these intangibles are related to "the operation of the web site."

30. There is no economic or legal support for the implied suggestion that the PE in the TAG Draft's first fact pattern may be entitled to a return on marketing intangibles, including the so-called e-commerce marketing intangible. The PE in that example, lacking as it does personnel or assets beyond the mere server and related telecommunications equipment, has no ability to affect whether the web-site operating on the server is a good or valuable site or a detriment to the business. Nor does the PE have any ability to decide to invest in its web site or any ability to evaluate and assume risks associated with such an investment. If the web site itself has value by virtue of its design and functionality, that value is created by the people who develop the web site and by those who make the decision and bear the risk of funding the investment required for such development.

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15 Guidelines at paragraph 6.13, *et seq.*

16 TAG Draft at paragraph 50.

17 TAG Draft at paragraphs 103, 140.

31. In the first fact pattern in the TAG Draft there can be no question that these functions were all performed by home office personnel, and that the home office, rather than the PE, therefore created any value attributable to the function of the web site. The fact that the web-site operates on a server of the PE in the source country does not mean that the PE is creating intangible value. The home office, and not the PE, should therefore be entitled to the entire return on these marketing intangibles.

32. We are concerned that the comments in the TAG Draft regarding marketing intangibles reflect the same confusion between development and use of intangible property as is described in the preceding section. For example, outside the e-commerce context it is generally conceded that a distributor of trademarked products produced by the trademark owner ordinarily has no claim to a return on the trademark and other marketing intangibles.[18] Such a distributor "uses" the trademark in its distribution activities. It is compensated for its distribution activities, but does not become a co-owner of the trademark by virtue of performing those distribution functions. The distributor is not the developer or owner of the trademark or other marketing intangibles. Accordingly, when a determination is made under transfer pricing rules of the appropriate arm's length return derived by the distributor from its distribution activities, it is generally accepted that comparison is properly made to the resale price margins or other financial ratios of independent distributors that do not market products under their own proprietary brand names. In that manner, an arm's length return to the distribution function, as distinguished from the trademark owner's return on its trademark ownership rights, can be isolated and identified.

33. The use made by the PE of marketing intangibles in the first example in the TAG Draft is very analogous to the use made of a producer's marketing intangibles by a typical distributor. The trademark, web design and other marketing intangibles in the first example are displayed to potential customers through the PE's server. In one sense, therefore, the PE "uses" the marketing intangibles. But, the PE is not the developer of the marketing intangibles. If the functions of the PE were outsourced to an independent service provider, the enterprise would pay that independent service provider the same amount for its functions, whether or not the enterprise had valuable marketing intangibles, including e-commerce marketing intangibles. The fact the marketing intangible exists does not allow the PE to charge more for its limited service functions, or otherwise increase the amount of income attributed to the PE. Just like the typical controlled distributor, therefore, the PE should earn no return related to marketing intangibles. Its return, as the TAG Draft concludes, should be limited to a payment for the limited automated communication functions it actually performs.

34. In future revisions of the TAG Draft, we recommend that the distinction between the developer of intangible property and the user of intangible property be more clearly and consistently delineated. The TAG Draft should clearly articulate the position that the developer of intangible property, including specifically the developer of traditional marketing intangibles and any e-commerce marketing intangible, should be entitled to the full return on those intangibles. A PE should not have intangible property related profit attributed to it unless it actually performs the function of developing the intangibles and assumes the economic risk with respect to such development.

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18 Even if one gives credit to the notorious "cheese examples" in the U.S. transfer pricing regulations and the similar comments contained in paragraph 6.38 of the Guidelines, the conditions for attributing marketing intangible value to a PE are most assuredly not present in the first example in the TAG Draft. Implicit in such pronouncements is the assumption that the distributor who gains economic ownership of intangible value through "use" as opposed to development has a long term, exclusive right to use the relevant marketing intangible. That condition~~s~~ is decidedly not present in the TAG Draft example, nor could that condition conceivably be present in the context of a server based PE. Moreover, the proper characterization of the PE as a service provider, compensated on a cost plus basis, is completely at odds with the notion of long term risk taking that underlies even those limited suggestions that do exist in transfer pricing rules that economic rights to marketing intangibles can be developed solely by a distributor's use of the intangible over time.

Implied Existence of a Cost Contribution Agreement

35. The CFA Draft suggests at a number of points that it may be possible to infer from the functions and activities of a PE the existence of a cost contribution agreement with respect to intangible property.[19] Such a possibility is also raised in the TAG Draft.[20] The TAG Draft also goes further, suggesting that it may be appropriate to infer the existence of a cost contribution agreement in any situation where (i) the PE is in existence when the intangible in question is developed, and (ii) there is an intention to have the PE use the intangible when and if developed.

36. The ECTSG is very concerned about the implications of the various comments in the CFA Draft and the TAG Draft regarding the existence of cost contribution agreements. We do not believe that the existence of a cost contribution agreement can or should be inferred in the absence of clear evidence suggesting an intention on the part of the taxpayer to have the home office and the PE share development costs and activities. We strongly disagree with the proposition that a cost contribution agreement can or should be inferred, and a PE be treated as developing interests in intangible property over time, in any situation where a PE is in existence when the relevant development activities are undertaken. In the absence of facts indicating an actual sharing of development functions, risks, and costs, including specifically a clear statement of taxpayer intention to have the PE share the economic and financial risks of such development, there can be no clear basis on which to infer the existence of a cost contribution arrangement.

37. The rules in many countries relating to cost contribution arrangements require a clear, contemporaneous expression of taxpayer intent to establish such an arrangement. In the United States, for example, a written cost sharing agreement must be in place as of the commencement of the development work that is jointly undertaken.[21] These rules exist because it is very difficult or impossible, after the fact, to objectively determine whether the user of an intangible actually bore some of the risk with regard to its development. There may be little or no objective functional difference between an entity which develops intangibles on its own account, with a view to licensing such intangibles to potential related users, and an entity which performs the same development activity under a cost contribution arrangement, intending to share the fruits of the development activity with other participants on a royalty free basis. This is especially true if a PE does not maintain separate books of account. The economic difference between the two arrangements, viewed on an *ex post facto* basis, may nevertheless be profound.

38. After the fact, either a taxpayer or a revenue authority may have a strong vested interest in which alternative characterisation is accorded either a successful or unsuccessful research and development effort. Deductions allocated to a PE under a cost contribution arrangement may either be significantly larger or significantly smaller than the actual return from a particular development effort. Permitting countries to either assert or fail to assert, on an *ex post facto* basis, that the functions of a home office and its PE either are or are not consistent with the existence of a cost contribution arrangement, merely because a PE existed at the time development activity was undertaken, opens the door to a tremendous potential for double taxation.

39. Both the TAG Draft and the CFA Draft are critical of the existing commentary language on intangible ownership. It is asserted that the existing language of paragraph 17.4 of the Model Treaty Commentary, which effectively mandates a sharing of the costs and benefits of intangible development

[19] CFA Draft at paragraphs 113, 115, 120.

[20] TAG Draft at paragraph 88.

[21] See, e.g., U.S. Treas. Reg. section 1.482-7(b)(4). See also Guidelines at paragraph 8.40 regarding the documentation of cost contribution arrangements.

undertakings between a home office and a PE, is inconsistent with the arm's length principle.[22] While we share many of the expressed concerns with the language in the existing Model Treaty Commentary, it would be far worse to allow either revenue authorities or taxpayers, after the fact, to assert the existence or non-existence of a cost contribution arrangement merely by virtue of the possibility that an existing PE might use the developed intangible in its operations.

40. Instead of such an open ended approach, we believe that the TAG Draft and the CFA Draft should make clear that a cost contribution arrangement will be deemed to exist between a PE and its home office only where there is a clearly articulated intention on the part of the taxpayer that such an arrangement exist. This rule would be consistent with practice under Article 9. The requisite taxpayer intention would need to include either the actual recording of development costs on the books of the PE or, as discussed in greater detail below, contemporaneous written documents suggesting an intention to share costs between a home office and a PE.

41. Absent such unambiguous expressions of intent, the developer of intangible property should be entitled to the full return from the intangible property it develops, and a PE should be prevented from claiming deductions for development costs incurred by the home office. The attribution of economic intangible ownership to a PE premised on the inferred existence of a cost contribution arrangement should not be permitted. In particular, it must be made clear that the existence of a cost contribution agreement may not be inferred from the mere fact that a PE is in existence when intangibles are developed and may be in a position to use the intangibles.

Reliance on Written Expressions of Intent

42. One issue likely to arise repeatedly in attributing income between a home office and a PE is the weight to be given to contemporaneous written expressions of the taxpayer's intent. In dealings between related entities, written agreements, binding on the parties, are considered to be relevant and probative. Indeed, in many countries such agreements are thought to be essential elements of required transfer pricing documentation. Obviously, such an agreement can be disregarded by tax authorities if the substance of the dealings between related parties is not in accord with their written agreement. However, in situations where a binding agreement is contemporaneously executed and where the course of dealings between the parties is consistent with that agreement, the agreement will generally be respected as a valid expression of the intent of the parties.

43. In connection with dealings between a home office and a PE, the question of how much deference to give written expressions of taxpayer intent becomes more difficult. In such a situation, an agreement between a home office and its PE is not viewed as a binding contract since it is generally not permissible for an entity to contract with itself. However, particularly in connection with dealings related to intangible property, situations are certain to arise where the same set of objective functional activities might be interpreted in more than one way. In such circumstances, written, contemporaneous expressions of taxpayer intent should be given full faith and credit by the tax authorities.

44. For example, a company may employ software developers in more than one country who jointly work on projects. Absent a clear expression of taxpayer intent, it may be difficult or impossible to determine whether the software developer resident in a Country A PE is providing a service to the home office in Country B for which the PE should be remunerated, or whether the software developer is instead operating under some form of cost contribution agreement with the home office, which would result in the PE obtaining economic rights in any intangible property developed through the development activities.

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[22] CFA Draft at paragraphs 111 - 112; TAG Draft at paragraph 83 - 87.

While we have noted that development risk must be evaluated in such a situation, an evaluation of the capacity to bear such risk may present difficult factual issues as a practical matter.

45. In such situations, we believe that tax authorities should respect the provisions of internal memoranda or other documents and financial statements which contemporaneously spell out the taxpayer's intention with respect to an arrangement. It should be possible for a home office to hire employees of its PEs to perform intangible development activities on its behalf on a fee for services basis. Such an arrangement, if properly documented, should not give rise to an assertion that the PE providing the service must be granted ownership rights in the intangible property developed.

46. We urge the TAG and the CFA to adopt language in future drafts of their work indicating clearly that contemporaneous written expressions of intent will be respected, at least in situations where the behaviour of the parties is consistent with those expressions of intent. Giving credence to such contemporaneous written expressions of intent, even where they do not constitute binding legal agreements, will aid the cause of certainty in addressing the attribution of intangible related income.

Conclusions Regarding Intangible Property

47. The fundamental conclusions reflected in the first three examples contained in the TAG Draft regarding the attribution of intangible property and income related to such property are correct. Some of the language of both the TAG Draft and the CFA Draft, however, is inconsistent with those fundamental conclusions and the basic principles on which they are based. In particular, it is important that the principle be clearly articulated that the developer and economic owner of an intangible property right be attributed the income or loss associated with the development and use of that intangible. In determining whether a PE is the developer and economic owner of particular intangibles, due regard must be given to both the performance of development functions and to the financial and managerial capacity of the PE to assume the risks of intangible development. A PE should not have intangible related income attributed to it merely because it is in existence at the time the intangible is developed and may make use of the intangible. Cost contribution arrangements involving a PE should be upheld, but only when the taxpayer's intention to establish such an arrangement is unambiguously reflected in books of account or other contemporary documents. We urge the TAG and the CFA to include these principles in future revisions of their work.

Attribution of Income to Dependent Agent PEs

48. The CFA Draft specifically requests comments regarding the treatment of so-called dependent agent PEs. In the most common version of this problem, a country may assert that a PE of a non-resident taxpayer exists in that country because of the activities of employees of a related entity that is resident in the country. If, for example, a Country A corporation appoints its Country B subsidiary to act as its sales agent in Country B, Country B may assert that the Country A parent corporation has a PE in Country B because the employees of the subsidiary have and habitually exercise the authority to contract on behalf of the Country A parent corporation.

49. In situations of this type, it may be an extremely close factual question as to whether a PE of the parent corporation actually exists as a result of the activities of the dependent agent subsidiary. Often, however, it is clear that the dependent agent sales representative has been generously compensated for its marketing functions at levels consistent with the arm's length standard. Accordingly, Country B in the example has already subjected to tax all of the income that could be thought of as attributable to the functions performed in Country B.

50. We believe that the CFA Draft should clearly articulate that, under these circumstances, the finding of a dependent agent PE in a country should not result in the attribution of additional income to the country. It is entirely consistent with the functional analysis based approach that underlies the working hypothesis in the CFA Draft to conclude that if no uncompensated functions are performed in a country then no additional income should be allocated to that country. If the dependent agent has already been adequately compensated for all of its activities and risks, and if no functions are performed in the country asserting the existence of the PE other than those performed by the dependent agent, then no income in addition to that received by the dependent agent should be allocated to the asserted PE.

51. In particular, the foregoing discussion makes it clear that it would be inappropriate under these circumstances to assert that intangible property related income should be attributed to the PE. If the dependent agent does not perform intangible development functions or assume intangible development risks on behalf of its principal, and if the principal has no other functions in the country that contribute to the development of intangible property, there is no basis on which to assert that intangible property related income should be attributed to the dependent agent PE.