SIGNIFICANT ECONOMIC PRESENCE

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1. Background

1.1. The Organization for Economic Co-operation and Development ('OECD'), with a view to curb double non-taxation and evasion of taxes introduced its report titled **'Action Plan on Base Erosion and Profit Shifting'**. The Base Erosion and Profit Shifting ('BEPS') Action Plan, inter-alia, addressed the challenges posed by the spread of the digital economy on international taxation. BEPS Action Plan 1 deals with identifying and addressing various challenges posed by taxation of digital economy.

1.2. Under the BEPS Action Plan, the OECD established the Task Force on the Digital Economy to develop a report identifying issues raised by the digital economy. The Task Force analysed the following options to curb the tax challenges faced in an increasingly digitalised economy:

- new nexus in the form of a Significant Economic Presence ('SEP')
- withholding tax on certain types of digital transactions
- equalisation levy

1.3. The above options / alternatives were not recommended by the Task Force; however, countries could adopt all / any of the above alternatives to address the challenges faced by them. Subsequently, the Central Board of Direct Taxes('CBDT') established a committee on taxation of e-commerce. The committee recommended the introduction of equalisation levy. Further, as a part of 'Other Recommendations', it was also of the view that the concept of 'business connection' may be expanded to include the concept of SEP. The object behind introducing the concept of SEP was to widen the scope of 'business connection' within which business profits could be taxed in order to include digital transactions. In connection with the same, the observations of the committee were as under-

"53. In view of the extensive analysis of these aspects provided in the BEPS Report on Action 1 and the observations made above, ***the Committee is of the view that the physical presence based threshold for taxing income in the economy from where the payments arise, was conceptualized in an era when it reasonably indicated the significant economic presence of an enterprise in the economy of a jurisdiction.*** *The evolution of the definition of permanent establishment, both in terms of its interpretation, as well as in terms of alternate conditions that give rise to it, is an evidence of the adaptation of this rule to the evolving ways in which business conducts itself.* ***It signifies the dynamic evolution of taxable nexus with business modes, and justifies its further evolution to the needs of new business models of digital economy."***

2. Overview of SEP provisions

2.1. Vide Finance Act, 2018, the scope of 'business connection' in India was expanded to include the concept of SEP by insertion of Explanation 2A to Section 9(1)(i) of the Income-tax Act, 1961 ('the Act'). The said provisions were enforceable with effect from 1 April 2019. The Memorandum explaining the provisions to the Finance Bill, 2018 categorically stated that –

- *"..with the advancement in **information and communication technology in the last few decades**, new business models operating remotely through **digital medium** have emerged.."*

- *"..**OECD under its BEPS Action Plan 1** addressed the tax challenges in a **digital economy** wherein it has discussed several options to tackle the direct tax challenges arising in **digital businesses**. **One such option is a new nexus rule based on 'significant economic presence'**.*

- *"As per the Action Plan 1 Report, a non-resident enterprise would create a taxable presence in a country if it has a significance economic presence in that country on the basis of factors that have a purposeful and sustained interaction with the economy by the aid of **technology and other automated tools**. It further recommended that revenue factor may be used in combination with the aforesaid factors to determine 'significance economic presence'."*

- *"..emerging business models such as **digitized businesses**, which do not require physical presence of itself or any agent in India, is not covered within the scope of clause (i) of sub-section (1) of section 9 of the Act.."*

2.2. However, vide Finance Bill 2020, the SEP provisions were deferred to apply from Assessment Year 2022-23. The explanation offered by Memorandum to the Finance Bill, 2020stated as under–

"..since discussion on this issue is still going on in G20-OECD BEPS project, these numbers have not been notified yet. G20-OECD report is expected by the end of December 2020.."

2.3. Also, apart from such deferral of the provisions, certain drafting changes were made to Explanation 2A to Section 9(1)(i) of the Act. Post the changes, SEP, as per Explanation 2A to Section 9(1)(i) of the Act shall mean:

(I) transaction in respect of any goods, services or property carried out by a non-resident with any person 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 such amount as may be prescribed **[Transaction based SEP]**; or

(ii) systematic and continuous soliciting of business activities or engaging in interaction with such number of users in India, as may be prescribed **[Activity based SEP]**.

2.4. Further as per the first proviso to Explanation 2A to Section 9(1)(i) of the Act, transactions shall constitute SEP irrespective of:

(i) Whether the agreement for such activities is entered in India or not; or

(ii) Whether the non-resident has a residence or place of business in India or not; or

(iii) Whether non-resident renders services in India or not

This proviso further solidifies the position that Explanation 2A was inserted to bring within the scope of 'business connection' those transactions / activities that would not be covered within the scope of 'general business connection' as per Explanation 1(a). This creates a virtual nexus of the non-resident in India.

Transaction based SEP

2.5. Transaction based SEP seeks to cover transactions '***in respect of***' goods / services / property. While interpreting the phrase 'in respect of', reference may be drawn to the judgement of the Hon'ble Supreme Court in the case of *Engineering Analysis Centre of Excellence Private Limited v CIT*(2021) 125 taxmann.com 42 (SC) which held that the phrase 'in respect of' has to be given a wide meaning. It has been used in the sense of *being connected with* something and must be interpreted in the broader sense. Accordingly, it can be inferred that SEP seeks to cover all transactions that *relate to* goods / services / property.

2.6. Further, with the inclusion of 'property' in Explanation 2A, the scope of Transaction based SEP is extended. As per *Black's Law Dictionary (6th edition, 1990)*, 'property' has been given following meanings:

- That which is peculiar or proper to any person; that which belongs exclusively to one. In the strict legal sense, an aggregate of rights which are guaranteed and protected by the Government.

- The word is commonly used to denote everything which is the subject of ownership, corporeal or incorporeal, tangible or intangible, visible or invisible, real or personal; everything that has an exchangeable value or which goes to make wealth or estate.

The above meaning of the term property is wide and thus, it indicates that Explanation 2A seeks to cover transactions relating to any kind of property.

2.7. It is important to note that the presence of physical operations in India is not a prerequisite for the establishment of a business connection and the subsequent attribution of income to India.

2.8. The transaction must be carried out with 'any person in India'. This implies that the counter party with whom the non-resident is transacting must be *in India*, irrespective of whether such person is resident or non-resident. This ensures that the non-resident is virtually economically connected with India for the purpose of creating a business connection.

2.9. Further, the transactions should be 'carried out'. 'carryout' has been defined in **New Shorter Oxford English Dictionary (1993)** as "*perform, conduct to completion and put into practice*".

2.10. Having regard to above, it appears that the clause is wide enough to cover all kinds of transactions of goods / services/ property by non-residents with persons in India provided the payments are above the prescribed monetary threshold. In this connection, Rule 11UD of the Income-tax Rules, 1962 ('the Rules') prescribes the threshold limit of Rs. 2 Crores during the previous year for aggregate amount of payments to trigger Transaction based SEP

Activity based SEP

2.11. To fall within the scope of Activity based SEP, there should either be 'systematic and continuous soliciting of business activities' or 'engaging in interaction with' such number of users in India.

2.12. As per Black's Law Dictionary, 'systematic' is defined to mean a methodical and repeatable procedure. Therefore, for the activity to constitute SEP, it should not be carried out in a haphazard manner and must be done in an orderly and planned manner.

2.13. As per Pramanatha Aiyar's Advanced Law Lexicon, 'continuous' is defined to mean recurring at repeated intervals so as to be of repeated occurrence; without interval or interruption. Therefore, the activity should be of a recurring nature and should not be a one-time act.

2.14. There should be 'soliciting of business activities', therefore, in order to constitute SEP there need not be solicitation of the business as a whole. As per Oxford Learner's Dictionary, 'solicitation' refers to the act of asking somebody for something, such as support, money or information; the act of trying to get something or persuading somebody to do something.

2.15. Therefore, to summarise, the solicitation of business activities should be done in a repeated, recurring and methodical manner in order to constitute SEP.

2.16. Under Activity Based SEP, SEP can also be constituted if the non-resident is engaging in interaction with such number of users in India. As per Pramanatha Aiyar's Advanced Law Lexicon, the term 'engaged' ordinarily, means doing of more than one act or one transaction. In a way, the term 'engaged' also represents continuous activity and not a mere one-off activity.

2.17. Further, 'interaction' with users also constitutes SEP in India. While the scope of what constitutes 'interaction' with users is not specified in the Act, the OECD in its 'Public Consultation Document Addressing the Tax Challenges of the Digitalisation of the Economy' had identified various indicative factors that would constitute a sustained interaction with users via digital means:

- the existence of a user base and the associated data input;
- the volume of digital content derived from the jurisdiction;
- billing and collection in local currency or with a local form of payment;
- the maintenance of a website in a local language;
- responsibility for the final delivery of goods to customers or the provision by the enterprise of other support services such as after-sales service or repairs and maintenance; or
- sustained marketing and sales promotion activities, either online or otherwise, to attract customers.

2.18. The scope of what constitutes 'users' in India is also not defined. Similar to transaction-based SEP, the counter party should be 'in India' irrespective of its residential status. In this connection, Rule 11UD of the Rules prescribes the threshold limit of 3 lakh users for the number of users with whom systematic and continuous business activities are solicited or who are engaged in interaction in order to determine Activity based SEP.

2.19. One of the question which could arise is; does the above threshold include 'free' users or does it only include 'paid' users who pay consideration to the non-resident. In such a situation, it has to be determined whether the users and the e-commerce operator are *interacting* for the purpose of establishing SEP. Will such 'users' be considered in determining SEP threshold? will such solicitation of business activities be considered as 'continuous' and 'systematic'? – clarity is not provided on such key points and differing interpretations can be drawn for the same.

Scope of SEP – Whether also covers non-digital transactions?

2.20. The definition of SEP was amended through Finance Act, 2020, wherein the term 'digital means' was deleted from Clause (b) of Explanation 2A to section 9(1)(i) of the Act. Thus, it can be inferred that SEP provisions cover 'digital' as well as 'non-digital' transactions.

2.21. Therefore, the scope of SEP is quite wide and can potentially cover any transaction carried out by a non-resident irrespective of whether it is through digital means or otherwise.

2.22. Further, vide **Letter No. 370412/11/2018-TPL**, the CBDT had called for suggestions/comments of stakeholders and the general public regarding revenue threshold for transactions in respect of ***physical goods or services.*** Although Rule 11UD as enacted does not prescribe such threshold for physical goods or services, doubt still remains over the scope of SEP provisions.

2.23. However, another possible interpretation is that, although the words "through digital means" were deleted vide Finance Act, 2020, the intent to introduce the concept of SEP remains the same i.e. to levy tax on emerging business models in the era of "digital economy".Such an inference could be drawn since the Committee on taxation of e-commerce formed by the CBDT which recommended the inclusion of SEP within the scope of 'business connection', was specifically formed to provide recommendations to address challenges posed by emerging business models in the "digital economy". Further, BEPS Action Plan 1 on 'Digital Economy' recognises SEP as one of the measures for taxing digital transactions.

2.24. In this connection, it may be noted that vide Finance Act 2020, Explanation 3A to Section 9(1)(i) was inserted which has extended the scope of income attributable to operations in India as per Explanation 1 by including within its purview income from:

(i) Advertisement services targeting Indian customers;

(ii) Sale of data;

(iii) Sale of goods and services using data collected.

The Finance Act also states that the above Explanation shall apply to income attributable to transactions or activities as referred to in Explanation 2A w.e.f. AY 2022-23.

2.25. The above Explanation merely extends the scope of Explanation 1 to include within its ambit the aforementioned income which are attributable to operations carried out in India. Further, it shall also include income attributable to transactions or activities that constitute SEP. The Explanation starts with the phrase '*for the removal of doubts…*' Accordingly, Explanation 3A does not create a nexus / business connection by itself but merely clarifies that such income is included in the scope of Explanation 1 and Explanation 2A.Since Explanation 3A mainly deals with digital economy related specific items which are specifically covered for attribution purposes in Explanation 2A 'also', one may contend that Explanation 2A covers within its purview only such digital transactions or income generated on account of the digital transactions.

2.26. From a practical standpoint, it may be noted that even the Indian tax authorities do not require filing of Form 15CA/ 15CB with respect to payments for import dues. Therefore, such payments do not even require reporting before the tax authorities. If the intent was to levy tax even in respect of traditional imports payments, CBDT could have amended the Rules requiring furnishing of Form 15CA / CB in respect of all transactions where the threshold under SEP rules is met. However, this has not been done yet. Thus, above practical indicator could be relied on to interpret that only the digital transactions should be covered within the purview of SEP.

2.27. However, this is still an untested proposition and only time would tell whether purposive interpretation would succeed over the literal interpretation; and the manner in which jurisprudence develops on this aspect.

3. Equalisation Levy

3.1. As mentioned earlier, Committee on taxation of e-commercerecommended the introduction of equalisation levy. Subsequently, vide Finance Act, 2016, the concept of Equalisation Levy was introduced (India becoming one of the first countries to do so)at the rate of 6% of the amount of consideration for online advertisement services.

3.2. Further, the scope of equalisation levy was expanded by Finance Act, 2020, to include online sale of goods and services in India through digital means at the rate of 2% of the amount of consideration received or receivable by an e-commerce operator.

Interplay between Equalisation Levy and SEP

3.3. In case of co-existenceof Equalisation Levy and SEP provisions, a doubt may arise as to which of the provisions are applicable.

3.4. In this regard, reference may be drawn to section 10(50) of the Act, which stipulates that income chargeable to equalisation levy will be exempt from tax under the provisions of the Act. Accordingly, in case of overlap, the provisions of Equalisation Levy will prevail and income attributable to SEP will not be chargeable to tax.

3.5. Both equalisation levy and SEP provisions are concerned with taxation of digital economy. The concept of SEP is much broader than Equalisation Levy. SEP would result in Business Connection whereas Equalisation Levy will be levied where there is no PE. Further, SEP covers the services which are covered under Equalisation levy regime, giving rise to overlapping of services covered under both the concepts. However, there will be no double taxation on those items which are subjected to equalization levy and accordingly, exempted as per the provisions of section 10(50) of the Act.

3.6. Also, it is interesting to note that given the above interpretation the provisions of equalization levy would prevail, the thresholds provided for the trigger of SEP provisions become academic. This aspect further deepens the controversy regarding relevance of SEP and its applicability to non-digital transactions.

3.7. In other words, such an overlap of SEP and equalization levy could lead to an adverse impact on non-residents if a view is taken that SEP is wide enough to cover even non-digital transactions. For example, if a non-resident enters into a digitalized transaction for online sale of goods or services

with a person in India which is subject to both SEP and Equalisation levy provisions, the equalization levy provisions will prevail, accordingly, the non-resident will be liable to such levy at the rate of 2% of the consideration received / receivable (instead of 40% in case SEP provisions were applicable). However, in case of import of physical goods which do not attract equalisation levy, owing to ambiguity regarding the scope of SEP, the non-resident (assuming from a non-treaty country) may be covered within SEP provisions and shall be taxed at the rate of 40% (plus surcharge and cess). Therefore, on account of the provisions of section 10(50) of the Act, the non-resident would be taxed at the rate of 2% for digital transactions and at the rate of 40% for non-digital transactions even though the very purpose of insertion of SEP provisions was to tax digital transactions.

4. Interplay with tax treaties

4.1. The SEP provisions form part of the scheme of the Act, therefore they cannot override the beneficial provisions of the tax treaties that contain the conventional concept of permanent establishment ('PE') for taxing business profits of a non-resident (unless the tax treaties are amended).The Memorandum to Finance Bill 2018also clarified that unless corresponding modifications to PE rules are made in the DTAAs, the cross border business profits will continue to be taxed as per the existing treaty rules.

4.2. Further, even MLI does not contain a separate article for e-commerce taxation. Thus, as long as a non-resident is entitled to the tax treaty benefits, the provisions of such tax treaty would prevail over the SEP provisions and such provisions would become academic.

Impact on non-treaty jurisdictions and non-residents not eligible for treaty benefit

4.3. In case of non-resident located in a non-treaty jurisdiction, the SEP provisions of section 9 of the Act may apply.

4.4. Therefore, where SEP/ business connection of a non-resident is constituted in India, it would be subject to tax at 40% (plus surcharge and education cess) on its net income attributable to its operations in India. Consequently, the payer may be required to withhold tax at such rate from the payments.

4.5. However, Equalisation Levy does not form part of the provisions of the Act but it is an independent chapter in the Finance Act and therefore, remains unaffected whether the tax treaty provisions are applicable or not.

5. Withholding Implications

5.1. In case of non-residents situated in non-treaty jurisdictions who are not able to avail treaty benefits and in case of non-residents to whom treaty benefits have been denied, withholding implications under section 195 of the Act may apply(provided the provisions of equalization levy do not apply) in case it is determined that such non-residents have SEP in India.

5.2. However, in absence of well-defined rules, this may lead to significant compliance burden in the hands of the non-resident to provide information regarding its users, revenue, etc. and at the same time very onerous obligation on the payer given the grave consequences which could result if tax is not withheld at the rate of 40%.

5.3. Thus, from a withholding perspective, it is imperative that the payer always insists for the non-resident recipient to provide adequate documentation which would support its claim for tax treaty benefits to mitigate the tax impact on account of harsh SEP provisions.

6. Profit attribution to SEP

6.1. As per second proviso to Explanation 2A, only so much of income as is attributable to the transactions or activities referred to in clause (a) or clause (b) of Explanation 2A shall be deemed to accrue or arise in India.

6.2. However, there is no specific guidance provided by CBDT for attribution of profits in case of SEP and the aspect of attribution of profits to SEP is ambiguous.

.3. The primary concern that arises in this regard is as to how profit should be attributed based on user activity. Traditionally, profit has been attributed based on sales, manpower / wages and assets (with appropriate weightage to be given to all three factors) i.e. FAR (Functions, Assets and Risk Analysis). However, profit arising out on account of Transaction or Activity based SEP may not fall within the scope of traditional factors of profit attribution.

6.4. However, reference may be drawn to BEPS Action Plan 1 which analyses three alternatives / options for attributing profits to SEP as under:

- Replacing functional analysis with an analysis based on game theory that would allocate profits by analogy with a bargaining process within a joint venture.

- The fractional apportionment method wherein the profits of the whole enterprise relating to the digital presence would be apportioned either on the basis of a predetermined formula or on the basis of variable allocation factors determined on a case-by-case basis. However, this would require –(1) definition of the tax base to be divided, (2) the determination of the allocation keys to divide that tax base, and (3) the weighting of these allocation keys.

- The deemed profit method wherein the SEP for each industry has a deemed net income by applying a ratio of the presumed expenses to the taxpayer's revenue derived in the country. Determining an appropriate ratio would depend on a number of factors, including the industry concerned, the degree of integration of the particular enterprise, and the type of product and service provided.

6.5. Further, the CBDT included a chapter in its draft report on Profit Attribution to Permanent Establishments (CBDT Press Release F 500/33/2017-FTD.I dated 18th April, 2019)also laid out various recommendations for determining the profits attributable to SEP of non-resident in India and the requisite amendments which should be carried out either in Rule 10 or the amendment of the Income-tax Act itself to incorporate a provision for profit attribution to a PE. However, none of these recommendations have still seen the light of the day.

6.6. Therefore, the contention that the entire income attributable to the transactions or activities shall be taxable in India based on second proviso of Explanation 2A, seems to be against the alternatives for profit attribution as laid down in BEPS Action Plan 1 as well as CBDT draft report for profit attribution. Thus, until the Government provides any clarity on attribution of profits to SEP, confusion shall persist over such attribution methodology.

Overlap between Explanation 1 and Explanation 2A of section 9(1)(i)

6.7. As per second proviso to Explanation 2A, only so much of income as is attributable to the transactions or activities referred to in clause (a) or clause (b) of Explanation 2A shall be deemed to accrue or arise in India. At the same time Explanation 1(a) seeks to cover only those business for which the operations are ***'carried out in India'***.Further, Explanation 1(a) specifically mentions that its scope is restricted to businesses having a business connection in India provided that such business connection is not constituted by means of SEP.

6.8. Therefore, in case of business connection by way of SEP, it is not necessary that the transaction must be 'carried out in India'. Furthermore, the purpose of inclusion of Explanation 2A was to bring within the scope of 'business connection' those transactions that eluded Explanation 1(a) since such transactions were not carried out in India.

6.9. While one may contend that the provisions of SEP overpower those contained in Explanation 1(a) since they seek to cover transactions carried out in India as well as outside India with a counter party in India as long as it meets the Transaction or Activity based SEP thresholds.

6.10. However, if Explanation 2A were to be read with the interpretation that transactions 'carried out in India' were also to be included within its scope, then it would render the very purpose of its insertion redundant. Therefore, if a transaction satisfies the threshold limits prescribed in Rule 11UD but falls within the scope of Explanation 1 (i.e. business connection is formed as a result of business carried out in India), it should not be covered by SEP provisions.

6.11. Thus, it appears that the provisions of Explanation 1(a) and Explanation 2A have been designed to ensure that both remain mutually exclusive and apply in their respective spheres.

7. Applicability of SEP to certain transactions

Import of goods

7.1. In case of import of goods or services, one may need to evaluate SEP provisions (provided that the prescribed thresholds are met). In order to determine the applicability of the provisions, one has to first consider whether the transaction has been 'carried out'. As per the Oxford Learner's Dictionaries, **carry out** means '*to do something that you have said you will do or have been asked to do*'. Further, as mentioned earlier, merely 'entering into' the transaction is not sufficient. The counter party importing the goods (whether resident or non-resident) has to be in India. One may also need to consider the *nature* of the transactions entered into. A view may be taken that considering the legislative intent behind introducing SEP provisions i.e. taxation of digital transactions, non-digital transactions can be considered to be outside the scope of SEP provisions. However, in absence of sufficient clarity / judicial precedents, doubts still remain if the said Explanation 2A could apply in case of non-digitalised transactions, especially where aggregate payments made to non-residents exceed Rs. 2 crores. Thus, it is imperative that the payer shall always insist for the non-resident recipient to provide adequate documentation which would support its claim for tax treaty benefits to mitigate the tax impact on account of harsh SEP provisions

Dividend income earned by non-resident entities

7.2. A question that may arise is whether the receipt of dividend income by non-residents as a result of investment made in Indian companies would constitute SEP. In this regard, it is pertinent to note that SEP covers only those transactions which are chargeable to tax as business income. Further, where there is an express provision for treating an item of income as deemed to accrue or arise in India, then the case may not fall within the general provision of "business connection". As income by way of dividend paid by an Indian company outside India is provided for in section 9(1)(iv) of the Act, this case may not again be brought within the scope of "business connection". Further, in order to qualify as SEP, the 'transaction' must be in respect of any goods / services / property. Since dividend becomes payable on account of the Board of Directors of the Company passing a resolution, the payment of dividend cannot be considered a 'transaction' between the resident and non-resident.

Income from royalty or Fees for technical services (FTS)

7.3. In case of payment towards royalty or FTS, a question which would arise is whether the SEP provisions would be applicable given its wide coverage. In this connection, it is imperative to note that there are specific provisions under the Act (i.e. clause (vi) and (vii) of section 9) to deal with specific case of royalty or FTS. Thus, in view of various precedents such as CIT vs. Copes Vulcan Inc. (1987) (167 ITR 884) (Bom), wherein it is held that specific would prevail over general, such specific provisions dealing with royalty / FTS under the law shall apply and the SEP provisions shall take a back seat.

Tax return filing compliances

7.4. Another issue that has arisen on the introduction of SEP provisions, is the significant compliances that need to be followed. In the income-tax return (ITR-6), non-residents are required to disclose whether they have SEP in India. In case SEP exists, non-residents are also required to disclose quantum of payment made / number of users as per Explanation 2A. In case non-resident is claiming treaty benefits to escape virtual PE created because of SEP, the non-resident is required to disclose details of the same in Schedule Exempt Income (EI). However, one may take a stand that owing to beneficial provisions of DTAA, if no income is chargeable to tax in India, reporting requirement may not arise since the requirements are based on machinery provisions. Thus, each non-resident would have to weigh the pros and cons before deciding the requirement of filing tax return in India.

8. Conclusion

Judicially, the SEP provisions have not been analysed to a large extent, mainly because of beneficial treaty provisions which prevent its application.

Various ambiguities remain over the provisions such as, whether the provisions cover non-digital transactions, rules regarding attribution of profits, the enforcement of thresholds, whether a taxpayer can obtain relief by submitting a declaration for non-applicability of the provisions, etc.

However, these provisions can be of greater significance in the future if tax treaties are amended or MLI provisions are introduced for creating a virtual PE.

In order to resolve ambiguities regarding the scope and applicability of SEP provisions and the related compliances, it is imperative that CBDT provide sufficient clarifications for the same.

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