International Tax Update: Significant Economic Presence October 2022

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Significant Economic Presence (SEP) – WHOM DOES IT APPLY

SEP introduced in Income Tax Act, 1961 from April 1, 2018, and made applicable from 1st April 2022

For non-residents, it expands the scope of taxable income which accrues or arises through "Business connection" in India. The resulting income, attributable to the SEP, is taxable in India.

Who is impacted?

-Non-residents carrying on specified activities above the thresholds prescribed

Non-residents located in countries that do not have tax treaty with India may get significantly impacted

-Non-residents located in countries that have tax treaty with India may have insignificant impact. However, all documents required to avail treaty benefits needs to be provided

-Indian Companies dealing with non-resident parties need to assess the impact on their withholding tax obligations & elaborate documents to be maintained where treaty benefits are to be availed

Genesis:

The concept of SEP is modelled around Base erosion and profit shifting (BEPS) Action 1. India has taken the lead to introduce the SEP concept in its tax law after introducing the Equalization levy in 2016.

- SEP has been defined in Explanation 2A to section 9(1)(i) of the ITA to mean: –

a. Transaction in respect of any goods, services or property carried out by a non-resident **with any person in India**, including the provision of download of data or software in India, if the aggregate of payments arising from such transaction or transactions during the previous year exceeds the prescribed amount; or

b. Systematic and continuous soliciting of business activities or engaging in interaction with such number of users as may be prescribed in India.

The Central Board of Direct Taxes (CBDT) in order to prescribe the thresholds for constituting SEP and thereby establishing a business connection in India, issued notification no 41 dated 3 May 2021 (Notification) in this regard. The amendments become applicable from 1st April 2022.

The transaction covered include both **related party** & unrelated party transactions

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CRITERIA

The thresholds beyond which a non-resident taxpayer may be considered to have an SEP in India have now been prescribed under Rule 11UD of the Income-tax Rules, 1962 (Rules):

Revenue Criteria:

Aggregate payments for sales transactions with any person in India during FY shall be greater than 2 crore

Users Criteria:

Number of users with whom systematic and continuous business activities are solicited shall be greater than three lakh

Impact of falling under SEP definition

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Once SEP applicability is triggered in India, the payer is required to withhold any tax due or demonstrate applicability for tax treaty benefits available, and the non-resident is obligated to file a tax return as below

-31st October where TP regulation are not applicable

-30th November where TP regulations are applicable

Non-compliance with the withholding tax obligations can trigger disallowance of expenses and interest & penalties for the person resident in India.

For the non-residents, the penal consequences for non-compliance includes

-Interest and late filing fee

-Penalties for unreported income

-Penalties for tax evasion

-Penalties for non-filing of returns

Furthermore, the Indian payer can also run the risk of being regarded as a representative assesses of the non-resident

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Attribution of Profit – Grey area and judgemental

As per Rule 10 of the Income Tax Rules, 1962, a profit rate can be applied to India specific turnover of the foreign company for ascertaining profits attributable to operations carried out in India.

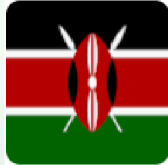
Rule-10

- In any case in which the Assessing Officer is of opinion that the actual amount of the income accruing or arising to any non-resident person whether directly or indirectly, through or from any business connection in India or through or from any property in India or through or from any asset or source of income in India or through or from any money lent at interest and brought into India in cash or in kind cannot be definitely ascertained, the amount of such income for the purposes of assessment to income-tax may be calculated :—
  - at such percentage of the turnover so accruing or arisings the Assessing Officer may consider to be reasonable, or
  - on any amount which bears the same proportion to the total profits and gains of the business of such person (such profits and gains being computed in accordance with the provisions of the Act), as the receipts so accruing or arising bear to the total receipts of the business, or
  - in such other manner as the Assessing Officer may deem suitable."

- *Draft guidelines for attribution of profit to PE were released in April 2019 however these have not yet been notified.*

Illustration 1

Avocado Tea Kenya Limited



Sale of Avocados and Tea

- Exports to India for Avocado Tea Kenya Limited amounts to INR 50 million for FY 2021-2022
- India and Kenya have an active DTAA
- Avocado Tea Kenya does not have any Permanent Establishment ("PE") in India as per the definition of PE under the DTAA between both countries

Veg Delight India Limited

Tax framework	Up-to FY 2020-2021	From FY 2021-2022
Income Tax Act	No Tax as no business connection	Tax provisions triggered as Sale above SEP thresholds
Impact under Kenya-India DTAA	No Tax as no PE	No Tax as no PE
Tax return filing	Not applicable	Tax return to be filed by Avocado Tea Kenya Ltd disclosing sales value

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Illustration 2

A foreign company does not have any Permanent Establishment in India. It has provided some technical services to an Indian company from a place outside India amounting to INR 35 Million and the Indian company has deducted and paid the required amount of tax (Withholding tax) to the credit of Indian Government.

Question arises that whether such foreign company is required to file its tax return in India or not?

In this case the foreign company does have a source of Income within India. This source of income (Fees for technical services) is not the source of income which is covered by the exemption granted by section 115A(5). Therefore, this foreign company is required to file its tax return in India within the timelines as specified under Section 139(1) of The Act.

However, since the Indian company, the payer, has deducted and paid the required amount of tax on such income, there will not be any additional tax liability on the foreign company. It will simply have to furnish its tax return declaring the income derived from India and claim the tax which is deducted and paid by the Indian company.

Summary

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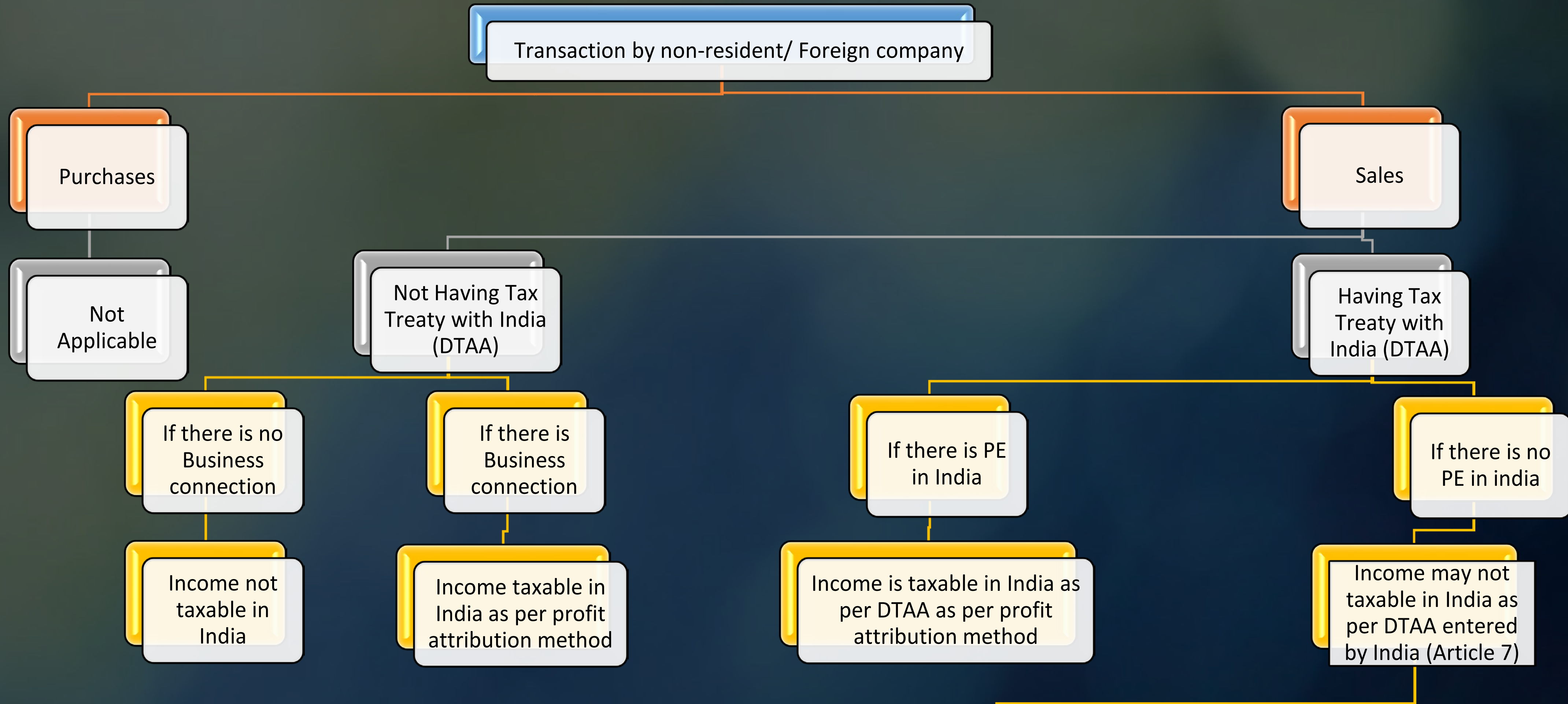

Even if there is business connection but there is no PE, then section 9(1)(i) shall not apply since DTAA provides that income is not taxable in india in absence of PE. As per section 90, DTAA or Income Tax Act, whichever is beneficial to assessee shall apply. However, all conditions and documents to avail the tax treaty benefits must be available and vetted. this includes:

- Tax residency certificate (TRC) issued by government of home country of non-resident

-Form 10 (self-declaration)

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How can we assist you:

Foreign company/ Non-resident

1. Analyze the impact of SEP provisions w.r.t transactions with Indian counterparts

2. Analysis the impact of Permanent Establishment (PE) provisions applicability

3. Evaluation the benefits of double tax treaty, if any available

4. Assistance in obtaining Permanent Account Number (PAN) and filing tax returns in India

Indian company/ Resident

1. Analyze the impact of SEP provisions w.r.t transactions with overseas suppliers

2. Opinion on the impact of withholding tax (WHT) requirement in respect of transaction with non-residents

3. Advise relating to documentation requirements from non-residents to avail double tax treaty benefits

4. Assistance in filing 15CA and 15CB form

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Thank you

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