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From a FAR to a FARM Analysis with respect to Profit Attribution to the Indian Significant Economic Presence (SEP) Test

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The Existing Framework: Nexus and Profit Attribution Rules

Under the current Double Taxation Avoidance Agreement (DTAA) framework, business profits are in principle taxable in the State of residence of the enterprise. However, the source (market) jurisdictions may tax the profits if a permanent establishment (PE) is triggered therein. A PE arises when the non-resident operates in the market State through a physical presence such as a fixed place of business (e.g. office or construction site) or through dependant agents (e.g. employees). Thus, when a traditional business operates through a tangible presence in the market State (and subject to certain conditions) a PE is constituted unless the activities carried out through the fixed place or by the dependant agents fall under the list of exceptions.

However, State practice varies with respect to profit attribution to such a nexus. States could allocate profits by resorting to the authorized OECD approach (AOA) or by deploying formulary or deemed profit allocation methods. With respect to the former, profit allocation to the PE depends on tangible factors in the market state such as significant people functions, assets and risks (FAR) linked to the PE. With respect to the latter, States may allocate profits to the PE based on elements linked to turnover derived from the market States (total net profit*local turnover/total turnover). Typically, developed States (OECD or EU Member States such as Austria, Germany or Netherlands) apply the AOA whereas developing States (India or China) usually apply formulary or deemed profit methods.[1]

The Policy Debate Triggered by Highly Digitalized Businesses

Highly digitalized businesses may operate in the market State through online or digital means and derive substantial revenues from that State. For example, the following digitalized businesses may operate and commercialize in the market State without any physical presence, primarily, due to their heavy reliance on software related intangibles: i) businesses that provide an online marketplace for the sale of goods and services such as eBay, Booking.com, Uber and Airbnb; ii) businesses

providing online services such as online advertising: Facebook, online gaming: PartyPoker or online payment services: PayPal; iii) businesses selling digitalized products and content through an online platform such as Netflix or Spotify; and iv) businesses providing online solutions such as cloud computing solutions as provided by Microsoft Azure or SalesForce.com. Accordingly, the question arises as to how can market States tax (in particular highly) digitalized businesses as the current treaty rules are not equipped to tax such businesses since they focus on physical presence. Currently, policy makers (OECD and EU Commission) are discussing two possibilities to solve the issue at stake. The first option, an interim measure, involves the introduction of turnover taxes (a discussion on this option is beyond the scope of this contribution). The second option, a longer-term measure, involves modifying the PE definition and profit attribution rules, in particular, the AOA framework. With respect to the latter option, the current debate revolves around whether such new rules should be targeted only for digitalized businesses or for traditional as well as digitalized businesses?

New Rules Targeted only at Digitalized Businesses – The Issue of Ring Fencing

In relation to taxing digitalized businesses, in the BEPS Action 1 Final Report (2015), the OECD discusses the possibility that States may introduce a significant economic presence (SEP) test. This test proposes creating a new nexus or presence based on either revenue, digital or user related factors, or a combination thereof. The EU Commission also follows a similar approach in its recent draft directive on Significant Digital Presence. According to the Commission, a Digital PE arises in a Member State when the digital services provided through a digital interface exceeds either (i) a revenue threshold of Euro 7 Million or ii) the number of users availing the digital services exceed 100,000 users or; iii) the number of business contracts for digital services concluded by users in a Member State exceeds 3,000 contracts.

Both OECD and the EU Commission recognize that the profit allocation rules, in particular, the AOA framework needs modification in order to attribute profits to the new nexus. While the OECD has not elaborated on the potential modification, the EU Commission has made a proposal, especially, with respect to digitalized businesses that depend on user participation. According to the EU Commission: functions, assets and risks that relate to data or users in the market State shall be attributed to the digital PE even if (all of) these activities are performed at the level of the head office. Moreover, the profit attribution principles should take into account the development, enhancement, maintenance, protection and exploitation of intangible assets. Furthermore, the draft directive states that taxpayers should use the profit split method as a default method to allocate profits to such a digital presence unless and until the application of another method is put forward. The draft directive indicates that further guidance on the application of such rules will be developed in the due course of time.

The rules proposed by the EU Commission are based on amending the AOA. However, as argued by Spinosa and Chand in a recent publication in the June/July issue of Intertax, the AOA is itself unsettled and unclear. Therefore, building new rules on an unstable foundation will surely cause tax uncertainty for businesses and open the

doors for more tax disputes. Moreover, such rules clearly ring-fence digitalized businesses.

New Rules Targeted for all Enterprises: The Indian SEP Test

In order to avoid ring-fencing concerns for digitalized businesses, we are of the opinion that international tax principles for conventional businesses as well as e-commerce should be similar. The new nexus and profit attribution rules should apply to 'all enterprises' in a neutral, efficient, simple & certain, fair & equal and flexible manner. In this regard, the introduction of the SEP test in the Indian domestic tax law applicable to "all enterprises" is clearly a step in the right direction. A SEP arises for all non-resident enterprises if they exceed either a revenue or a user threshold (although one of the author's to this blog believes that the user threshold should be a part of the revenue threshold and not an independent threshold per se). This being said, the SEP test will apply to treaty partners only when the new provisions are incorporated in tax treaties. Undoubtedly, getting OECD Member States to agree on this test will be a daunting task for the Indian treaty negotiators unless this test becomes the new global standard (similar to the equalization levy – a turnover type measure). Even if the SEP test, as implemented in India, becomes the global standard, the key issue that will then need to be solved pertains to profit attribution.

Profit Attribution: The Migration from a FAR to FARM Analysis

Consider the following situation where an entity in State R sells goods or services on a remote basis into State S. Let us further assume that the turnover from State S is USD 500 and this amount also represents the total turnover of the entity. Moreover, the total operating costs of the entity amount to USD 400. Thus, the entity makes a taxable net profit of USD 100.

If State S applies the AOA framework as it currently stands, the profit will only not be taxable in State S. This is because the Functions, Assets and Risks (FAR) are only performed, deployed or assumed in State R. Put differently, the existing AOA framework, primarily, takes into account only production side factors whereas demand side factors represented by sales are completely ignored.

The question then arises as to how should the taxable net profit be divided between the residence and source States? At the outset, we are of the opinion that "full" formulary approaches should not be used as they conflict with the arm's length standard. A possible solution could be to introduce a new interpretation on profit attribution in Article 7 or introduce a market apportionment key within the AOA framework. Both approaches will take into consideration not only residence state factors (FAR) but also source state factors (the market or M). However, the outcome would be different under both scenarios as illustrated below.

Under the new interpretation approach, the Functions, Assets and Risks linked to the sale in the Market State could be allocated to the new nexus. Essentially, the SEP would be allocated the sales as reduced by the expenses in relation to those sales. Therefore, the entire profit of USD 100 could be allocated to the SEP.

Under the market apportionment key approach, once a new nexus is established, the

market State will obtain a right to tax a part of that profit linked to sales in State S. For instance, based on facts and circumstances, an equal weight could be allocated to Functions (25%), Assets (25%), Risks (25%) and Market (25%). Consequently, as the market reflects a 25% weight, the new nexus will be attributed USD 25 as profits on which the non-resident taxpayer will have to pay taxes in the market State.

This market apportionment key approach, in our opinion, is far less radical than the aforementioned interpretation approach or a destination based cash flow approach or a sales based formulary apportionment mechanism under which the market State will receive the entire or a substantial part of the profit on which it may levy its tax.

Of course, both proposals can only be viable internationally if there is international consensus on the new interpretation or the weights that can be allocated to Functions, Assets, Risks and Market.

It should be noted that the purpose of the contribution was only to throw up ideas to solve the profit attribution issue at stake if a SEP test is introduced for all enterprises. The authors do identify that there are several shortcomings in these proposals, Thus, the authors welcome comments from the international tax community on such an idea.

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