

TAXREP 13/01

ATTRIBUTION OF PROFIT TO A PERMANENT ESTABLISHMENT INVOLVED IN ELECTRONIC COMMERCE TRANSACTIONS

*Text of a memorandum submitted in June 2001 to the OECD in response to a
Discussion paper issued in February 2001*

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Comments on the Discussion Paper issued by OECD Technical Advisory Group (TAG) in February 2001.

Introduction

- 1 Set out below are the comments of the Tax Faculty of the Institute of Chartered Accountants in England and Wales on the paper issued by the Business Profits TAG of the OECD in February 2001.

General comments

- 2 Our first concern with this paper is that it is written based upon the assumption that the working hypothesis, namely the separate entity hypothesis as set out in paragraph 32 of the discussion paper 'Attribution of profits to a permanent establishment, is the proper application of Article 7(2) of the OECD Model Treaty.
- 3 We are not convinced that this hypothesis is the correct basis upon which to proceed to examine e-commerce transactions. In any event, there are other interpretations as to what Article 7(2) actually means which appear to us need to be considered, for example whether it simply provides a method for allocating profits within the entity.
- 4 Given the uncertainty, it appears to us to be premature to discuss the specific application of a controversial interpretation when the general application is still unsettled. This is particularly so in the context of e-commerce where there is not very much practical experience of the issues involved. This contrasts with banking, the other area where the hypothesis is discussed, where there is a great deal of experience among both taxpayers and revenue authorities.
- 5 Although we do not agree that the working hypothesis as set out in the paper is necessarily the correct starting point, our specific comments on the discussion draft are as follows:

Specific comments

- 6 This discussion paper provides a detailed analysis of the amount of profit that is attributable to the four listed variations of an 'e-tailing' business, namely:

Server creates a PE

- Variation 1 - single server (paragraphs 41 to 110)
- Variation 2 - multiple servers (paragraphs 111 to 116)

Server is part of an existing PE

- Variation 3 - technical support staff in permanent establishment (paragraphs 118 to 128)
- Variation 4 - Web site fully developed in permanent establishment (paragraphs 129 to 138).

- 7 The variations start from the assumption that a server by itself can create a permanent establishment. As the OECD will be aware, the UK Inland Revenue on 11 April 2000 set out the UK Government's view on the tax status of web sites and servers. The UK takes the view that 'a web site of itself is not a permanent establishment, and that a server is insufficient of itself to constitute a permanent establishment of a business that is conducting e-commerce through a web site on the server'.
- 8 We agree with the approach adopted by the UK Government. In our view, the analysis of variation 1 merely emphasises that the UK approach is the right approach. The lengthy analysis leads to conclusions (see paragraph 105, for example) that the activities are 'low level automated functions' and 'the level of profit is likely to be commensurately low and be very significantly less than that earned by full function retail outlets/distributors or full function service providers.'
- 9 In fact, the activities described in variation 1 appear to fall fairly squarely within the usual categories of activities, as set out in paragraph 4 of Article 5 of the OECD Model Treaty, that are deemed not to be activities which give rise to a permanent establishment. Even the exhaustive analysis of the position in the paper appears to be leading to pretty much the same conclusion.
- 10 The examples do not really advance our understanding of the particular problems associated with e-commerce and transfer pricing as identified at the Ottawa conference in 1998. It would have been better to have analysed variation 4 in much more detail than variation 1, as in the former case it is fairly clear that there is a permanent establishment in the country in which the server is located. In that case, clearly more of the profit should be attributed to the permanent establishment, particularly if the economic ownership of the software is at the permanent establishment level.
- 11 It is clear from reading the paper that those involved in computing attributable profit (including the revenue authorities) need a thorough understanding of e-commerce in order to perform the necessary functional analysis of precisely what value is added at each location. This is a necessary step in any transfer pricing situation, but is a particular concern where there is development of the software and hardware in the permanent establishment as this introduces the added complication of intellectual property valuation.
- 12 There is a wider need for transfer pricing methodologies in respect of e-commerce to be first agreed internationally and then to be applied consistently to the type of situation outlined in example 4.

Conclusions

- 13 We think that before the OECD attempts to address the questions of attributing profits to a permanent establishment involved in e-commerce operations, it is necessary to reach a consensus on the following questions:
- the general rules about how profits of a permanent establishment are taxed;
 - what amounts to a permanent establishment in e-commerce; and
 - transfer pricing in e-commerce.
- 14 Our experience in practice suggests that there are not many businesses establishing PE's in the circumstances described in this paper, so rather than addressing these questions now, they should be considered once the wider questions are resolved.

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