E-COMMERCE, TRANSFER PRICING AND DOUBLE TAX TREATIES

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The *Forrester Research Institute* established in 2007 that in the next 5 years, e-commerce would develop very fast and more quickly than retail sales: it will grow annually by about 20 –30 billion and by 2012 will reach, at least, 215 billion dollars[2].

E-commerce has been defined by the OECD-proposed "rules of the road" as "*any transaction conducted over the internet access, comprising the sale, lease, license, offer or delivery of property, goods, services, or information whether or not for consideration, and includes the provision of Internet access*"[3]. In an E-commerce environment, the sales of services might be, for example, legal advice provided by exchange of e-mail used to reduce tax liabilities. In the same situation the sales of digitised products such as music recordings can be done without any physical transaction.

E-commerce mechanisms pose challenges to tax authorities but also to taxpayers. Article 7 of the OECD Model states that the "*the profits of an enterprise of a Contracting state shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein*". Such a statement illustrates the attribution of taxing rights between the contracting States in a double tax treaty. Through the use of E-commerce, an enterprise does not need to establish any kind of physical structure to access into the market of another State. E-commerce can typically involve transactions where the participants are from several countries, and where their locations might be deliberately masked by using computers or satellite communications techniques. The lack of physical presence poses a challenge on the allocation of taxing rights but also leads to some difficulties for the tax administrations to identify or trace the participants and the transactions.

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2 This does not, of course, take into account the recent world economic crisis, and these figures may now require adjustment down

3 E-commerce: Law, Business and Tax Planning, chapter 16, Julian JB Hickey, 2006

Traditional tax administrations may also run into trouble because of the nearly instantaneous transmission of information and the development of internal private networks within a Multinational Enterprise[4]. Indeed, how would the tax administration be able to identify quantify or even verify cross-border transactions[5]? In fact the Revenue authority may have to deal with two main issues, which are to identify when a non-resident is exercising a trade and the enforcement of its taxing rights on a non-resident with no physical presence[6]. However the fact that business is achieved electronically should not, in principle, make any difference to how the profits arising from electronic commerce should be taxed. Therefore, there should be no need to restructure our tax systems. Worldwide tax systems are designed to tax business profits whatever their form and origin. However E-commerce may create a new game field for "tax players", insofar as there is a huge potential for profit-shifting into low tax jurisdictions, which may lead to new kinds of issues in transfer pricing.

These mechanisms might be in some circumstances structured between associated parties and used in order to shift the taxable profits to low tax jurisdiction. The transfer pricing rules should be applicable (article 9 of the OECD Model) with consistency to e-commerce situations. The transfer pricing rules imply that associated enterprises must be taxed "on the basis that they act at arm's length"[7]. The object of the arm's length principle which has been adopted by the OECD members' countries is to eliminate "the effect of special conditions on the levels of profits"[8]. "Application of the arm's length principle is generally based on a comparison with the conditions in a controlled transaction with the conditions in transactions between independent enterprises"[9].

The incentive exists, and especially by MNEs to use cross-border transactions between associated parties in order to take advantage of the different tax regimes by shifting the profit to a low tax jurisdiction from a high tax country.[10] In such a way, a Cayman Island company may provide an internet service to its French Subsidiary for €200,000 a year, whereas, in a comparable situation, independent enterprises dealing on an arm's length basis would only pay €100,000. Therefore the French subsidiary may shift €100,000 of its taxable profit, according to an arm's length analysis, to its parent company located in the Cayman Islands. The Transfer pricing operation might result in a loss for the French Revenue authority and in an increase of the taxable profit for the Cayman Island Revenue authority.

4 Transfer Pricing and Electronic Commerce, Jonathan S. Schwarz, 1999

5 The communications revolution and its effect on transfer pricing, Working party N°6, 2005

6 E-commerce: Law, Business and Tax Planning, chapter 16 - Julian JB Hickey, 2006

7 The OECD Transfer Pricing Guidelines, preface §6, 2000

8 The OECD Transfer Pricing Guidelines, chapter 1 §1.1, 2000

9 The OECD Transfer Pricing Guidelines, chapter 1 §1.15, 2000

10 E-commerce: Law, Business and Tax Planning, chapter 6 - Julian JB Hickey, 2006

The OECD held several conferences about E-commerce: the first one, which was based in Finland in 1997 tried to identify the challenges and recent issues created by electronic commerce. The Revenue authorities have focused their action on E-commerce mechanisms and its tax impacts on small and medium sized enterprises. The impact of E-commerce on transfer pricing has been discussed at the OECD Conference of Ottawa on electronic commerce in 1998. The most significant issues of E-commerce transfer pricing lie in the application of the transactional approach by establishing comparability and a functional analysis, and in the application of traditional transaction methods. However the OECD Committee on Fiscal Affairs claimed that the existing guidelines were still sufficient to be applied to E-commerce.

A full understanding of the existing treaty rules for taxing business profits is essential to describe the impact or the influence of the electronic commerce on the transfer pricing rules. This article examines the application of double tax treaties to e-commerce situations, and then outlines the impact this interaction has on the transfer pricing guidelines.

1. The Allocation of taxing rights

1.1 States allocate economic interests by entering into double tax conventions. Such conventions will determine the jurisdiction to tax of the States involved in the convention. The rules created for that purpose shall be established as far as possible in the interests of both States.

1.2 The Residence State and the Source State Jurisdiction

The underlying issue of the allocation of taxing rights is in the endless conflict between Residence and Source State taxation of business profits. A number of theoretical arguments have been developed to justify where a generated income from cross-border transactions should be taxed. An exclusive source approach was generally held by the developing countries, and an exclusive residence based taxation argument was generally held by developed countries. However a pragmatic decision has been adopted by the Tax Advisory Group leading to an international consensus, where double tax convention allocates the taxing right of business profit to both residence and source State. The OECD recognised that "*it is generally accepted that source countries are entitled to tax income originating within their borders, including income accruing to foreigners. One justification for this entitlement is that foreign-owned factors of production usually benefit from the public services and the protection of property rights provided by the government of the host country. A source-based tax like the corporation tax may also serve to prevent foreign investors from capturing all* *of the economic rent which may arise when foreign capital moves in to exploit the host country's production opportunities, e.g. its natural resources*"[11].

The jurisdiction to tax, being one of the main manifestations of the state's sovereignty, should be strictly organised and streamlined into a double tax convention by application of precise nexus rules.

1.3 The Current Nexus Rules

One of the main prerogatives of a sovereign State is the jurisdiction to tax. As defined by Martha in "*The Jurisdiction to Tax in International Law*" the State's sovereignty is "the right, or rather the competence, of states under international law to create internal law and to take executing action pursuant to or consequent to the making of law and/or upon divisions of courts"[12]. Nonetheless, the power to tax of each contracting State should be precisely determined by the double tax convention for the taxation of business profits. In fact the existing rules which determine the tax jurisdiction of the contracting States for the taxation of business profits did not come from economic principles but usually from negotiation process where one of the primary concerns was the enforcement of such rules[13]. Indeed the national sovereignty and powers to determine, verify, collect tax and enforce its national laws are limited to the territorial boundaries, so that the determination of the taxing rights mechanisms and application will be affected by enforcement considerations. These considerations are essential to understand what the rules are and should be.

1.3.1. The Residence Based Taxation

The League of Nations report of 1923, by expert economists (Professors Bruins, Luigi Einaudi, E.R.A Seligman and Sir Josiah Stamp) tried to deal with the basic principles underlying jurisdiction to tax in an international context and how to tackle double taxation. When discussing the principles of jurisdiction to tax, four connecting factors were identified (the origin, the situs, the enforceability and the domicile). In the OECD MTC the liability to a country's tax primarily depends on whether or not the taxpayer is a resident of that country.

11 Taxing profit in a global economy – Domestic and International Issues, at 36-37, OECD, Paris, 1991

12 The Jurisdiction to Tax in International Law, pp. 62-63, J. Martha, 1992

13 E-commerce: Transfer pricing and business profits taxation, OECD Tax Policy Study n°10, 2005

The article 7 of the OECD MTC[14] states that "*the profits of an enterprise of a Contracting state shall be taxable only in that State*". Residence based taxation has therefore been established as a primary nexus for the taxing right in the OECD model tax convention. As discussed above, the enforcement considerations justify such a principle. Because a taxpayer might be resident of both contracting States it was important to restrict its application. The following article 4 of the Convention states that for the purpose of such Convention, "the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, or any criterion of a similar nature".

The "tie breaker rules", stated in article 4 of the OECD Model Tax Convention, have been developed to ensure that a taxpayer will have a single country's residence for purposes of applying the treaty. The UK Courts, in the same way, refine the definition of a company's State of residence in order to avoid situations where a company may be considered as a resident of both contracting States. The UK Court held in *De Beers Consolidated Mines Ltd. v. Howe* (1906) 5 TC 198 that a company resides where its real business is carried on and the real business is carried on where the central management and control actually abides. However with the new communications technologies can we still adopt the same criterion for the determination of the State of residence?

Article 7 of the OECD Model Tax Convention states that "*the profits of an enterprise of a Contracting state shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein*". This illustrates the balance between residence-based and source-based taxation. The understanding of the permanent establishment definition is significant in the determination of the tax jurisdiction and particularly in the context of the electronic commerce involving extremely mobile activities.

1.3.2. Source-Based Taxation

Article 4 of the OECD MTC states that the term resident "*does not include any person liable to tax in that State in respect only of income from sources in that State or capital situated therein*". Non-resident taxpayers therefore might be taxed in the source State on their business profits insofar as they are attributable to a permanent establishment situated in the country. The concept of permanent establishment is used

14 The OECD MTC 2005

for taxing business profits by the treaty rules as a basic nexus/threshold rule for determining the jurisdiction to tax.

The current nexus rule found in double tax treaties and based on the existence of a permanent establishment in a country, is in line with a recognised principle considering that business profits should be taxed in the country where the enterprise carries on its business (Article 7 OECD MTC) and uses the country's infrastructures. The permanent establishment definition laid down by the Model Tax Convention has to allow determination of whether there is a sufficient nexus with the source state to be or not to be taxed therein.

A permanent establishment has been defined in the same article as "*a fixed place of business through which the business of an enterprise is wholly or partly carried on*". Such a statement refers to both a physical or more broadly a geographical requirement, and a time requirement. The physical presence condition requires that a place must be at the disposal of the enterprise for the purpose of its business activity in the other contracting State by way, for example, of labour and/or property.

Article 5 of the OECD MTC, excludes, nonetheless, activities of a preparatory or auxiliary character. In such a case the place will be deemed not to constitute a permanent establishment in the meaning of article 5. Briefly, the particular case of agents acting on behalf of an enterprise with the authority to conclude contracts in its name, should be mentioned. They are deemed to have a permanent establishment; independent agents are excluded from this extension.

Nevertheless, in certain circumstances profits arising in the source country might be taxed therein, even though there is no permanent establishment in that country. It is the case for profits which derives from immovable property. Also, the income received by the performance of entertainers or athletes is taxed in the country where the performance took place. These exceptions might be extended in certain double tax treaties. For example, the profits, which derive from the provision of services if the presence of the provider in the country of source exceeds 183 days in a 12 month period, are taxed therein.

2. E-commerce Challenges to DTC

The underlying issue in taxation of e-commerce is in the allocation of revenue between the country of residence and the country of source. The new communications technologies challenge the concept of permanent establishment through web-based services, the ability to deliver products electronically and the ability to operate a web-based business remotely[15]. Services and digitized products can be delivered to customers around the world. The new economy should not undermine the use of existing nexus rules to determine the tax jurisdiction. There will still remain, for enterprises connected to e-commerce, a physical activity, a risk assumption, a labour deployment, and property investments[16].

In theory a traditional application of the tax treaties' rules to the electronic commerce should be sufficient in determining the taxable income and the tax jurisdiction. However, and because the e-commerce facilitates these enterprises in participating in geographically distant markets, it may no longer be appropriate to focus only on the activities in determining where functions are performed. Indeed, through the use of new communications technologies, an enterprise can carry on business in another country and participate to a significant degree in the economic life of a country without the need to establish the kind of physical presence therein, that would result in a permanent establishment. Therefore it is necessary first to get an overall understanding of these activities and also to identify the impact of such activities in the application of the current treaty rules.

2.1 The Traditional Application of the Concept of Permanent Establishment to E-commerce

A web site is defined as "*a collection of programs, data, and images which may be accessed over the internet using a browser or some other form of access*"[17]. According to that definition a web site is not a fixed place of business and generally it may be reduced to an auxiliary or preparatory activity. Therefore, it may not constitute a taxable entity or permanent establishment in the country where it is established.

However, such an analysis might not be valid in every country, and especially in "source countries". Indeed, if a server is loaded with a digitised product and is designed to process and deliver the orders, it might be seen as a permanent establishment because of its direct participation in the economic activities in that State. In addition, if the enterprise carrying on the business through the web site also owns the server, the activities linked to the web site might not be seen as preparatory or auxiliary activities.

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15 Taxation of e-commerce: Persistent problems and recent developments, Markus Hubbert, 2000

16 Clarification on the application of the permanent establishment definition in e-commerce – changes to the commentary on the model tax convention on article 5, 2000

17 Hardesty, 1999

An Internet Service Provider is a commercial company that sells access to the internet for a fee. It also includes a wide range of other services such as web hosting, internet firewall configuration, maintenance, and monitoring. In the same way, these activities would not meet the conditions laid down by the OECD MTC to characterise a permanent establishment in its traditional sense.

Finally web servers or hosted web site, are individual computers running software that allows them to access and be accessed by other computers throughout the world.

The Technical Advisory Group has been given the general mandate "*to examine how the current treaty rules for the taxation of business profits apply in the context of electronic commerce and examine proposals for alternatives rules*". The Committee on Fiscal Affairs of 2000 tried to determine whether the definition of permanent establishment should be changed or abandoned. It came to the conclusion that the traditional definition of a permanent establishment should be applied with respect to e-commerce operations.

The Committee has posited that a web site, web-hosting arrangements, and an Internet service provider could not constitute a permanent establishment in itself. However the physical presence is not considered as being a requirement by Spain and Portugal in the context of E-commerce. So in some countries an enterprise carrying on business through a web site could be treated as having a permanent establishment.

The Committee has examined whether intervention in these e-commerce operations brought them within the meaning of permanent establishment. In the discussion draft of March 2000 it was stated that: "a*lthough electronic commerce is developing rapidly, this statement is still accurate, i.e. usually enterprises that have fixed places of business carry on their business through personnel. This, however, does not and was not intended to, rule out that a business may be at least partly carried on without personnel*"[18]. Therefore, it appears obvious to the Committee that important and essential business functions could be performed through fixed automated equipment. In such a case it would be contrary to the object and the purpose of article 5 of the OECD Model to exclude these activities from the permanent establishment definition.

Tax authorities will have to determine if the functions performed exceed the preparatory or auxiliary threshold in order to determine whether computer equipment, at a given location, should or should not be considered as a permanent establishment. The necessity for such an analysis will result in a certain degree of uncertainty for tax administrations and taxpayers alike. Nonetheless the OECD members have generally accepted the view expressed

18 Clarification on the application of the permanent establishment definition in e-commerce – changes to the commentary on the model tax convention on article 5, 2000

above, noting that they will have to be precise as to what are preparatory and auxiliary activities. Unsurprisingly the United Kingdom has declared that in no circumstances will servers or web sites constitute permanent establishments.

2.2 The Nexus of "Electronic Permanent Establishment"

The OECD discussion draft published on March 2003 gave a relevant analysis on whether it was appropriate to add a new nexus of "*electronic (virtual) permanent establishment*". The concept of a "virtual permanent establishment" has been suggested as an alternative nexus for E-commerce operations, resulting in a modification of the PE definition in order to cover, "virtual fixed places of business", "virtual agency" and "on-site business presence"[19]. One of the main issues discussed in the paper was the question of the attribution of profits.

With regard to the application of the arm's length principle the allocation of profits is typically determined on the basis of the functions performed (i.e. the assets used and risks assumed). However, a new criterion, which refers to the economic activity generated through e-commerce technologies into a country without any fixed place of business, might be relevant in the attribution of profits. Indeed the application of the functional analysis, studied in further detail below, results in no attribution of profits towards the so called "virtual permanent establishment" such as web sites located on a server. It can be argued that a State should receive a certain return for the use of a country's infrastructure but also for the access, whether virtually or physically, by enterprises located in another State, into the market of that State. In other words the source taxation would be determined by consideration of sufficient participation in the economy. Thus even where no functions are performed in a State, according to this criterion profits arising from economic activities in that State might be taxed with regard of a certain threshold determining the economic participation of an enterprise therein[20].

An enterprise which participates in "the economic life" of a country should be distinguished from one that "merely interacts" with its economic life. However difficulties arise in determining how the tax authorities may precisely and accurately measure the taxable profits resulting from such activities. The adoption of such criteria could create a great incentive to tax planning or transfer pricing.

Finally, the TAG did consider that it was inappropriate to adopt these changes insofar as it was not proved that the new communications revolution generated

19 "Are the current treaty rules for taxing business profits appropriate for e-commerce?", OECD, 2003

20 E-commerce: Transfer pricing and business profits taxation, OECD Tax Policy Study n°10, 2005

a loss of tax revenues for capital importing countries. In addition it seems that these propositions are not clearly superior to the current treaty rules. Thus, an overall agreement in such a direction could not be reached at that time. Nonetheless the TAG did acknowledge that even though theses changes were not pertinent at the present time, the current treaty rules do have some shortcomings[21].

3. The Critical Application of the Transfer Pricing Methods to e-commerce: a Summary

There are difficulties with applying traditional and transactional transfer pricing methods to e-commerce operations. There is no one method to be applied to e-commerce and therefore each method shall be regarded as being potentially applicable to electronic commerce. However it might be relevant to examine the common issues challenged by e-commerce to the application of the transfer pricing methods.

Electronic commerce facilitates business and more particularly business relocation. It gives to enterprises the ability to relocate non physical activities to different jurisdictions, or to shift physical activities to low cost jurisdictions. Such phenomena are becoming of an increasing importance for enterprises providing services. It could involve services such as, accounting, auditing, financial advice, or administrative services. However the OECD did not consider web sites or servers as permanent establishments[22]. As a result, they should not pose significant problems in the determination of the arm's length price.

The objective of comparability is to seek a high degree of comparability among transactions. The existence of specific situations or unique intangibles renders an effective application of the traditional methods uncertain and therefore those methods cannot reliably be applied alone. In such circumstances, the profit split method is usually used, since the residual profit which has not been assigned shall represent the value of such intangibles. In fact where the tax revenues or the taxpayer have to deal with unique intangibles[23], it is almost impossible to apply the traditional methods because of the unavailability of comparables involving independent enterprises. The availability of reliable data[24] may also

21 The Technical Advisory Group (TAG) on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits, (Conclusion 5), 1999

22 The Technical Advisory Group (TAG) on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits, 1999

23 Transfer Pricing and Electronic Commerce, Jonathan S. Schwarz, 1999

24 The communications revolution and its effect on transfer pricing, §21, Working party N°6, 2005

pose another difficulty for the application of traditional methods insofar as the comparability may not be accurate.

In the context of electronic commerce the comparability standard may suffer from the lack of reliable data to make comparisons with uncontrolled situations and dealings. This issue will influence the taxpayer or the tax administration on the transfer pricing methodologies to be adopted. Indeed one method will be preferred by the participants in cases where there is no sufficient data to ascertain an arm's length price. Typically, and because traditional transaction methods require effective and reliable data in the determination of the arm's length price, the participants might examine the transactional profit methods (e.g. the profit split method).

Dematerialisation is another issue which may affect the comparability analysis. In fact, electronic commerce is marked by the phenomenon of the dematerialisation[25] process of goods transferred and services (digital products). According to the comparability theory developed in the guidelines, it should be inappropriate to compare physical products with digital ones. For example, it is possible to supply digital products, such as music and video, for a single use. The concept of durability, resulting in a different application between these two forms, has also to be taken into account in the identification of comparables. On the other hand, digitised products may also suffer from piracy.

Multinational enterprises may present other hurdles to the use of traditional transfer pricing methods, due to the integration of functions and the great interaction between the different entities of the group. The transactions, made between associated parties belonging to a multinational group, might not easily be identified, discovered, or traced, and particularly those which reside inside private networks[26]. The main difficulty is in the application of the transactional approach which requires the evaluation of the fair market value to apply the arm's length principle on a transaction by transaction basis. However, under certain circumstances separate transactions are so closely linked to each other, that it is impossible or virtually impossible to evaluate them accurately on a separate basis.

Indeed, it might not be appropriate to apply a separate analysis in the context of the integration of exchanges over the internet and the development of such private networks among multinational enterprises (The global trading of Financial Instruments 1997). The mobility of functions means in practice it is difficult to link such activities to a specific jurisdiction. The entities of a multinational group may work through the use of emails and video conference and therefore the contribution of each entity by their functions performed could

25 Transfer Pricing and Electronic Commerce, Jonathan S. Schwarz, 1999

26 The communications revolution and its effect on transfer pricing, §29, Working party N°6, 2005

not be analysed separately, but as a global activity. The profit split method is generally preferred where business functions are highly integrated, and this would continue to be the case where the integration was a result of e-commerce operations.

The issues relating to the application of the transfer pricing methodologies, developed in the context of electronic commerce, usually tend to be solved by the use of methods of last resort either as a complement to the traditional methods or even as the only reliable method.

4. Conclusions

The communications revolution of the last two decades has given rise to intensive debates on the impact of such change on the tax systems and more particularly on the adaptation and application of current treaty rules to electronic commerce activities.

Identifying e-commerce mechanisms and their application in the economy has led to a recognition of how e-commerce has changed the world, and how both transfer pricing and double taxation treaties must develop also. E-commerce has radically altered the way in which enterprises do business, by the nearly instantaneous transmission of information, the removal of boundaries of time and space, and the business integration this has facilitated. Because of the communications revolution, enterprises do not need to establish a physical presence in a country to access a specific market there, and therefore do not necessarily economically participate in the economic life of a State in which they do business.

By considering the shortcomings of the double taxation treaties it becomes apparent that there will be an impact on transfer pricing methods. Therefore the legal framework must be considered to properly analyse where the transfer pricing methodology may be inappropriate in an e-commerce situation.

Several shortcomings have been analysed in the both application of the OECD treaty rules and transfer pricing methods to electronic commerce. Concerning the OECD model tax convention two corollary issues have been identified as being significant: the removal of physical presence, and therefore the allocation of tax profits between tax jurisdictions, and the concept of permanent establishment in the context of electronic commerce. The extreme mobility of such activities and the nearly instantaneous transmission of information allow certain enterprises to participate directly in the economic life of a country without the need of establishing any physical presence there. As a result, the application of the current definition, recently confirmed by TAG, excludes the taxation of the source profits from such “virtual” activities.

The main issue relating to the transfer pricing methods was the application of the developed methods to electronic commerce situations (whether the traditional transaction methods or the transactional profit methods). The most significant challenges in the application of the methods concerned the case of unique intangibles, the availability of efficient data in the comparability, and the dematerialisation of the activities and the transactions which may be difficult to trace, identify, or quantify. Other particular issues relate to multinational enterprises where the integration of functions and the development of private internal networks have rendered difficult the application of such methods.

The traditional methods were not effective in the determination of the arm's length price because of persistent shortcomings in the comparability analysis. However the transactional profit method and more particularly the profit split method were able to provide the most accurate answers. Nevertheless the OECD transfer pricing guidelines still consider the traditional transaction methods as the preferred methods to be applied. It is important to underline that even in an e-commerce situation there is not a unique method adapted to each situation and every method should be examined to determine the arm's length price.

To conclude, "*the communications revolutions presents neither fundamentally new nor categorically different problems that arise from electronic commerce*"[27] at this time. However, the further development of e-commerce may impact on the double tax treaties and transfer pricing rules that it may become necessary for them to evolve in common with prevalent business practice.

27 The OECD working party n°6: the communications revolution and its effect on transfer pricing, 2005