KrayMan
Years of Demystifying Complexities

Significant Economic Presence (SEP) in India for Non-Resident entities

Background

The way of doing business has changed drastically over the last decade. Digitization and E-commerce have become order of the day. 'Brick and mortar' or physical presence is no longer considered as benchmark or evidence of doing business. New business models are emerging. Countries are trying to re-align their tax laws to avoid being obsolete and cope up with these changes.

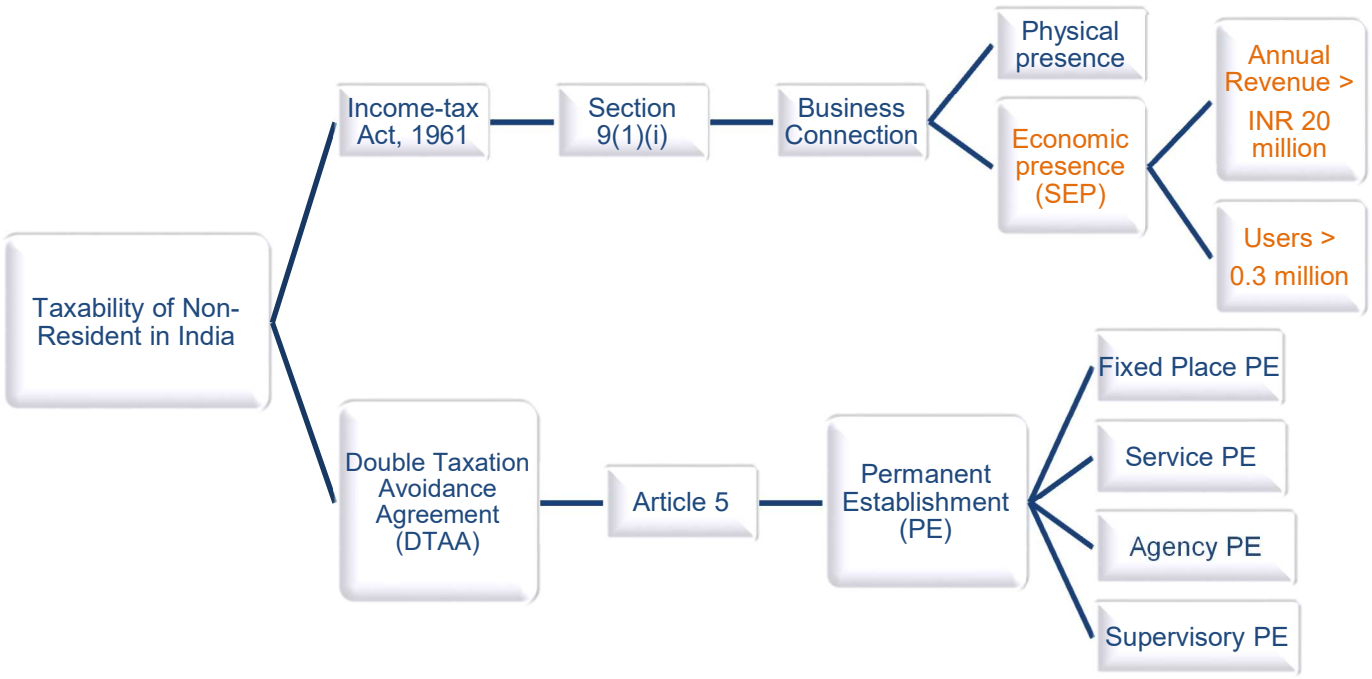
In such environment, it has become important for India to amend its tax laws to avoid revenue leakage on account of income arising to Non-Resident entities doing business in India through digital means.

Recent measures adopted by India – Equalization Levy introduced in 2016

In 2016, India introduced 'Equalization Levy' (EL) to impose following tax on Non-Residents:

- 6% EL on consideration receivable by a Non-Resident from online advertisement / provision of digital advertising space to a resident in India
- 2% EL on consideration receivable by a Non-Resident E-commerce operator from E-commerce supply or services made to a resident in India (provided the annual sale from E-commerce supply or services ≥ INR 20 million a year)

Concept of SEP introduced in 2018



India follows a source based regime of taxation for Non-Residents, i.e., it prefers to tax income originating or having its source in India. As per the domestic tax law of India [existing section 9(1)(i) of the of the Income-tax Act, 1961] income accruing or arising to a Non-Resident through any '*business connection*' in India, is considered as originating in India and hence, taxable in India.

The existing meaning of '*business connection*' under section 9(1)(i) is considered restrictive as it provides for 'physical presence' in India for taxation of business income of a Non-Resident in India. However, with the advancement in information technology in the last decade, new business models of operating remotely through digital medium have emerged. Under these new business models, the Non-Resident enterprises interact with customers in India without having any 'physical presence' in India thus resulting in avoidance of tax in India. Therefore, the existing rule based on 'physical presence' in India does not hold sufficient for taxation of business profits of a Non-Resident in India, especially those Non-Residents who are doing business in India through digital means.

To address the above issue, India has adopted SEP regulations through Finance Act, 2018. SEP is a concept borrowed from 'Base Erosion & Profit Shifting (BEPS) Action Plan 1' of the Organization for Economic Co-operation and Development (OECD). OECD is an international forum of 38 countries founded in 1961 to stimulate economic progress and world trade. BEPS refers to tax planning strategies used by multinational enterprises that exploit gaps and mismatches in tax rules to avoid paying tax.

OECD under its BEPS Action Plan 1 addressed the tax challenges in a digital economy wherein it has discussed several options to tackle the direct tax challenges arising in digital businesses. SEP is one such option and is a new rule based on the criteria of, as the name suggests, 'significant-economic-presence' in India (and not necessarily 'physical presence') for taxation of business income of Non-Residents in India.

Scope of 'Business Connection' u/s 9(1)(i) of the Income-tax Act, 1961 widened to include SEP in India

Effective from Assessment Year 2022-23 onwards, Section 9(1)(i) of the Income-tax Act, 1961 has been amended to state that henceforth, SEP in India of a Non-Resident shall constitute 'business connection' in India. Even though the amendment was introduced in 2018, implementation of the same was deferred on the grounds that the threshold for constituting SEP were not finalised and discussions on the issue were ongoing at a global level as a part of the OECD BEPS project. Finally, after waiting for couple of years, the provisions have been implemented from Financial Year 2021-22 onwards.

The entire profit attributable to SEP in India will be taxable in India. The draft rules for profit attribution were released in April 2019, however, the same are yet to be notified. The (economic) criteria or threshold for constitution of SEP in India has been mentioned as below under Rule 11UD of the Income-tax Rules, 1962.

Revenue Criteria, *OR*

- Transaction in respect of any goods, services or property carried out by Non-Resident with any person in India (including related party),
- Including download of data or software in India, if
- Aggregate payments from such transactions during the year > **INR 20 million**

No. of Users' Criteria

- Systematic and continuous soliciting of business activities, or
- Engaging in interaction with users, if
- No. of such Users **> 0.3 million**

Further, transactions or activities would create SEP in India irrespective of whether or not

- The agreement for such transactions or activities is entered in India, or
- Non-Resident has a residence or place of business in India, or
- Non-Resident renders services in India

Illustratively, the following transactions / activities will get covered under SEP in India:

- Sale or Purchase of Goods / Services / Property through digital means
- Download of Data or Software in India (such as training modules, online games, in-app purchases, etc.)
- Websites, Online Database, Cloud Storage and Computing Services, etc.

Unintended consequences and grey areas

- All transactions relating to goods, services or property carried out by Non-Resident would get covered. The definition of SEP is very wide and stretches beyond taxing digital businesses to cover even traditional businesses who are following conventional business methods without involvement of e-commerce.

  For example, high-seas sales or off-shore supplies by Non-Residents to Indian customers which was hitherto considered non-taxable in India (due to transfer of ownership outside India) for a long time, will again be considered as taxable in India under the SEP provisions if the threshold limit is breached. This means re-opening of Pandora's box for an already settled legal dispute

- Owing to the low threshold limit (INR 20 million / 0.3 million users) set by lawmaker, many Non-Residents would get covered within the SEP net

- Even if goods are sold or services rendered from outside India, it would get covered, i.e., SEP will be created even for those Non-Residents who are not undertaking any activity in India or who are following traditional methods without much change due to digital advancements

- The meaning of 'systematic and continuous soliciting of business activities' or 'engaging in interaction' to determine number of users' criteria, is not fully clear

- Whether royalty, fee for technical services, cost recharges would get covered. Interplay between Equalization Levy and SEP. Method of profit attribution in case of SEP

- Additional compliance burden for Non-Residents in India as per the Income-tax Act, 1961, such as determination of volume of transactions which will constitute SEP in India, maintenance of books of accounts in relation to Indian operations, obtaining Permanent Account No. (PAN), preparation and filing of tax return in India, and above all, facing the exposure of scrutiny / audit / tax assessment proceedings in India which could be a long drawn process

- There could be significant challenges in implementation of SEP rules on account of interpretational differences, operation and administration

- Increased responsibility on Indian buyers / customers to withhold and deposit appropriate tax at source before making cross-border payments

Immunity from SEP – Double Taxation Avoidance Agreement (DTAA) / tax treaty comes to rescue!

The good news for Non-Residents is that the armor of a favourable DTAA will continue to protect against the attack of SEP provisions' sword. In other words, the SEP provisions will not adversely impact the liability of Non-Residents belonging to a country with which India has a favourable tax treaty (India has tax treaty with about 90 countries). By 'favourable' tax treaty, we mean the definition of 'Permanent Establishment' (PE) in Article 5 of the DTAAs since it has a comparatively restrictive scope than 'business connection' under section 9(1)(i) of the Income-tax Act. As per the statute, the provisions of domestic tax law or tax treaty, whichever are more beneficial for a Non-Resident, would apply. The blessing for Non-Residents doing business with India lies in the fact that inclusion of SEP in the Income-tax Act will not be considered as read or automatically embedded into the tax treaties unless the latter are amended.

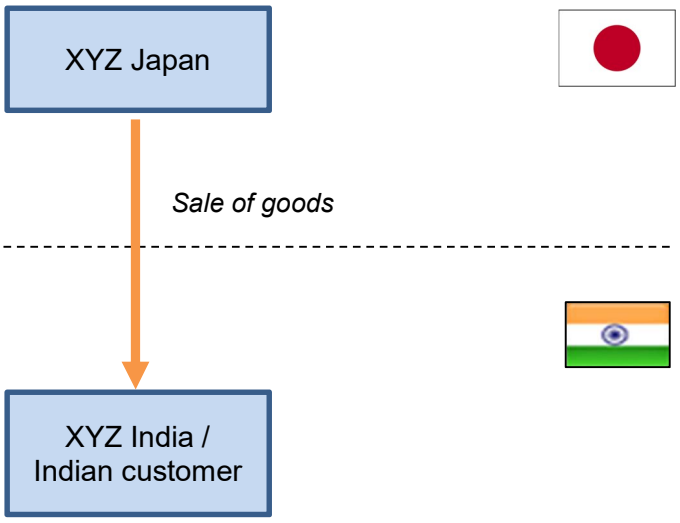
Till date, India's tax treaties with foreign countries is not amended to include SEP. As per the allocation of taxing rules under Article 7 of India's DTAA with foreign countries, business profit of an enterprise is taxable in the country of residence. If an enterprise carries on its business in India through a 'PE' situated in India, in that case India has the right to tax the business profits attributable to the 'PE'. For this purpose, 'PE' means a 'fixed place of businesses' (i.e., physical presence) through which the business of a Non-Resident entity is carried out in India.

To claim treaty benefits, however, the onus to prove treaty residency is of paramount importance and lies with the Non-Resident. The Non-Resident will need to provide the following documents to the Indian buyer to substantiate immunity from SEP provisions and avoid withholding tax in India.

- Tax Residency Certificate (TRC) issued by the Government of the home country, and
- Form 10F (self-declaration equivalent / similar to TRC), and
- No-PE declaration, and
- No-SEP declaration

In case the Non-Resident fails to provide all the above documents to the Indian buyer, the latter may withhold tax in India on the assumption that the Non-Resident does not have immunity under the tax treaty. The said position would be valid since the Indian buyer would need to safeguard itself against the wrath of tax authorities in India due to non / lower withholding of tax. The tax rate could be as high as 43.68% on business income earned by the Non-Resident from India. Hence, Non-Residents doing business with India must be very careful and revisit their eligibility to claim tax treaty benefits in India, since they no longer have immunity from taxation in India under the Income-tax Act / domestic tax law of India.

Illustration



- *XYZ Japan does not PE in India within the meaning of India Japan DTAA*
- *Aggregate receipts from sale of goods > INR 20 million in FY 2021-22*

Tax Implications	Till FY 2020-21	FY 2021-22 onwards
As per Income-tax Act, 1961	Non-taxable *(due to no business connection)*	Taxable *(due to SEP)*
As per India Japan DTAA	Non-taxable *(due to no PE)*	
Obligation to file tax return in India by XYZ Japan	Not required	Required, including disclosure of sales value in tax return

Impact of SEP regulation on Non-Residents belonging to countries with which India has no DTAA / tax treaty

As mentioned above, India has DTAA with only 90 countries (approx.). The question arises, what will be the impact on Non-Residents belonging to those countries with which India has no tax treaty. The applicability of SEP on such Non-Residents needs to be deeply evaluated. There are high chances that such Non-Residents would be taxable in India under the SEP provisions if the annual threshold limit of transactions / activity is breached. It is of utmost importance for Non-Residents belonging to such countries to check the volume of their transactions / activity with India going forward and plan well in advance if any corrective measure needs to be taken.

New reporting requirement for FY 2021-22 onwards

Non-residents who are obliged to file tax returns in India have to now declare in the tax return if they have a SEP in India or not. Also, they need to mention the aggregate amount of payments received from India and number of users so that the tax authorities can check whether the threshold limit has been breached or not. This imposes a tedious task on Non-Residents doing business with India to compile the necessary information and analyse the transactions which need to be reported in the tax return under SEP provisions.

Due date for filing of tax return in India by Non-Residents for FY 2021-22

As per the law prevailing currently, Non-Residents who have been impacted by SEP or whose volume of transactions with Indian buyers / customers has breached the threshold limit during FY 2021-22, are obligated to file annual tax return in India for the said year and disclose the necessary details by:

- **31 Oct 2022**, in case transfer pricing regulations are *not* applicable
- **30 Nov 2022**, in case transfer pricing regulations are applicable

Penal consequences on failure to file tax return or follow SEP regulations

The Income-tax Act of India provides a plethora of punishments in cases of violation. Depending on facts of the case and quantum of loss to the exchequer, the following penal consequences may arise on failure to file tax return / implement SEP regulations:

- Interest and late filing fee
- Penalty ranging between 50% to 200% of amount of tax payable on 'unreported income'
- Penalty ranging between 100% to 300% of amount of 'tax sought to be evaded by way of concealment of income / furnishing inaccurate particulars of income'
- Penalty for failure to furnish tax return
- Penalty for failure to withhold appropriate tax at source on cross-border remittance
- Imprisonment ranging from 3 months to 7 years on willful evasion of tax – Arises in cases of serious tax defaults / evasion

It is not only the Non-Resident but also the Indian buyer / customer in question who will be within the radar of the tax authorities in India for failure to implement the SEP regulations.

Measures adopted by other countries

Many countries have adopted 'Digital Services tax' following the OECD guidelines. Others are getting ready to implement measures for taxing their digital economy. For instance,

- European Union has proposed to tax 'Significant Digital Presence' based on revenue, number of users / contracts for digital services
- Israel has prescribed 'digital factors' which constitute SEP for foreign e-commerce and online services companies
- New York had passed the 'Amazon Tax Law' years ago
- Consumption tax introduced by Japan on digital services supplied to Japanese customers

Conclusion

SEP provisions have far reaching effect on Non-Residents doing business with India, especially those belonging to countries with which India has no DTAA / tax treaty. For Non-Residents belonging to countries with which India *has* a tax treaty, immunity under the DTAA will be valid so far as tax authorities do not challenge the eligibility to claim treaty benefits by such Non-Residents.

The parallel mirror effect would be on Indian buyers / customers / users since they have the responsibility to withhold and deposit appropriate tax at source in India on cross-border payments. Related party transactions would also be covered by SEP.

Responsibility of, and reliability on, tax auditors will increase when they report regarding fulfillment of withholding tax obligation of Indian buyers / customers on cross-border remittances. Importance of documentation to be obtained from Non-Residents will increase especially if the Indian buyers / customers decide not to withhold tax. Income-tax department may expect more applications from the industry requesting for issue of nil / lower withholding tax certificates.

While the unavoidability to make changes in the Income-tax Act due to change in ways and means of doing business globally is well understood, it is yet to be seen how the Indian Government will implement the SEP provisions going forward. Keeping a track of such transactions / activities which trigger SEP in India for Non-Residents, could be a bit challenging for the Government. Clarifications from Government are expected in respect of some of the unintended consequences and grey areas as discussed in this article above.

How KrayMan can support

For Non-Residents

- Impact analysis of new SEP provisions in respect of cross-border transactions with Indian buyers / customers, whether through digital or conventional means
- Determination of volume of transactions that will be affected by SEP in India including assistance in quantification of tax liability
- Analysis of PE exposure in India
- Assistance in obtaining PAN
- Assistance in preparation and filing of tax return in India

For Residents (Indian buyers / customers)

- Analysis of withholding tax requirement on transactions with Non-Residents
- Advise on documentation to be obtained from the Non-Residents
- Assistance in obtaining nil / lower withholding tax order from the tax department
- Assistance in issue of certificate for payment of cross-border remittances

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