SIGNIFICANT ECONOMIC PRESENCE IN INDIA: EXPANDING THE NEXUS BETWEEN TAXATION RIGHTS AND BRICK AND MORTAR BUSINESSES.

Parth Gada

Email : parthgada008@gmail.com

"*The oranges upon the trees in California are not acquired wealth until they are picked, not even at that stage until they are packed, and not even at that stage until they are transported to the place where demand exists and until they are put where the consumer can use them. These stages, upto the point where wealth reached fruition, may be shared in by different territorial authorities.*"

This is quote included by the Government in the memorandum to the finance bill, 2018 while introducing the concept of Significant economic presence("SEP").

Need for a digital nexus:

Advent of modern technology and development in information systems has resulted digital businesses across the world to gain boom and led to mass scale globalisation. Businesses now a days do not require any physical presence in a particular country to earn revenue or establish their customer base. This has led to a massive shift from brick-and-mortar business to digitally enabled businesses. Such businesses operate globally and earn revenues from across the borders including India without falling under the tax net. This is possible due to their digital presence and country's prima facie focus on the physical presence to link revenue with taxation rights. India has entered into bilateral treaties with various countries according to which the business profits of a non-resident would be taxable only on existence of a permanent establishment ("PE") in India. This caused the global companies to set up their physical establishments in a low tax jurisdiction area while earning huge incomes digitally from higher tax jurisdiction areas without any real presence and escaping the tax provisions.

This gave birth to the practice of profit erosion and consequently led to tax leakages which was a point of concern for the Organization for Economic Cooperation and Development ("OECD"). Hence OECD introduced the concept of SEP to provide a mechanism to the countries for earning their fair share of tax from the profit pies earned by the global companies.

What is SEP?

To counter the hurdles identified above, the OECD had begun is work on the Base Erosion Profit Shifting ("BEPS") and had laid down 15 Action plans. Out of these 15 Action plans genesis of the SEP concept can be traced to the BEPS Action Plan 1. Thereby, taking leaf from OECD's action plan, India introduced SEP in its domestic tax law. Since there are a lot of hassles in taxing the digital income, the action plan had laid down three interim measures to plug the leakages:

- Consideration of digital nexus for determining the taxing rights: The presence of a business in any jurisdiction should be based on its digital/technological footprints rather than its physical presence.
- Withholding tax on digital transactions
- Equalization levy

India even though being an observer to the OECD decided to adopt the BEPS action plan 1 and hence introduced explanation 2A to section 9(1)(i) vide Finance Act 2018. Accordingly, the definition of business connection was amended to include SEP under section 9(1)(i) of the Income Tax Act,1961 ("Act"). Thus, bringing the Indian tranche of global businesses within the ambit of the domestic taxation system

Now, it is important to understand what conditions should be fulfilled for establishment of a business connection through existence of SEP in India. The legislature has laid down the following conditions:

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; or

ii. Systematic and continuous soliciting of business activities or engaging in interaction with such number of users in India, as may be prescribed.

Further as per proviso to explanation 2A, the abovementioned transactions/activities would constitute a SEP in India irrespective of the facts such as:

- The agreement for such transactions or activities is entered in India; or
- the non-resident has a residence or place of business in India; or
- the non-resident renders services in India.

Therefore, the parliament has enlarged the definition of business connection. For instance, if a non-resident who neither lives in India nor has a place of business in India provides any goods/services outside India to a person in India would also be covered by the explanation and deem to have a SEP in India leading to business connection within the meaning of section 9.

The BEPS Action plan 1 laid down the view that a taxable presence in a jurisdiction would be established on existence of SEP and having a Permanent establishment may not be paramount.

Prior to the introduction of concept of SEP, one of the situations where a business connection would be established is where any business activity was habitually undertaken through an agent in India. By the virtue of this amendment, a company's SEP in India itself would establish a business connection and accordingly the provisions of section 9(1)(i) would be attracted. Hence, the income generated from the Indian operations of such company would deem to accrue or arise in India and be liable to tax at 40% on net basis.

If simply put, **SEP is nothing but a digital PE**. If PE doesn't get you, SEP sure would.

It is further provided that only the income attributable to the transactions/activities carried out in India would deem to accrue or arise in India and be taxed on net basis.

The legislature has also clarified that attributable income from Indian operations would include any:

- Advertisement which targets a customer who resides in India or a customer who accesses the advertisement through internet protocol address located in India;
- Sale of data collected from a person who resides in India or from a person who uses internet protocol address located in India; and
- Sale of goods or services using data collected from a person who resides in India or from a person who uses internet protocol address located in India.

Though in 2018 the scope of business connection was expanded, the operability of SEP was not effective as its thresholds were not notified.

CBDT vide notification no. 41/2021 issued on 3rd May 2021 notified the following threshold limits for effective application of the SEP concept:

- For Transactions based condition the revenue threshold of Rs. 2 Crore is prescribed.
- For User based condition threshold of 3 lakh users is prescribed.

Though the provisions of SEP were introduced for more than 3 years prior to 2021, the thresholds are effective from 1 April 2022, i.e. assessment year 2022-23 onwards which is also the effective date of the SEP provisions.

In a nutshell, if any non-resident enters into a defined transaction for a consideration exceeding Rs 2 crore or engages in an interaction with users in India exceeding 3 lakhs would have a SEP in India which in turn establishes a business connection rendering the Indian operations taxable under the domestic laws.

Tax Treaty Implications:

It would be of paramount importance for us to understand the interplay between SEP and the international tax treaties entered by India with other countries. To curb the issue of double taxation of income, India has entered into Double Taxation Avoidance Agreement (DTAA) with all the major countries.

The DTAA provides that one of the pre-requisites for taxing rights is existence of a Permanent Establishment (PE) in the source country i.e. India. PE is nothing but a nexus of the non-resident in the source country which triggers the domestic tax laws. PE may include a branch, an office, a Factory or even a Workshop. Hence it can be said that business profits of non-residents are taxable in India only on existence of a PE.

It is important to note that India majorly acts as the source country when the companies tap the growing and emerging market. In absence of specific provisions in the treaties, the taxation rights in regard to such transaction is severely affected. As on date, no treaty includes the concept of SEP. Therefore, SEP is restricted to domestic taxation system and has no implications in cases where treaty benefit is availed. Further as per the understanding drawn from section 90 of the Act the domestic tax laws cannot override the tax treaty. Therefore, the extended scope of business connection/PE will not be applicable to non-residents claiming treaty benefits.

Therefore, the non-residents entitled to the treaty benefits would continue to be governed by the traditional PE definition as opposed to the dynamic SEP concept. This massively narrows down the application of SEP as India has already entered into DTAA with all the major players in the global economy.

Thus, SEP would be applicable in cases where the non-residents are from the jurisdictions with whom India does not have a DTAA yet or where the non-residents are not eligible for claiming the treaty benefit.

Such ineligibility could be either due to non-submission of Form 10F, failure of providing tax residency certificate, applicability of anti-avoidance provisions such as General Avoidance Rule (GAAR) or failure to fulfil the Principal Purpose Test (PPT).

Moreover, many legal luminaries as well as tax laureates have stated that merely bringing the SEP concept is not enough and the treaties should be amended in this context as well. Even the Government while introducing the concept had clarified in its memorandum to the Finance Bill, 2018 that existing treaty rules will apply until corresponding modification are made to the PE rules in the DTAAs.

Hinderances and ambiguities:

Since SEP is an evolving concept, there are various challenges and roadblocks in its effective implementation. Various clarifications are required from CBDT for our better understanding. Below mentioned are few of the concerns:

- Definitions/Meanings of various terms used in the section have not been assigned such as “systematic and continuous”, “soliciting of business” or “interaction with users”. Further the meaning of “download of data or software” is quite broad and open which will lead to many interpretations.

- Similarly, the clarity as to whether these transactions/activities would constitute SEP irrespective of it being undertaken through digital means or not is missing.

- Further, the revenue threshold of Rs 2 crore seems to be extremely low. For instance, any foreign company desiring to do business in Indian market could be discouraged due to the tedious compliances on getting covered under the scope of SEP. Hence, this shall be a matter of concern for Indian law makers to fixate a reasonable monetary threshold so that SEP provisions do not get easily attracted to every foreign company.

- Whether the term "users in India" shall mean people residing in India or merely operating from an IP address located in India. If the latter is the case, then even occasional tourists travelling to India and accessing any website/shopping online for their home consumption in another country would be included for computing the user threshold of 3 lakhs.

- Another major area of dispute is the manner of profit attribution to the Indian operations of a global business. Due to absence of any guidance, can It be assumed that businesses are required to follow rule 10 of the Act for attributing the profits taxable in India due to SEP? Although in the draft rules issued by the CBDT on 13th July 2018, it is provided that only so much of income as is attributable to the transactions or activities referred above shall be deemed to accrue or arise in India. This matter is still open for interpretation until any further rules have been notified/finalised.

- If the scope of SEP is to be broadened, India would be required to renegotiate and reframe its existing DTAAs to include SEP in the PE definition and thereby establish a digital nexus for gaining taxation rights. Hence unless the DTAA's are amended the application of SEP would be restricted to the non-residents to whom treaty benefits are unavailable.

Conclusion:

These issues are likely to open doors to litigations during the assessment stages. To conclude, SEP is an evolving concept which requires further measures for a global consensus and seamless application. Nevertheless, it is a progressive step in breaking the shackles for e-commerce taxation and avoiding tax erosion.

Being a developing concept, all eyes are on the Government in regard to its implementation.
