


Direct Tax Alert

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CBDT notifies threshold limits for constitution of Significant Economic Presence in India

CBDT has notified threshold limits for constitution of Significant Economic Presence in India. As per the CBDT notification, the de minimis limit for 'revenue threshold' is fixed at INR 20 million and the de minimis limit for 'user threshold' is fixed at 0.3 million users.

Background

The changing business environment from the traditional brick and mortar system to the modern "digital system" has fundamentally changed the way businesses carry out their global activities. Enterprises can now carry out business across different jurisdictions without maintaining or having a physical presence in a particular jurisdiction. The crucial question which arises is whether the international tax framework is flexible enough to accommodate different business models within the digital economy and ensure fair outcomes that align profits with value creation. Recognizing the enormity of the situation and with a view to developing a

unified approach for tackling the tax challenges posed by the digital economy, the Organization for Economic Co-operation and Development ('OECD'), at the request of the G20 Finance Ministers, launched an Action Plan on Base Erosion and Profit Shifting ('BEPS') in July 2013. OECD under its BEPS Action Plan 1 addressed the tax challenges of the digital economy wherein it enlisted three alternatives that countries could consider for tackling the tax challenges arising in a digital business:

- (i) A new nexus based on the concept of significant economic presence.
- (ii) A withholding tax on digital transactions.



(iii) Introducing an “equalisation levy”.

Over the years, many countries including India have introduced several unilateral measures for taxing the digital economy. Out of the aforementioned three alternatives, India first introduced the Equalization Levy (‘EQL’) in year 2016 to levy tax on certain stipulated online transactions, the scope of which was expanded in year 2020 to cover cross-border e-commerce transactions. Thereafter, in the year 2018, the concept of ‘significant economic presence’ (‘SEP’) was introduced in the Income-tax Act, 1961 (‘the Act’).

The concept of SEP seeks to expand the scope of income of non-residents that can be deemed to accrue or arise in India by establishing a “business connection” of non-resident entities in India. As per the Explanatory Memorandum, the existing nexus rules based on physical presence contained in section 9(1)(i) of the Act were not sufficient to tax the emerging business models of the digital economy. Therefore, the law was amended by inserting Explanation 2A in section 9(1)(i) to provide that a SEP in India shall also constitute business connection of a non-resident in India. Further, the Act provides that either of the following two situations would constitute a SEP in India:

- i. Transactions 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 during**

the previous year exceeds such amount as may be prescribed; (hereinafter referred to as “payment threshold” or “revenue threshold”); or

- ii. 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. (hereinafter referred to as “user threshold”)

Accordingly, if the aggregate of payments arising from 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 exceeds a prescribed revenue threshold, then the transaction will result in a non-resident having a SEP and thereby a business connection in India.

Similarly, if the non-resident engages in systematic and continuous soliciting of business or interaction with the users in India through digital means, and if he satisfies the prescribed ‘user threshold’, then it will result in a non-resident having a SEP and thereby a business connection in India.

Thereafter, further amendments were made by the Finance Act, 2020 by inserting Explanation 3A¹ and carving out SEP from the ambit/applicability of Explanation 1(a) to section 9(1)(i)².

The applicability of SEP provisions was deferred by Finance Act 2020 to April 1, 2021 given that the global consensus on taxation of digital economy was perceived to be forthcoming from the OECD³.

¹ Explanation 3A states that that certain specified income (advertisement income targeting Indian customers, income from sale of data, etc.) shall be considered as income attributable to operations carried out in India

² As per Explanation 1(a) to section 9(1)(i), only income which is reasonably attributable from operations carried out in India can be regarded as deemed to accrue or arise in India.

³ Presently, OECD has released blueprints on Pillar One and Pillar Two proposals on which comments



CBDT Notification

The CBDT has recently issued a notification⁴ prescribing the 'payment threshold' and 'user threshold' for the purpose of constituting a SEP. The thresholds have been prescribed by inserting Rule 11UD in the Income-tax Rules, 1962. As per the said notification, the thresholds are as follows:

Nature of threshold	De minimis limit
Payment threshold' or 'revenue threshold' (applicable for payments for transactions in respect of goods, services or property with any person in India including transactions on download of data or software)	INR 20 million
User threshold (applicable in cases where there is a systematic and continuous soliciting of business activities or engaging or interacting with Indian users)	3 lakh users

Dhruva Comments

The concept of SEP is still at an evolving stage and it would be interesting to evaluate certain issues and challenges while analysing these provisions. The scope and ambit of SEP is quite wide and can potentially have far-reaching implications. For instance, it can potentially cover any transaction carried out by a non-resident in India, irrespective of

whether it is through digital means or otherwise. Thus, the SEP provisions can apply not only to social media platforms, market-place aggregators, online gaming business, online streaming websites, etc. but may also apply to physical import of goods by a Indian resident from a non-resident based in countries with whom India does not have a tax treaty.

Even for non-residents based in tax treaty jurisdictions, determining the eligibility for tax treaty benefits will play a very crucial role going forward even for transactions pertaining to import of goods. If it is found that the non-resident is not eligible for treaty benefits, there could be potential implications such as disallowance of expenses, withholding tax liability, etc. which could be fastened upon the Indian importer. However, if the treaty eligibility is not in dispute, the SEP provisions will not have any impact as the definition of Permanent establishment ('PE') in a typical Tax Treaty covers only a fixed place of business in India without any reference to a virtual or economic presence.

Further, there may be an overlap of SEP and EQL on the same transaction. For instance, the Act provides that download of software and data in India would constitute SEP in India. The same transaction may also be covered as "royalty" or as "equalisation levy" and therefore it needs to be examined on whether those specific provisions would

from the stakeholders were invited. It is expected that the consensus is likely to be achieved by the end of this year.

⁴ Notification No. 41/2021/F.No 370142/11/2018 – TPL dated 3 May 2021



prevail despite a non-resident constituting a SEP in India.

There could also be potential challenges in counting the number of users to determine the “user threshold” and the Revenue may find it difficult to verify the accuracy of such data. Currently, there is no mechanism prescribed on how the data on number of users is to be collected and the source from which such data could be relied upon (self-declaration, certificate from Internet service provider, internal reports, etc). There could also be challenges in counting the user threshold if the same user logs into his account with multiple devices. In such a case, there would be multiple IP addresses which could be reflected for a single user thereby inadvertently increasing the user threshold if the same is calculated basis the IP address. Also, given that the user threshold is quite low, it can potentially cover even smaller businesses.

Further, there may be a mismatch between the year of payment and accrual of income. It

may be possible that the SEP gets constituted due to payment in year 1 whereas, the income accrues to the non-resident in Year 2.

It is also pertinent to note that at present there is very limited guidance on how profits can be attributed in India in a case where a non-resident has a SEP in India as per the prescribed parameters. Whilst, Rule 10 of the Income-tax Rules, 1962 does lay down certain parameters in this regard, the Assessing Officer has been given a discretionary power to compute and attribute profits in the manner he deems fit.

Taxpayers would also need to evaluate their withholding tax obligations in line with the SEP requirements.

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