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Analysing developments impacting business

TAXING THE DIGITAL ECONOMY - THRESHOLDS FOR CONSTITUTING SIGNIFICANT ECONOMIC PRESENCE NOTIFIED

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The concept of 'Significant Economic Presence' (SEP) was introduced in India's domestic tax law in 2018, with the intent of bringing income of non-residents operating in the online / digital space (such as e-commerce, online streaming, etc.) within the ambit of India-sourced income. However, the concept of SEP remained inapplicable as the thresholds for constituting SEP had not been prescribed. Through a notification dated 3 May 2021 (Notification), the Government of India (Government) has prescribed the relevant thresholds for non-residents to constitute SEP in India, which will come into force from 1 April 2022.

Non-residents having SEP in India would be deemed to have a 'business connection' in India, and income attributable to the SEP would now be taxable in India (except in cases where a tax-treaty is applicable). A non-resident will be considered to have SEP in India in either of the following situations –

- (a) Transaction in respect of any goods, services or property are 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(s) exceed the prescribed amount (given below); or
- (b) Systematic and continuous soliciting of business activities or engaging in interaction with such number of users in India as may be prescribed (*given below*).

Through the Notification, the Government has prescribed the threshold as INR 20 million in case of (a) above, and 300,000 users in case of (b) above.

Notably, the income-tax law was recently amended to provide that income attributable to the SEP would include income from –

- (a) Advertisement targeting an Indian resident customer or a customer accessing the advertisement through an Indian IP address;
- (b) Sale of data collected from Indian residents or from persons who use an Indian IP address; and
- (c) Sale of goods or services using data collected from Indian residents or from persons who use an Indian IP address.

Analysis of SEP and prescribed thresholds

The wide language of the SEP provision seems to go beyond the stated objective of taxing digitized businesses and may bring within its purview even non-digitized businesses. For instance, it is unclear whether sale of physical goods outside India by a non-resident to a resident would fall within the ambit of SEP. Further, the phrase "systematic and continuous" is ambiguous and its interpretation could be a magnet for tax litigation. Further, the prescribed thresholds for constituting SEP appear to be on the lower side, especially for the threshold on payments being set at INR 20 million. Lastly, the income attribution mechanism for non-residents constituting 'business connection' (including by way of SEP) remains unclear, and it is hoped that the Government would provide guidance on this matter to provide certainty to foreign businesses.

Relevance of SEP

Even though the thresholds for constituting SEP have been notified, it is important to note that SEP will not be applicable for non-residents / foreign companies that are eligible to avail benefits of a tax treaty entered with India. This is because if a tax treaty is applicable, foreign companies' income is taxable in India only if it has a 'Permanent Establishment' (PE) in India and the income is attributable to the PE.

Further, it is important to note that India has legislated a tax on non-residents in the online space in the form of 'equalisation levy' (EL). EL is levied through the Finance Act, 2016 and not the Income Tax Act, 1961 (IT Act), and as such, it overrides the tax treaty provisions. Further, incomes chargeable to EL are exempt from income-tax under the IT Act. Therefore, even in case of non-resident businesses that are from non-treaty jurisdictions and operating in online/digital space, SEP provisions will not apply *vis-à-vis* incomes that are chargeable to EL. Therefore, from a practical standpoint, SEP provisions are unlikely to affect many non-resident businesses in view of comprehensive tax-treaties entered by India with many countries and the recently-introduced EL provisions.

That said, the relevance of SEP provisions should be seen in the context of ongoing negotiations at the OECD-G20 Inclusive Framework for arriving at a global consensus-based solution on taxing the digital economy, which is expected to reach a conclusion around mid-2021. When SEP provisions were introduced for the first time in 2018, the Government had stated that inclusion of SEP in India's domestic law would enable India to negotiate for inclusion of SEP in its tax treaties. With EL provisions already in place and SEP thresholds now notified, the Government may perhaps be further equipped at the negotiation table for a consensus-based solution to tax income from the digital economy.

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