

India Consulting on ‘Significant Economic Presence’: Some Observations

Kluwer International Tax Blog

July 19, 2018

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Please refer to this post as: Shilpa Goel (Editor), ‘India Consulting on ‘Significant Economic Presence’: Some Observations’, Kluwer International Tax Blog, July 19 2018,

<http://kluwertaxblog.com/2018/07/19/india-consulting-significant-economic-presence-observations/>

On July 13, 2018, India’s Central Board of Direct Taxes (CBDT) issued for stakeholders’ comments a consultation document on framing of tax rules in respect of the concept of “significant economic presence” – a recent addition to the Indian Income Tax jurisprudence. Readers will recollect that India’s 2018 Budget proposed to amend the definition of “business connection” stipulated in Explanation 2 to section 9(1)(i) of the IT Act to include a new nexus to tax business profits of foreign businesses based on a “significant economic presence.”

It is true that any change in the domestic tax definition of “business connection” will not mean much until the Indian Government is able to bring its treaty partners to the negotiating table and convince them to incorporate a digital nexus in the permanent establishment Article of the treaty. Time will tell when and how that is done. Clearly, countries have not been able to reach a consensus on the issue and its complexity and significance was one reason why the OECD did not recommend countries to incorporate a new nexus at this stage.

When the Finance Ministry announced the introduction of a new tax nexus in the IT Act in its 2018 Budget proposal, concerns were raised as to how the Government is going to apply the new nexus. It was felt that a move that attempts to deviate

from traditional international tax principles that have served countries and businesses for decades must be proportionate to the objectives sought to be achieved and must be clear and certain. This clarity was lacking in the definition of “significant economic presence” and much was left to be desired.

As I have previously noted in this blog, the definition of “significant economic presence” as incorporated in section 9 of the IT Act is vague and ambiguous. At the time of releasing the 2018 Budget, the Finance Ministry had said that it would consult stakeholders before finalizing several aspects of the definition including the threshold for revenue and number of users. The Finance Ministry must be commended for launching a public consultation given the significance and of the move and complexities involved.

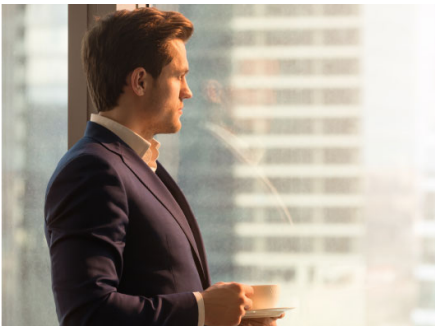
The move to amend the domestic law definition of “business connection” was clearly informed by the OECD’s ongoing work on base erosion and profit shifting (BEPS) Action 1, on addressing the tax challenges of the digital economy. However, the manner in which the definition of significant economic presence is drafted, it was felt that it would also include within its ambit business activities that involve dealing in physical goods. The consultation document makes this explicit: foreign businesses selling physical goods in India will fall under the new tax nexus. The Finance Ministry should have considered stakeholders’ views on this important aspect.

Next, the consultation document does not speak about profit attribution. Foreign businesses with a significant economic presence in India will undoubtedly be said to have a “business connection” (as per the proposed definition) and be liable to income tax in India. But is that the be all and end all? No. The definition notes that only that portion of profits will be taxable that is attributed to the Indian significant economic presence (unlike equalisation levy with a flat rate of tax). How profits need to be attributed to the Indian significant economic presence is a complex exercise and requires broad consultation.

Finally, as we know, the OECD’s Action 1 report suggested applying other considerations subject to a certain revenue threshold. But the Indian version of significant economic presence suggests that the revenue-based factor would apply regardless of and not subject to other considerations. It is unfortunate that the Finance Ministry did not take into account public comments on this important aspect. As regards, the actual threshold is concerned, we can only wait and hope

to see something concrete comes out of the consultation process.


It seems from the language of the consultation documents that the Finance Ministry has put a lot of emphasis on the threshold requirement. In other words, there are many aspects of the proposal that need consultation, some of which have already been highlighted in my previous blog such as what amounts to “systematic and continuous” soliciting of business activities and what is meant by “engaging in interaction” with users. I wish to reiterate that in coming up with the final rules, the Government must carefully consider and honor existing international tax principles of neutrality, efficiency, certainty, and simplicity so that these basic principles governing the source-based taxation are kept in-tact.



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