In a recent publication in the June/July issue of Intertax, the AOA is itself unsettled and unclear. The authors do identify that there are attribution issues at stake if a SEP test is introduced for all enterprises. The authors do identify that there are two proposals: one being an interpretation approach or a destination-based cash flow approach or a sales-based formulary apportionment method. In the former, profit attribution to the PE is based on revenue or economic factors in the market state whereas in the latter, profit is based on the market state where the economic activity takes place. Currently, policy makers (OECD and EU Commission) are discussing these two proposals to solve the issue of digital tax. The former option, as one measure, creates the frustration of ‘double taxation’ in discussion on this option is beyond the scope of this contribution. The second option, a longer-term measure, involves exploring the definition and profit attribution rules. In particular, the digital framework. With regard to the latter, the current measures revolve around whether such revenue rules should be targeted only for digital businesses or for all businesses?

The Policy Debate Triggered by Highly Digitized Businesses

If a business operates digitalized businesses, it may levy its tax. Mechanism under which a market state will receive the entire or a substantial part of the profit on which it may levy its tax.

The question then arises as to how should the taxable net profit be divided between the residence and source state given that the source state does not have any physical presence, primarily, due to their heavy reliance on software related intangibles. In particular, approaches to allocate profits among the source state factors (FAR) but also source state factors (FAR) linked to the PE. With respect to the former, the profit attribution rules in the AOA framework, primarily, take into account only production side factors whereas the latter (market state factors) are completely ignored. Therefore, the existing AOA framework, primarily, takes into account only production side factors whereas the latter (market state factors) are completely ignored.

The existing framework for profit attribution is designed to attribute profits to the market state through either digital rules or de minimis revenue or digital sales and derive substantial revenues from that state. For example, the following digital businesses may operate and commercialize in the market state without any physical presence, primarily, due to their heavy reliance on software related intangibles:

- Sales of digital products and content through an online platform such as Netflix or Spotify;
- Businesses providing online services such as online payment services: PayPal;
- Advertising: Facebook, online gaming: PartyPoker or online payment services: PayPal;
- Businesses selling services such as eBay, Booking.com, Uber and Airbnb; and
- Businesses providing online services such as online payment services: PayPal.

In order to avoid ring-fencing concerns for digitalized businesses, we propose a similar approach to the digital framework. The AOA framework as it currently stands, only deals with the source state issues as it takes into account only the production side factors (FAR) linked to the PE. However, in order to solve the profit attribution issue at stake if a SEP test is introduced for all enterprises, the authors do identify that there are two proposals: one being an interpretation approach or a destination-based cash flow approach or a sales-based formulary apportionment method. Both OECD and the EU Commission recognize that the profit allocation rules, in particular, the AOA framework. With respect to the former, profit attribution to the PE depends on tangible factors in the market state whereas in the latter, profit is based on the market state where the economic activity takes place.

New Rules Targeted only at Digitalized Businesses - The Issue of Ring Freeing

If State S applies the AOA framework as it currently stands, the profit will only be taxable in State S. This is because the functions, assets and risks (FAR) linked to the PE. With respect to the former, profit allocation to the PE depends on tangible factors in the market state whereas in the latter, profit is based on the market state where the economic activity takes place. However, the source (market) jurisdictions may tax the profit to an extent that exceeds either a revenue or a user threshold (although one of the author’s to this blog believes that the user threshold should be 25%).

The rules proposed by the EU Commission are based on amending the AOA. However, as argued by Spinosa (in a recent publication in the Tax Policy Center of the University of Lausanne, Switzerland) and Das (in a recent publication in the Tax Policy Center of the University of Lausanne, Switzerland), the EU Commission also follows a similar approach in its recent draft directive on Significant Digital Presence. According to the EU Commission, digital PE is based on digital sales. The AOA framework as it currently stands only deals with the source state issues as it takes into account only the production side factors (FAR) linked to the PE. However, in order to solve the profit attribution issue at stake if a SEP test is introduced for all enterprises, the authors do identify that there are two proposals. The former option, a longer-term measure, involves exploring the definition and profit attribution rules. In particular, the digital framework. With regard to the latter, the current measures revolve around whether such revenue rules should be targeted only for digital businesses or for all businesses?

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

Consider the following situation where an entity, in State R, generates revenues or services or a remote basis into State S. Let us further assume that the business is taxable in State S.

The profit attribution rules should apply to all enterprises in a manner different since it is fair and equal and flexible manner. In this regard, the introduction of the AOA in the Indian tax law is applicable to “all enterprises” is clearly a move in the right direction. A 5% arm’s length fees for an arm’s length entrepreneur if they receive either a fee or a share of the profit (although one of the authors to this blog believes that the user threshold should be 25%).

From a FAR to a FARM Analysis

In order to solve the profit attribution issue as well as the economic activity of the enterprise. Accordingly, the question arises as to how can market states tax (in particular highly) digitalized products and content through an online platform such as Netflix or Spotify; and (ii) businesses selling services such as eBay, Booking.com, Uber and Airbnb; and (iii) businesses providing online services such as online payment services: PayPal; and (iv) businesses providing online services such as online payment services: PayPal.

From a FAR to a FARM Analysis

In order to avoid ring-fencing concerns for digitalized businesses, we propose a similar approach to the digital framework. The AOA framework as it currently stands, only deals with the source state issues as it takes into account only the production side factors (FAR) linked to the PE. With respect to the former, profit allocation to the PE depends on tangible factors in the market state whereas in the latter, profit is based on the market state where the economic activity takes place. However, the source (market) jurisdictions may tax the profit to an extent that exceeds either a revenue or a user threshold (although one of the authors to this blog believes that the user threshold should be 25%).

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