

The significant people function concept:

The concept of significant people function “SPF” was introduced in OECD 2010 report on attribution of profits to PE. SPF are people who conduct fundamental business function that lead to assumption of risk, the ownership of assets, or the on-going management of those risk & assets. In other words SPF means those people functions which make significant contribution to value creation and therefore are entitled to a portion of the residual profit/ loss. It must be noted that SPF is not considered to be the provision of advisory function or supervisory function (for example saying yes or no to a particular proposal) or governance arrangement.

The report starts by adopting the functionally separate entity approach as the authorized OECD approach for attributing profits to PE. Arguably its most salient point, however, is summarized by the following quote: “the authorized OECD approach attributes to the PE those risks for which the significant functions relevant to the assumption and/or management of risks are performed by people in the PE and also attributes to the PE economic ownership of assets for which the significant functions relevant to the economic ownership of assets are performed by people in the PE. It should be stressed that a particular enterprise may have one or more significant people functions”.

An SPF analysis is also required by the company to see whether it passes the litmus test to determine applicability of CFC norms. Given the importance of the SPF concept in the new setoff rules & subjective way it can be interpreted, it is believed that companies will have to seek assistance of transfer pricing specialist (who are used to addressing questions of relative values and importance of differing functional profiles) in order to determine how effectively CFC regime should be applied for a particular situation. The emphasis for TP specialist would be to determine whether operational profit from overseas business should be brought into CFC regime i.e. to say controlling company is subject to tax on undistributed profit of CFC.

There is an evolving consensus globally that TP audits should acknowledge broader business dynamics and market realities faced by MNE's, at the same time given due consideration to principle of substance & SPF for “true allocation of risk”. However an obvious question arises here: don't OECD developments relating to significant people functions (SPFs) concern only PEs? If so, how are they relevant to transfer pricing in a wider sense? In strict terms, the SPF concept put forward by the OECD does indeed not just relate only to the attribution of profit to PEs and will apply, among others, on revision of the OECD Commentary on the Model Tax Convention on Income and on Capital. The position of group entities working together in integrated operations, however, has much in common with the relationship between an entity and a PE. The SPF concept is therefore likely to have a profound impact on how transfer pricing analyses are conducted, especially given that the analytical approach used in both cases will be the same. This is for a number of reasons. First, the SPF concept seems particularly well suited to being used in function and risk analyses and the examination of whether the activities of an entity should be characterized as routine. Furthermore, the allocation of risks to a group entity that does not have the resources and capabilities to manage and carry them effectively will become more visible with an SPF-based analysis. A significant degree of methodological spill-over is therefore inevitable. In a broader sense, in fact, the SPF idea represents a significant step forward in specifying more precisely what is meant by the essentially undefined, and vague, concept of substance.

Second, the SPF concept also lends itself very well to the evaluation of how, in a profit split analysis, the combined profits in a transaction should be split between related parties. A commonly used technique in residual profit split analyses, for instance, is to split residual profit among transacting parties based on their contribution to the development of core intangibles. The SPF concept can play a key role in determining these contributions. In this context, it is also noteworthy how much overlap there is between the definition of the SPF concept and the OECD discussion of the division of functions (and assets and risks) in profit split analyses.

Finally, using the SPF concept will become an obvious tool for tax authorities to use in asserting that a permanent establishment exists, not least where a tax inspector disagrees with a taxpayer's transfer pricing. A tax authority may investigate, for instance, whether significant people functions are carried out in a particular jurisdiction by, or on behalf of, an overseas entity. If so, then it might have a strong argument for asserting that a place of management or even dependent agent PE exists, thereby attracting more than routine remuneration.

The above points notwithstanding, application of the SPF concept will have its limitations. This is particularly the case where assets are concerned. In many industries, for example, assets are acquired or developed over a long period of time. The SPF tool could, in such circumstances, lead to incorrect Transfer pricing analysis if not properly used. As a further example, the location of marketing directors may give very little direction as to the remuneration attributable to legal ownership of a trade mark. Completion of a value chain analysis that identifies the contribution made by intangible assets to overall value creation will therefore remain indispensable.

India therefore believes that by adopting diligently "significant people functions" approach would enable in rightly identifying the economic owner of intangibles, Hence it is essential that in case of transfer pricing audit we should adopt defense strategy of determining based on function who undertakes SPF with respect to advertising, marketing & distribution as this will enable in significantly resolving the problem of disconnect between profit and related economic activity.
