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Indian 2018 Budget: New Nexus to Tax Based on Virtual Presence

Shilpa Goel (Tax Lawyer) · Monday, February 5th, 2018

On February 1, 2018, Indian Finance Minister presented the country's latest Budget, which contains an international tax proposal that may not send a positive message to foreign companies doing business with India. The Budget proposes to amend the definition of "business connection" stipulated in Explanation 2 to section 9(1)(i) of the Income Tax (IT) Act to include a new nexus to tax business profits based on a "significant economic presence."

The Budget also proposes to amend the definition of "business connection" to bring it into line with the Multilateral Instrument to implement the tax treaty-related base erosion and profit shifting (BEPS) measures (as such, the new definition will include agents who habitually play the principal role leading to conclusion of contracts by the non-resident). India was one of the 67 jurisdictions that signed the Instrument on June 6, 2017, and there is nothing new or shocking about this proposal.

Significant economic presence

What this piece will examine closely is the Budget proposal to create a new nexus to tax business profits of foreign companies in India's domestic tax law. Currently, under section 9(1)(i) of the IT Act, an income is deemed to accrue or arise in India if it accrues or arises, directly or indirectly, through or from any "business connection" in India. Explanation 2 to that section defines "business connection" to include business activities carried out through a person who, acting on behalf of the non-resident, habitually exercises an authority to conclude contracts in India on behalf of the non-resident, or habitually maintains in India a stock of goods or merchandise, or habitually secures orders in India for the non-resident.

The Budget seeks to lower the current business connection threshold stipulated in section 9(1)(i) of the IT Act. From April 1, 2019, profits of a foreign company will be taxed in India if the company has a "significant economic presence" in India (subject of course to the benefit of the permanent establishment (PE) definition contained in a tax treaty as discussed below). The intent behind this change is clear. As pointed out in the Explanatory Memorandum, the recent advancement in information and communication technology (ICT) has enabled new business models to carry on business activities in the source state remotely and through digital means, without the need for establishing a physical or representative presence. As such, the traditional nexus to tax does not "hold good anymore" for taxation of business profits of foreign companies in the source country and a need was felt to supplement it with a new nexus to tax based on digital or virtual economic

presence.

The Indian Government's proposal must not have taken many with surprise (reference is made to the Government's position on the 2017 update to the OECD Model Convention). The direct tax challenges posed by the digital economy has been a subject matter of debate in India since 1999 (when for the first time a High Powered Committee on E-commerce was set up), and the debate gained enormous traction in the last few years in the wake of the OECD's BEPS project. The OECD's Final Report on BEPS Action 1 (published in October 2015) discusses various options to address the tax challenges of the digital economy. Among other options is included the option (not recommendation) for countries to incorporate in tax treaties a new PE nexus to tax business profits.

Under the traditional rule, the source state has the right to tax business profits of a foreign company only if the company carries on business activities in the source state through a PE, which requires physical or representative presence. Because companies operating in the digital sphere do not necessarily need to be physically present in the source state, countries discussed if there was a need to reconceptualize the traditional PE definition to provide for a virtual or digital economic presence. I have earlier discussed this in some detail in this article.

How to establish significant economic presence

The Explanatory Memorandum states that "as per BEPS Action 1 Report, a non-resident enterprise would create a taxable presence in a country if it has a 'significance economic presence' in that country on the basis of factors that have a purposeful and sustained interaction with the economy by the aid of technology and other automated tools. It further recommended that revenue factor may be used in combination with the aforesaid factors to determine 'significance economic presence'."

Along these lines, the Finance Bill, 2018 notes that a foreign company shall be said to have a "significant economic presence" in India if: (a) the aggregate of payments arising from a transaction carried out by a non-resident during the financial year exceeds an yet-to-be prescribed amount; or (b) systematic and continuous soliciting of business activities or engaging in interaction with a yet-to-be prescribed number of Indian users through digital means.

While it is true that the BEPS Action 1 Final Report discusses (although not in great detail) the idea of creating a new PE nexus to tax, the Report does nowhere recommend countries to incorporate the new nexus in their tax treaties. The Report states that the new PE nexus to tax requires "substantial changes to key international tax standards," adding that there is no clarity at this stage if changes to basic international tax principles of which allocation of taxing rights is based are needed to deal with the changes brought about by advances in the information and communication technology. Finally, the OECD made it clear that the digital economy is becoming a part of the economy and it is difficult, if not impossible, to ring-fence digital economy.

Questions remain

Changes to tax law must be certain, simple, and efficient. The definition of "significant economic presence" proposed to be inserted in the IT Act is vague and ambiguous. What amounts to "systematic and continuous" soliciting of business activities, or what is meant by "engaging in interaction" with users. How and on what basis will the revenue threshold be calculated (also, the proposed definition is not clear if it applies only to digital transactions)? How will profits be attributed to the virtual PE?

These are questions that will confront the Finance Ministry in the days and months to come. That said, the existence or otherwise of a new nexus to tax business profits of foreign companies in its domestic tax law will not have significant impact in near future. The application of the traditional PE rule in India's tax treaties with other countries will continue to apply.

The OECD is currently working on an extensive proposal on how to best address the tax challenges posed by the digital economy and is due to submit a Report in 2020. Till then, it is likely that countries will hesitate to enter into bilateral negotiations with the Indian Government to amend the PE definition in Article 5 to incorporate a new PE nexus based on virtual economic presence. Even if discussions do take place, what needs to be seen is how these countries reach agreement on the definition of "significant economic presence". It cannot be stressed enough, though, that a re-allocation of taxing rights will require countries to carefully consider and honor existing international tax principles of neutrality, efficiency, certainty, and simplicity so that these basic principles governing the PE rule are kept in-tact.

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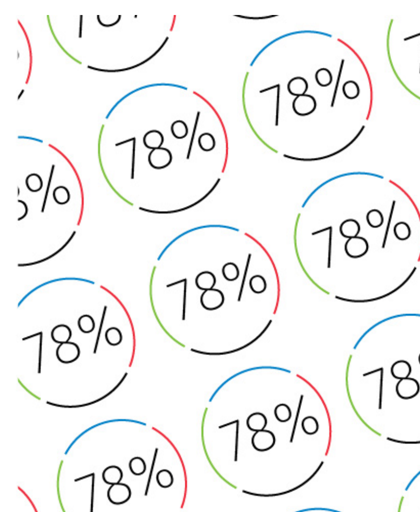

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