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Dear Sir / Madam,

International Tax provisions in Finance Bill 2020

It is our pleasure to send a note on some important International tax provisions announced in the Budget 2020.

The Government has continued with plugging the gaps and loopholes for tax avoidance and tax evasion.

India has in place, Automatic Exchange of Information Agreements. Several million pieces of information are coming to India from various countries. Some people are still hopeful of having foreign assets and not getting caught. They are into deep trouble.

If you have any queries, please write to us.

Rashmin Sanghvi and Associates

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1. **Residence in India for individual and HUF – Section 6 [Clause 4 of Finance Bill 2020]:**

This has been one of the most controversial provisions of the Finance Bill. It required the Government to give a clarification by a press release on 2nd Feb 2020 (Sunday).

There are three specific amendments in the definition of residence of an individual, and one amendment for an HUF. These are as under:

i) Relief for **NRIs to visit India** and maintain their non-resident status has been reduced from 181 days to 119 days in a year.

ii) **Deemed residence** has been introduced for Indian citizens who are not residents of any country.

iii) The period of relief for **Resident but Not Ordinarily Resident** has been enhanced.

These amendments will come into force from AY 2021-22. The details are discussed below.

1.1 **Relief for NRIs to visit India reduced (Explanation (b) to S. 6(1)):**

Existing provisions:

1.1.1 If an NRI who is outside India, comes on a "visit" to India, he can be upto 181 days in India during the year and still be a non-resident. Under S. 6(1)(c), normally if a person is India for:

- 365 days or more in previous 4 years, and
- 60 days or more in the relevant year (for which the residence has to be determined)

the person will be considered as a "resident of India".

This test of 60 days has been increased to 182 days for NRIs. This is the existing relief.

The term "NRI" is used in common parlance. Legally the relief is available for Indian citizens, and persons of Indian origin as explained in Explanation to S. 115C(e).

1.1.2 This relief was provided as NRIs represented that they are being invited by India to invest. If they invest, they have to come to India to look after their investments. They should be granted relief from the 60 days test as it is too short. The relief has been increased from 90 days to 182 days over 20 years.

Finance Bill proposal:

1.1.3 It is now proposed that the number of days which a NRI can be in India for a visit and maintain his non-resident status will be reduced to 119 days.

Several people maintain their NRI status by just being in India for less than 181 days. They have Indian and foreign activities but manage the same from India while they are here. They claim NRI status and do not pay tax on foreign income. To curb this practice, the period has been reduced to 119 days (about 4 months).

It now means that a person should be out of India for at least 246 days (247 days in a leap year) to maintain their non-resident status.

1.1.4 This will affect different kinds of NRIs as under:

- Employees who work abroad. They will not be affected by this provision as they actually come to India only for short vacations. Their stay in India will be much less than 119 days.

- Retired people who come to stay in India – especially during winter months in USA and Europe. They will have to see that they spend less than 119 days in a year.

- People who have their own business abroad. They will not be affected if they stay abroad for more than 8 months.

- Those who have Indian businesses but want to stay abroad to be NRIs. Such persons will have a lot of difficulties. If people have businesses in India, to stay abroad for six months is also difficult. Now to stay abroad for 8 months will be even more difficult.

The amendment is targeted for last category of people.

1.2 Deemed residence for Indian citizens – New section 6(1A):

Finance Bill proposal:

1.2.1 This is a new provision proposed in the Finance Bill. It provides that:

- an individual,
- who is Indian citizen,
- and who is not liable to tax in any other country or territory,

- by reason of domicile, residence or any criteria of similar nature,
- **will be deemed to be an Indian resident**.

The above is "notwithstanding anything contained in clause (1)"… i.e. even if a person is a non-resident u/s. 6(1), he will be considered as an Indian resident.

This provision will **apply only to Indian citizens**.

1.2.2 The memorandum explaining the finance bill states that the issue of "**stateless person**" has been causing difficulties internationally. Persons can arrange affairs in a manner that they are not residents of any country. Hence they pay tax only on incomes arising in a country. They may not pay tax on all their income in any one country.

As an anti-avoidance measure, such persons (who are Indian citizens) will be considered as Indian residents.

It may be noted that stateless person has a different meaning in International law. Article 1 (1) of the 1954 Convention relating to the Status of Stateless Persons defines a stateless person as 'a person who is not considered as a national by any State under the operation of its law'.

What the memorandum refers to are **nomads** – not residents in any country.

1.2.3 This provision has caused concern among many NRIs. This difficulty is more acute in case of NRIs in UAE, Oman, Qatar, etc. where there is no income-tax law applicable to individuals. As there is no income-tax law, a person <u>cannot be "liable to tax"</u> in that country in absence of tax law. If a person is not liable to tax, he will be considered as Indian resident.

Thus legally, persons who are not liable to tax in Dubai will be Indian residents even if they do not come to India even for one day.

The objective is not to catch genuine residents of other countries. However as per interpretation of the amendment, such people will be caught by the amendment.

This issue was dealt with extensively in the Advance Ruling of Cyril Pereira (239 ITR 650) where the authority ruled that if there is no tax in UAE, there is no double tax. DTA applies only if there is double tax. There is no income-tax law in UAE applicable to individuals. As there is no law, a person cannot be "liable to tax". As there is no liability to tax in UAE, there is no double tax. Hence DTA cannot apply. It was argued that there is a potential liability to tax as in future, tax law can be enacted. However this argument was rejected.

Subsequent to this, section 90 was amended to provide that India can enter into DTA to promote mutual economic relations, trade and investment.

If one strictly reads the amendment, person who are not be liable to tax in UAE, will be considered Indian residents.

1.2.4 Due to adverse media reports, the Government issued a press release dated 2.2.2020. It provides that <u>bonafide employees</u> will not be affected and only their Indian incomes will be charge to tax. If necessary the Government will make provision in the tax law to clarify the above.

This is a positive approach of the Government. The objective is not to catch bonafide employees. However what is bonafide and what is not bonafide can lead to difficulties.

The clarification in the meaning of residence should be stated that bonafide employees will not be considered as Indian residents.

If they are only given relief by saying that their foreign incomes will not be taxable (but will be residents), it will not resolve all the issues. For example, such persons will have to disclose foreign assets.

1.2.5 Further, those who are in UAE for their own business but are not employees, will be affected if the Government provides relief only for employees.

The Government should come out with comprehensive relaxation for all bonafide residents and not just employees.

For example, it can be provided that if a person has stayed in any country for atleast 183 days in a year and obtains a Tax Residency Certificate, will not be considered as deemed resident under the new provision. Such a provision is already there in the DTAs which India has signed with a few countries (including UAE). This will clearly help bonafide residents of other countries.

Just because the other country does not levy income-tax should not make bonafide residents of other countries, as residents of India.

1.2.6 This provision will however not affect residents of those countries which levy tax based on territoriality basis. For example, Hong Kong levies tax based on income sourced in Hong Kong even for its own residents. Such persons are still residents of Hong Kong. If a Hong Kong resident has income outside Hong Kong (say Singapore), he will not pay tax in Hong Kong. If Singapore also does not levy tax on such income, the person will not pay tax anywhere. While under BEPS anti-avoidance measures, double non-taxation is not preferred, if the counties do not want to tax, it is all right.

1.2.7 **Tie-breaking rules in a DTA** – One needs to consider tie-breaking rules of a DTA.

Under the India-UAE DTA, a person is a resident if he stays in UAE for at least 183 days in a year. Such a person will be a resident of UAE. Such a person can also be a resident of India under the new proposal. Such a person will be a **dual resident**.

In this situation, one will have to apply tie-breaking rules in Article 4(2) of the DTA. The rules contain a hierarchy of tests. These includes examining where does a person have a permanent home, personal and economic relations, habitual abode or citizenship.

For many people, they may be having permanent home, personal and economic relations and habitual abode in UAE and India. Indian residents will not get citizenship in UAE. In such situations, the person will be considered as Indian resident under the tie-breaking rules.

Assuming that the person is a UAE resident under the DTA, still such person is an Indian resident under section of ITA. Only for DTA the person is a non-resident. While he may not be liable to tax on incomes earned out of India, he will have to file a return and claim the DTA relief. Further such person will have to disclose his foreign assets. This is based on the clear understanding that a person who is a non-resident of any country only because of the DTA, does not get reliefs as a non-resident of that country. He will get relief only as per the DTA. Subject to the DTA, other provisions of Indian income-tax act will continue to apply to such residents.

1.2.8 Thus people in countries without a tax law will face difficulties.

1.3 **Relief for Resident but Not Ordinarily Resident (Section 6(6)):**

Existing provisions:

1.3.1 Under section 6(6), a person is considered as Resident but Not Ordinary Resident (RNOR) if:

- the person has been a non-resident in 9 out of 10 preceding years (preceding the year for which residence has to be determined), or
- during the preceding 7 years, the person has been India for not more than 729 days.

Being RNOR means that the person's foreign income is not taxable in India.

The whole idea is that when a person becomes an Indian resident, such person is not immediately taxable on the global income right away. There is a breathing time.

Finance Bill proposal:

1.3.2 It is now proposed to delete the test of 729 days in preceding 7 years.

Further it is proposed that persons who are non-residents in 7 out of 10 preceding years, such persons will be RNOR.

Thus for example, for FY 2020-21, if a person has been a non-resident in 7 years out of the 10 years 2010-11 to 2019-20, he will be RNOR.

This means, if a person is a non-resident for 10 or more consecutive years, such a person can be a RNOR for 4 years.

This is a welcome relief.

1.3.3 A similar proposal is there for HUFs. If the above conditions are satisfied by the manager, then the HUF will be considered as RNOR.

1.4 These amendments will apply from AY 2021-22.

2. **Limitation on interest deduction on payment to non-resident Associated Enterprise - Section 94B [Clause 46 of Finance Bill 2020]:**

Existing provisions:

2.1 Under S. 94B, there is a limitation on deduction of <u>interest paid to a non-resident Associated Enterprise (AE)</u> based on prescribed formula. Briefly, the limitation is that any <u>interest paid</u> by an Indian company or a PE of a non-resident, <u>in excess of 30% of</u> Earnings before interest, tax, depreciation and amortisation (EBIDTA), will be <u>disallowed</u>. Any excess interest which is disallowed, can be carried forward to subsequent years. This disallowance will also happen if the non-resident AE gives a guarantee or places a corresponding and matching deposit with the lender. (The lender and borrower are not AEs. Still disallowance will happen.)

The interest paid is allowed as a deduction from profits. If the person is liable to tax @ 30%, deduction of interest, reduces tax by 30% of interest paid. This interest when paid to the non-resident AE, may be taxed at a lower rate. Under the income-tax, the rate is usually 20% u/s. 115A in case of foreign currency borrowings. In case of a DTA, the rate is still lower. Thus for the group, there is a tax saving. Profits are shifted out of India.

At the same time, there are bonafide requirements for a loan. If the group company has funds, there should be no need to borrow from a third part bank. Hence interest upto 30% of EBIDTA has been considered as reasonable.

This provision is a part Base Erosion measures of OECD / G20 in which India is an active participant. Profits can be shifted abroad by way of interest. To curb excessive interest deduction, the limitation on interest deduction has been provided.

2.2 Representations were made for interest paid to Indian branches of foreign bank (Indian bank branch). Indian bank branch is fully taxable in India at 40% plus surcharge and education cess as it is a foreign company. If an Indian resident pays interest to such an Indian branch, there is no base erosion. Therefore it should not be covered by S. 94B.

However section 94B applies if interest is paid to an AE. Does Indian bank branch become an AE?

2.3 This is legally an involved matter. However briefly, Under section 92A(2)(c), if one enterprise gives loan to another enterprise and the loan is atleast equal to 51% of the book value of assets of the borrower, then the two enterprises will be AEs.

This view is itself a debatable matter. The reason is as under:

Section 92A had two sub-sections. S. 92A(1) provides that if one enterprise participates in management or control or ownership of another enterprise, then the two are AEs.

S. 92A(2) provides that "For the purpose of sub-section (1), two enterprises shall be deemed to be associated enterprises, ….". This sub-section provides for thirteen specific situations where two enterprises will be AEs.

One interpretation is that only if both sub-sections are applicable, then the enterprises can be considered as AEs. This means if one enterprise owns capital in another enterprise (sub-section (1) is satisfied) AND, the first enterprise has given a loan to the other enterprise which exceeds 51% of the book value of the second enterprise(sub-section 2 is satisfied), then the two enterprises are AEs. This is our view too.

The other view is that if any one sub-section applies, two enterprises are AEs. This is the view of the revenue. There are a few tribunal decisions which have ruled that both sub-sections of S. 92A should be fulfilled for two enterprises to become AEs. The position remains that today this is a grey area.

Assuming that the Indian bank branch and borrower becomes AEs, the Finance Bill will proposal provides a relief.

Finance Bill proposal:

2.4 It has been proposed that interest paid to an Indian bank branch will not be affected by S. 94B.

Hence if an Indian resident pays any interest to such an Indian branch, there will be no disallowance of the interest.

Thus disallowance of interest will not happen in any of the following situations:

i) Where the Indian bank branch and borrower are AEs.

ii) Where a non-resident AE has given a guarantee to the Indian bank branch for loan given to the Indian borrower (borrower is an AE of non-resident guarantor).

iii) Where a non-resident AE has placed a deposit of corresponding and matching amount with the Indian bank branch, for loan given to the Indian borrower (borrower is an AE of non-resident depositor).

This is a logical and beneficial proposal.

2.5 The amendment will apply from AY 2021-22.

3. Safe harbour under Transfer Pricing rules – Section 92CB [Clause 43 of Finance Bill 2020]:

Existing provisions:

3.1 Under the Transfer Pricing rules, any transaction between two Associated Enterprises (related entities) where at least one of the AE is a non-resident, has to be considered as Arm's Length Price (market price). Without these rules, profits can be shifted out of India by over-pricing or under-pricing the transactions.

3.2 Conceptually it is all right. However transfer pricing is a very subjective area. It has led to a lot of litigation. To mitigate the litigation risk, under section 92CB, the CBDT has been empowered to prescribe safe harbour rules. Safe harbour means that if the transaction is above certain thresholds, these will be accepted by the income-tax department. There is minimal risk of litigation. It helps to provide certainty to the assessees.

3.3 CBDT has prescribed detailed rules for safe harbour for some businesses – particularly low end businesses (like BPO), or where transactions are simple and prices are available (like loan transactions).

For example, if a software development company in India charges fees for developing software for its MNC parent company, and it declares an operating profit margin on operating costs of not less than 20% where aggregate value of the transactions does not exceed Rs. 500 cr., that will be accepted by the revenue. Thus a minimum 20% operating margin is a safe harbour.

Finance Bill proposal:

3.4 While the safe harbour rules are designed for transactions between two AEs, there are no safe harbour rules for attribution of profits to a PE. Attribution of profits to a PE is a separate issue. To give a simplified view, consider following examples.

Example 1 – An MNC has received a project of building a dam and hydel power plant in India. It sets up a project office in India. The project involves procuring goods from abroad and in India; procuring services from abroad and in India. The Indian project office will be a PE in India. It will be taxed based on the scope of income prescribed in sections 5 and 9. The entire profits of the MNC cannot be taxed. What can be taxed is income which accrues in India or which is deemed to accrue in India. This involves attributing the profits to the PE in India. Safe harbour rules do not consider such a situation.

Example 2 - MNC has a subsidiary in India which acts as an agent for procuring sales orders. Under transfer pricing rules, the subsidiary is required to charge commission as per market price under the Transfer Pricing rules. Safe harbour rules do not consider agency business specifically. However assuming that safe harbour rules were applicable to such agency transactions, the rules would have considered transactions between two AEs.

Considering further, the subsidiary is also considered as a dependent agent of the MNC. This is because it gets sales orders for the MNC. As a dependent agent, it becomes a PE of the MNC. If the MNC is considered to have a PE in India, then profit (of the MNC) attributable to the PE will be charged to tax. The profit can be over and above the price paid to the subsidiary under safe harbour rules. For such attribution of profits to the PE of the MNC, safe harbour rules are not prescribed.

3.5 Attribution of profits has been a subjective area for many decades. This is because PE is not a separate person. It is a part of the MNC. Hence to attribute profits to the PE out of the total profits of the MNC is a subjective area.

The finance bill now provides that CBDT can prescribe safe harbour rules for attribution of profits to a PE u/s. 9(1)(i). This is an enabling provision. After the Finance Bill is passed by the Parliament, CBDT will come out with detailed rules.

This should help in providing certainty to the assessees and help in reducing disputes.

3.6 Income u/s. 9(1)(i) refers to income on account of business connection, property , asset or source of income, or transfer of capital asset in India. However safe harbour is not for all kinds of incomes. The main disputes are for business profits. Hence profits attributable to PE / business connection in India would be covered.

3.7 The amendment comes into effect from 1.4.2020.

4. Advance pricing agreement under Transfer Pricing rules – Section 92CC [Clause 44 of Finance Bill 2020]:

Existing provisions:

4.1 Section 92CC provides that the CBDT may enter into an Advance Pricing Agreement (APA) for transactions between AEs. This is another provision to reduce disputes under Transfer Pricing. The APA is an involved exercise and requires understanding the business of the assessee, etc. The revenue and the assessee may then enter into an agreement for agreeing on the parameters of income under Transfer Pricing rules.

The agreement can be for 5 years, or even 4 years in the past.

The APA provides certainty to the payer and the revenue and minimises disputes.

While safe harbour is for any assessee which falls within the safe harbour rules, the APA operates qua each assessee and for businesses covered within the APA.

As in case of safe harbour rules, the APA is for international transactions between AEs. There is no provision for APA for attribution of profits to a PE.

Finance Bill proposal:

4.2 The finance bill now proposes to enable CBDT to enter into an APA for attribution of profits to a PE.

This will be one more step in minimising disputes.

It may however be mentioned that an APA is a long and costly exercise. During past 7 years, about 300 APAs have been entered into. This is a good achievement by India. However in the overall context of number of assessees and number of businesses, it is a small number.

4.3 The amendment comes into effect from 1.4.2020.

5. Double Tax Avoidance Agreement with countries, specified territories and specified associations – Sections 90 and 9A [Clauses 41 and 42 of Finance Bill 2020]:

Existing provisions:

5.1 Section 90 enables the Government to enter into agreement with other countries for the purpose of avoiding double taxation. S. 90A enables the Government to adopt the agreement between specified associations in the two countries for the purpose of avoiding double taxation. Under the BEPS programme, more than 100 countries have agreed to amend their laws and enter into Multilateral Instrument (MLI) to curb tax avoidance.

One of the minimum standard of the MLI is to have a preamble in the DTAs stating that the DTA is for avoiding double taxation "*without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in the said agreement for the indirect benefit to residents of any other country or territory)*".

India has entered into the MLI and also given its final position on several provisions in the MLI. The MLI will operate alongside the DTAs.

The particular phrase in italics above is not there in section 90 and 90A. It may be argued that without this phrase, India cannot enter into a DTA with such a preamble.

Finance Bill proposal:

5.2 It is proposed to provide in section 90(1)(b) and insert the phrase in italics in the above para.

This phrase will also be useful for entering to DTA in future with countries with which India does not have any DTA; or where India and the other country want to negotiate a revised DTA.

5.3 It should be noted that this is a preamble. In case of interpretation of a DTA, the object and purpose of the DTA has to be kept in mind. The DTA should also have specific clauses which do not permit tax avoidance and tax evasion.

However this does not mean that in every case of double non-taxation, the DTA relief has to be denied. See para below.

5.3 The above phrase has led to discussion within professional circles regarding non-taxation or reduced taxation of a person. Let us take an example of a person working in Dubai. He is a proper resident of Dubai and has obtained a Tax Residency Certificate from UAE. He has various kinds of incomes from India.

As per the DTA with India, he will pay no tax in India or reduced tax in India – depending on the kind of income. In Dubai, there is no tax. It leads to Nil taxation of some incomes and reduced taxation of some other incomes.

Will the preamble prevent such non-taxation or reduced taxation?

No. This is a case of a bonafide resident who is actually staying in Dubai for employment. If as per the laws of the country there is no tax, DTA does not prevent such a situation.

5.4 Consider the full phrase in italics. A DTA is for avoiding double taxation –

without creating opportunities for non-taxation or reduced taxation

through tax evasion or avoidance

(including through treaty-shopping arrangements aimed at obtaining reliefs provided in the said agreement for the indirect benefit to residents of any other country or territory)

The non-taxation or reduced taxation should happen <u>*through tax evasion of avoidance*</u>. Tax evasion or avoidance can be through various means including treaty shopping where DTA benefits are available to residents of a country which is not a signatory to the DTA.

Thus there is a requirement of tax evasion or tax avoidance. If there is no tax evasion of tax avoidance, then double non-taxation or reduced taxation will not be affected.

Consider a case of a resident of UK. The UK resident wants to avail of the India-UAE DTA benefit. Hence it will set up a company in UAE and then invest in India. This is known as treaty shopping. The benefit of India-UAE DTA will be available to the UK resident through is UAE company. Such arrangements will be caught within the preamble.

Take another example, where a person becomes a non-resident of India for one year in which he expects to make a capital gain in India. He becomes a resident of Mauritius, undertakes a transaction and takes advantage of the India-Mauritius DTA. He does not pay tax in India and Mauritius also does not charge any tax. Then he returns to India and becomes an Indian resident again. Such arrangement leads to non-taxation or reduced taxation. This will be caught by the preamble. Of course it may be caught by other anti-avoidance provisions also.

Thus if the matter is controversial, then the preamble will be considered to interpret whether DTA relief will be available or not.

5.5 The amendment will come into force from AY 2021-22.

6. Significant Economic Presence in India of non-residents – Sections 9 and 295 [clauses 5 and 103 of Finance Bill 2020]:

Background and Existing provisions:

6.1 Taxing non-residents on business income which accrues in India is one of the most difficult and subjective issues. It is an accepted principle, that a non-resident who does business "with India" is not taxable. If however he does business "in India", then he is taxable.

It is also accepted that the entire income cannot be taxed. Only that much income can be taxed which accrues in India u/s. 5, or which is deemed to accrue in India u/s. 9.

6.2 Under section 9(1)(i), income is deemed to accrue in India which arises on account of **Business Connection in India**. If there is a DTA, a non-resident is taxable only if he has a **PE in India**.

One can consider business connection and PE as **nexus**. Once nexus is established, India gets the rights to tax.

While business connection is a broad term, PE is narrower term. PE exists only if the non-resident has a **physical presence in the country**. It has a historical background. Earlier it was possible to do business in any foreign country by being physically present in that country. Hence PE was linked to physical presence. If there was no physical presence, no PE was constituted. If there was no PE, there could not be any tax in the Country of source.

There are other kinds of PEs such as dependent agency PE, construction PE and service PE. Each of them tries to overcome the limitation of physical PE. However with technology growing exponentially, all these PEs become inadequate for a country to tax the income of a non-resident even though the non-resident may be earning substantial income from that country.

6.3 If nexus is established, the next issue is **attributing income** to the nexus. Under both – business connection and PE – only that much profits can be taxed which can be considered to be attributed to Indian operations.

Attribution is an involved exercise. Full profits cannot be taxed. Income attributable to the operations in India or attributable to the activities of a PE only can be taxed. The rule for business connection and PE lay down a cap on income which can be attributed to the nexus.

6.4 Technology has improved tremendously over the past 20 or 30 years. Today it is possible for a non-resident to be actively involved in the economy of the country without being physically present. Most the technology companies such as Google, Facebook, Amazon and even Apple would fall under this category. Apart from these, there are several smaller companies in the area of entertainment, social space, consultancy, news, etc. which use technology to deliver services to the consumer over internet, TV etc. without being physically being present in the country where customers are located.

The law has not kept pace with technology. The law is still based on tax based on physical presence in the country. **As companies do not have physical presence in the country of source, there is no nexus. As there is no nexus, such companies do not pay any tax in country of source**. To overcome such unfairness, countries have come together to frame new rules to tax such businesses – broadly known as digital commerce.

Under the forum of G20/OECD, discussions are going on as to how to tax such income.

Most of the technology companies are in USA. Hence USA does not want other countries to tax such incomes. They would like status quo or minimal changes in tax rules. Some European countries, India, Australia, Brazil etc, would like changes to happen. The negotiations are likely to be concluded by end of 2020. Final rules may take another year or so - and that too if countries can come to an understanding. If there is no understanding, unilateral actions may be taken by the countries. Already some countries like India, France, Australia, UK have taken unilateral actions. This will lead to difficulties, double taxation, etc. **OECD has cautioned that tax war should not lead to trade war**.

6.5 As a message to the world, India had proposed Equalisation levy in 2016. This was largely on advertisement and related revenues. This directly affected Google and Facebook.

In the negotiations going on internationally, **Significant Economic Presence** is one of the nexus being considered actively. Briefly it is being considered that if the non-resident is involved with country of source through digital means, or it has revenue beyond a certain threshold, it is participating in the economy of the country. It has **Significant Economic Presence**.

In anticipation of the changes in International tax rules, subsequently India has enacted the concept of **Significant Economic Presence (SEP)** in 2018. It provides that SEP will be business connection. The SEP is not yet operative. Criteria of revenue and users (discussed later in case of revised SEP) has to be fixed as to what can constitute SEP. Further unless the SEP concept is incorporated in the DTAs, SEP in the ITA will be inoperative. This is because DTA overrides the ITA.

6.6 The SEP as drafted in Finance Act 2018 had ambiguities. However as it was not operative, it did not have any impact.

In anticipation that OECD will be able to finalise the rules for digital commerce by 2020 / 2021, India has enacted a new definition of SEP in this finance bill.

Pending finalisation of SEP, finance bill has proposed rules for taxing advertisement & data related incomes.

Finance Bill proposal:

6.7 It should be noted that there are several issues in this topic. A comprehensive discussion can take a few hundred pages. Here a gist has been discussed.

There are two proposals in the Finance Bill:

i) Removing the old SEP meaning from AY 2021-22, and inserting a new meaning of SEP from AY 2022-23. (There will be no SEP phrase for AY 2021-22 as it is not expected that countries will come to a conclusion before that). (Explanation 2A).

ii) Providing that income attributable to operations in India will include income from advertisement and data related revenues. (Explanation 3A).

These are discussed below.

6.8 **Revised meaning of SEP** –

6.8.1 It has been proposed to replace the existing definition of SEP with a new definition from AY 2022-23. Thus today it is not operative. It is possible that based on negotiations, this may be further modified.

The old definition will not exist from AY 2021-22. Even if old definition exists, there is no implication as the criteria for SEP has not been notified.

SEP will be the additional nexus.

6.8.2 The new definition of SEP has been provided in Explanation 2A to S. 9(1)(i). SEP will be considered as business connection. The new definition provides two tests. Fulfillment of any of the tests will mean that the non-resident has SEP in India.

Test 1 – If there is any *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, and*

if the aggregate of payments arising from such transaction or transactions during the previous year exceeds such amount as may be prescribed,

the non-resident will be considered to have SEP.

Test 2 - If there is *systematic and continuous soliciting of business activities or engaging in interaction with such number of users in India, as may be prescribed,*

the non-resident will be considered to have SEP.

The revenue threshold in first test and number of users threshold in the second test will be prescribed. Till then the SEP nexus will be inoperative.

In the first test, any "transaction" with Indian residents including download of data or software, will be SEP if it exceeds a certain amount (to be prescribed). This test does not apply only to digital commerce. It applies to all kinds of transactions.

In the second test, if there is any soliciting of business activities, or engaging in interaction with prescribed number of users (to be prescribed) in India, it will be SEP. This will apply to digital companies like Google etc. It should be noted that when people use gmail or google maps, there is an interaction with Indian residents. However Google does not earn any money from the users. But the data which it collects of the users, is used for its advertisement services. This will make Google taxable in India on its advertisement revenue.

6.8.3 Both the tests (discussed in para 6.8.2) establish "**nexus**" with India. Once there is nexus, India can tax the income. How much income can be taxed is dependent on how much can be attributed to such transactions of interactions. Detailed attribution rules may be prescribed later.

There is a proviso to explanation 2A. It states that only so much of income as is attributable to the transactions or activities, shall be deemed to accrue or arise in India.

Thus entire income will not be taxable. It will be restricted to income attributable to transactions or activities.

6.9 **Income from advertisement and data related revenues:**

6.9.1 There is a new explanation – 3A - which is proposed to be inserted from AY 2021-22 (i.e. FY 2020-21). This pertains to income from advertisement and data related services.

6.9.2 The explanation begins with the phrase "**for the removal of doubts**". It has been enacted as if it is a clarification. However it has no retrospective application. The memorandum explaining the finance bill explains that internationally it is accepted that advertisement and data related income should be taxed in the country from where it arises. If customers are in India, it should be Indian based income.

6.9.3 The explanation further states that income from **advertisement** and **data related revenue** will be included in income from Indian operations. Following incomes will be considered as income from Indian operations:

i) such advertisement which targets a customer who resides in India or a customer who accesses the advertisement through internet protocol address located in India;

(ii) sale of data collected from a person who resides in India or from a person who uses internet protocol address 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 internet protocol address located in India.

Thus incomes which are covered in the explanation are income from advertisements, sale of data, sale of goods and services using the data.

6.9.4 In case of **advertisement,** the advertisements targeted at customers **residing in India** are covered. Even if customers are not residing in India, but access advertisement through Indian ISP, it will be considered as Indian operations.

It may be noted that companies like Google do not advertise to Indian viewers. It is the customers of Google who use Google platform to advertise, target the advertisement to viewers. The word "customer" creates a confusion. The viewer to whom advertisement is targetted, does not pay. Here the "customers" should mean those who are targeted as "viewers" by the advertiser.

For Google, viewers are users of Google services. Google does not charge anything to users / viewers.

Advertiser also does not charge anything to viewers.

Advertiser pays to Google for the use of platform.

Tax is to be levied on Google which is the income earner.

Google can earn income from:

i) Indian advertisers who target Indian viewers.
ii) Indian advertisers who target foreign viewers.
iii) Foreign advertisers who target Indian viewers.
iv) Foreign advertisers who target foreign viewers.

The first kind of income is clear. Google will be taxed.

The fourth kind of income is clear. Google will not be taxed in India.

The second kind of income will not be taxed as viewers are not residing in India. However if they are in India and use an Indian ISP to view the advertisements, then it will be taxed.

The third kind of income will be taxed. However will Indian Government tax the income, is a separate matter

In reality, the things are mixed. Practically it will be difficult to have a segregation of various kinds of incomes.

6.9.5 In case of **data**, income will be taxed if following criteria is fulfilled.

Data is collected from persons **residing in** India or those who use **Indian ISP**, and

that data is sold, or
data is used to sell goods or services.

For example, if Facebook sells Indian data to anyone interested in targeting Indian customers (advertisement or otherwise), it is taxable in India.

If such data is used to provide goods and services, then also the same can be taxed. For example, if weather apps collect data and sell weather analysis services, it will be taxed in India.

However how will this provision apply to sale of goods based on data collected, is difficult to comprehend. For example, if Nike wants to sell its shoes in India, they will collect market data of various kinds. Only then they can decide on their sales strategy and then sell the shoes. The sale will happen from outside India. Will such sale be taxed?

One can consider the following example to have a logical meaning. A seller of fashion garments sells the garments on Amazon's platform. Amazon's platform and the data analytics helps the seller to sell the garments to targeted customers. Without the data, the online seller of garments would not be in a position to sell. If the garment seller sells garments based on the data collected, then such sale of goods will be considered as income from Indian operations. It may be noted that data can be collected by anyone and not necessarily the seller.

6.9.6 In the above situations of advertisement income or data related income, will whole of the income be taxable in India or only that which can be attributable to collection of data? Explanation 3A does not have provision of attributing income only to these activities. This cannot be the intention. One will have to wait for the rules. The manner in which the explanation is enacted, it seems that the entire income will be taxable in India. However that will be unfair and is not the objective.

6.9.7 It is further proposed that the Explanation 3A (advertisement and data will apply to attribute income to transactions and activities referred to in SEP. This will be applicable from AY 2022-23.

It is difficult to understand how will the explanation pertaining to advertisement and data related income, apply to SEP transactions and activities. SEP covers several more kinds of transactions than advertisement and data activities.

6.9.8 **Legal issue** – Before income can be taxed in India, it has to be established that it has a nexus with India. The Explanation 3A only says income from advertisement and data will be considered as income from Indian operations. It does not state that such activities will be considered as business connection. Only if there is business connection, income can be considered for taxation in India.

One may counter the above by saying that advertisement and data related activities amount to SEP as defined in explanation 2A. However explanation 2A is operative from AY 2022-23; and that too after the criteria for revenue and users is specified. Further for explanation 2A, the proviso in the explanation itself states that income attributable to transactions and activities in India will considered as deemed to accrue in India.

Explanation for advertisement and data related income has been drafted independently and is linked to Non-SEP business connection.

There is thus inconsistency in the drafting.

Further unless the DTA is amended to consider advertisement and data related activities as taxable in India, it will be difficult to tax the same.

6.10 As there are several explanations for different activities, the same are captured below in the table.

Explanation to S. 9(1)(i)	**Nexus / activity**	**Limitation on attribution of income**
1	Business connection – other than SEP (for business other than those covered by SEP).	Income attributable to operations carried out in India.
2A	SEP business.	Income attributable to transactions or activities.
3A	Advertisement and data related revenue	Income will be considered as attributable to operations in India under Explanation 1.

6.11 It is also proposed to amend section 295 which gives power to CBDT to make rules for certain purposes. It is proposed to give power to CBDT to prescribe rules for operations carried out by a non-resident in India; and transactions and activities of a non-resident.

There are no guidelines for attributing profits to a PE except Rule 10 under which the revenue can attribute profits if the books and accounts of the assessee do not provide reliable information.

CBDT may come out with rules to attribute profits u/s. 9(1)(i) for normal business connection and SEP.

Notes:

1. The views expressed in this note are based on prima facie reading of the Finance Bill 2020 read with Income-tax Act, 1961. Going forward there may be clarifications issued by the Government. Further, more issues and interpretations may come to light.

2. By the time the Finance Bill is passed into an Act, there can be amendments in the Finance Bill proposals.

3. Readers should not take any decision based on this article. This article is meant for academic information of the readers.