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International Tax
May 28, 2021

Significant Economic Presence (SEP) - *Lower thresholds, significant impact for MNCs*

Snapshot

Newly implemented SEP provisions could significantly impact the taxability and related compliance / documentation requirements for every foreign company having transactions of goods, services or property with persons in India. The parameter for taxing transactions of pure sale of goods has gradually shifted from 'transactions in India' to 'transactions with any person India', thereby exposing all multinational companies (MNCs) to possible tax implications, at least under the Income-tax Act, 1961. Further, Government has prescribed low thresholds of INR 20 million and 3 lakh users so as to constitute SEP which would cover almost all MNCs operating with customers in India.

Being at the nascent stage, there is lot of ambiguity and uncertainty with respect to taxation of non-residents and withholding tax obligations on payers making remittances to the non-residents. SEP provisions which are already effective from April 1, 2021 are likely to inflict additional requirements on persons making remittances to non-residents including towards import of goods for determining whether or not the remittances should be subjected to withholding tax in India mandating analysis to avoid any non-compliance.

Background

With technology dwelling in every section of economy, 'digital economy' is becoming intertwined with the traditional economy in a manner that it has become difficult to delineate it to tax the digital economy. Owing to the advent of digitalisation, countries are not able to tax the income arising to non-residents who sell goods or provide services without being actually present in the country. OECD vide its BEPS Action Plan 1 has expressed its concern on the incomes escaping tax in the source country as a result of virtual presence of the taxpayers. Although countries across the globe are waiting for the consensus approach to be issued by OECD for taxing such transactions, India vide Finance Act 2018 has widened the scope of Business Connection defined under Section 9 of the Income-tax Act, 1961 ('the Act') to cover Significant Economic Presence ('SEP') of any non-resident in India.

With 'market' or 'demand' as a factor for share in taxing rights gaining significance, the concept of SEP introduced under Indian domestic tax law has been defined with a scope much wider than the traditional concept of Business Connection under the domestic law and that of Permanent Establishment appearing in the tax treaties.

Although SEP provisions were notified three years ago, the same were not made functional as the Government was waiting for the OECD to reach a consensus on taxation of the digital transaction. As per amendments proposed vide Finance Act 2020, SEP provisions have become applicable from FY 2021-22 onwards. Further, thresholds for determining whether or not activities of a non-resident constitute SEP have been notified recently, vide

notification dated May 03, 2021. As these provisions are applicable with effect from April 01, 2021, the taxpayers will have to gear up and evaluate the applicability of SEP provisions on the international transactions considering the wide ambit of SEP provisions.

SEP - Definition and Scope

Pursuant to the amendments *vide* Finance Act 2020 and the recent notification prescribing the thresholds, SEP in India has been defined to include:

- Any 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 INR 20 million; or
- Systematic and continuous soliciting of its business activities or engaging in interaction with 3 Lakh users or more in India.

It is important to note that the Act clarifies that SEP provisions are applicable whether or not:

- The agreement for the transaction / activity has been entered in India
- Non-resident has a place of residence in India
- Non-resident renders any service in India.

SEP as defined above would thus constitute business connection of the non-resident in India and business profits arising to the non-resident would be considered as taxable in India.

The wide language of SEP provisions seems to cover both digital as well as non-digital transactions as the words used are "any goods, services or property" and clarification with regards to what constitutes goods, services, digital means or soliciting of business activities is still awaited. The existing draft of the provisions may cover transactions such as sale of goods by non-residents in India under the normal course of business and thus may also impact various transactions relating to import of goods or services from non-residents. The stated legislation of the SEP provisions seems to be going beyond the understood original intent of the government of taxing only digitised transactions or transactions of non-residents with virtual presence in India, which was otherwise not getting taxable in India. It would be important for the Government to clarify as to what would "with any person in India" mean.

While the erstwhile concept of 'Business connection' covered within the tax net the non-resident's activities and 'transactions carried in India', the widened provisions through SEP would entail taxation of non-resident's 'transactions with persons in India'. Further, the threshold of aggregate payments of INR 20 million and user base of 3 lakh seems very low considering the size of Indian market and the huge consumer base in India for various non-resident sellers.

SEP under Domestic tax laws

With the widened scope and low thresholds prescribed for determining whether or not the non-resident has a SEP in India, every non-resident carrying out transactions with customers in India would need to test the applicability of extensive SEP provisions.

The widened scope of Business Connection arising on account of SEP is also bound to pose significant practical challenges in terms of attribution of profits of the non-resident in absence of clear Profit Attribution Rules for determination of profits chargeable to tax in India. While one may draw an inference from the Draft Rules, it is high time that the Government rolls out clear final Rules.

Interestingly, considering that SEP provisions are likely to be attracted even when the non-resident does not carry out any physical activity or operation in India, the traditional rules applicable for determination of profits chargeable to tax in India when the non-resident has Business Connection in India are not applicable in case of SEP. Business having Business Connection on account of SEP have been specifically excluded from Explanation 1 to Section 9(1)(i) of the Act which deems

only incomes reasonably attributable to operations carried out in India as income accruing or arising in India. Further, proviso to Explanation 2A provides that income attributable to transactions and activities which lead to SEP shall be deemed to accrue or arise in India. The said provisions relating to attribution of income to transactions and activities constituting SEP could lead to a possible interpretation that entire business profit arising to the non-resident from such transactions (for example, sale of goods by the non-resident in India aggregating more than INR 20 million during the year) would be chargeable to tax in India, without taking into consideration activities or operations of the non-resident carried outside India. The provisions relating to profit attribution in case of business connection in form of SEP are therefore extremely ambiguous and debatable taking into consideration that there is a disconnect between overall possible intent and logical interpretation vis-a-vis the enacted provisions.

The SEP provisions would also have wide impact from the perspective of the payers. Effective April 1, 2021, all import payments by Indian residents would also be required to be tested for obligations with respect to withholding tax liability arising under Section 195 of the Act on account of the introduction and implementation of the extensive SEP provisions. Section 195 of the Act requires that tax should be withheld on payments to non-residents in respect of any sum chargeable to tax in India. However, from a payer's perspective, it would not be feasible to determine profits attributable to the Indian SEP of the non-resident and to identify sums chargeable to tax in India. As a consequence, cases of payments to non-resident companies towards import of goods and services other than those taxable as royalty / fees for technical services, may attract withholding tax liability of 40% plus applicable surcharge and cess and such withholding tax may be required to be deducted on gross revenue basis. There could be some relaxation from such huge withholding tax obligations only by way of obtaining prior approvals from assessing officer in form of nil or lower withholding tax certificates under the provisions of Section 195 or Section 197 of the Act.

SEP and Tax Treaties

The provision of SEP has been introduced in the Act whereas India's existing tax treaties continue to contain the conventional concept of 'Permanent Establishment' for taxing the business profits of non-residents in India. Thus, the non-residents from countries with which India has tax treaties may be shielded from SEP under the narrow definition of Permanent Establishment until the government takes necessary steps to renegotiate and modify the tax treaties to include the concept of SEP in the tax treaties as well. India currently has Double Taxation Avoidance Agreements with 97 countries, including the U.S., U.K., Australia, Netherlands, Germany, France, Japan, South Korea, China, among others.

On the other side, SEP will be triggered for the transactions entered with parties from countries with whom India does not have tax treaties and thus such transactions should be evaluated carefully to analyse the impact of the SEP provisions.

Though the residents of treaty countries can claim the beneficial provisions of treaty, resident of non-treaty jurisdictions and non-residents not eligible for treaty benefit, may have to review their position on taxability and compliances. Further, for invoking the tax treaty protection to avoid SEP, taxpayers shall also be required to analyse the definition of Permanent Establishment separately for each treaty and necessary documents with regards to claiming the benefit of tax treaties viz. Tax Residency Certificate, Form 10F, No PE Declaration, will have to be made available by the non-residents to payers in India even for transaction of goods.

SEP and Equalisation Levy

The provisions of Equalisation Levy were introduced vide Finance Act 2016 (Equalisation Levy 1.0) wherein the payers are required to withhold equalisation levy at 6% on the online advertisement and other specified income of non-residents. Vide Finance Act 2020, the scope of Equalisation Levy was widened to cast liability of Equalisation Levy 2.0 on the non-residents with respect to the consideration received by the non-resident e-commerce operators from e-commerce supply or services made or facilitated by it in India.

As can be seen, there already exists a separate provision for taxing certain specified digital supply of goods and services. Considering that the scope of SEP is much wider than Equalisation levy, there shall be several instances wherein certain transactions could be governed by the provisions of SEP as well as Equalisation Levy 2.0. It is imperative to note that the equalisation levy does not form part of the Act and is an independent Chapter in itself containing all the applicable provisions. Considering the possible overlap under the two provisions under domestic laws of India, section 10(50) of the Act was amended to provide that in a situation where income has been subjected to Equalisation Levy, it shall be exempt from tax in the hands of the non-resident recipient in India under the provisions of the Act. However, there remains ambiguity as to how the payers from India while making payment to the non-resident would ensure whether the non-resident is subject to Equalisation Levy or whether it is required to withhold tax based on the SEP provisions. Further, the terms 'E-Commerce operator', 'E-commerce supply or services', 'Online sale of goods and online provision of services' have been extremely widely defined creating lot of ambiguity with respect to transactions which would be subject Equalisation Levy 2.0 thereby getting excluded from income tax by virtue of implementation of SEP provisions.

It is also imperative to note that Equalisation Levy 2.0 is a gross taxation and is not taxed as income-tax. Accordingly, it may be difficult for the non-residents to claim its credit in their country by invoking tax treaties. On the other hand, there exists significant difference in the tax rate wherein Equalisation Levy is only 2% or 6% of the transaction value whereas if the business profits of non-residents are taxed in India on the basis of Business Connection, the tax rate may reach up to 40% (plus surcharge and cess). These factors will certainly play a vital role during conjoint evaluation of SEP and Equalisation Levy for taxing the digital transactions.

Royalty / FTS vs. Equalisation Levy

Further, Equalisation Levy excludes from its scope incomes arising to non-residents which are chargeable to tax in India as royalty or fees for technical services under the provisions of the Act read with relevant tax treaties. Recently, Supreme Court of India has settled highly disputed issue of taxation of software wherein it was held that software shall not be taxed as royalty under tax treaties if the copyright of the software is not transferred. However, with taxability of digital transactions under SEP, the matter remains open for litigation and applicability of SEP vis-à-vis Equalisation Levy would need to be tested in such cases too.

Conclusion and Way Forward

SEP and the corresponding lower thresholds could very well be a move by the Government to have an upper hand at the time of Treaty renegotiations. In any case, it is definitely a substantial shift in the manner of taxing non-residents in India.

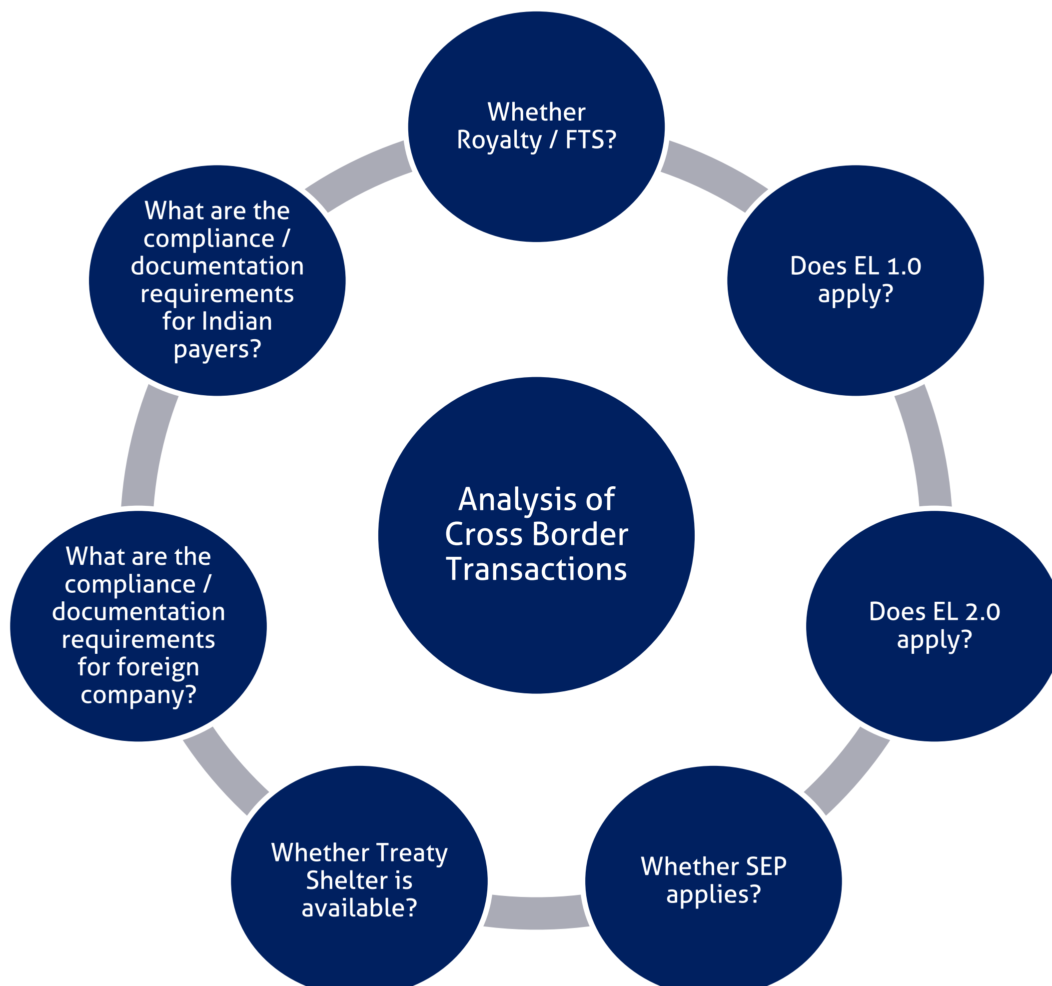
With the widened scope and low thresholds prescribed for determining whether or not the non-resident constitutes SEP, every non-resident carrying out transactions with persons in India would need to test the applicability of extensive SEP provisions.

While MNCs from Tax Treaty jurisdictions may, for the time being, get a shelter from SEP, they would need to intimate their Indian customers about their residential status and provide documents like Tax Residency

Certificates along with Form 10F, No PE declarations and all relevant declarations and confirmations to ensure that there is no tax withholding in cases protected under tax treaty. Non-resident enterprises would also need to evaluate need for keeping separate accounting records for identification of profits that could reasonably be attributed to Indian business connection / SEP in cases where its incomes become taxable in India as per the provisions of the Act read with Tax treaty. Cases where Sellers are from non-Tax Treaty countries would have a larger impact as it may mandate tax withholding at a rate as high as 40% on the gross revenue. Non-residents may also have to obtain Permanent Account Number (PAN) and ensure compliances such as filing of returns, etc. if they constitute Business connection in form of SEP in India.

From the perspective of the Indian payers, evaluation of withholding tax implications would be critical in light of the various amendments in relation to SEP, Equalisation Levy and interplay between various provisions of the two laws. Payers may need to evaluate need for renegotiation of contracts with non-residents. Apart from the above, detailed exercise is required by payers for identifying the documents required to be obtained from non-resident payees such as Tax residency certificates, Form 10F, various declarations, etc. and for evaluating risks of non-compliance of tax withholding obligations, if any.

Certain clarifications from the Government are need of the hour, especially, the procedure and manner of complying with the onerous withholding tax obligations on the Indian payer in absence of all necessary information / documents.



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