M2K Advisors

Introduction of Significant Economic Presence provisions and unintended consequences

1. Background

- As part of the Base Erosion and Profit Shifting (BEPS) measure, to address the tax challenges caused by the digital companies, India has introduced the Significant Economic Presence (SEP) provisions through the Finance Act 2018. An Explanation 2A to Section 9(1)(i) of the Income-tax Act, 1961 (Act) was introduced, and the SEP is in addition to business connection. However, the operationality of the provision was postponed considering the development of global consensus under the Inclusive Framework group.

- The Central Government vide Finance Act, 2020 made few amendments without providing the rationale in the memorandum. The provisions will apply to the Financial year beginning on or after 01 April 2021. As per the amendment, the SEP provisions are triggered if a non-resident carries out any transaction with respect to goods or services or property (including any provision of download of software in India) with a resident in India and the aggregate value of such transactions exceeds the prescribed limits. Further, the user-based SEP is also triggered if the interaction with the users exceeds the prescribed limits.

- The above amendment to Explanation 2A increased the scope of SEP substantially, and it is a significant departure from the traditional understanding of the term 'business connection' upheld by the Supreme Court/High Court in several landmark decisions.

- Under the powers conferred under Section 295 of the Act, the Central Board of Direct Taxes (CBDT) vide notification no 41/2021/F.no 370142/11/2018-TPL notified the threshold of value of transactions and user. The limit for the value of transactions is fixed at INR 2 Crores, and the user interaction is set at 3 Lakhs.

- The consequence of the amendment and few open issues are discussed below:

2. Implications of the proposed amendment

- The comparison of the language of the Explanation 2A between Finance Act 2018 and Finance Act 2020 is reproduced below

Finance Act 2018	Finance Act 2020
*"Explanation 2A.—For the removal of doubts, **it is hereby clarified** that the significant economic presence of a non-resident in India shall constitute "business connection" in India and "significant economic presence" for this purpose, shall mean—* *(a) transaction in respect of any goods, services or property **carried out by a non-resident in India** including provision of download of data or software in India, if the aggregate of payments arising from such transaction or transactions*	*Explanation 2A - For removal of doubts **it is hereby declared** that the significant economic presence of a non-resident in India shall constitute "business connection" in India and "significant economic presence" for this purpose, shall mean—* *(a) 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*

Finance Act 2018	Finance Act 2020
during the previous year exceeds such amount as may be prescribed; ***or*** *(b) systematic and continuous soliciting of business activities or engaging in interaction with such* ***number of users*** *as may be prescribed,* ***in India through digital means****:"*	*year exceeds such amount as may be prescribed;* ***or*** *(b) systematic and continuous soliciting of business activities or engaging in interaction with* ***such number of users in India****, as may be prescribed:*

- In addition to the above, Explanation 1(b) to Section 9(1)(i) of the Act, which restricts the attribution of income in proportion with the activities carried in India, was amended to exclude SEP from its scope. Further, an Explanation 3A was introduced to expand the scope of income attributable to Indian operations, which includes selling advertisements or data collected from Indian users or selling goods or services using the data collected from Indian users.

- Traditionally, the term business connection was understood in a situation where the non-resident carries on the activity in India on his own or through an agent in India acting on his behalf. It is also held that an isolated or stray activity cannot be regarded as a business connection, and there should be a real and intimate connection[1].

- The amendment in FA 2020 to Explanation 2A displaces the requirement of non-resident carrying on an activity in India. This amendment has increased the scope of taxation for non-resident in India. As per the amendment, if the non-resident carries out any transaction regarding goods, services, or property with a resident in India and exceeds the limit of INR 2 Crores, then a SEP is triggered. Therefore, an isolated or stray activity may be caught under the rigors of SEP if the value of the transaction exceeds the threshold of INR 2 Crores.

- Post introduction of SEP, the business connection under Section 9(1)(i) are subject to three mutually exclusive categories:

  1. Traditional business connection – based on the activity of the non-resident in India
  2. Dependent Agent business connection – based on the activity of agent as per Explanation 2
  3. SEP – based on Value and User threshold.

- Hitherto, the resident importing goods into India were not subject to tax in India on the premise that the non-resident does not have a business connection in India. In the absence of taxability of such imports under the Act, the requirement of claiming exemption under the tax treaty did not arise. Consequentially, the resident payer was not obligated to withheld taxes on such transactions.

- Rule 37BB(3) of the Income-tax Rules, 1962 (Rules) provides relaxation in reporting transactions relating to payment towards import of goods. The relaxation in the reporting for import transactions is subject to a condition that the income is not chargeable under the provisions of the Act.

- With the amended Explanation 2A, the import of goods satisfies **the requirement of SEP** if the aggregate value of such imports exceeds INR 2 Crores. For manufacturing companies, predominant imports of goods (including capital goods), be it intercompany or third party imports, would cross the threshold of INR 2 Crores in aggregate from each non-resident in a financial year.

- In the case of services or royalties transactions, Section 9(1)(vi)/9(1)(vii) of the Act get priority over Section 9(1)(i) of the Act by adopting the principles of ***Lex Specialis.*** This principle was approved by the **Hon'ble Gujarat High Court** in **Meteor Satellite**[2] and **Hon'ble Madras High Court** in **Copes Vulcan**[3]**.** Further, the Explanation to Section 9(2) advocates this principle.

- In addition to the above provisions, one must keep in mind the rigors of Equalisation Levy 2.0 introduced under the Finance Act, 2020.

[1] CIT vs R D Aggarwal & Co [56 ITR 20] (SC); Carborandum Co vs. CIT [108 ITR 335] (SC)
[2] (1979) 2 Taxman 424 (Guj)
[3] (1987) 30 Taxman 549 (Mad)

- The magnitude of this amendment in Section 9 causes many imports of the corporates with the non-resident fall under the ambit of SEP. Consequentially, the income from such transaction is deemed to accrue or arise in India.

- This trigger of taxation under SEP lead to the following situations:

Category	Remarks
Transaction with a country where no DTAA exist	Under this category, the income of the non-resident on account of SEP would be chargeable to tax India as business profits at the effective rate of 43.68%
Transaction with a country where DTAA exist	Under this category, as per Section 90(2) of the Act, the non-resident can invoke the provisions of the tax treaty to the extent the same is beneficial. Under the existing treaties, the definition of permanent establishment is narrower compared to the provisions of SEP. Therefore, the non-resident can invoke the provisions of DTAA to get out of the rigors of SEP.

- Regarding the country where the DTAA exists, the treaty benefits are subject to producing a tax residency certificate[4] from its home country and providing additional information in certain situations[5]. Further, with the Multilateral Instruments came into force w.e.f 01 April 2020[6], the benefits under the treaty will be subject to the scrutiny of the principal purpose test (PPT).

3. Consequences of the amendment[7]

- Hitherto the resident payer was not required to obtain the TRC of the non-resident as the transactions (import of goods) were not subject to tax in India under the erstwhile business connection. Now with the applicability of SEP, the resident has to obtain the following documents from their overseas suppliers:
  - TRC,
  - Form 10F,
  - No PE declaration, and
  - A declaration that the principal purpose of the transaction is not to obtain a tax benefit.

- In the absence of the above documents, Section 195 of the Act creates an obligation on the non-resident to deduct taxes at source on the income chargeable to tax. In the absence of any guidelines, the taxpayer may either have to approach the Assessing Officer (AO) to determine income from SEP or deduct 43.68% on the gross consideration. The possibility of AO adopting an ad-hoc or formulary approach for the attribution of income to SEP cannot be ruled out.

- Failure to deduct taxes at source would involve disallowance of purchases, and consequential proceedings under Section 201 and 201(1A) of the Act could be initiated on the resident payer to recover taxes along with interest.

- Further, as mentioned earlier, Rule 37BB(3) provides relaxation only if the income is not chargeable to the income tax. In practice, once a treaty benefit is availed, a certificate in Form 15CB is obtained from a Chartered Accountant, and then 15CA is filed by the payer. In case treaty benefits are availed for goods, whether the payer is mandatorily required to file the Form 15CB or 15CA, or can it take a position that it is not required to file the forms due to specific exclusion under Rule 37BB(3)? There is no specific clarification on this, and it is left to the wisdom of the taxpayers.

- As per Section 271-I of the Act, any default in filing of Form 15CA/15CB involves a penalty of INR 100,000/- per failure.

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[4] Section 90(4) of the Act

[5] Form 10F as per Section 90(5) of the Act

[6] 28 out of 46 Covered Tax Agreement MLI comes into force w.e.f 01 April 2020 (as on 20 April 2021)

[7] The scope of this note is restricted to transaction related SEP and does not address user related SEP.

4. Open issues

In addition to the consequences mentioned above, the following are few additional issues that remain open:

a) While the CBDT has prescribed the limit for determining the threshold for SEP, the manner of computing the threshold is not free from doubt. For e.g., whether transactions already covered under Royalty/FTS/EL will be included in SEP determination.

b) While the section provides the trigger for SEP-based taxation, rules relating to income attribution to such SEP are not notified by the CBDT. In April 2019, the CBDT issued a draft attribution of income to PE issued for public consultation wherein a formulary approach was discussed. However, no such guidelines were issued to date on the determination of income arising on account of a SEP.

c) Under Section 163 of the Act, a resident could be treated as an agent of the non-resident who has a business connection in India. Since the business connection includes SEP, the resident could be treated as an agent.

d) In a situation where a non-resident is availing treaty benefits, it may be obligated to file a return of income in India. This leads to a significant compliance burden on such non-resident, whereby the non-resident is obligated to obtain a permanent account number (PAN).

e) Hitherto, the non-resident who is an associated enterprise (AEs) of an Indian entity did not disclose the transactions relating to goods in its Form 3CEB (flipside) because the transactions were not taxable under the Act. In case treaty benefits are availed, whether such transactions are now required to be reported in the Form 3CEB or existing position can be continued? Non-reporting of a transaction involves a penalty of 2% of the value of transactions under Section 271AA(1)(ii) of the Act.

5. Way forward

- Given the intricacies involved in the determination of SEP and potential taxability of the non-resident under the Act owing to breach of threshold provided under the Act, to avail the benefits under the treaty and to avoid withholding taxes, the Indian entities have to obtain necessary documents mentioned in para 3 above to safeguard themselves from the consequences.

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