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 Allocation 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 resident state (principally the host country) may tax a part of the profit if a permanent establishment (PE) is triggered therein. A PEs 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 independent agents (e.g. employees). Thus, where a resident business operates through a permanent establishment in the market State linked to the business activities of the PE in the PE State, the PE State is entitled to tax a part of the profit generated in the PE State.

However, State practice varies with respect to profit attribution to such a venue. States could allocate profits by resorting to the authorized OECD approach (ISR) or by deploying formulas or deemed profit allocation methods. With respect to the former, profit attribution to the PE resides on the factor-link approach in the market State such as significant people factors, assets and/or profit linked to the PE. With respect to the latter, States may allocate profits to the PE based on economic factors to tax the profit generated in the PE State. Both approaches are based on the OECD formulary approach as well as the FARM analysis approach. However, the EU Commission’s approach has several drawbacks in relation to digitalized businesses. The new EU Commission’s proposal only for digitalized businesses and in the digitalized businesses is characterized by the following key approach: a digital interface, equal weight could be allocated to Functions (25%), Assets (25%), Risks (25%) and Market (25%).

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 without a physical presence, primarily, due to their heavy reliance on software related intangibles (e.g. businesses that provide an online marketplace for the sale of goods or services such as eBay, Booking.com, Uber and/or Airbnb) and provide online services such as cloud computing services provided by Microsoft Azure or Salesforce.com. Accordingly, the question arises as to how can tax matters be settled in such a context if the jurisdiction in which the digitalized business operates, as the current treaty rules are not equipped to tax such businesses since they focus on physical presence. Currently, the EU Commission (EC) and the Commission is exploring new possibilities to close the tax issue. The FARM approach, as elaborated in the Commission, involves the introduction of turnover (net) as a factor to capture the digital nature of this transaction. The EU Commission is also considering the adoption of the new Nexus/SEP test.

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

In relation to taxing digitalized businesses, in the EU’s Action 13 Report (2016), the EC Commission states that there may be a significant economic presence (SEP) if the profit generated by the digitalized entity can be attributed to such a digital presence. The EC Commission has found a similar approach in its digital drft directive on Significant Digital Presence. According to the EC Commission, a Digital PE arises in a Member State when the digital services provided through a digital interface exceed either a revenue threshold of Euro 7 Million or ii) the number of users accessing the digital services exceeds 150,000 users. Under the new interpretation approach, the profit allocation to the PE depends on the number of users in the market State (the market or M).

The draft directive indicates that further guidance on the application of such rules will be developed in the near future. Therefore, as a temporary measure, the EU Commission has made a proposal, especially, with respect to digitalized businesses that depend on user participation. According to the EC Commission, the assets and costs that relate to data or users in the market State shall be attributed to the digital PE even if all other activities (e.g. the provision of services) are performed in the country of the legal entity. Moreover, the profit attribution rules should take into account both those activities (in the market State) and the activities performed in other countries. Furthermore, the Directive states that taxpayers should be able to profit allocation as a default method. To attribute profits to such a digital presence victory and will be applied on a country-by-country basis. However, some countries are already considering different rules for digitalized businesses. The draft directive indicates that further guidance on the application of such rules will be developed in the near future.

The rules proposed by the EC Commission are based on amending the AOA. However, as argued by the Joint OECD Tax Committee, 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 for all Digitalized Businesses: The Issue of Ring Fencing

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 for e-commerce businesses should be similar. The new nexus and profit allocation rules should apply to all ‘entities’ in a neutral, effective, simple, fair, and flexible manner. In this regard, the introduction of the ISR and the digitalized businesses are comparable to "all industries" is clearly a step in the right direction. An ISR arises for all non-resident entities if they maintain a digital interface to attract profits (in the absence of a physical presence) to the market State. The user connection in the market State creates an economic element through the use of a digital interface. Therefore, the user state may tax the profits generated through the digital interface, unless the digital entity's activities are performed at the level of the head office. Moreover, the profit attribution principles should take into account both those activities (in the market State) and the activities performed in other countries. Furthermore, the Directive states that taxpayers should be able to profit allocation as a default method. To attribute profits to such a digital presence victory and will be applied on a country-by-country basis. However, some countries are already considering different rules for digitalized businesses. The draft directive indicates that further guidance on the application of such rules will be developed in the near future.

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Profit Attribution: The Migration from a FAR to a FARM Analysis

Consider the following situation where an entity in State R sells goods or services on a remote basis into State S. For instance, based on facts and circumstances, an entity in State R sells goods or services to State S, with respect to the latter, the current debate does not seem to be resolved yet. Therefore, such cases rely on the digitalising of a Formulary or deemed profit methods. In this regard, the introduction of the ISR and the digitalized businesses are comparable to "all industries" is clearly a step in the right direction. An ISR arises for all non-resident entities if they maintain a digital interface to attract profits (in the absence of a physical presence) to the market State. The user connection in the market State creates an economic element through the use of a digital interface. Therefore, the user state may tax the profits generated through the digital interface, unless the digital entity's activities are performed at the level of the head office. Moreover, the profit attribution principles should take into account both those activities (in the market State) and the activities performed in other countries. Furthermore, the Directive states that taxpayers should be able to profit allocation as a default method. To attribute profits to such a digital presence victory and will be applied on a country-by-country basis. However, some countries are already considering different rules for digitalized businesses. The draft directive indicates that further guidance on the application of such rules will be developed in the near future.