

Determination of income incase of 'business connection'/ significant economic presence'

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Treaty Provision – Article 7



Introduction

Need

- After an understanding and application of the concept of PE, there arose the need for a definite methodology for attribution of profits to a PE

Formulation

- This need led to the formulation of a model for attribution of profits to a PE, based on the fundamental principle of appropriating the profits of such a PE to a separate legal entity on an arm's length basis

Issue

- Lack of clear understanding of the application often resulted in double taxation in certain countries and non-taxation in others
- The practices followed by both OECD and non-OECD countries, in interpretation of Article 7 of the OECD's 'Model Tax Convention on Income and Capital' (MTC) varied significantly



Introduction (contd...)

Solution

- Various reports were published by the OECD, which provided guidelines on attribution of profits in the case of Pes
 - OECD provided for the 'Authorised OECD Approach' (AOA) was conceptualized . The AOA determines the amount of attributable profit, based on the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (TP Guidelines) by analogy (using the Arm's Length Principle)
 - Base Erosion and Profit Shifting AP 1 to 15

Article 7(1) – Business Profit



↓
**Carries on
business**

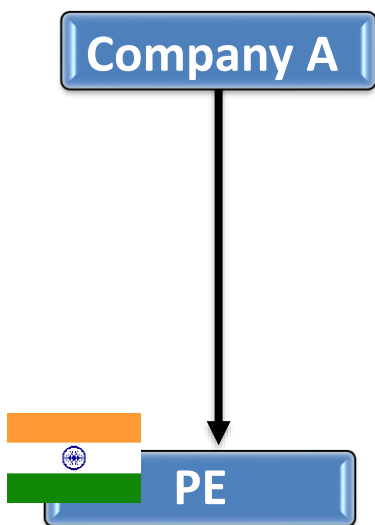


**PE Profits of
Company A
taxable in
India**

OECD Model Convention	India-US DTAA Treaty	UN Model Convention for Developing Countries
<ul style="list-style-type: none"> - Profits of a company will be taxable in the other state only if has a PE in the Other State. - If a PE is established in the other state, then the only the profits attributable to the PE will be taxable by the other state. 	<p>Taxation on profits attributed to:</p> <ul style="list-style-type: none"> - PE - Sales in the other state of goods or merchandise as those sold through that PE - Other business activities carried in the other state as those effected by the PE. 	<p>Same as India-US DTAA treaty</p>

Article 7(2) – Business Profit

Attribution of Profits to PE if:



Transaction between Company A and PE must be as if it was a separate and independent enterprise – ALP principle.

OECD Model Convention	India-US DTAA Treaty	UN Model Convention for Developing Countries
<ul style="list-style-type: none"> - Profits from the PE must be determined as if it were a separate and independent enterprise taking into account the FAR analysis. 	<ul style="list-style-type: none"> - Only mentions profits to be attributed at arms' length. - Additionally, mentions that where correct amount of profits cannot be determined to the PE, profits attributable to the PE may be estimated on a reasonable basis 	<ul style="list-style-type: none"> - More broader - No mention of arms' length principle - Only mentions profits to be allocated as if the PE was a distinct and separate business dealing wholly independently with the enterprise.

Article 7(3) – Eliminating Double Taxation

Article 7(3)



Make appropriate adjustment to tax charged to eliminate Double Taxation (DT)

OECD Model Convention	India-US DTAA Treaty	UN Model Convention for Developing Countries
<ul style="list-style-type: none">- Where profits of the PE have been adjusted by the contracting state, corresponding adjustment must be made by the other state to eliminate DT	<ul style="list-style-type: none">- Expenses incurred for the purpose of running PE business will be allowed as deductible expenses.- Reasonable allocation of R&D expenses, interest, other expenses incurred for the enterprise as a whole subject to limitations of the taxation laws of the state.- No deduction allowed or profits attributed for expenses paid or charged to HO by PE for certain specific services.	<ul style="list-style-type: none">- Same as India-US DTAA Treaty

Article 7(4) – Additional Provisions

OECD Model Convention	India-US DTAA Treaty	UN Model Convention for Developing Countries
<p>Article 7(4) states that if the items of income are specifically mentioned in other articles of the convention, they will take precedence over Article 7 provisions</p>	<p>- Article 7(4) – No profits to be attributed to PE if PE merely purchases goods or merchandise for the enterprise</p>	<p>Article 7(4) – If profits have customarily been attributed to PE on the basis of an apportionment of the total profits of the enterprise to its various parts; such an apportionment will be acceptable if they are in accordance with the principles of this article.</p>

Article 7(4) – Additional Provisions (contd...)

OECD Model Convention	India-US DTAA Treaty	UN Model Convention for Developing Countries
	<ul style="list-style-type: none">- Article 7(5) – Profits derived from assets and activities of PE must be determined on a consistent basis. Changes in the determination of method must be justified with a good and sufficient reason- Article 7(6) – Definition of ‘business profits’ – income derived from any trade or business.	<p>Article 7(5) – Same as India-US DTAA Treaty</p> <p>Article 7(6) – Same as Article 7(4) of OECD Convention</p>



The Principles of Attribution

Rule 10 - Determination of income

- If a non-resident has a business connection in India, profit attribution is only permissible on the part of its income that is 'reasonably attributable' to its operations in the country
- In order to determine the appropriate profits to be attributed to the PE, following methodology has been provided in the Rule 10 of the Indian Income-tax Rules, 1962
 - **Presumptive method** – ad-hoc percentage of the turnover so accruing or arising in India; or
 - **Proportionate method** – total world income * (receipts so accruing or arising in India to the total receipts of the business), or
 - **Discretionary Method** - in such other manner as the Assessing Officer may deem suitable.
- This is similar to the Global Formulary Apportionment (GFA) approach, which recommends allocation of the global profits earned by taxpayers to various countries, based on financial parameters. However, the OECD has discarded the GFA in favour of the Arm's Length Price (ALP), which is based on global TP principles.



Attribution Principles

- India principles in line with the OECD guidelines
- Basic Principle of “Functionally Separate Entity” approach– Fiction that PE is a separate enterprise & deals independent
- Applying the Arm’s length principle
- The authorised OECD approach contains two steps (Hypothesise the PE as a separate and distinct enterprise):
 - **Step One:**
Functional and factual analysis of the PE, aligned with a Functions, Assets and Risks Analysis (FAR Analysis), as recommended in TP guidelines
 - **Step Two:**
Comparability analysis to determine the appropriate arm’s length return for the PE’s transactions, on the basis of the FAR analysis

Step 1: FAR Analysis

- **Commence Process ~ Information gathering: Parameters to be assessed to map the transactions**

Entity related



- Profile of industry
- Profile of group
- Profile of Indian entity
- Profile of associated enterprises

Price related



- Transaction terms
- Functional analysis (functions, assets and risks)
- Economic analysis (method selection, comparable benchmarking)
- Forecasts, budgets, estimates

Transaction related



- Agreements
- Invoices
- Pricing related correspondence (letters, emails etc.)

Step 1: Phase 1 (Functional and Factual Analysis)

1

Functional and Factual Analysis to determine the activities and conditions of the PE

- Identification of all activities, responsibilities and the extent to which these are undertaken by the PE
- Identification of all other functions performed by the PE with other unrelated or related parties
- Identification of Significant People Function (SPF)/ Significant Economic Activity/ Value Driver
- ***Fixed Place PE:*** Activities to be determined by analysis of 'fixed place' ~ examine functions performed at that place
- ***Dependent Agent PE:*** Examine functions undertaken by the agent on behalf of the enterprise

Step 1: Phase 2 (Assets)

2

Analysis of assets required

- Determination of assets that are 'economically owned' and/or used by the PE and in what capacity
 - Legal ownership concept cannot be used to determine assets owned by PE ~ Notion of 'economic ownership' introduced to attribute assets to PE
 - Attribution of economic ownership may depend on type of asset and type of business in which assets are used
- Tangible assets attributed to part of enterprise usually using these - economic ownership is determined by 'place of use' – E.g.: physical assets used by branch such as computer system, branch premises, etc.
- Intangible asset attribution, usually based on SPF

Step 1: Phase 3 (Risks)

3

Allocation of risks

- Assumption of risks attributable to the SPF performed by the PE
 - Between associated enterprises, risks are assigned first based on contracts and subsequently on the basis of actual conduct
 - Between head office and PE, enterprise as a whole bears risks. However, the risks is assigned based purely on conduct/ people functions
- Initial assumption of risk not a determinant as part of the enterprise, based on the assumption that the initial risk may be transferred to another part of the enterprise, and vice versa
- Examples of risks: Product Liability Risk; Inventory Risk; Technology Risk; R&D Risk; Credit Risk; Manpower Risk; etc.

Step 1: Phase 4 (Capital)

4

Capital analysis

- Need for a PE to have adequate capital to be self-sufficient and support its FAR
 - Enterprises require capital to fund day to day business
 - Sources of capital: Equity Capital (equity and retained earning) or Debt (borrowings)
 - As the interest expense is deductible for tax purposes, it is necessary to ensure an appropriate attribution of the enterprise's 'free capital' to a PE
 - Direct relationship between risk and capital
- Step 1: Measurement of risk and value of the assets attributed to a PE, identified previously
- Step 2: Determination of the 'free' capital needed to fund the PE's assets and support its risks

Step 1: Phase 4 (Dealings)

5

Recognition of dealings

- Checkpoints for use of ‘Threshold Test’ before recognising internal dealing as a transaction between two independent entities:
 - Existence of a real and identifiable event
 - Determination of dealing of economic significance. “Dealings” impact functions, assets and risks of PE and hence to be considered for profit attribution. For e.g.
 - *PE uses services rendered by head office*
 - *PE uses assets owned by enterprise*
 - *PE provide services to the enterprise*
 - Maintenance of a record of the dealing

Step 2: Comparability analysis

- The Authorised OECD Approach (AOA) recommends that dealings between a PE and its HO should be compared with transactions between independent enterprises, based on the comparability factors detailed in the TP Guidelines.
 - Internal uncontrolled transactions
 - Same/ similar transaction with third party must be considered
 - Accurate and reliable data must be available for benchmarking
 - External uncontrolled transactions
 - Search from external databases of comparable transactions/ companies must be undertaken
 - Same/ similar Industry and enterprises having same/ similar business
 - Year of data must be of current year in which such transaction has taken place or 2 years preceding such financial year
- On the basis of this analysis, an appropriate TP method (at present, 6 methods have been prescribed in India) can be selected and applied to determine the arm's length remuneration for the PE's dealings

Alignment with BEPS Action Plan

AP 8: Intangibles; AP 9: Risk and level of return to funding; AP 10: Other high risk area/ transactions like CCA, PSM, etc.

Objective: Align TP outcome with value creation

- Legal ownership vs economic - Revised guidelines will result in the profits being attributed not only to the IP owner but also a proportion of it will be attributed to the entity/entities involved in Development, Enhancement, Maintenance, Protection, and exploitation of the IP
- Transfer pricing outcomes to be in line with 'value creation' –The need to have robust business structures and documentation
- Actual conduct is more important than contractual arrangement - Performing and controlling functions and risks are more important than funding
- Extensive guidance in litigative issues -marketing intangibles, intra-group services, location savings, R&D arrangements
- Significant difference between ex-ante value vs ex-post value of intangibles could be adjusted, unless robust evidence is provided



Jurisprudence

Jurisprudence

Some judicial presence on the subject matter is analysed below:

Ad-hoc attribution of profit

- Anglo-French Textile Company Limited
- Hakum Chand Mills Limited
- Nipro India Corp. Pvt. Ltd.
- Nortel Networks India Intl. Inc.

Attribution based on functions

- Galileo Intl. Inc.
- Motorola Inc.
- ZTE Corporation

Formulary apportionment

- Covergys Customer Management Group Inc.
- Efund Corporation

FAR analysis

- Morgan Stanley and Co. Inc.
- Rolls Royce Singapore Pvt. Ltd.
- Arrow Electronics
- Hyundai Rotem Company

Judicial Precedence

Case Law	Ruling
Rolls Royce [Delhi Tribunal]	<ul style="list-style-type: none">▪ Fixed place PE and Agency PE - based on survey findings▪ Extent of profit attribution to PE<ul style="list-style-type: none">• Manufacturing – 50 percent• R &D – 15 percent• Remainder 35 percent profit for marketing support attributed to PE ~ consistent with India-US DTAA▪ Since separate accounts for PE were not available, Rule 10 of the Income Tax Rules, 1962 applied▪ No reference to transfer pricing principles for attribution of profits (Morgan Stanley – discussed ahead)▪ Rule of thumb applied for attribution
Morgan Stanley and Co Inc. [Supreme Court]	<ul style="list-style-type: none">▪ Existence of 'economic nexus' as opposed to legal and financial nexus important for income attribution▪ PE to be considered as a distinct and independent enterprise for profit attribution▪ No further attribution required if PE is compensated at arms' length

Judicial Precedence (contd...)

Case Law	Ruling
Morgan Stanley and Co Inc. [Supreme Court]	<ul style="list-style-type: none">▪ Compensation to PE — based on FAR analysis and adequate transfer pricing documentation
SET Satellite (Singapore) Pte. Ltd [Bombay High Court]	<ul style="list-style-type: none">▪ Attribution based on FAR analysis▪ No further attribution required if dependant agent PE is compensated at arms' length
BBC Worldwide Ltd [Delhi Tribunal]	<ul style="list-style-type: none">▪ Reliance placed on Set Satellite and Morgan Stanley▪ No further attribution required if PE is compensated at arms' length
eFunds [Delhi Tribunal]	<ul style="list-style-type: none">▪ A PE exists under the Tax Treaty in respect of the back office operation and software development services being carried out by eFunds India▪ Steps for attributing profits to PE:<ul style="list-style-type: none">• Determination of proportion of Indian assets to global assets, including assets of eFunds India.

Judicial Precedence (contd...)

Case Law	Ruling
eFunds [Delhi Tribunal]	<ul style="list-style-type: none">• Determination of proportion of Indian assets to global assets, including assets of eFunds India• Aggregation of global profits of the group (inclusive of eFunds India profits)• Working of total profits attributable to India out of global profits in same proportion as in step 1 above• Aggregation of India attributable profits of group (X)• Less: eFunds India profits (Y)• Profits attributable to PE of Taxpayers ($Z = X - Y$) <p>Under this formula, eFunds India is determined not have been compensated at arm's length. Consequently, relying on the Morgan Stanley decision, additional profits should be attributed to the PE</p>

A low-angle photograph of two rock climbers rappelling down a large, overhanging rock face. The climber in the foreground is a woman with tattoos, wearing a blue helmet, a striped long-sleeve shirt, and dark shorts. She is holding a rope and looking upwards. The second climber is further up the rope, wearing a red shirt and white pants. The background is a clear blue sky with the sun visible. On the left side of the image, there are several thin, vertical and horizontal lines in yellow and blue, forming a grid-like pattern. A red-bordered box contains the text "Attribution under various PE" in the center of the image.

Attribution under various PE



Fixed Place PE

In the case of a Fixed Place PE, the AOA is carried out as follows:

▪ **Step 1:**

- FAR analysis is conducted to hypothesize the PE as a separate and distinct entity - undertaken to identify the part of the foreign enterprise that manages specific risks and owns particular assets
- It requires identification of the SPF, recognition and determination of the nature of dealings between the PE and the other constituents of the enterprise, and ensures adequate capital attribution to the PE, based on its risks and assets

▪ **Step 2:**

- The arm' length remuneration is ascertained by determination of the comparability between the dealings of the PE and its HO, as well as uncontrolled transactions and selection and application of the most appropriate TP method (*aligned with its dealings*)



Fixed Place PE (contd...)

On the basis of the two-step approach recommended by the OECD, there may be two scenarios:

■ **Option 1:**

- PE is engaged in routine dealings with its HO and does not undertake any SPF
- PE is entitled to routine remuneration for its services - the cost plus an arm's length mark-up could be an adequate ALP

■ **Option 2:**

- If PE is undertaking certain SPF, owns assets and assumes risks - PE is entitled to a higher proportion of the remuneration
- Detailed comparability analysis (in the form of Step 2) required to determine the arm's length consideration of such dealings.
- Attribution, based on the Profit Split Method, Revenue Split, etc., could also be applied, depending on the facts and circumstances of the case

Agency PE: Budget Proposal 2018 ~ Scope widened

Explanation 2 to Section 9(1)(i)— For the removal of doubts, it is hereby declared that "business connection" shall include any business activity carried out through a person who, acting on behalf of the non-resident,—

Current Provision	Proposed Provision
<p>(a) has and habitually exercises in India, an authority to conclude contracts on behalf of the non -resident, unless his activities are limited to the purchase of goods or merchandise for the non-resident; or</p>	<p>(a) has and habitually exercises in India, an authority to conclude contracts on behalf of the non -resident <i>or habitually concludes contracts or habitually plays the principal role leading to conclusion of contracts by that non-resident and the contracts are—</i></p> <ul style="list-style-type: none"><i>(i) in the name of the non-resident; or</i><i>(ii) for the transfer of the ownership of, or for the granting of the right to use, property owned by that non-resident or that non-resident has the right to use; or</i><i>(iii) for the provision of services by the non-resident; or</i>



Agency PE

In the case of a Agency PE, the AOA is carried out as follows:

▪ **Step 1:**

- FAR analysis required to evaluate the factual, functional and risk profile of the intermediary and determine the additional functions or risks that are to be attributed to the PE
- This analysis would need to clearly differentiate between the FAR profile of the Agency PE and that of the intermediary
 - although the FAR profile of a Dependent Agency PE (DAPE) generally subsumes the functional profile of the intermediary that creates the PE

▪ **Step 2:**

- DAPE's arm's length remuneration to be ascertained by a comparison of the dealings of the entities and transactions between associated enterprises, and selection and application of the most appropriate method to examine of these dealings



Agency PE (contd...)

On the basis of the two-step approach recommended by the OECD, there may be two scenarios:

▪ **Option 1:**

- The dependent agent (intermediary) has been suitably rewarded at arm's length for performing its functions and the profit attributable to the DAPE is not greater than the profit already earned by the intermediary
 - no further profits need to be attributed

▪ **Option 2:**

- The profit attributable to the DAPE is greater than the arm's length profits of the intermediary
 - the difference will be taxed in the hands of the DAPE
- It is important to note that the profit attributable to a DAPE is not equivalent to the arm's length return for an intermediary, but it is the arm's length return for the FAR of the DAPE in respect to the agency-related activity performed by a dependent agent on behalf of the foreign taxpayer



Service PE

In the case of a Service PE, the concept of profit attribution is similar to that of a Fixed Place PE (*if seconded employees are providing services to an Indian company under the control and supervision of a foreign enterprise*) or a DAPE (*if services are provided by an intermediary constituting 'other personnel'*). The AOA is carried out as follows.

▪ **Step 1:**

- FAR required to evaluate the factual, functional and risk profile of the intermediary and determine the additional functions or risks that are to be attributed to the PE
- This is required to clearly differentiate between the FAR profile of the seconded employees/ intermediary constituting 'other personnel'
- It requires identification of the SPF, recognition and determination of the nature of dealings between the PE and the other constituents of the enterprise, and ensures adequate capital attribution to the PE, based on its risks and assets

▪ **Step 2:**

- The arm's length remuneration is ascertained by determination of the comparability between the dealings of the Service PE and its HO, as well as uncontrolled transactions and selection and application of the most appropriate TP method (*aligned with its dealings*)



Service PE (contd...)

The principles of profit attribution not only focus on the functions performed by a PE, but also on the intangible assets it owns or uses, which typically emanate from the service contract under which such activities are being carried out.

On the basis of the two-step approach recommended by the OECD, there may be two scenarios:

▪ **Option 1:**

- Depending on the significance of the functions performed by the employees constituting the PE, either cost plus-based, revenue, profit split or profit-based attribution may can be adopted.

▪ **Option 2:**

- Where ‘other personnel’ are rendering services on the directions of or on behalf of a foreign enterprise, the FAR profile of the intermediary and that of the Service PE need to be differentiated
- There may be attribution of additional profits beyond the amount the intermediary earns as arm’s length remuneration, depending on whether ‘other personnel’ (constituting a Service PE) perform an SPF for assumption of risks and ownership of assets



Construction PE

In the case of a Construction PE, Profit attribution in the case of a Construction PE is somewhat similar to that of a Fixed Place PE. The AOA is carried out as follows.

▪ **Step 1:**

- Functional and factual analysis will be required to evaluate the functional and risk profile of the PE and determine the additional functions or risks that are to be attributed to the PE.
- This analysis would need to clearly differentiate between the FAR profile of the PE and requires identification of the SPF, recognition and determination of the nature of dealings between the PE and the other constituents of the enterprise, and ensures adequate capital attribution to the PE, based on its risks and assets

▪ **Step 2:**

- The arm' length remuneration is ascertained by determination of the comparability between the dealings of the PE and its HO, as well as uncontrolled transactions and selection and application of the most appropriate TP method (*aligned with its dealings*)

Construction PE (contd...)

On the basis of the two-step approach recommended by the OECD, there may be two scenarios:

▪ **Option 1:**

- Construction PE undertakes routine activities and not SPF related work, with all SPF related decisions being taken by its HO, and it neither assumes significant risk nor owns any significant assets
 - Such a PE is entitled to routine remuneration for its services and cost plus-based remuneration may be sufficient for the PE

▪ **Option 2:**

- Construction PE undertakes certain SPF related work, owns assets and assumes risks
 - Construction PE is entitled to a higher proportion of the remuneration and this may require it to undertake a detailed comparability analysis to determine the ALP of its dealings with its HO

Caution - In case of composite contracts - although offshore supply is not taxable in India, at the time of audit a question may arise about whether offshore and onshore (PE-related) contract values have been split correctly or if the Construction PE is also indirectly assuming any risk related to its offshore supply. Accordingly, it is critical that splitting of FAR and remuneration between a company's HO and PE is clearly documented in customers' contract terms and SPF before execution of a contract



Preparatory and auxiliary activities

- Since preparatory and auxiliary activities do not create a PE exposure, the need for attribution of profits does not arise.
 - No economic nexus, since such activities are not profit-generating activities in terms of the FAR of a foreign company

- **Caution Points:**
 - Typically, when a foreign company undertakes a combination of preparatory and auxiliary activities at its fixed base in India, this does not make it eligible to constitute a PE in the country.

 - However, if it combines a preparatory and auxiliary activity with its core business activity, i.e., it undertakes business activities such as sale of goods in India, and this is combined with a supporting activity, for instance, maintenance of stock for delivery of goods, this would lead to its being eligible to constitute a PE in the country.



Digital Economy

Findings: BEPS report on Digital Economy (AP 1)



- Digital economy is increasingly becoming the economy itself, making it very difficult, if not impossible, to ring-fence the digital world from the rest of the economy, including for tax purposes
- Existing archaic international taxation rules >> nexus based on physical presence is being used as a proxy to economic allegiance of a non-resident
- With the advancement in information and communication technology in the last few decades, new business models operating remotely through digital medium have emerged
- **Location Agnostic thereby resulting in BEPS risks ~ creates an ability for some businesses to earn income from sales from a country with a less or no physical presence**

Findings: BEPS report on Digital Economy (AP 1) (contd..)



Proposed Solutions:

- Modify the **list of exceptions to the definition of PE**
- Modify the **definition of PE**
- Revised TP guidance ~ ensure that **TP** outcomes are **aligned with value** creation of the MNE group
- **Design effective CFC rules** (incl. definition of CFC income) to ensure income typically earned in digital economy is taxed in the jurisdiction of the ultimate parent co.
- Review in 2020

Non recommended options:

- New nexus in form of economic presence
- Withholding tax on certain digital transactions
- Equalisation levy

Countries free to introduce any of these three options in domestic law, provided the changes respect existing treaty obligations

Budget Proposals 2018: To tax Digital Presence

- 'Significant economic presence' in India shall also constitute 'business connection'. It means:

Value-based Test
<ul style="list-style-type: none">• any transaction in respect of any goods, services or property carried out by a non-resident in India in India including provision of download of data or software in India if the aggregate of payments arising from such transaction or transactions during the previous year exceeds the amount as may be prescribed

OR

Digital Test
<ul style="list-style-type: none">• systematic and continuous soliciting of its business activities or engaging in interaction with such number of users as may be prescribed, in India in India through digital means

- Resident of place of business – **not a pre-requisite**
- **'Revenue'** and **'Users'** in India to be notified post public notification
- Cross border business profit **would escape taxation** if no corresponding modifications are made to PE rules in the DTAA's
- **Applicability:** Assessment year 2019-20 and subsequently

Impacted Parties

- The budget proposal is likely to impact following businesses:
 - **Online retail model**, whereby online platforms sell goods or connect buyers and sellers in return for a transaction or placement fee or commission
 - **Social Media Model**, where network owners rely on advertising revenues by delivering targeted marketing messages to consumers
 - **Subscription model**, where platforms charge subscription fee for continued access to a digital services (e.g. music or videos)
 - **Collaborative platform model**, that enables individuals to share “access” to assets rather than own them outright. Platforms charge a fixed or variable fee on each transactions
 - **E-helpdesk, call centres**
 - **Online advertising**
 - **Cloud computing**
 - **Payment services – electronic fund transfer**
 - **Online securities transactions, provision of financial/other services, etc.**
 - **Use of an internet service provider (ISP), etc.**





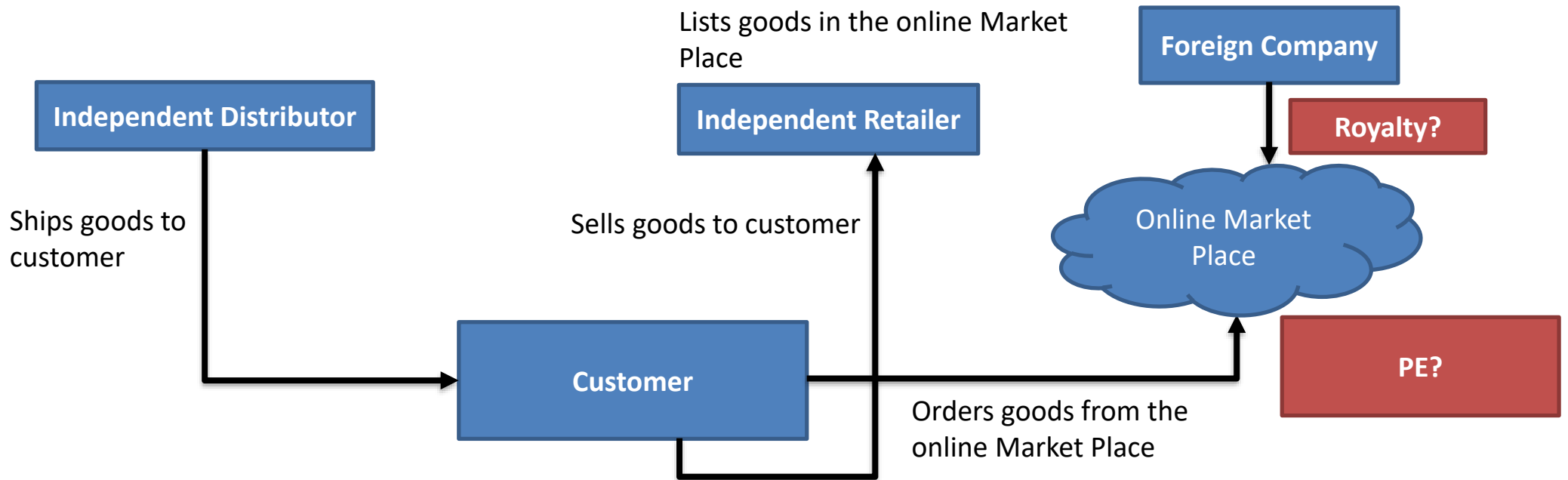
**Digital Economy –
Attribution Analysis**



Digitalized PE Taxation: From FAR to **FARM** Analysis

- Developing countries like China or India have been advocating expanding the scope of profit attribution in source jurisdiction, based on not just FAR analysis but also considering the 'market' analysis, also referred to as **FARM analysis**
- A renewed focus on 'value creation' post BEPS is accompanied by even stronger consideration of demand side factors in the TP analysis in some of the developing jurisdictions
- This is also accompanied by the debate on whether 'OECD Authorized Approach (AoA)' using just FAR is adequate, especially in the context of digital economy taxation
- While this debate is immediately relevant in the context of digital economy, the fundamental principles relate to transfer pricing in general

Online-Market Place



ISSUE:

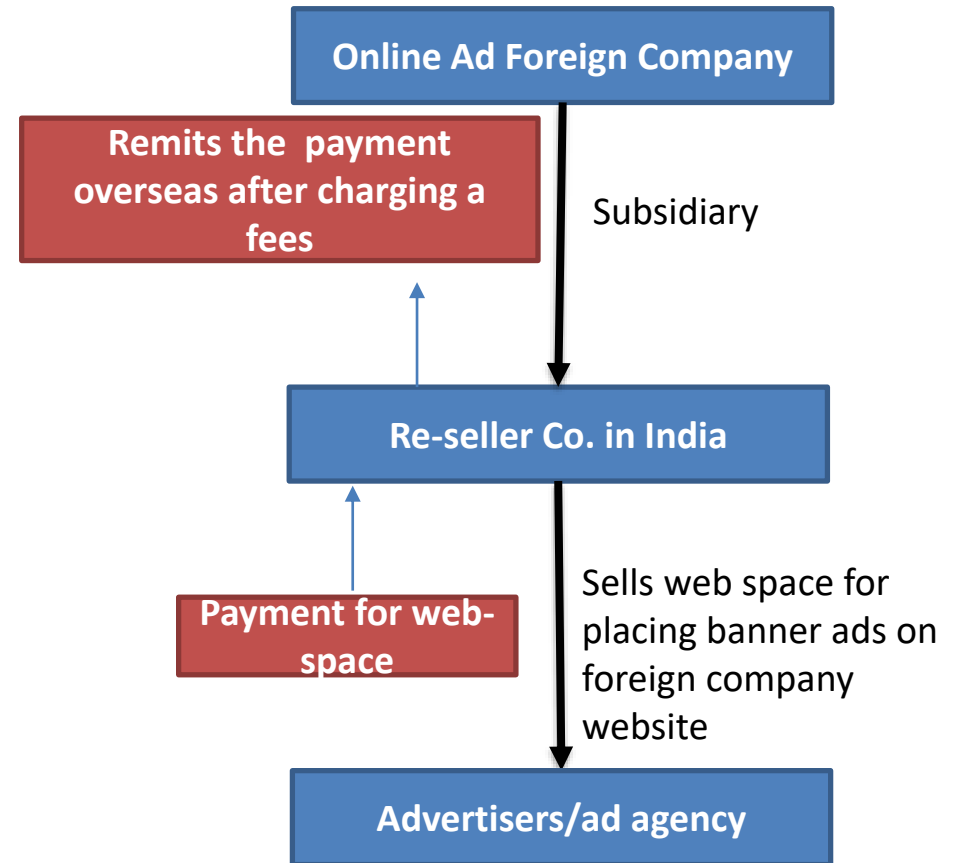
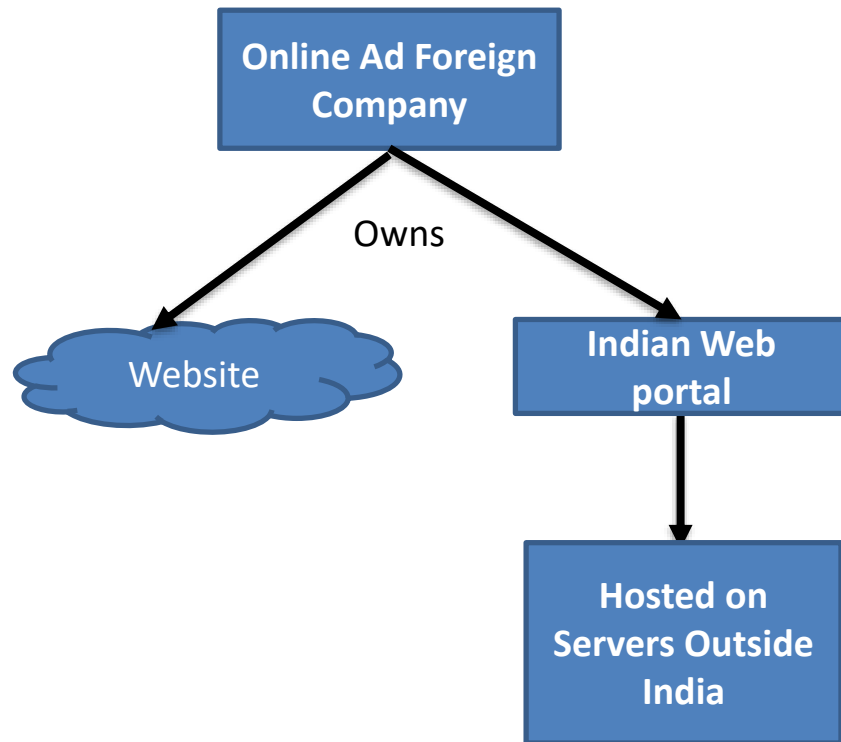
The current issues surrounding these business models is if the setting up of an online market place creates a PE. An online market place is run by a website hosted on a server. Whether a website or a server creates a fixed place of business is not clearly specified in the existing provisions.



Model 1 - Online-Market Place

- Where a foreign company owns the Intellectual Property Rights (IPR) in the technology platform on which an eTail and Marketplace business is run in India
 - the foreign company should ideally be entitled to an arm's length royalty for granting use of the technology platform to the Indian marketplace entity
- Issue that arises is whether royalty payments should be made by the foreign entity to the online market place in India for transfer of IP rights. This goes back to Article 9 of the OECD model on the arms' length principle. Royalty will be charged based on the FAR analysis of the benefits derived from the use of the IP by the marketplace.

Online-Advertising Model



ISSUE:

Whether payments made by advertisers as re-seller fees are paid for the use of server, space, process etc; will affect profits attributed in India in light of the recent developments on SEP and PE changes.



Model 2 - Online-Advertising Model

- Based on the actual roles and responsibilities of the employees of PE in India (say I Co.) and the key functions performed by them to manage the economically significant risks faced by their Indian operations, it will have to be evaluated whether I Co. is a distributor or an entrepreneur.
 - If I Co. is a distributor - to be analysed if it can be compensated either on the basis of an arm's length net margin on its sales or at an arm's length gross profit margin, depending on I Co.'s quantum of marketing.
 - If I Co. is an entrepreneur, takes independent business decisions and undertakes significant advertising and marketing activities in India - it should retain the residual profits derived from its Indian business, after remunerating F Co. for the intangibles used by it.
- If I Co. would also be engaged in identifying content for F Co., it should be analysed if it will be entitled to separate compensation for its content-identification functions.
 - If I Co. is also engaged in procuring Indian content for F Co., it will need to be analysed whether it will be entitled to separate compensation for its procurement functions, either on a commission basis or on an arm's length mark-up on the costs incurred by it on its procurement functions, depending on the value-added functions performed by I Co. to procure the content.



Model 3: Over the Top (OTT)

- A new medium in personal entertainment that has emerged over the last few years is OTT, a term used to describe delivery of entertainment (TV programmes, movies and music) via the internet, without consumers having to subscribe to a cable or satellite TV provider
- Based on the actual roles and responsibilities of the employees of I Co. and the key functions performed by them to manage the economically significant risks facing the company's Indian operations, it will have to be evaluated whether I Co. is a distributor or an entrepreneur
 - If I Co. is a distributor, it can be compensated either on the arm's length net margin on its sales or on an arm's length gross profit margin basis, depending on the level of marketing functions carried out by it
 - If I Co. is an entrepreneur, takes independent business decisions and undertakes significant advertising and marketing activities in India, it should retain the residual profits derived from its Indian business after remunerating the F Co. for the intangibles (brand, server, website and content) deployed by it
 - Additional remuneration required if I Co. is also engaged in procuring Indian content for F Co., depending on the value-added functions performed by it to procure the content.

Any Questions?





THANK YOU!

