

Western India Regional Council of ICAI
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Digital Taxation
Significant Economic Presence (SEP) and
Equalization Levy

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Background

Understanding Background of Domestic Tax; International Tax & Digital Taxation, Challenges & solutions

Slides marked “Suggestions” may be complex.

Digital Taxation

1. Impact of OECD latest statements on **Pillar 1** for Digital Tax rights of **COM**.
2. OECD Pillar 2 – Tax Rights of **COR**.
3. Indian ITA provides for SEP, Equalisation Levy-2016 & 2020, VDA tax and Royalty & FTS.

How will the Payer & Receiver determine their tax exposure?
Is there a hierarchy amongst several provisions?

Digital Taxation

Don't jump to interpret law.

Understand background, context, etc.

Who drafted the law? What are his perspectives?

What will be the consequences of the law?

What should be the law?

Short Forms used in this presentation

COR : Country of Residence

COS : Country of Source

COM: Country of Market

DC : Digital Corporation

BC : Business Connection (ITA)

SEP : Significant Economic Presence (ITA)

PE : Permanent Establishment (DTA)

Short Forms used in this presentation

ITA	:	Indian Income-tax Act
DTA	:	Double Tax Avoidance Agreement
FA	:	Finance Act
NR	:	Non-Resident of India
IR	:	Indian Tax Resident
Attr	:	Attribution of Profits

Digital Tax War

There is a war between:

- i. USA on one side; and
- ii. Rest of the world on the other side.

Some governments are greedy. They want the whole cake.

They go against the DTA principle of sharing revenues.

This causes Tax Wars.

Tax Experts from profession & department

May work together to protect Indian share.

International Taxation

In domestic taxation we ignore sections 1,4,5,6 & 9.

In International Taxation, these are the **first** provisions to look at.

S. 1 Jurisdiction

S. 4 Charge of Tax.

S. 5 Scope of Taxable Income.

S. 6 Residential Status

S. 9 Deeming provisions extending scope.

Next step is to apply computation, assessment, tax payment etc. provisions.

International Taxation

First step is to determine whether Government has jurisdiction to tax under ITA & DTA.

If yes, Tax liability under domestic law is determined.

Then DTA is applied to apply lower rates.

If both provisions are similar, okay.

In case of difference, normally whichever is more beneficial to the assessee applies.

However, if Parliament makes specific contrary provisions; then “Specific shall prevail over General”.

Digital Tax Conceptual Understanding

A country has **jurisdiction** to levy Income-tax on income only if it has connection / nexus.

So far two connections / nexus have been agreed internationally:

Residence of the assessee - COR

Source of his income - COS

Now a **third nexus** has been added: Market - **COM**

This has significant consequences on factors to determine nexus.

Digital Tax Conceptual Understanding

Computing taxable income is a three step process:

1. Determination of **Nexus**; and
2. **Attribution** of taxable income amongst –
COR, COS & COM.
3. Then the normal ITA provisions may follow.

Digital Tax Conceptual Understanding

Past Nexus was PE
PE irrelevant for Digital Taxation.

OECD spent 23 years (1998 to 2021) in searching for
right way to give taxing rights to COM.

(Or, rather denying & delaying COM rights.)

Finally, on 8th October, 2021 gave an unjust,
Complicated & impractical report on Pillars 1 & 2.

Digital Tax Conceptual Understanding

In digital commerce, USA is the largest COR.

Most digital MNCs are US residents.

(China having digital MNCs is not active party to Tax War).

Digital MNCs do not need any PE outside USA.

Hence, these MNCs were earning globally but paying tax only to USA; or parking their incomes in tax havens.

Digital Tax Conceptual Understanding

When US MNCs earned billions from U.K. & France but paid negligible taxes in COM-UK & France, they (COM) realised that something is fundamentally wrong.

With a mind-set of COR & COS – traditional system of international taxation; they could not diagnose the problem and could not find the solution.

Digital Tax Conceptual Understanding

Indian E-Commerce Committee, said in the year 2001, that the concept of PE is outdated, and needs to be redrafted. But with traditional mind-set – could not offer a solution.

At BEPS groups, our commissioners fought
Very well to protect our rights.

Digital Tax Conceptual Understanding

Any resolution of digital tax problem would mean that the US MNCs would have to pay taxes in COM – countries other than USA.

That would mean, under the DTA, US would have to give relief to its tax payers – US MNCs.

This was not acceptable to USA. So USA stonewalled all discussions at OECD – BEPS.

OECD cannot act against US desires.

Digital Tax Conceptual Understanding

By the year 2013 stone walling the discussions was not succeeding = individual countries ignored OECD and started enacting unilateral laws for taxing digital MNCs.

UK imposed “**Diverted Profits Tax**”. India imposed **Equalisation Levy**. France, Australia, EU started raising their voices and deviating from OECD.

EU proposed **SEP**.

Digital Tax Conceptual Understanding

USA threatened these countries with
Trade War & USTR action.

Because of the **threats from USA,**
all countries fell silent.

OECD, as if it were a US agency drafted Pillars 1 & 2.
Statement was released on 8th October, 2021.

Pillar 1

COM tax offices cannot scrutinise returns
to be filed by Digital MNCs.

Audited Consolidated Accounts & Profitability figures as given
have to be accepted.

These MNCs are known for aggressive tax planning.
How can their accounts be accepted without scrutiny?

Pillar 1

Threshold for taxing an MNC – **Euros 20 Bn.**

EQL – 2020 proposed a threshold of Rs. 2 crores –
Say Euros 50,000.

Has anyone heard of such high threshold for any tax?

U.N. Article 12B

UN reached almost final conclusion and approved Article 12B for digital taxation.

Illustration:

Digital Corporations normal Profit ratio - 15%

30% of the profit allotted to COM - 4.5%

Apply this to revenue from COM

Very simple system. Hence good.

UN Article 12B - Suggestion

This will not cover Sale of Data.

Have to accept profitability percentage
as given by the assessee.

Why not have tax at fixed percentage –
say, 2% on Gross?

Next Slides

Significant Economic Presence

SEP

Significant Economic Presence

Nexus: SEP provides India's connection with an NR's income.

This makes the NR liable to comply with Indian law i.e.,

U/S. 9(1)(i) Explanation 2A.

Attribution of profits: When NR's income has nexus with India, he needs to compute income taxable in India. This is income deemed to accrue or arise in India

U/S. 9(1)(i) Expl. 2A (2nd Proviso).

By applying Nexus & Attribution of profits, income taxable in India is computed.

Significant Economic Presence - SEP

Apply the Double Tax Avoidance Agreement (DTA) and see whether NR's income is taxable in India.

If the income is taxable in India pay tax and file IT return.

If not, file IT return and claim that the income is not taxable in India under DTA.

TDS: Once an NR's income is covered, the Indian payer must deduct tax at source. If no tax is deductible, the payee must obtain lower deduction certificate from the AO and give the same to the payer.

SEP provisions under ITA

SEP constitutes a business connection.

S. 9 (1) Expl. 2A. SEP is defined as:

1. Transaction in respect of **any goods, services or property** carried out by NR with a resident, including provision of download of data or software in India, if the aggregate payments exceed Rs. 2 crores; or
2. Systematic and continuous soliciting of business activities or engaging in interaction with 3 lakh users or more.

Thresholds prescribed as per **Rule 11UD**.

SEP provisions under ITA

“NR's **transaction** for goods, services or property with anyone in India”

If NR **sells** anything to anyone in India, it is his **transaction** with a person in India (Indian imports \$760 Bn).

If a NR **buys** anything from anyone in India, it is his **transaction** with a person in India (Indian exports \$670 Bn).

Total cross border business - **\$1,430 Bn.**

SEP – Nexus under ITA- suggestion.

Global businessmen doing business with India with turnover in excess of Rs. 2 crore are deemed to have a BC - SEP in India.

This will help if **Pillar 1** becomes OECD model.

Is it a correct drafting of law? Can India assume Nexus for all NRs transacting with India as subject to Indian tax provisions?

No.

SEP – Nexus under ITA

Under **DTA**, most transactions won't be **taxable** in India.

Wide scope of SEP will cover Pillar 1.

Once a person has a BC in India, he is **liable to file Income-tax return**. He may then claim to be "Not liable to Indian tax" under DTA of his COR with India.

For claiming this relief, he will have to file **TRC** to prove that he is resident of a particular country. **Form 10F** will also have to be filed.

Does CBDT expect all these people to file IT returns in India?

Probably, No.

Solution for SEP limitation

Concept of SEP should be improved
with one more condition:

Virtual Presence.

Then physical Import & export of goods will be out of SEP
net.

WhatsApp, YouTube, Google etc.

Having virtual presence + Indian Revenue will be covered.

SEP – Nexus under ITA

SEP only provides Nexus – like a PE.

Thereafter for computation of income, one has to follow normal provisions of ITA.

EQL is a complete code by itself.

SEP – Attribution of Profits

After determining Nexus,

Second part of International Taxation is to determine what share of the total profit earned by the NR is taxable in India.

Profits accruing or arising in India are included within the scope of Taxable income. (S.5 & S. 9).

A NR earns profits from his **business operations carried out within India** as well as **outside India**.

SEP – Attribution of Profits

For normal BC, 9(1)(i) Expl. 1(a): only profits attributable to the operations carried out in India are taxable in India.

DCs have no operations in India.

Profits attributable to Indian operations would be Zero.

2nd Proviso: Only income attributable to the **transactions** referred to in clause (a) or clause (b) shall be deemed to accrue or arise in India.

Profits earned by NRs from Indian Business of \$1,430 Billion will be deemed to have accrued or arisen in India.

SEP – Digital Corporations

Clause (b) systematic and continuous soliciting of business activities or engaging in interaction with such number of users in India, as may be prescribed.

This is an attempt to cover DCs who **don't charge any fees** – but regularly interact with users in India, collect Indian data &
Sell data abroad.

Such DCs will be considered to have an SEP in India.

SEP – Digital Corporations

Facebook, Google, WhatsApp etc. that provide some services without charges are deemed to have an SEP in India.

Note: The connection is with what the NR does.

Connection is NOT with Market.

CBDT has tried to tax NR DCs who carry out no operations in India. To overcome the restriction of Expl. 1(a), a new explanation is provided - 2A.

2nd proviso seeks to tax the whole profit for any operations whether carried out in India or outside India.

SEP – TDS and other provisions

- Section 195 of ITA: An IR payer has to deduct tax @ 31.2% (30%+4%) if amount is chargeable to tax; or
- NR should get lower TDS certificate from AO.

NR having SEP in India needs to compute its net profit, get tax audit done if applicable and file his return u/s. 139.

Illustration

M/s. G from Germany exports goods worth Rs.100 to Mr. I in India. G has no PE in India, no operations in India. Entire interaction between G & I has taken place or telephone calls and written / printed letters and documents. But there is transaction in respect of goods with a person in India.

Hence there is SEP. Under 2nd proviso to Expl 2A, only the profits arising from Rs.100 is deemed as accruing in India.

But the **whole of the profits** on this transaction.

Issue with Attribution method

COR and COS – both are **supply side/seller side** provisions. In digital commerce, attribution of profit to COM based on supplier's function is impractical.

Only when **Market** is recognized as an independent factor for attribution of profit, one can set up practical parameters for attribution of profit.

Next Slides

Equalisation Levy - 2016

EQL 16

Equalisation Levy – 2016

OECD was not able to give a workable system for digital taxation in 23 years – 1998 to 2021.

USA was stalling any progress in the matter.

To push for progress and claim India's right to tax;
India introduced EQL 2016.

It was a tool for bargaining at BEPS Action 1 Task Force.

EQL 16 – System Involved

Nexus: Revenue received from India

Threshold: Rs. One lakh of revenue earned by NR and Rs. One lakh payment by IR payer (for TDS).

Attribution of Profits and computation of tax on profits have been simplified – 6% of Indian revenue.

EQL16 – Applicability

EQL 16 applicable only to NR **service provider on advertisement revenue** earned from India.

Goods are not covered here.

Indian PEs also not liable to EQL.

Indian resident **home consumers** are not liable to deduct EQL.

IR business entity paying for specified services to **deduct EQL** – Section 166(1) of FA, 2016.

EQL 16 – Applicability

Whatever is taxable as **Royalty or FTS** will not be taxed as EQL – Proviso to Section 163 of FA, 2016

Whatever is taxed as EQL will not be taxable under ITA – **Section 10(50)** of ITA.

If due EQL is not deducted/paid; the relevant expenditure will not be allowed u/s. **40(a)(ib)** of ITA.

EQL 16 – Simple

- No categorization of Income.
- No computation of taxable income.
- No need for PE.
- No application of DTA.

All compliance is by Indian Resident payer.

Non-resident has no duty – except suffer TDS.

Next Slides

Equalisation Levy 2020

EQL 20

EQL 20 – System Involved

Nexus: Revenue received from India

Threshold: Rs. Two Crores of revenue earned by NR.

Attribution of Profits and computation of tax on profits have been simplified – 2% of Indian revenue.

EQL 20 – Applicability

Cumulative factors for application of EQL – 2020:

1. Assessee is a NR;
2. Assessee is an E-Commerce Operator. Just maintaining website is not sufficient. Website should enable sale.
3. A. He earns revenue from India; or
B. He earns revenue by sale of Indian data;
4. Online sale of goods or services;

Note: For exact words, see S. 165A.

EQL 20 – Applicability

Whatever is taxable as **Royalty or FTS** will not be taxed as EQL – Proviso to Section 163 of FA, 2016

Whatever is taxed as EQL 16 or EQL 20 will not be taxable under ITA – **Section 10(50)** of ITA.

EQL 20 – Simple

No categorization of Income.

No computation of taxable income.

No need for PE.

No application of DTA.

All compliance is by Non-resident.

EQL 20 – TDS - Section 166A

1. The NR E-Commerce Operator to pay EQL on –
 - (i) His own profit &
 - (ii) Payment made to IR Supplier.

Illustration:

IR manufacturer of goods sells his goods through a NR E-Commerce platform for \$ 100.

E-Commerce Operator receives \$ 100 from Indian customer, deducts \$ 30 as his commission and pays \$70 to manufacturer.

E-Commerce Operator to pay 2% EQL on \$ 30 & \$ 70.

EQL 20 – TDS

2. If an IR pays to NR E-Commerce Operator as EQL; then the amount is exempt u/s. 10(50). Hence, section 195 is not applicable.

3. If IR pays to NR any amount outside EQL; then section 195 would apply.

EQL 20 – Definitions- Section 164(ca)

E-Commerce Operator (ECO) means –
NR who owns/operates/manages
digital/electronic facility/ platform for
online sale of goods, or
online provision of services, or
both.

EQL 2020 – Definitions

Section 164 (cb): E-Commerce supply or services mean –

- (i) Online sale of goods by ECO; or
- (ii) Online provision of services by ECO; or
- (iii) Facilitation of (i) or (ii) by ECO.

EQL 2020 – Definitions

Section 164(cb) Explanation: Online sale of goods/
provision of services include:

- (a) acceptance of offer for sale; or
- (b) placing of purchase order; or
- (c) acceptance of the purchase order; or
- (d) payment of consideration; or
- (e) supply of goods or provision of services, partly or wholly;

EQL 20 – Definitions

In current times, almost all cross border business will involve any one or more of these five elements being “online”.

Which again means almost all imports will be covered under EQL 20 (Indian exports are not covered).

Sale etc. has to be to an IR, or Indian PE.

EQL and SEP – unilateral measures

EQL is outside ITA. It has been levied through Finance Act, 2016 and Finance Act, 2020; and then repeated every year. Hence, DTA is not applicable.

An NR DC that earns revenue from India has to pay EQL irrespective of DTA.

The scope of EQL16 was deliberately kept restricted. It was only a **bargaining tool**. Revenue was secondary.

SEP and DTA

SEP is a part of ITA. DTA is applicable.

Indian DTAs still do not provide for SEP.

NR -resident of a DTA country, will not pay tax qua SEP.

Purpose of SEP is to **prepare groundwork**. Whenever the DTA is modified to cover digital taxation, Indian ITA should be ready with basic tax law.

It is so widely worded that **Pillar 1** provisions will be covered.

Hierarchy – NR's Income from India - DTA

OECD statements are still under discussions.
It will take some time for it to come into effect.

Until then existing DTAs continue.
They do not provide for COM tax on digital income.
Hence SEP won't apply in DTA countries.

Hierarchy – NR's Income from India - ITA

- (i) VDA is applicable for Indian transactions.
DTA may not be applicable.

- (ii) EQL 16, (iii) EQL 20, (iv) SEP and (v) Royalty & FTS
are for Cross Border Transactions.

All provisions in ITA are applicable now.

DTA is applicable for SEP, Royalty & FTS.

Hierarchy – NR's Income from India - ITA

SEP is applicable only where there is no DTA.

EQL is outside ITA. DTA is not applicable. (This view has been challenged by some.) Hence EQL is applicable for Indian digital taxation irrespective of DTA.

Royalty is applicable under ITA & DTA.

Hierarchy - NR's Income from India

EQL - Section 163 Proviso:

If income is Royalty/FTS; then that has a first priority.

But the payment should be “taxable”.

For example, if it is FTS & not taxable because of “Make Available” clause; then EQL will apply.

Hierarchy - NR's Income from India

Between EQL 16 & EQL 20; give priority to EQL 16 & pay 6%.

For EQL, DTA is ignored. Under EQL 20, pay 2%.

If EQL 16 & EQL 20 both do not apply; and Royalty/FTS also do not apply; then go back to ITA.

Now existing law, case law etc. would apply.

DTA relief is also available.

Hierarchy - NR's Income from India

If a payment is covered under Royalty/FTS and then it is not taxable because of DTA; then it is not taxable.

SEP, BC etc. provisions cannot brought in.

If it is taxable as Royalty/FTS under ITA & DTA, Pay.

Matter closed.

Hierarchy - NR's Income from India

If payment is not covered under Royalty/FTS & EQL; then see whether SEP or BC is applicable.

If applicable; then apply DTA & see which treatment is beneficial to the taxpayer.

However, if a tax avoidance provision (BEPS/GAAR, etc.) applies; then the DTA relief may be curtailed.

Hierarchy - NR's Income from India - Suggestion.

SEP - if there is no DTA,

43% Tax on Net Profits attributable to **Total Profits?**

Taxing a NR's profits attributable to foreign operations do not seem justifiable.

And yet, for Digital Taxation, it is necessary -
Digital corporations may not have any operations in India.

Data Sales may happen outside India.

SEP may be defined to cover - Indian Revenue + Virtual presence; then tax only a part of its global profits.

Hierarchy II

SEP is most widely worded. Includes **imports** as well as **exports** from India. Tax on Net Profit. At present not applicable to DTA countries.

EQL 20 is widely worded - 2%

EQL 16 is restricted only to advertisement - 6%

Royalty & FTS are widely worded - Normally - 10%

Key: Follow the highest rate applicable

Consequences of even allegations of tax avoidance are harsh.

Summary of Hierarchy

Consider different provisions in the following order.

Pay -Royalty & FTS if taxable under ITA & DTA.
If not payable as R & F; consider EQL-16; Next EQL -20

If Royalty & FTS not taxable;
examine whether you get out of tax net.
If Royalty, FTS & EQL are not applicable, then consider:
SEP & Next BC.
As usual, apply DTA.

Case Study - 1

Facts: IR pays NR for On Line Purchase of goods
No PE. No FTS/Royalty.

Law: EQL 2%. No TDS - Resident Payer not
bothered.

NR to pay tax.

S.195 does not apply to EQL.

SEP is Not Applicable as DTA does not cover it.

Case Study – 2 DTA

Facts: An IR used On Line Services provided by NR.

Law: ITA S.9(1)(vii) taxable as FTS.

Under India-US DTA

“ Make Available” is not satisfied. Hence no tax.

EQL 20 applies.

NR liable to pay 2%

IR Payer has no responsibility at all.

Future of Digital Taxation

It will depend upon what WE do now.

Tax Payers, Advisors, Tax Officers,

OECD, UN, USA & all.

Future of Digital Taxation

- There will always be greedy people.
- There will be struggles & fights & threats.
- It is part of life.
- Will we act without greed,
- For the benefit of the nation as a whole?
- For the earth as a whole?

Important aspects of future of Tax Practice

My personal view.

With GAAR, TP, a hundred SAARs & BEPS.

Comply with law in Substance & in Form.

Avoid all aggressive tax planning.

Understand Automatic Exchange of Information together
with Digitalisation of most records &

linking of Aadhar & PAN.

Forget about Tax Evasion.

Summary

PE not relevant for Digital Commerce.

COM as a connecting Factor is necessary.

SEP based on revenue + virtual presence is the right solution.

8th October OECD Proposal is bad & impractical.

Who will make USA accept this?

Nature.

Universal Love

सर्व मंगल प्रार्थना

प्रणाम



रश्मिन संघवी