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Significant Economic Presence – Confusion persists

PARUL JOLLY

SCV & Co. LLP

YUVRAJ AWASTHI

SCV & Co. LLP

Remote participation in the domestic economy of a country facilitated by digital means but without a taxable physical presence is often seen as a key concern in the digital tax debate. With the rapid evolution of information and communication technology, the possibility to reach and interact with customers remotely through the internet has significantly reduced the need for local infrastructure and personnel to perform sales activities in a specific jurisdiction. As a result, the rights of the source country to tax business profits that are derived from its economy are unfairly and unreasonably eroded.

Origin of SEP

In 2013, Organization for Economic Co-operation and Development ('OECD') and the G-20 countries came together and jointly developed a package of 15 measures to tackle Base Erosion and Profit Shifting ('BEPS'). Action Plan 1 of BEPS suggested three potential options to tax digital transactions:

- **Nexus based SEP** – This option would create a taxable presence in a country when a NR has a SEP on the basis of factors that evidence a purposeful and sustained interaction with the economy of that country via technology and other automated tools;
- **Equalization Levy** – to address the broader direct tax challenges of the digital economy;
- **Withholding tax on digital transactions** - on payments by residents [and local Permanent Establishments ('PE')] of a country for goods and services purchased online from non-resident providers.

The attempts of OECD to address the issue of digital taxation via the BEPS Action plans could not receive global consensus. Initially, the discussion on digital taxation was based on economic principles but later turned into a political debate and thus the jurisdictions chose to adopt unilateral measures to tax such income arising from digital activities. The recently inserted Article 12B in the UN Model Double Taxation Convention specifically addresses the taxation of "automated digital services". The G7 countries have also ratified a global minimum corporate tax rate of 15% to defy the possibility of countries undercutting each other to attract capital. This change has been proposed considering the fact that major digital companies are making money in multiple countries but paying taxes only in home country.

India has gone ahead and introduced all 3 options stated above as follows:

- 2016: Introduced Equalization Levy at 6% of the consideration received by non-resident for specified services (being online advertisements or provision for digital advertising space) if the consideration exceeds INR 0.1 million.
- 2018: SEP provisions added
- 2020: Equalization Levy 2.0 incorporated expanding the scope to include online supply of goods or services by e-commerce operators. EL is charged at 2% of the gross consideration if such consideration received by the NR e-commerce operator from residents (or NRs under specified circumstances) exceeds INR 20 million.

Further, new withholding tax regulations were introduced for e-commerce payments (Section 194O w.e.f. October, 2020).

Provisions related to SEP

The Indian tax authorities introduced the concept of SEP (now applicable from Assessment Year 2022-23) as an amendment to Section 9 of the Income Tax Act, 1961 vide the Finance Act, 2018, by way of insertion of Explanation 2A. Section 9 (1) (i) deals with deeming business income of a non resident to accrue/arise in India if a business connection is established in India, and thus exposes such non resident to taxability in India if certain conditions are satisfied. The concept of SEP has been introduced with an intent of including digital transactions under business connection concept and newly inserted provision provided that for the purposes of the said section, SEP of a non-resident ('NR') in India shall constitute business connection('BC') in India.

As per the SEP provisions, a BC will be constituted in India based on the following parameters:

(*a*) ***Revenue based threshold****: 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*

(*b*) ***User based threshold****: Systematic and continuous* ***soliciting of business*** *activities or engaging in interaction* ***with such number of users in India, as may be prescribed.***

Through a notification dated 3rd May 2021, the Indian government has prescribed the threshold as INR 20 million in case of (a) above, and 300,000 users in case of (b) above.

The present language of the section has led to some unintended complexities and issues which are highlighted as under:

♦ Transaction 'with any person in India'

The language of the section as introduced by Finance Act 2018 is now altered by Finance Act 2020, wherein in clause(a) the term covering transactions 'in respect of any *goods, services or property carried out by* ***a non-resident in India****" has been amended to* cover the transactions '*in respect of any goods, services or property carried out by a non-resident "****with any person in India****'*. The amendment had been done to clarify the scope of the coverage of SEP, however the term "any person in India" is subject to various possible interpretations. Whether it would cover a person resident in India or a person who though is not a resident in India but is physically present in India? Also, whether such situs of the person is to be seen at the time when the transaction has been entered into? There could be issues where a person has a branch in India, but the transaction is not related to the branch. Would it be considered that transaction is with a person who is in India? From the language of the section, one could interpret that it is the **physical**

presence of the person at the time of transaction which is to be seen for the purpose of assessing the exposure of SEP in India.

♦ SEP triggered on imports?

If one looks at the wording of Explanation 2A, it covers almost anything under the Sun. However, if one starts to tax all imports, it would lead to an absurd situation. Any person in India who buys goods from a NR appears to be too tenuous a nexus to establish a BC. As the law is ambiguous, one needs to look at the Memorandum and understand the legislative intent behind the provision. The law should not be read merely as an English sentence but should be interpreted purposively. By interpreting the provisions of SEP literally, the classical BC in Explanation 1(a) and subsequent judicial interpretations as to covering transactions of physical goods under BC on fulfilment of certain conditions becomes redundant which cannot be the intention. At the same time, it is very likely that Assessing Officers or even Courts at the Tribunal level opine that imports beyond the threshold would trigger SEP. Even in such situation, the NR would get benefit under the treaty. If that interpretation is taken then transactions with non-treaty countries could come under the radar of SEP.

♦ Applicability of SEP in case of download of software in India and its interplay with EL and Royalty/FTS provisions

Explanation 4 to Section 9(1)(vi) of the Act expanded the definition of royalty by including the 'right for use' or 'right to use' a computer software (including granting of a licence). On the other hand, SEP includes transactions in respect of provision of download of data or software. The tax implications on payment for Download of software are governed by different provisions of law depending on nature of transaction under which software is downloaded.

- Sale of any Software to end user or to reseller: Explanation 4 to section 9(1)(vi) would be inapplicable here as when there is an outright sale of software, it is not for a right to use or right for using the software. However, the same would be covered typically under the scope of EL and hence in pursuant to exemption given under section 10(50) should not be covered under SEP.
- License of any Software/ Subscription model: It is squarely covered under explanation 4 to Section 9(1)(vi) as Royalty. In case a treaty relief is available pursuant to which the payment is not taxable as royalty, then such payment will be exposed to the EL and given the exemption under section 10(50), should not be tested for SEP exposure. In case there is no treaty benefit, still the same will be covered under both SEP and Royalty, and hence priority would be given to the specific provision i.e. Explanation 4 to 9(1)(vi) (*lex specialis)*.

The above analysis indicates that download of software is either covered under Royalty or EL and SEP might not have any application in computer software payment due to overlapping of provisions. However, it appears that the intent of the Government to especially include 'provision of download of data or software' in the clause is to want India to have taxing rights under the Act.

♦ Interaction with user base – how to identify?

Limb (b) of Explanation 2A proposes systematic and continuous soliciting of business activities or interaction with users to constitute a BC with a threshold of 3 lac users during the year. The prescribed threshold is annual but the condition aims at targeting systematic and continuous soliciting. If the number of users falls below the threshold in a particular year, would that mean there will be no SEP on that count? In real life, it is quite likely that once the test of 3 lac users is met, Assessing Officers would argue that SEP has been established for the years to come. As each assessment year is a different year, SEP needs to be seen each year and therefore a reasonable interpretation could be that once the number of users fall below the threshold SEP would cease to exist. This interpretation also comes out from the fact that both the activities i.e. 'soliciting' and 'engaging' are linked to the number of users. Therefore if any year the number of persons

with whom business is solicited or are engaged with falls below the threshold SEP should not trigger. The question still remains as to how does one define continuous soliciting of business or interaction with users? How the data will be collected and verified? What if the law is circumvented through usage of a VPN? The language of the provision leaves many such questions unanswered and could meet practical roadblocks.

Conclusion

Due to the restrictive provisions of taxing business profits of an NR (taxed when a PE is created), SEP provisions may not have a large impact wherever there is a treaty entitlement available. However, we need to understand the contours of the SEP provisions and the impact they can have, especially as the possibilities of a treaty benefit being denied to an NR are increasing with so many anti abuse provisions coming in to play like GAAR, operations of the MLI – Dual residents article, PPT clause, 3rd Country PE clause etc.). Jurisdictions and NRs, who are not eligible for treaty benefits, need an immediate evaluation of their exposure with respect to taxability and compliance under these new provisions.

With the negotiations at the OECD–G-20 Inclusive Framework continuing, reaching a global consensus would be vital to improve the coherence of international tax rules and ensure a more transparent tax environment.

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