Profit Attribution Methods In The Post BEPS Era

(Evolution in benchmarking approaches, compliances with specific emphasis on online platform business)

In response to the concern expressed by the G20 countries on tax planning behavior of the Multinational Enterprises (MNEs) leading to the base erosion and profit shifting and in consequence to the joint efforts of the OECD and the G20, an Action Plan on Base Erosion and Profit Shifting was published in 2013. It included 15 action points to encompass all those issues where actions were required to plug the gaps that are used by the MNEs to reduce their taxable income from tax jurisdictions where economic activity is performed to shift it artificially to low tax jurisdictions. The BEPS Project undertaken jointly by the OECD and G20, after concerted efforts that involved extensive consultation with stakeholders and analysis of voluminous written submissions received in this regard published final report in 2015.

After releasing BEPS final report, the OECD has published its revised Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017. This edition of TP guidelines incorporates substantial changes based on BEPS final Reports. A significant change made in the revised guidelines is in respect to aligning Transfer Pricing outcomes with value creation and making it clear that legal ownership alone does not necessarily generate a right in the returns. However, Post-BEPS the new guidelines continue to develop the understanding of the arm's length principles on an economic interpretations. It implies that the members of the MNE group should be remunerated for their contribution in value chain based on transfer pricing analysis (which involves the analysis of functions performed, assets used and risks assumed by the related parties in a transaction.

Tax treaties provide that the business profits of a foreign enterprise are taxable in a state only to the extent that the enterprise has in that state a permanent establishment (PE) to which the profits are attributable. The Action Plan on Base Erosion and profit shifting called for a review of that definition to prevent the use of certain common tax avoidance strategies that are currently used to circumvent the existing PE definition. Change made post BEPS in definition of a Dependent Agent Permanent Establishment (DAPE), or the anti-fragmentation rule made to prevent artificial avoidance of PE status through the specific exceptions in Article 5(4), or through other strategies will enable countries to address BEPS concerns resulting from tax treaties, which was a key focus of the work mandated by the BEPS Action Plan. Though the changes made to Article 5(5) and 5(6) of the Model Tax convention by the report on Action 7 have modified the threshold for the existence of a deemed PE under Article 5(5), but post BEPS nature of deemed PE has not been modified. Broadly profits to be attributed to a PE are to be determined in accordance with Article 7 of the relevant tax treaty. Accordingly profits attributable to PE are those that the PE would have derived if it were a separate and independent enterprise engaged in the same or similar activities under the same and similar conditions. These principles would apply regardless of whether a tax administration adopts the Authorized OECD Approach contained in Article 7 of the 2010 version of the Model Tax

Convention or any other approach used to attribute profits under a previous version of Article 7 of the MTC.

The OECD/G20 BEPS Project has also made attempt to address the challenges of Digitalization of the economy in Action 1 Final report. The key feature of digitalized economy has always been the lack of need for physical presence. Therefore, the existing international taxation principles which are based on physical presence of a business in a tax jurisdiction for attribution of profit are not applicable in the case of Digitalized business. The Action 1 Final report considers that the digital economy and its business models do not generate unique BEPS issues, some of its key features exacerbate BEPS risks. These BEPS risks were identified and took these issues into account to ensure that proposed solutions fully address BEPS in the Digital economy. Accordingly, it was believed that various measures, including the measures discussed above, developed in the BEPS Project would substantially address the BEPS issue intensified by the digital economy at the level of both the market jurisdiction and jurisdiction of the ultimate parent company. But none of the options analyzed by the Task force on Digital Economy (TFDE) namely (i) a new nexus in the form of significant economic presence (ii) a withholding tax on certain types of digital transactions, and (iii) an equalization levy were recommended by the Final BEPS Report. Countries were however given the liberty to introduce any of these options in their domestic law as additional safeguard against BEPS provided they either respect their existing treaty obligations, or the treaties themselves are amended to introduce these changes.

In March 2017 following the mandate from the Finance Ministers of G20 Countries, the inclusive framework on BEPS through TFDE issues interim report 2018 “Tax Challenges arising from Digitalization” The interim report conveys that members agreed to review the impact of digitalization on nexus and profit allocation rules. Several valuable suggestions made since then are under active considerations but that does not represent the commitment of any member of the inclusive framework to adopt them. Inclusive framework has released consultation document seeking views of public on technical and policy issues.

The presence of virtual PE has been a key focus of discussion and debate in considering the tax implication of the Digitalized economy. A tax nexus based on “significant economic presence” would lead to the expansion of the scope under the existing definitions in the treaties. Highly digitalized business models are characterized by high mobility, reliance on valuable data contributed by the users, use of network synergies etc. The assets such as brand, platform, knowhow, and data, the debate is focused on the means of valuing the relative computation of data across the digital value chains. Customers who generate unconscious value to the business could be considered key value drivers; and data or active customers might provide the sufficient nexus with the market jurisdiction. This perspective is not recognized in the current framework of allocating profit. If this perspective is recognized then the transfer pricing analysis will have to attribute profits to such virtual PEs.

BEPS public consultation document “Addressing the Challenges of the Digitalisation of the Economy” released in February 2019 gives details of three proposals for revising the profit

allocation and nexus rules to deal with the challenges posed by the digitalization. These three proposals which seek to expand the taxing rights of the user or market jurisdiction are 'User Participation Proposal', 'Marketing Intangibles Proposal' and the 'Significant Economic Presence Proposal'.

The user participation proposal is premised on the ideas that soliciting the sustained engagement and active participation of users is a critical component of value creation for certain highly digitalized businesses such as social media platforms, search engines and online market places. The value is generated by user participation in not captured in user jurisdiction under the existing international taxation framework, which focuses on physical activities of a business itself in determining where profit should be allocated and the extent of the taxing rights of user jurisdiction. To better align profit allocation outcomes with value creation, the proposal seeks to revise profit allocation rules to accommodate the value creating activities of an active engaged user base. The proposal acknowledges the difficulties in using traditional transfer pricing methods for determining the amount of profit that should be allocated to a user jurisdiction. It dismisses the idea that the value created by user activities can be determined through the application of the arm's length principle, that is by hypothesizing the user base as a separate enterprise and determining what returns it would receive at arm's length in its dealings with other group entities. It is instead proposed that the profit allocated to a user jurisdiction, in respect of activities of users, be calculated through a non-routine or residual profit split approach.

The Marketing Intangibles proposal, unlike user based taxation that is limited to highly digitized businesses, would have wider application in view of broader impact of digitalization on the economy. It addresses a situation where an MNE group can reach into jurisdiction either remotely or through a limited local presence to develop a user/customer base and other marketing intangibles. It sees an intrinsic functional link between marketing intangibles and market jurisdictions. Unlike marketing intangibles, trade intangibles are seen as not similarly possessing an intrinsic functional link market jurisdiction. A marketing intangible proposal would also help mitigating BEPS concerns regarding shifting the returns on marketing intangibles to low tax jurisdictions. As discussed in respect to user participation based proposal traditional transfer pricing methods cannot be applied in case of marketing intangible proposal also. It is instead proposed that the profit allocated to a user jurisdiction, in respect to marketing intangibles, be calculated through a non-routine or residual profit split approach regardless of which entity in the MNE group owns legal title to the marketing intangibles.

The Inclusive framework will also explore a proposal on the concept of significant economic presence. As noted in the Action Report 1, a link would have to be established between revenue generating activity of the non-resident enterprise and its significant economic presence. Additional issues to address in respect of revenue as a factor would include the definition of the types of transactions that are to be covered and appropriate thresholds. The proposal contemplates that the allocation of profit to a significant economic presence could be

based on fractional apportionment method. The tax base could be determined by applying the global profit rate of the MNE group to the revenue generated in a particular jurisdiction. The tax base would be apportioned by taking into account factors such as sales, assets and employees. However in case of user participation contributing value to the business users would also be taken into account in apportioning income.

It is expected that final OECD Report due in 2020 will provide certainty on nexus as well as attribution of profit in case of digital economy, but meanwhile number of countries including India have taken additional unilateral measures in domestic tax laws.

India has made certain amendments vide Budget presented on February 1 2018. Under the Budget amendments have been made to adopt lower threshold of DAPE set out in the OECD's BEPS report on artificial avoidance of PE. India has opted for the lower DAPE threshold by signing multilateral instruments also. Some of the India Treaty partners like France, Japan and Netherlands have also signed MLIs but many have not signed it. They include UK, Ireland, Singapore etc. Indian Domestic law will also be amended to include the concept of significant economic presence in the definition of PE. The budget has also defined SEP in terms of transactions in goods, service or property by the nonresident in India including provisions of down load of data/software beyond a specific threshold as well as systematic and continuous soliciting of business activities or engaging in interaction with specified number of users through digital means. The number of users beyond which this will trigger is yet to be prescribed.

India considers AOA approach can have significant adverse consequences for developing economies like India, which are primarily importers of capital and technology. It restricts the taxing rights of the jurisdiction that contribute to business profits by facilitating demand and thereby has the potential to break the virtuous cycle of taxation that benefits all stakeholders. India hold the view that since business profits are dependent on sale revenues and costs and since the sales revenue depends on both demand and supply, it is not appropriate to attribute profits exclusively on the basis of functions, assets and risks. Though formulary apportionment method is one of the alternative option to apportion global profits but it is considered not feasible in view of the practical constraints in obtaining information related to jurisdictions outside India. Therefore India proposes to choose the option of fractional apportionment based on apportionment of profits derived from India permissible under Indian Tax Treaties as well as rule 10. It is relatively feasible as it is largely based on information related to Indian operations. It will be based on three factors namely sales, manpower and assets that will be given equal weightage. Profit derived from India will be derived by multiplying the revenue derived from India with global operational profit margin. However, in case of global profit margin being loss or less than 2% to protect India's revenue interest under a deeming provision 2% of revenues from Indian operation would be considered as profit.

After taking into account the developments in taxation of digital economy and the new explanation 2A inserted by the Finance Act 2018, explicitly including significant economic

presence within the definition of business connection, India hold that it is considered necessary to take into account the role and relevance of users in contributing to the business profit of MNEs. User can be a substitute to either asset or employee and supplement their role in contributing profit of the enterprise. Therefore, for the purpose of attribution of profits, as the fourth factor of apportionment, in addition to three other factors of sales, manpower and assets.

Based on above mentioned approach which India has taken, a Committee constituted by the CBDT to propose changes in rule 10, has made certain recommendations. In brief these recommendations are as follows-

i) Rule 10 may be amended to provide that in case of an assesse who is not a resident of India having business connections in India and derives sales revenue from India by a business all the operations of which are not carried out in India, the income from India by a business that is attributable to the operations carried out in India and deemed to accrue or arise under clause (i) of sub section (1) of section 9 of Income Tax Act 1961 shall be determined by apportioning the profit derived from India by three equally weighted factors of sales, employees and assets.

ii) The amended rules should also provide an exception for enterprises in case of which the business connection is primarily constituted by the existence of users beyond the prescribed threshold. Income in case of such business shall be determined by apportioning the profits derived from India on the basis of four factors of sales, employees, assets and users. The users should be assigned a weight of 10 % in case of low and medium user intensity, where as in case of high user intensity weight to this factor should be 20%. Though sales factor in second situation will be 30 percent, assets and employees factor together will be 25 % each.

India has also imposed 6% levy on specified base eroding digital business. This levy is kept out of tax treaty network.

EU recommended 3% levy. However some countries in EU have opposed this levy namely Ireland, Sweden, Denmark and Germany.

UK is proposing levy of Digital service Tax

US has also opposed levy of digital tax.

It is evident the measures are unilateral and uncoordinated. These measures may lead to disputes on account of disproportionate tax burden on MNEs in multiple tax jurisdiction.

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