E-COMMERCE AND TRANSFER PRICING SOME SELECTED ISSUES

by

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The aim of this article is to draft a concise and clear picture concerning the applicability of transfer pricing regime in a typical e-commerce scenario. Provided two legal and business models (intra-company transaction between head office and branch, and inter-companies transaction between parent company and subsidiary, or between two subsidiaries of the same group), we will assess whether, and to what extent, a website and a server, used by the enterprise or the group to carry on its e-business, can be conceived as a permanent establishment and, then, we will analyse which methods have to be used in order to apply the arm's length principle. Our research will predominantly take into account the OECD Model Convention and Transfer Pricing Guidelines.

KEYWORDS

Taxation, e-commerce, transfer pricing, permanent establishment.

INTRODUCTION: THE ARM'S LENGTH PRINCIPLE AND E-COMMERCE [1]

Internationalisation of enterprises (or groups of companies) and electronic commerce are two different aspects of the globalisation of business, which attracts the attention of policy makers, governments, tax experts and academics. The aim of this article is to analyse, within this economic and social framework, to what extent companies are able to play in the global market of goods and services, through a branch, subsidiary or, in more general

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terms, a controlled entity, exploiting fast and efficient technological means like the Internet and Intranet networks[1] and, at the same time, allocating their taxable income in lower-tax jurisdictions. This phenomenon can be referred to what is called, by the literature and the legal practitioners, transfer pricing. To the ends of this article, we will take into account a wide concept of transfer pricing, which consists of the methods, adopted by multinational companies and groups, aimed to allocate taxable wealth where it is more convenient for the taxpayer, through inter-companies or intra-company transfer prices (as we will more in detail explain infra).[2]

To be more precise, we will take into account the two following scenarios:

An enterprise provides goods or (more likely) services through a branch situated in a different country, using an electronic communications network (the Internet or an Intranet).

Two companies that are part of the same group (basically, a holding and a subsidiary, or two or more subsidiaries) and that are located in different jurisdictions enter into a transaction (namely an e-commerce transaction) directed to trade goods or services.

In the light of the consensus reached at international level, and expressed primarily by the documents issued by the Organisation for Economic Co-operation and Development (thereinafter, the OECD), the prices set in transactions between associated enterprises (that is, between parent and subsidiaries and, on the other side, companies that are under common control) and between an enterprise and its branch, acting as permanent establishment of the enterprise, located in a different country, must be at arm's length. Briefly, the application of the arm's length principle means that the 'behaviour' of the parties involved in the above controlled transactions[3] (and the prices set in their mutual business operations) must corres-

1 As pointed out in the literature, "the lack of geographic boundaries has helped increased [sic] the amount of e-commerce activity; small-sized companies can become international players by using e-commerce." Siliafis, K. 2007, 'Taxation of E-commerce. A Task for Jugglers', Masaryk University Journal of Law and Technology, vol. 1, no. 1, p. 145.

2 In general, in fact, "due to the variance in tax rates and tax systems among the countries, a multinational enterprise may have a strong incentive to shift income, deductions, or tax credits among commonly controlled entities in order to arrive at a reduced overall tax burden. Such a shifting of items between commonly controlled entities could be accomplished by setting artificial transfer prices for transactions between group members." Westin, R.A. 2000, International Taxation of Electronic Commerce, Kluwer Law International, The Hague, p. 185.

3 With this expression we mean, according to the taxonomy used by the OECD, a transaction entered into by related, non independent, parties.

pond to the practice between independent parties, in order to avoid the illicit transfer of taxable income to a low-taxation country or to a tax-heaven.

Taking into account the two abovementioned scenarios, we can say that, in the former model, the enterprise must not indirectly allocate taxable income to the country where the permanent establishment, or the company itself, is based, according to the convenience, with the consequence that the profits generated by the enterprise and the permanent establishment do not correspond to those that two independent parties would have made in the free market. This result can be obtained by over- or under-invoicing the goods and services that are traded by the permanent establishment, or through transaction prices that do not respect the arm's length principle, in other words, that do not correspond to those that the parties would have set in the free and open market (intra-company transfer pricing).

In the latter situation, corresponding to the inter-companies transfer pricing, the entities, that are part of the same multinational group, agree on a price, in their controlled transaction, which, as pointed out above, does not correspond to that that two independent companies would have set in a similar trading operation. The result, also in this case, is that the taxable profits of the group can be concentrated in jurisdictions that are, let us say, 'taxpayer friendly'.

The main sources at international level, which play a pivotal role in the analysis of the transfer pricing regime and which we will take into account, are the OECD Model Convention with Respect to Taxes on Income and on Capital[4] (and its Commentaries), in particular Articles 5, 7[5] and 9,[6] and the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,[7] published by the OECD in 1995. It would go beyond the scope of this paper to address the issues related to the effects of such documents in the national legal systems of OECD member and non-member States, but in principle we have to say that, even if they are non-binding legal texts, they have, from the practical point of view, a great impact on the legislations of all the developed countries and of many developing economies[8].

In the following pages we will focus our attention in particular on two key aspects, which are of fundamental importance in the field of transfer pricing and e-commerce. First, provided that the principle of arm's length,

[4] On which a great number of bilateral tax treaties are based.

as briefly described above, must be applied in a controlled transaction (either intra-company or inter-companies), it is necessary to assess whether, and to what extent, the traditional concept of permanent establishment plays a role if the branch of the enterprise (in an intra-company transaction) or its subsidiary (in an inter-companies trading operation, considering that, in general terms, a subsidiary of a holding company may be considered a permanent establishment[9]) is represented by a server or a web-site. To be more precise, this issue is definitely more dramatically important in case of intra-company operations, for the very fact that the enterprise sells its goods or services to the final customers through a (basically virtual) entity situated in another country and the regime of transfer pricing can be applied (and, more radically, the issue of transfer pricing comes into being) only if such an entity is recognised to be a permanent establishment of the enterprise. In this situation, therefore, the tax authorities concerned have the power to rectify the income of the two parties involved, in the light of the arm's length principle (and the same applies in case of inter-companies transfer pricing).

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5 Article 7 [Business Profits]: "1. 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. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment. 2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which is a permanent establishment. 3. In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. 4. Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the results shall be in accordance with the principles contained in this Article. 5. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise. 6. For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary. 7. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article."

6 Article 9 [Associated Enterprises]: "1. Where
a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

Other than that, we will analyse which methods, used to allocate the right apportionment of income between the parties involved, should be adopted by the tax consultants and authorities, and, in particular, we will wonder whether or not the traditional methods (which will be infra summarised) can be applied in case of controlled transactions (both intra-company and inter-companies).

As a matter of method, we will take into account the OECD Commentaries to the Model Tax Convention, because they represent the necessary starting point for every researcher, tax inspector and lawmaker. Finally, it is important to point out that the focus of our article is only on business to business transactions, for the very fact that business to consumers deals are beyond the application of transfer pricing regime.

THE CONCEPT OF PERMANENT ESTABLISHMENT: SERVERS AND WEBSITES [2]

One of the most controversial and complex issues in the area of transfer pricing and e-commerce regards the concept of permanent establishment. In case of an enterprise with international business operations, the profits gen-

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly. 2. Where a Contracting State includes in the profits of an enterprise of that State – and taxes accordingly – profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other."

7 OECD 1995, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD, Paris.

8 For what concerns the effects of the rules contained in the OECD Model Convention (and in the corresponding Commentaries) in the European legal order, see: Wouters, J., Vidal, M. 2007, The OECD Model Tax Convention Commentaries and the European Court of Justice: Law, Guidance, Inspiration?, Working Paper No. 109, July 2007, Institute for International Law, K.U. Leuven Faculty of Law, Leuven. For what regards non-member States and the impact of the regulations issued by the OECD, we mention the examples of Kenya (see PricewaterhouseCoopers 2006, Transfer pricing and inter-company transactions: clarity for multinationals in Kenya, available at: http://www.pwc.com/Extweb/pwcpublications.nsf/docid/4012FCE5EBDA2B458025723C0028FFE9 [accessed 12/11/2007]) and Brazil (see Parrilli, D.M. 2005, 'La Disciplina Brasiliana in Tema di Transfer Pricing nelle Ipotesi di Operazioni Commerciali', Diritto e Pratica Tributaria Internazionale, vol. II, no. 2, pp. 601-609).

erated in the country, other than that of residence, can be taxed only if such an enterprise has a permanent establishment in that jurisdiction, pursuant to the abovementioned Article 7, paragraph 1, of the OECD Model Convention: "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. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment."

The definition of permanent establishment is provided for by Article 5 of the Model Convention, in particular paragraph 1 and 2, according to which: "1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on. 2. The term "permanent establishment" includes especially: a) a place of management; b) a branch; c) an office); d) a factory; e) a workshop, and (f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources." The list included in the second paragraph of Article 5 is not intended to be exhaustive, and the number of possible permanent establishments is, at least theoretically, very wide. In any case, a permanent establishment must be fixed and, to a certain extent, stable.[10] Other than that, it is necessary that the requisites set in the fourth paragraph of Article 5 are not met, so that, in general terms, if the site

[9] The Commentaries of the OECD point out, with this respect, that "it is generally accepted that the existence of a subsidiary company does not, of itself, constitute that subsidiary company a permanent establishment of its parent company. This follows from the principle that, for the purpose of taxation, such a subsidiary company constitutes an independent legal entity. Even the fact that the trade or business carried on by the subsidiary company is managed by the parent company does not constitute the subsidiary company a permanent establishment of the parent company. A parent company may, however, be found, under the rules of paragraph 1 or 5 of the Article [5], to have a permanent establishment in a State where a subsidiary has a place of business. Thus, any space or premises belonging to the subsidiary that is at the disposal of the parent company […] and that constitutes a fixed place of business through which the parent carries on its own business will constitute a permanent establishment of the parent under paragraph 1, subject to paragraph 3 and 4 of the Article [5] […]. Also, under paragraph 5, a parent will be deemed to have a permanent establishment in a State in respect of any activities that its subsidiary undertakes for it if the subsidiary has, and habitually exercises, in that State an authority to conclude contracts in the name of the parents […], unless these activities are limited to those referred to in paragraph 4 of the Article or unless the subsidiary acts in the ordinary course of its business as an independent agent to which paragraph 6 of the Article [5] applies. The same principles apply to any company forming part of a multinational group so that such a company may be found to have a permanent establishment in a State where it has at its disposal […] and uses premises belonging to another company of the group, or if the former company is deemed to have a permanent establishment under paragraph 5 of the Article [5] […]."

has the only aim to store, display or deliver goods or merchandise for the enterprise, or to carry on "activity of a preparatory or auxiliary character", it is deemed not to be a permanent establishment.[11]

To the ends of this article, it is of pivotal importance to assess to what extent the concept of permanent establishment is applicable in an e-commerce scenario, in the light of the assumption that the branch through which the enterprise carries on its business (and/or with which it enters into trading operations) can be substituted by a server (or, to a certain extent, a web-site hosted in a server). The transaction between the company and its branch will fall under the (intra-company,[12] according to the taxonomy used in this article) transfer pricing regime, provided that such a branch is a permanent establishment of the company.[13]

As reasonably stressed out by the OECD Commentaries, it is necessary to make a clear distinction between "computer equipment, which may be set up at a location so as to constitute a permanent establishment under certain circumstances, and the data and software which is used by, or stored on, that equipment." In other words, between a server and a website, which "does not have a location that can constitute a "place of business" as there is

[10] As pointed out by Article 5, paragraph 3: "A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months."

[11] The content of Article 5, paragraph 4, is the following: "Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:
a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character."

[12] We have to point out that, for what concerns the inter-companies transfer pricing, the situation is slightly different. A subsidiary of a holding company, in fact, is, from the company and tax law point of view, a different entity with its own legal personality, so that the provision of the first paragraph of Article 7 of the Model Convention (see above) is not applicable. In other terms, the profits of a branch (or factory, etc.) of a company, located in a different country, can be taxed only if such a branch is a permanent establishment. A subsidiary of an enterprise, equally based in a different jurisdiction, for the very fact that it is an entity other than its parent company, will be normally taxed in that state, and the main aim of the tax convention entered into by the country of residence of the holding and that of the subsidiary is to avoid that such profits are taxed twice.

no "facility such as premises or, in certain instances, machinery or equipment" […] as far as the software and data constituting that web site is concerned." The server "on which the website is stored and through which it is accessible", on the other hand, "is a piece of equipment having a physical location and such location thus constitute a "fixed place of business" of the enterprise that operates that server."

It seems quite clear that the OCDE is willing to apply the traditional concept of permanent establishment to e-commerce scenarios, so that only physical devices or premises (like, in the traditional off-line world, a factory, a branch or an oil well) can constitute a permanent establishment.[14] From the practical point of view, we have to say that the alterity proposed by the OECD is useful in order to distinguish between the cases in which the enterprise directly controls and manages the server, located in a different country, and the situations in which the server is operated by a third company, typically an Internet Service Provider (thereinafter, ISP). In the former scenario, in fact, one could wonder whether the website of the enterprise is a permanent establishment, and the most logical solution is the neg-

[13] The principle is that (Article 5, paragraph 7, Model Convention) "the fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other." The Commentaries to the Model Convention point out, for what concerns the applicability of the arm's length principle (and, as a consequence, of the transfer pricing regime) to the transaction between the enterprise and its permanent establishment, that "the paragraph [2 of Article 5] incorporates the view, which is generally contained in bilateral conventions, that the profits to be attributed to a permanent establishment are those which that permanent establishment would have made if, instead of dealing with its head office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. This corresponds to the "arm's length principle" discussed in the Commentary on Article 9. Normally, the profits so determined would be the same profits that one would expect to be determined by the ordinary processes of good business accountancy. The arm's length principle also extends to the allocation of profits which the permanent establishment may derive from transactions with other permanent establishments of the enterprise." In particular, "even when a permanent establishment is able to produce detailed accounts which purport to show the profits arising from its activities, it may still be necessary for the taxation authorities of the countries concerned to rectify those accounts in accordance with the arm's length principle […]. Adjustment of this kind may be necessary, for example, because goods have been invoiced from the head office to the permanent establishment at prices which are not consistent with this principle, and profits have thus been diverted from the permanent establishment to the head office, or vice versa."

[14] It has been pointed out, in the literature, that "on the Internet [electronic] commercial activities do not normally create a permanent establishment." Pastukhov, O. 2006, 'International Taxation of Income Derived from Electronic Commerce: Current Problems and Possible Solutions', Boston University Journal of Science & Technology Law, vol. 12, no. 2, p. 319.

ative one. Provided, in fact, that "the enterprise cannot be considered to have acquired a place of business by virtue of that hosting arrangement", it is necessary to say, more radically, that in this case the conditions for the applicability of the transfer pricing regime are not met, for the very fact that the transaction is between the enterprise and an independent company (the ISP) and is not, therefore, controlled.

Once having assessed that only a server (managed and controlled by the enterprise) can constitute a permanent establishment, the Commentaries underline that "computer equipment at a given location may only constitute a permanent establishment if it meets the requirement of being fixed." Provided that a server, for its very nature, can be moved from place to place, "what is relevant is not the possibility of the server being moved, but whether it is in fact moved." It is, then, essential to establish, on a case-by-case basis, what constitutes the reasonable period of time, provided for by the Model Convention, during which the server does not have to be moved. We would suggest taking into account the provision of Article 5, paragraph 5, and consider that twelve months can be deemed to be such a reasonable period.

From a different perspective, tax authorities have to assess whether the business of the enterprise is (totally or partly) carried on at the location where the server is situated. If we consider, in fact, that the company may have more servers located around the world, and that it can be difficult to keep track of the transactions made by the enterprise itself through these servers, the solution will be found on a case-by-case basis.[15]

One element that we would find reasonable to take into account in order to establish the nature of the server, in particular to assess whether it constitutes a fixed place of business, is the presence of personnel. With this regard, the Commentaries clearly state that "where an enterprise operates computer equipment at a particular location, a permanent establishment may exist even though no personnel of that enterprise is required at that location for the operation of the equipment. The presence of personnel is

[15] As pointed out by the OECD Commentaries to Article 5 of the Model Convention, in fact, "the question of whether the business of an enterprise is wholly or partly carried on through such equipment needs to be examined on a case-by-case basis, having regard to whether it can be said that, because of such equipment, the enterprise has facilities at its disposal where business functions of the enterprise are performed."

not necessary to consider that an enterprise wholly or partly carries on its business at a location where no personnel are in fact required to carry on business activities at that location." Even if we agree that "this conclusion applies to electronic commerce to the same extent that it applies with respect to other activities in which equipment operates automatically, e.g. automatic pumping equipment used in the exploitation of natural resources", we therefore believe that the presence of personnel is a further indicator (if not, from a critical perspective, the only one) that the server constitutes a fixed place of business and, thus, a permanent establishment.

From a different point of view, then, we highlight that the provision of Article 5, paragraph 4, of the Model Convention will apply also in case of a server, in order to assess whether or not it is a permanent establishment. It is not, therefore, always an easy task to distinguish between core functions and preparatory or auxiliary activities, considering that the very nature of the server seems to be included more in the former than in latter category. The Commentaries provide the reader with a non-exhaustive list of preparatory or auxiliary activities, namely: "providing a communication link – much a telephone line – between suppliers and customers"; "advertising of goods and services"; "relaying information through a mirror server for security and efficiency purposes"; "gathering market data for the enterprise"; 'supplying information."

It is, therefore, true, as pointed out by the OECD in the Commentaries, that "what constitutes core functions for a particular enterprise clearly depends on the nature of the business carried on by that enterprise". In the case of an e-tailer,[16] for instance, provided that "the enterprise is not in the business of operating servers", it is not possible to interfere, from the mere existence of a server, that the place where it is located is a permanent establishment of the enterprise. This is the case, however, if "the typical functions related to a sale are performed at that location (for example, the conclusion of the contract with the customer, the processing of the payment and the delivery of the products are performed automatically through the equipment located there)", for the very fact that "these activities cannot be considered to be merely preparatory or auxiliary."

[16] Currently defined as "one that sells goods or commodities to consumers electronically, as over the Internet." E-tailer (n.d.) 2006, The American Heritage Dictionary of the English Language, Fourth edition, Houghton Mifflin Company, Boston.

Finally, we have to wonder whether or not an ISP is deemed to be conceived as a permanent establishment of the enterprise. Provided that, in fact, a server controlled and managed by the company is a permanent establishment, what if the enterprise enters into an agreement with an independent ISP? We already mentioned that, in our view, an ISP cannot be conceived as a permanent establishment because there is no link, from the company law point of view, between the two entities involved. It is, nevertheless, necessary to analyse whether or not the ISP can be an agent of the enterprise, within the meaning of Article 5, paragraph 5,[17] of the Model Convention. According to the Commentaries of the OECD, with which we agree, this provision "will generally not be applicable because the ISPs will not constitute an agent of the enterprises to which the sites belong, because they will not have authority to conclude contracts in the name of these enterprises and will not regularly conclude such contracts or because they will constitute independent agents acting in the ordinary course of their business,[18] as evidenced by the fact that they host the web sites of many different enterprises."[19]

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17 "Notwithstanding the provisions of paragraph 1 and 2, where a person – other than an agent of an independent status to whom paragraph 6 applies – is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph."

18 And, thus, the provision of Article 5, paragraph 6, will apply: "An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business."

19 From a comparative point of view, the American literature underlines that "under Kegs. Sec. 1.864-7(d)(1), the ISP's presence in the US cannot be attributed to any foreign user unless the ISP is the foreign user's "dependent agent". To be the foreign person's dependent agent, the ISP must have authority to negotiate and conclude contracts in the foreign person's name, and regularly exercise such authority. Generally, ISPs are mere carriers of information and do not have authority to conclude contracts for their users. The physical presence of an ISP in the U.S. acting as an independent contractor for many persons using its server should not result in any foreign user having an office or other fixed place of business in the U.S. Thus, foreign-source income earned by a foreign seller using a website maintained by an independent ISP should not be effectively connected to a U.S. trade or business taxable in the U.S." Nakamoto, K. 2003, 'Internet transactions and PE issues (permanent establishment)', The Tax Adviser, May 1, 2003, available at: http://goliath.ecnext.com/coms2/gi_0199-2935510/Internet-transactions-and-PE-issues.html [accessed 12/11/2007].

THE METHODS TO BE APPLIED IN A CONTROLLED TRANSACTION [3]

After having assessed in which cases a controlled transaction, both inter-companies and intra-company, raises transfer pricing issues, and to what extent a server, used by the parent (or holding) company to carry on e-commerce business, is deemed to be a permanent establishment, it is now necessary to evaluate which methods must be used by taxpayers and tax authorities in order to assess arm's length prices. In other words, provided that the dealing conditions in a controlled transaction must correspond to those of a similar operation between independent parties, there is the need to define arm's length prices that, at least in principle, correspond to those that are likely to be set in the free and open market.

We have, nevertheless, to say that the main concern of the tax authorities regards the determination of profits of the branch or subsidiary. The main aim of transfer pricing regimes, in fact, is to avoid the allocation of profits, within a multinational enterprise or group, to lower-tax countries, on the grounds that taxpayers can achieve this illicit goal by manipulating their intra-group or intra-company prices. The competent tax authorities, thus, will readjust the profits of the company or companies investigated, in the light of the arm's length[20] and the separate entity accounting principles (according to which "each branch of subsidiary that is part of a multinational enterprise is […] treated separately for purposes of the computation of profits under tax treaties").[21]

The abovementioned OECD 1995 Guidelines indicate the following methods, divided into two groups: traditional transaction methods (a-b-c), and profit-based methods (d-e):

Comparable uncontrolled price (CUP) method: "a transfer pricing method that compares the price for property or services transferred in a con-

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[20] "To choose the best transfer pricing method, the rule requires that the arm's length result of related party transactions be determined under the method that, given the facts and circumstances, provides the most reliable indicator of an arm's length result." Abdallah, W.M. 2002, 'Global Transfer Pricing of Multinational and E-commerce in the Twenty-first Century', Multinational Business Review, Fall 2002, available at: http://findarticles.com/p/articles/mi_qa3674/is_200210/ai_n9109897 [accessed 12/11/2007].

[21] OECD 2004, Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-commerce? *Final Report*, p. 8, available at: http://www.oecd.org/dataoecd/58/53/35869032.pdf [accessed 12/11/2007].

trolled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances".[22]

Resale price method: "a transfer price method based on the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. The resale price is reduced by the resale price margin. What is left after subtracting the resale price margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g. custom duties), as an arm's length price of the original transfer of property between the associated enterprises."[23]

Cost plus method: "a transfer pricing method using the costs incurred by the supplier of property (or services) in a controlled transaction. An appropriate cost plus mark up is added to this cost, to make an appropriate profit in light of the functions performed (taking into account assets used and risks assumed) and the market conditions. What is arrived at after adding the cost plus mark up to the above costs may be regarded as an arm's length price of the original controlled transaction."[24]

Transactional profit method: "a transfer pricing method that examines the profits that arise from particular controlled transactions of one or more of the associated enterprises participating in those transactions".[25]

Profit split method: "a transactional profit method that identifies the combined profit to be split for the associated enterprises from a controlled transaction (or controlled transactions that it is appropriate to aggregate […]) and then splits those profits between the associated enterprises based upon an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length."[26]

For what concerns the applicability of such methods to e-commerce scenarios, even if many authors have argued that traditional methodology are not applicable, or at least are difficult to be used, due to the specific nature of the controlled transactions,[27] we have to say that there are no particular reasons not to apply transaction-based methods, provided that suffi-

[22] OECD 1995, *op. cit.*, p. G-3.
[23] *Ibid.*, p. G-7.
[24] *Ibid.*, p. G-4.
[25] *Ibid.*, p. G-9.
[26] *Ibid.*, p. G-7. .

cient data on a controlled operation (and on the corresponding uncontrolled, arm's length, one) is available and that such data is reliable.

In both an inter-companies and intra-company transfer pricing scenario, thus, preference must be given to the traditional transaction methods, if comparable uncontrolled prices are available. Otherwise, "for highly integrated transactions […] a more appropriate approach may be the profit split method. It would be applied on a case-by-case basis, determining the profit share of each branch or affiliate with the profit experience of independent traders and risk managers in similar circumstances."[28] In particular, however, in case the profit split method is applied, it is true that the portion of profits attributed to the permanent establishment is usually very small, for the very fact that the operations carried on by the server are predominantly automatic and do not involve the presence of a complex structure (as pointed out above).[29]

CONCLUSIONS: CRITICAL REMARKS [4]

In the previous paragraphs we analysed whether and to what extent, in the light of the positions expressed by the OECD in the last years, a server or a website can be considered a permanent establishment of a multinational enterprise, and which methods should be applied in order to assess an arm's length price in a controlled transaction (in a typical e-commerce scenario). It

[27] Schwarz, J.S. 1999, 'Transfer Pricing and Electronic Commerce', Bulletin for International Fiscal Documentation, vol. 53, no. 7, pp. 286-290. Other Authors highlighted that "in many cases of electronic commerce, the application […] of traditional transactional methods recommended by current OECD Guidelines may therefore not be adequate. Interpretation and applications by national authorities risk being divergent, giving rise to problems of profit reallocation and double taxation but also to tax planning opportunities for MNE's and fiscal competition among national authorities." Doernberg, R.L., Hinnekens, L., Hellerstein, W. & Li, J. 2001, Electronic Commerce and Multijurisdictional Taxation, Kluwer Law International, The Hague, p. 312.

[28] *Ibid*., p. 319.

[29] Della Rovere, A. & Mejnardi, C. 2003, 'Il Transfer Pricing nel Commercio Elettronico' in Transfer Pricing, Amministrazione & Finanza Oro, no. 5/2003, p. 149. In the light of the regulations adopted in the US, "where transactions over the internet (or intranet) are not closely integrated and comparable are available (e.g., in many manufacturing, distribution and support activities), it may be possible and appropriate to apply traditional standard methods (e.g., CUP, cost plus, resale minus). Where the electronic commerce among specialized MNE-undertakings is integrated and the performance unitary, the aggregation of continuous transactions may be the most appropriate approach and the application of transactional profit split formulae the most fitting valuation method. As in the case of global trading, the profit-split method may become a standard method for integrated electronic commerce rather than a method of last resort." Doernberg, R.L., Hinnekens, L., Hellerstein, W. & Li, J., *op. cit*., p. 313.

seems quite evident, for what concerns the former point, that the OECD has the aim to apply, to a certain extent, the traditional concept of permanent establishment to (relatively) new physical and virtual features like a server or a website. If we safely agree with the statement, expressed by the OECD in the above Commentaries, that a website cannot be considered a permanent establishment of the company, at least in the light of the actual technological development (leaving nevertheless open the door to realistic future radical changes of the way in which businesses operate and 'virtualize' their activities), it is our opinion that the concept of server must be more carefully assessed. In particular, if we take into account the functions performed by a server, whose task is only that of conveying and managing the e-business carried on by the enterprise (especially if operating without the presence of dedicated personnel), we would suggest to take a different approach, and evaluate the possibility of excluding the server from the list of possible permanent establishments of an enterprise.

If, in fact, the abovementioned reasoning of the OECD makes sense, it is, at the same time, necessary to point out that a server cannot be compared to other traditional technical devices like a vending machine or a place of extraction of natural resources. Firstly because a server, even if composed of mechanical and physical apparatus, is aimed to carry on an activity, which is basically virtual and immaterial (unlike a vending machine or a quarry). Then, for the very fact that a server does not have any link with the country and territory where it is based unlike the permanent establishments listed in Article 5, paragraph 2, of the Model Convention.[30] A server, in fact, can trade with customers located all around the world (and not only with local clients like, for instance, a vending machine), and thus its link with the territory is (or can be) non-existent.

If we agree with the idea that the permanent establishment, according to the OECD, is a tool for taxing profits generated in a country where the foreign enterprise carries on business activities and where is, to a certain extent, located through one of its ramifications, a server is probably not, in an e-commerce scenario, the best case in point.

[30] See *supra*, § 2.