

Significant Economic Presence – Deemed Nexus for Import of Goods & Services

BACKGROUND

Under existing International Tax rules, nexus based on physical presence has been used as a proxy to tax business profits. However, with the technological advancements, new business models interact with customers in another country without having any physical presence in that country resulting in avoidance of taxation in the source country. Thus, existing nexus rule based on physical presence do not hold good anymore for taxation of business profits in source country.

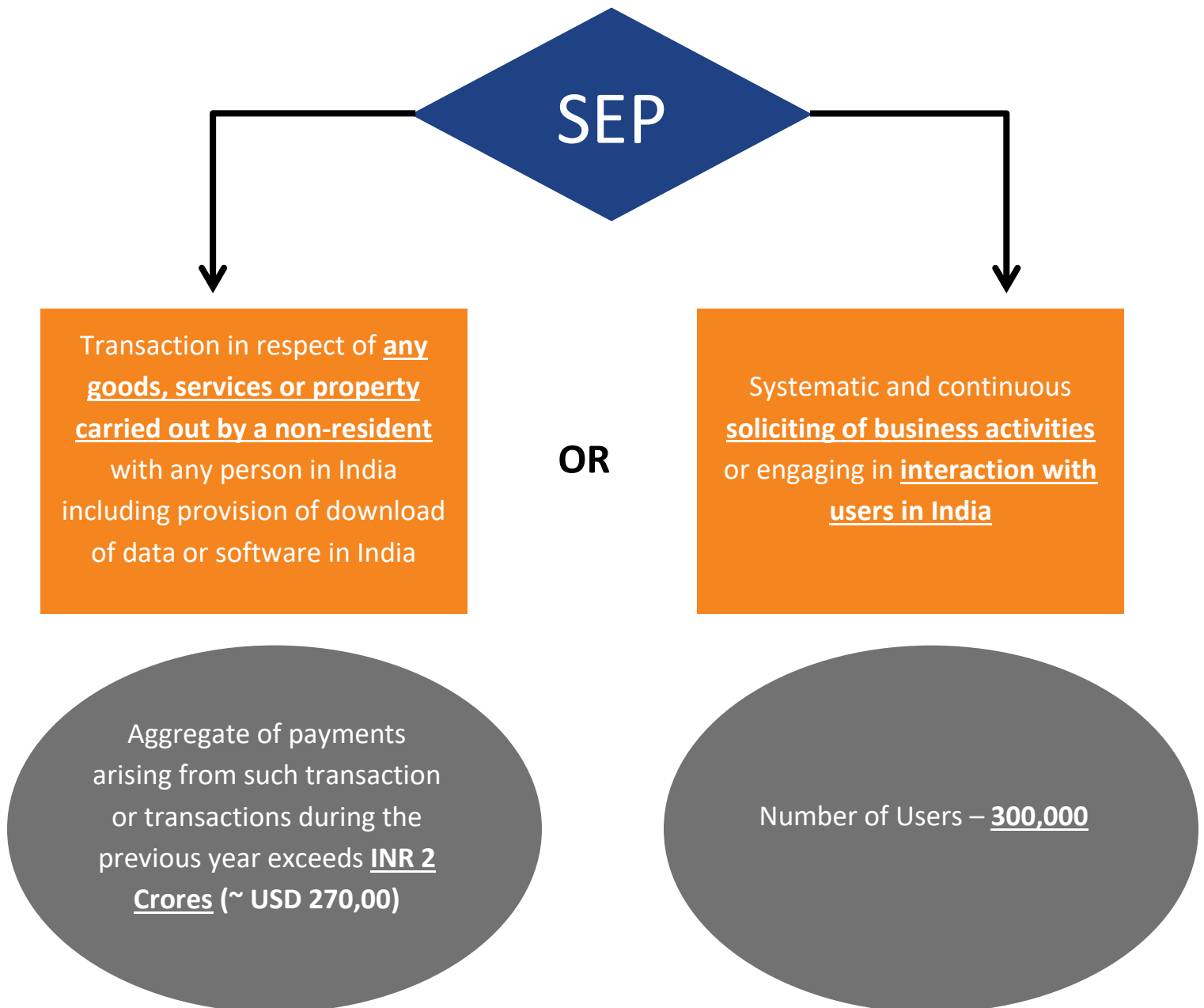
LEGISLATIVE AMENDMENT

Section 9 of the Income Tax Act, 1961 (“the Act”) provides for deeming fiction for income to accrue or arise in India. The scope of existing provisions of clause (i) of sub-section (1) of section 9 of the Act is restrictive as it essentially provides for physical presence based nexus rule for taxation of business income of the non-resident in India. Explanation 2 to the said section which defines ‘business connection’ is also narrow in its scope since it limits the taxability of certain activities or transactions of non-resident to those carried out through a dependent agent. Therefore, emerging business models such as digitized businesses, which do not require physical presence of itself or any agent in India, is not covered within the scope of clause (i) of sub-section (1) of section 9 of the Act.

Thus, Section 9 has been amended to provide that Significant Economic Presence (SEP) in India for non-resident shall also constitute business connection.

APPLICABILITY

Though SEP was originally introduced with the intention to tax digitalized businesses, SEP provisions have been worded widely to bring into ambit all types of transactions by non-resident whether digitalized or not. **SEP provisions are effective from 01st April, 2021 i.e. FY 2020-21. The threshold limits for SEP Applicability have been notified on 3rd May, 2021 making SEP operational -**



The threshold limits for SEP are significantly lower which can trigger irrespective whether the agreement is entered in India or not, non-resident has residence or place of business in India or non-resident renders services in India.

IMPLICATIONS

In case SEP is constituted in India, income of non-residents attributable to transactions or activities mentioned above shall be deemed to accrue or arise in India and accordingly taxable in India subject to availability of treaty benefits. This shall also include income from –

- (i) such advertisement which targets a customer who resides in India or a customer who accesses the advertisement through IP address located in India;
- (ii) sale of data collected from a person who resides in India or from a person who uses IP located in India; and
- (iii) sale of goods or services using data collected from a person who resides in India or from a person who uses IP address located in India.

Accordingly, any person making payment for transaction/activities to Non-Residents constituting SEP shall be required to carry on appropriate withholding tax obligations. In case of any non-compliance by Indian payer, there can be tax disallowance along with interest and penalties. There can also be risk of Indian payer being regarded as representative assessee of non-residents. The non-residents shall be obligated to file tax return in India.

IMPACT ANALYSIS

- Earlier, transactions for sale of goods where property transferred outside India or transactions for export commission would generally not be taxable in India. However, with introduction of SEP, even such transactions can come within the ambit of taxation.
- **The coverage of SEP is wide to cover goods, services or property as well as systematic and continuous solicitation of business activities or interactions.**
- It may be noted that SEP do not override Treaty provisions. Thus, cross border profits shall continue to be taxed as per existing DTAA unless corresponding modifications are made to the Treaties. **Accordingly, transactions with countries/jurisdictions having DTAA with India may not be impacted by the SEP provisions. Indian payers should obtain necessary documentation and indemnity while transacting with non-residents.**

- Rule 10 of Income Tax Rules, 1962 provides discretion to tax officer to determine profits attributable in India where reliable accounts are not available. Thus, where SEP is constituted, attribution of profits would be subjective unless draft profit attribution rules are notified. **To achieve tax certainty, Indian payers should obtain certificate from tax authorities to determine appropriate sum on which tax should be deducted.**

CONCLUDING THOUGHTS

SEP provisions were introduced primarily for digital transactions and to enable India in its negotiations for the new nexus rules in the treaties. However, the present coverage includes transactions of all types whether or not digital. Though transactions with countries/jurisdictions having DTAA with India may not be impacted by SEP provisions, Indian payers should obtain necessary documentation/declaration while transacting with non-residents. Indian parties may also have to renegotiate commercial and tax indemnity terms with its suppliers. With the around 130 member countries in OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting agreeing to the two pillar approach to address tax challenges from digitalization, it is to be seen how India would modify or amend its SEP provisions in line with the global consensus on digital taxation.

13 July 2021

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