



CA. ASHWANI RASTOGI

M. Com, F.C.A., A.C.S., F.A.F.D.(ICAI)

Email [ashwani.rastogi.ca@gmail.com](mailto:ashwani.rastogi.ca@gmail.com)

(+91) 9990999281

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## Taxation issues on Digital Economy



**In-dept analysis of Domestic Income Tax provision with Tax Treaty Benefits available and MLI Impact.**

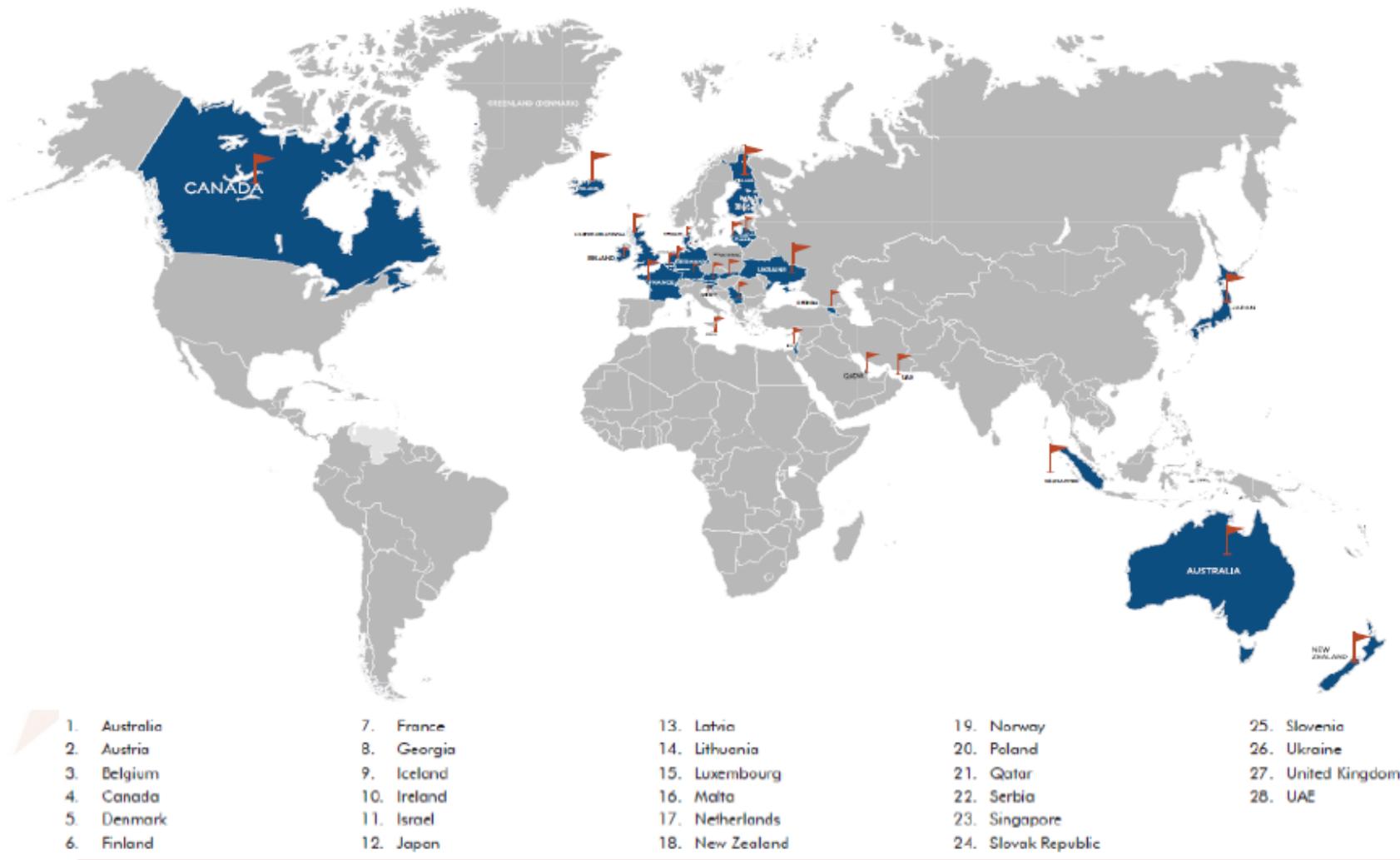
**With the view cross border transactions with territorial nexus...**

## KEY POINTS

- After pandemic situation of COVID19 entire world shifted to Online platform, we saw 2 years of digital transformation in 2 months.
- India has DTAA about 94 out of 195+ jurisdiction.
- Out of 94 DTAA, 60 are CTA as per MLI
- Out of 60 CTA, about 24 MLI have come into effect from 1.4.2020
- Equalisation Levy scope has been enhanced to cover 6% Google tax as well as Non-Resident E-Commerce Operator entity 2% tax in India, if no PE in India.
- Explanation 3A inserted w.e.f. 1.4.2021 AY 22-23 to cover E-commerce company as BC in India in respect of advertisement, data sale and goods or services delivery using such data.
- Finance Act, 2020 has deferred Explanation 2A relating to SEP In India till 31.3.2021
- after 1.4.2021 AY 22-23, that Non-resident entity/ or through any Indian entity doing business in India. Liable to tax on income derived will be taxable in India as SEP in India.
- 1% GST- TCS will be deducted by Ecommerce operator in India in respect of E-commerce participant.
- 1% TDS will be deducted by Ecommerce operator in India in respect of E-commerce participant. Sec. 194O.

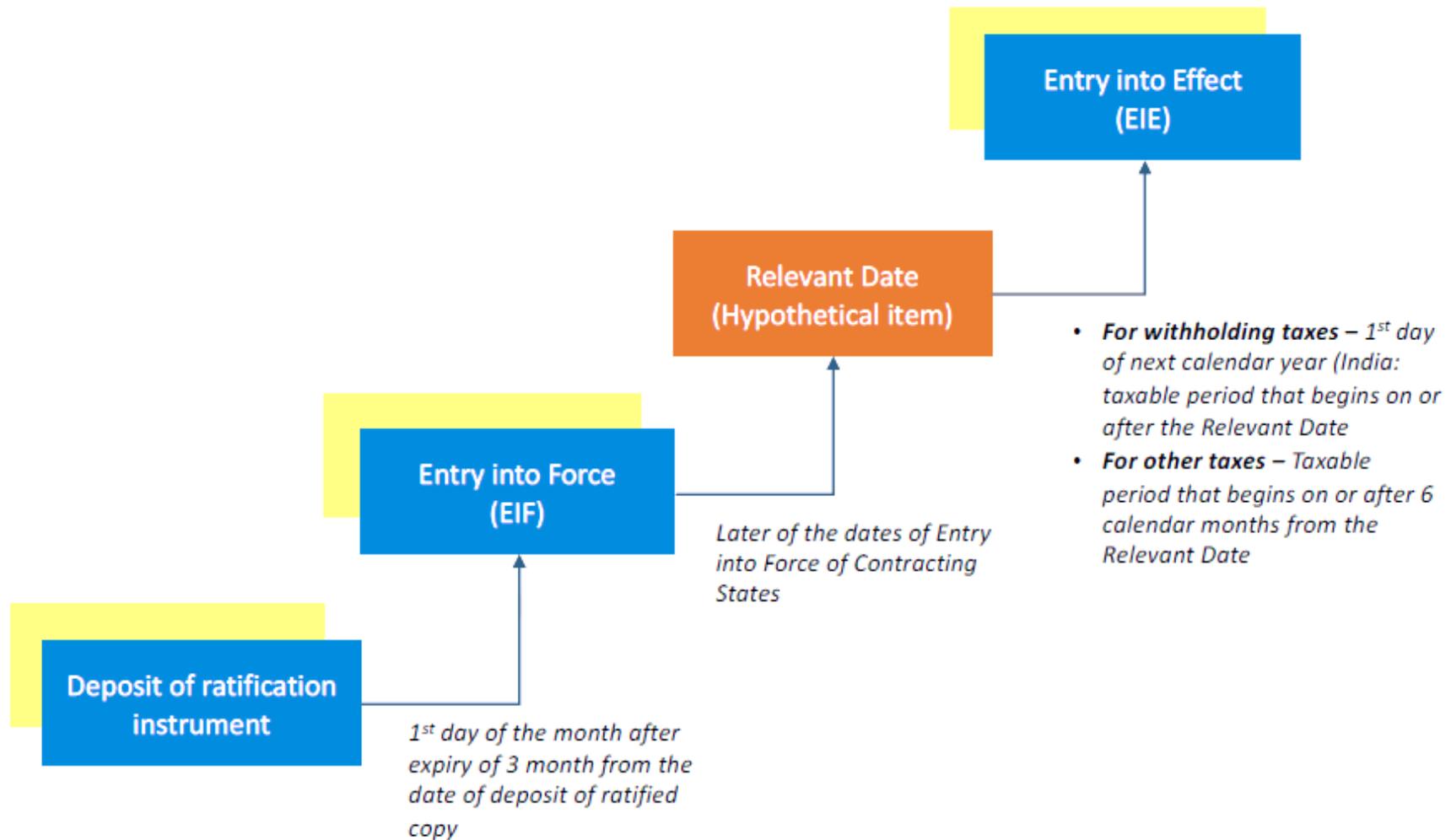
# Covered Tax agreement (CTA), Multilateral Instruments (MLI), Significant Economic Presence (SEP), Business Connection (BC) vs. Permanent Establishment (PE)

# Indian Tax Treaties impacted by the MLI from 1 April 2020



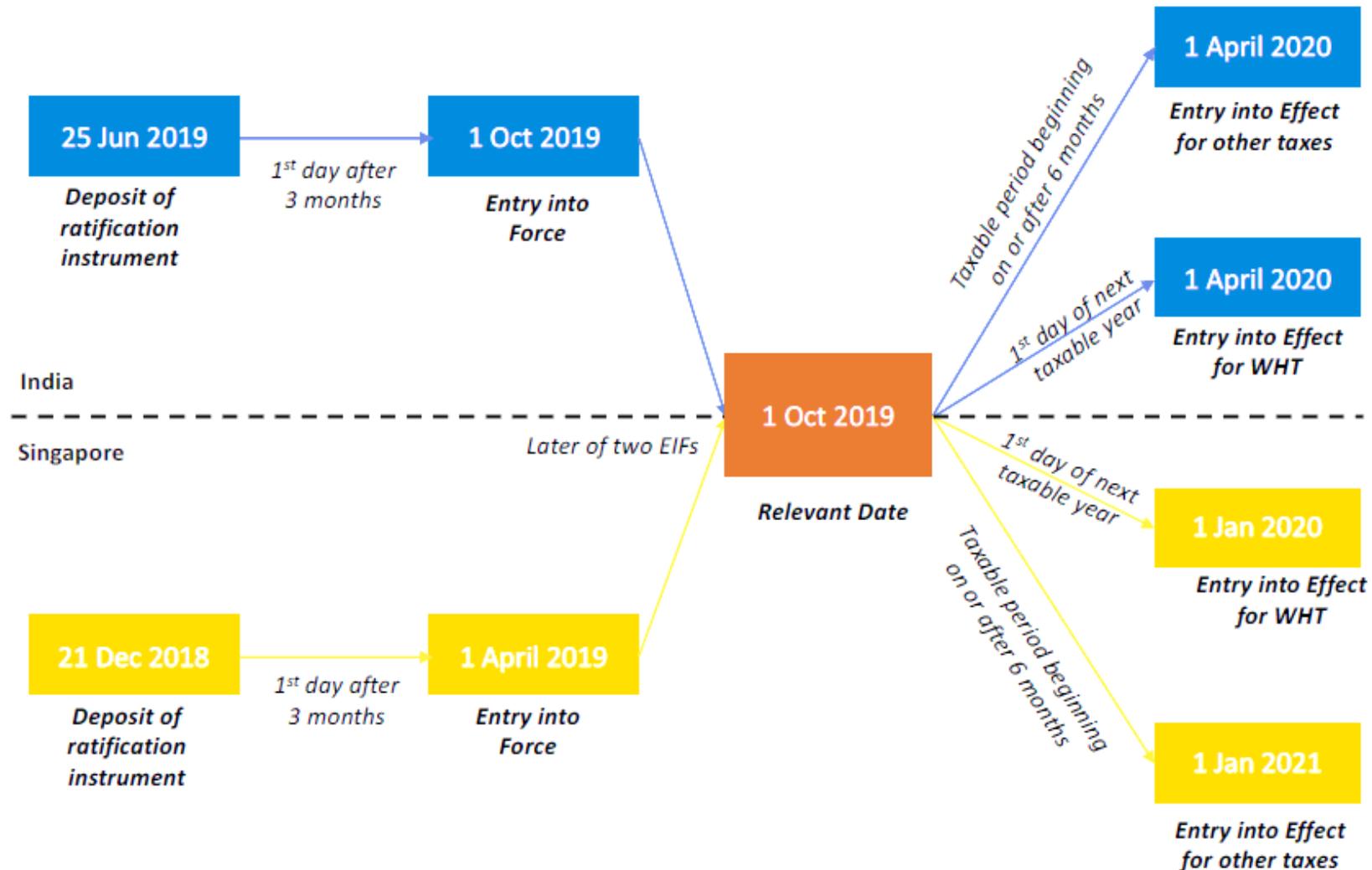
# Determination of Effective Date for application of MLI

## Flowchart



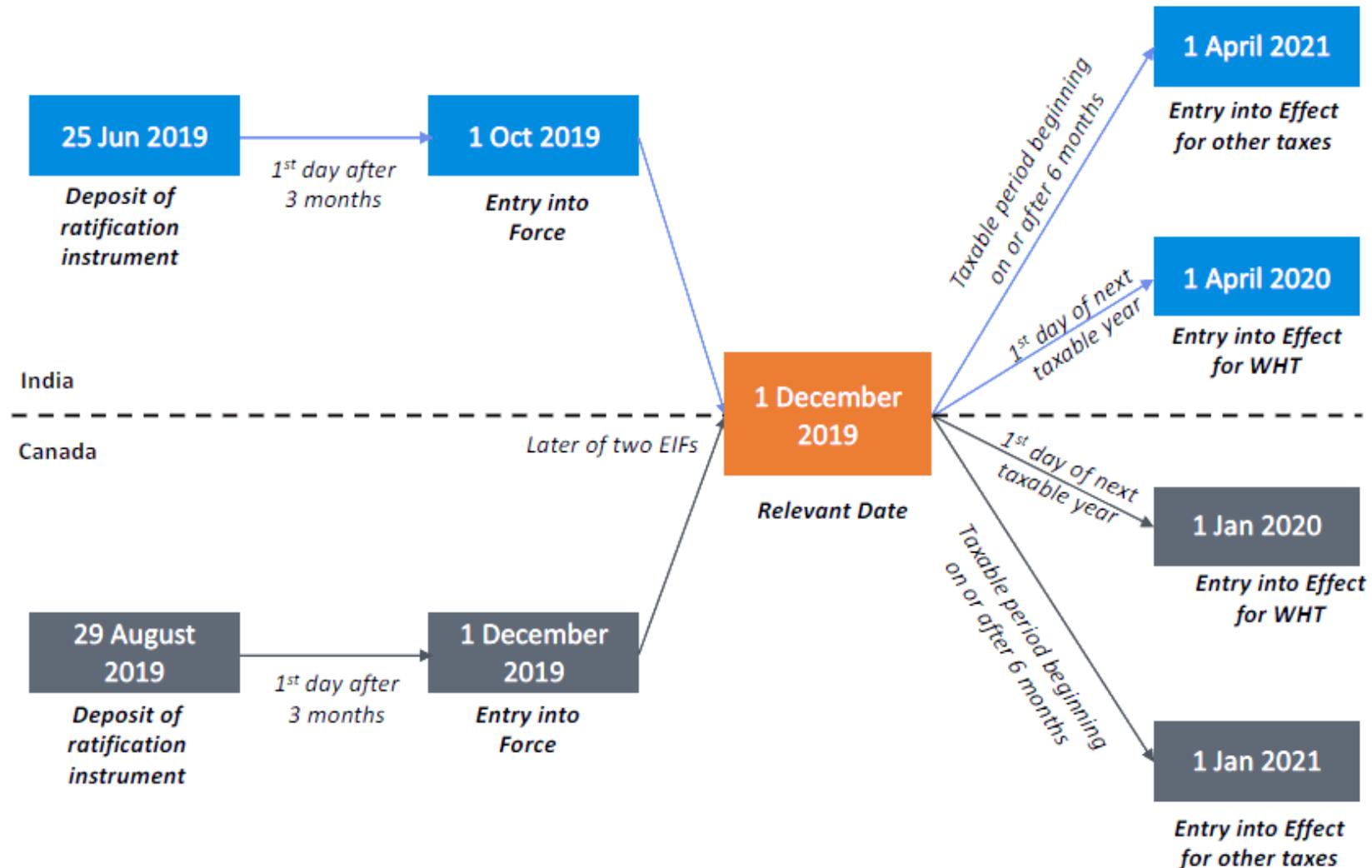
# Determination of Effective Date for application of MLI

Example: India-Singapore



# Determination of Effective Date for application of MLI

Example: India-Canada



## **What is Going on In India??**

Indian Govt. has taken their well appreciated first step towards taxing the non-residents who are benefitted from the India economy via e-commerce and related transactions. However, the Indian Govt. has to go miles before they sleep in order to keep their promise of not letting non-residents benefit from India without contributing in its developments.

Looking from the MNC point of view, tax compliances under different regimes might prove to be burdensome and ultimately lead to reduction of profits specially in case where grossing of equalisation levy is done and the consequent tax burden is borne by payer itself.

The concept of SEP introduced by Finance Act 2018 to tax digital, Covering of Overseas E-Commerce Operator and related transactions would not be invoked in case beneficial treatment is available to non-resident under the applicable treaties which seems to be a relief for non-resident particularly giant tech-companies operating remotely in India. Treaty provide more beneficial tax treatment to the non-resident then treaty provisions shall prevail over the Act.

Now we need to do in-dept tax analysis what is covered as per law and how we can mitigate our tax in neutral way. Tax avoidance is permissible under the law since it is not a tax evasion.

We need to do restructuring to fulfil principal purpose test – PPT in order to avoid fear of GAAR and substantiate document in such a way to take beneficial provision of tax treaty alongwith impact of MLI.

Therefore, even if as per the provisions of the Act if a non-resident is construed to have a BC/ PE in India, the non-resident can still resort to the provisions of relevant DTAA if they are more favourable to him. Article 7 of DTAAs, generally provides that the relevant business profits of non-resident will only be taxable in the source country i.e. India if such non-resident has a PE in India.

In view of the aforesaid, a non-resident who has a BC/PE in India however, does not have a PE in India may avoid his tax liability by simply relying upon the relevant provisions of DTAAs. At this juncture, it is pertinent to mention that for claiming benefit under DTAAs, the country in which the non-resident is resident i.e. residence country must have a tax treaty with India and the non-resident must have a tax residency certificate ('TRC') from the respective residence country.

On perusal of the above, it can be clearly inferred that:-

The non-residents undertaking following transactions beyond the prescribed threshold limit in India namely:-

Covered in 2A explanation:-

- ✓ Sale or purchase of goods, services or property digitally or otherwise,
- ✓ Any transaction involving download of data or software in India,
- ✓ Provision of online training / gaming services,
- ✓ Provision of services of streaming of e-content (audio / video),
- ✓ Interaction with customers such as for trouble shooting, etc,
- ✓ Websites, online database, cloud storage and computing services, with significant user base in India;
- ✓ would be said to have a SEP in India and hence, the relevant income derived will be taxable in India.

Covered in 3A explanation:-

- ✓ Income from advertisement targeting customer in India
- ✓ Income from sale of data collected from India.
- ✓ Income from sale of goods and services using such data collected from India.

## Equalisation Levy (EL)

In order to tackle the challenges in taxation in respect of digital transactions, equalization levy was introduced by the Finance Act, 2016/ 2020 on the recomd. of BEPS Action Plan-1.

- **Online advertisement: Charge of equalization levy at rate of 6% of the amount consideration received for any specified services (Online advertisement) received or receivable (exceeds Rs. 1 lakhs) by a person, being non-resident from**

- A person resident in India and carrying on business or profession.
- A NE having a PE in India.

**Amount deducted by payer pay 7<sup>th</sup> following month.**

- **NR E-Commerce :- Charge equalization levy at rate of 2% of the amount *consideration* received or receivable (exceeds Rs. 2 Crore) by an e-commerce operator from e-commerce supply or services made or provided or facilitate by it**

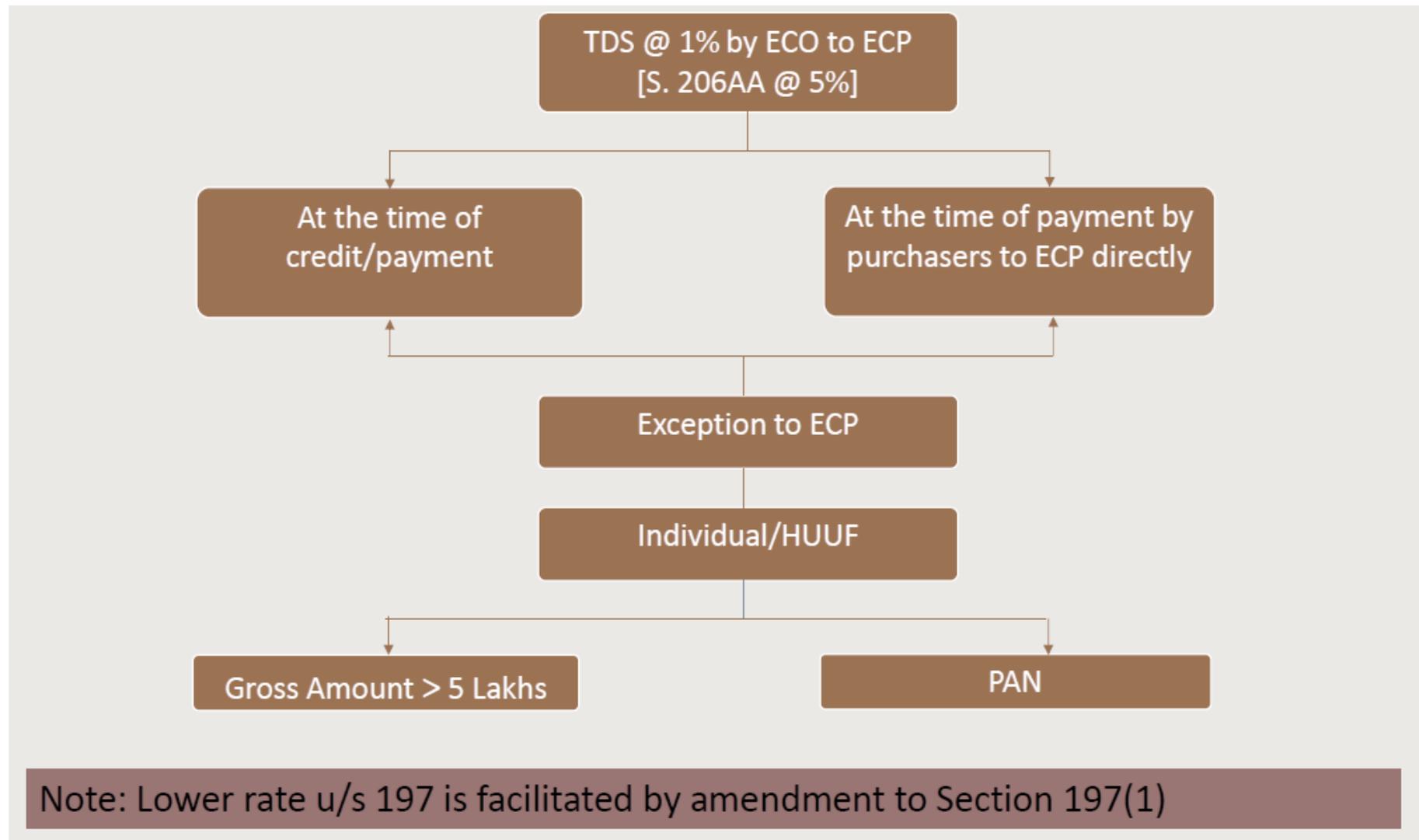
- A person resident in India
- A NR for advertisement/ data/ sale customer target in India.
- Amount deducted by participant pay 7<sup>th</sup> following Quarter./ 31 March.

### Likely targets

- Google, Facebook etc.,
- Amazon, Flipcart, Walmart, Eway
- Google Pay etc.,
- Netflix, Hotstar
- Urban clap
- Zoom cars, OYO, AirBnB
- Foreign stock exchanges, commodity exchanges
- 99 Acres, Nobrokers
- eLearning platforms like Khan Academy, Biju's

**Key take away: Equalisation Levy is Income tax? Yes.**

- **EL levied under AP-1, where an enterprise engaged in fully de-materlised digital activity would constitute a PE if it maintained a significant digital presence in another country.**
- **In order to provide double taxation, Section 10(50) exempt income where EL is levied.**
- **No EL if the service provider has a PE in India.**
- **E-commerce supply or services sought to be dealt with EL are also dealt with by Explanation 3A to section 9(1)(i) and in term of section 10(50), both are mutual exclusive.**
- **Under the GST OIDAR – If recipient of service is registered under the GST and B2B transaction reverse charge GST is applicable.**
- **Person who advertise on e.g. Google / E-commerce participant (who sell on amazon) deduct EL in respect of ECOM operator, pay EL to the Govt within due date.**
- **1% TDS in sec. 194O deducted by ECOM operator in respect of E-commerce participant.**
- **1% GST TCS deducted by ECOM operator in respect of E-commerce participant.**
- **Placement of section 40a(ib) along with section 40a(i) / (ia) and not with section 43B.**



### Illustration.-1

Can a NR eCommerce operator consider having a PE in India

- He is not liable to EL as he has a PE in India
- He may be liable on the net profits he makes and is subject to DTAA
- Explanation 3A may be avoided by falling back upon article 7 of the DTAA

### Illustration.-2

Can a NR eCommerce operator **X** interpose a third party NR **Z** who shall have a PE in India.

- X makes/provides/facilitates supply or service to Z
- Z in turn makes/provides/facilitates supply or service to Residents or customers using IPA
- X is not liable to EL as he provides services to Z who is a NR
- Z is not liable to EL as he has a PE in India
- Z may be liable on the net profits he makes and is subject to DTAA
- GAAR/MLI etc do not apply to EL

## Taxation of digital economy – Explanation 3A

Finance Bill 2020 - Widening the scope of business connection:

Thus, any non-resident earning income through advertisement, sale of data or e-commerce activities from a person residing in India or a person using Indian IP address shall constitute business connection in India. Page | 13

Further, the exemption from ambit of business connection given for income generated through sale, distribution or exhibition of cinematographic films has been proposed to be omitted. This step seems to bring in the ambit of tax any subscription fees paid by Over the Top media players such as Netflix, Amazon Prime, Hulu etc. to the copyright holders of such films being non-residents.

Impact of this recent amendment in business connection:

- **In case of non-resident covered by DTAA:** Where any non-resident covered by DTAA with India, earns any income in India through digital means as discussed above will be construed as income accrued and arose in India under section 9(1) of the Act. Though the domestic tax law has been amended to cover specified digital transactions, most of the treaty agreement still construe PE based on physical presence. Therefore, where as per the provisions of the Act a non-resident is construed to have a business connection in India, the non-

## Taxation of digital economy – Explanation 3A

resident can still resort to the provisions of relevant DTAA if they are more beneficial.

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Though certain specified transactions which are not in ambit of provisions of PE under DTAA, they may attract equalization levy and be liable to pay tax in India subject to prescribed conditions.

- **In case of non-resident not covered by DTAA:** In such a case, non-resident earning specified income will **construe business connection in India and will be required to pay tax in India to the extent such income accrue and arise in India.** It is pertinent to note here that Central Board of Direct Taxes has issued a draft circular for profit attribution rules in this regard, however same are yet to attain finalization.

It is interesting to note that in such cases, going forward any payment made to non-resident will require withholding tax at applicable rate from India tax perspective.

### **The path to future:**

Digital PE is a concept under discussion and work in progress for both OECD and European Union. Countering the digital business techniques, UK has proposed to introduce a new 2% tax on the revenues of search engines, social media platforms and online marketplaces which derive value from UK users from April 2020. Whereas some countries such as Israel, the Slovak Republic and India have unilaterally implemented legislation addressing the concept of digital PE in form of SEP in their domestic law.

India with introduction of Equalization Levy, SEP and its recent amendment to expand the scope of business connection has clearly shown its intent towards taxing the non-residents who are benefitted from the India economy via e-commerce and related transactions. India with its huge consumption base is negating its terms in international treaty negotiations and taking lead to change the rule in the game of digital economy taxation to ensure fair allocation of its share.

## Taxation of digital economy – Explanation 3A

“Explanation 3A.—For the removal of doubts, it is hereby **declared that the income attributable to the operations carried out in India**, as referred to in Explanation 1, **shall include income from**—

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(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.”;

Provided that the provisions contained in this Explanation shall also apply to the income attributable to the transactions or activities referred to in Explanation 2A

**Applicable w.e.f. 1.4.2021 AY 22-23**

## Explanation 3A

Such income attribution, is now proposed to include income from the following 3 activities viz.:

- income from advertisement that **targets Indian customers** or
- income from sale of data collected from India or
- income from sale of goods and services using such data collected from India

Explanation 3A expands the attribution which is otherwise limited by Explanation 1(a) and thus interferes with the latter.

## Explanation 3A – Overall scheme to tax

Overall scheme & object – makes very tough domestic provision, forces use of DTAA and makes DTAA subject to MLI to achieve the APs

- Section 92CB amended to provide safe harbor rule to income declared under Section 9(1)(i)
- Section 92CC amended to provide for APAs in respect of determination of income under section 9(1)(i)
- Section 295(2)(b)(iia) & (iib) introduced- Power to make rule in respect of --
  - “(iia) operations carried out in India by a non-resident;”
  - “(iib) transactions or activities of a non-resident;”

## Explanation 3A vs. 92CC – APA - inapplicable

It appears that language of **section 92CC(1)(b)** makes **APA inapplicable to SEP under Explanation 2A read with Explanation 3A**

- Section 92CC(1)(b) provides APA for determining income referred to in clause (i) of sub-section (1) of section 9, or specifying the manner in which said income is to be determined, as is **reasonably attributable to the operations carried out in India by or on behalf of that person, being a non-resident**
- The above would cover generic business connection under section 9(1)(i) read with Explanation 1(a)
- Language of Explanation 2A does not support ‘the operations carried out in India by .....,a non-resident’

## Explanation 3A goes beyond 'operations carried out in India'

### Language 'Shall include'

- Not 'shall also include'
- 'shall include' v 'consists'
- Expansive v. Exhaustive

### Language 'Shall include income from'

- Makes it very wide
- Ideally it should be 'shall include income reasonably attributable to activities from'
- May make entire income from sale of data [clause (ii)] and sale of goods/services [clause (iii)] attributable to and taxed in India

## Explanation 3A: Clause (i)

income from advertisement that targets Indian customers or

- **Income from such advertisement targeting customers in India/accessing advertisement through Indian IP address [Indian customer]**

Income from such advertisement v. Income derived from such advertisement

➤ Example:

- Microsoft, USA advertises MS office through Google, Ireland targeting Indian customers
- **Google pays tax under this Clause** and **Microsoft pays under Clause (iii)**

The prefix 'such' in the phrase 'such advertisement'

- May remotely connect to Explanation 2A(b)
- But may not connect to Explanation 1(a)

Explanation 3A: Clause (ii)  
income from sale of data collected from India

**NR. A Collect data from B.**

**Sell it to C.**

**NR. C sells goods to other.**

**A is covered by E-3A(ii)**

C is covered by E-3A(iii)

*Location of B or B using IP Address located in India is relevant only at the time of collection of data and not thereafter*

**When A sells to C, he is covered by (ii) above [Even all subsequent sales will also get covered]**

When A sells such data to an Indian customer – hit by Explanation 2A(a)

### Explanation 3A: Clause (iii)

income from sale of goods and services using such data collected from India

- Overlaps with Explanation 2A(a)
- May go beyond Explanation 2A(a) as it does not insist sale to customers in India.

## SEP v. Explanation 3A

A NR with SEP may consider to trigger a **DAPE through Explanation 2**

Explanation 2.—For the removal of doubts, it is hereby declared that "business connection" shall include any business activity carried out through a person who, acting on behalf of the non-resident,—

- (a) has and habitually exercises in India, an authority to conclude contracts on behalf of the non-resident or habitually concludes contracts or habitually plays the principal role leading to conclusion of contracts by that non-resident and the contracts are—
- (b) in the name of the non-resident; or
- (c) for the transfer of the ownership of, or for the granting of the right to use, property owned by that non-resident or that non-resident has the right to use; or

- In such case, he is safely covered by Explanation 3 and would not get covered by Explanation 3A

Explanation 3.—Where a business is carried on in India through a person referred to in clause (a) or clause (b) or clause (c) of Explanation 2, only so much of income as is attributable to the operations carried out in India shall be deemed to accrue or arise in India.

- **A NR who has a potential SEP, may deal with a NR's PE in India and overcome Explanation 2A(a) – An aggressive view**
- **A NR who is liable to EL in respect of SS or ESS need not worry about SEP and Explanation 3A due to exemption under section 10(50).**

## Significant Economic Presence– Explanation 2A

Applicable for FY 19-20 but not for FY 20-21

w.e.f. 1.4.21 AY 22-23 wide area covered.. **NR deal with any person in India.**

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As you would have notice above, the applicability of SEP is primarily depending on the threshold of attributes agreed by the member nations. However, in absence of consensus among the OECD nations, the attributes for qualifying as SEP is not yet finalized and hence India is forced to defer its applicability by one year.

However, in this context it is interesting to note that India by Finance Bill 2020 propose to omit "through digital means" in explanation 2A of section 9(1) of the Act. This can be seen as India posturing to the OECD that in absence of any consensus on the SEP as per BEPS Action Plan 1, India will be open to tax MNCs who interacts with certain number of users in India which may be prescribed either through digital means or not. As of now, this may not have any effect on those MNCs who have double tax avoidance agreement ('DTAA') protection but it is matter of time when India based on its deep consumer base will re-negotiate the DTAA to widen the PE definition to target such MNCs.

## Significant Economic Presence– Explanation 2A

- Section 9(1)(i) – Income from Business Connection
- Finance Act, 2018 inserted Explanation 2A w.e.f 01.04.2019: Significant Economic Presence (SEP) shall constitute BC
- SEP Determination: Based on threshold of ‘revenue’ and the ‘users’ in India, to be prescribed by the Board.

Explanation 2A to section 9(1)(i)

Existing Provision applicable FY 19-20	Existing Provision applicable FY 21-22
<p>For the removal of doubts, it is hereby <b>clarified</b> that the significant economic presence of a non-resident in India shall constitute "business connection" in India and "significant economic presence" for this purpose, shall mean—</p>	<p>For the removal of doubts, it is hereby <b>declared</b> that the significant economic presence of a non-resident in India shall constitute "business connection" in India and "significant economic presence" for this purpose, shall mean—</p>
<p>(a) transaction in respect of any goods, services or property carried out by a <b>non-resident in India</b> including 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 such amount as may be prescribed; or</p>	<p>(a) transaction in respect of any goods, services or property carried out by a <b>non-resident with any person in India</b> including 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 such amount as may be prescribed; or</p>

Proviso: Provided further that **only so much of income as is attributable to the transactions or activities referred to in clause (a) or clause (b)** shall be deemed to accrue or arise in India.’;

## Nexus for dynamic change widen the scope of Explanation 2A

- Earlier phrase 'carried out by a non-resident in India' is **replaced by 'carried out by a non-resident with any person in India'** Page | 28
- Makes the scope very wide and does not require the activities to be carried out in India
- **As long as the customer is in India, all exports of goods/services made by NR are covered**
- **Only a thin line of Territorial nexus i.e. 'customer in India'**

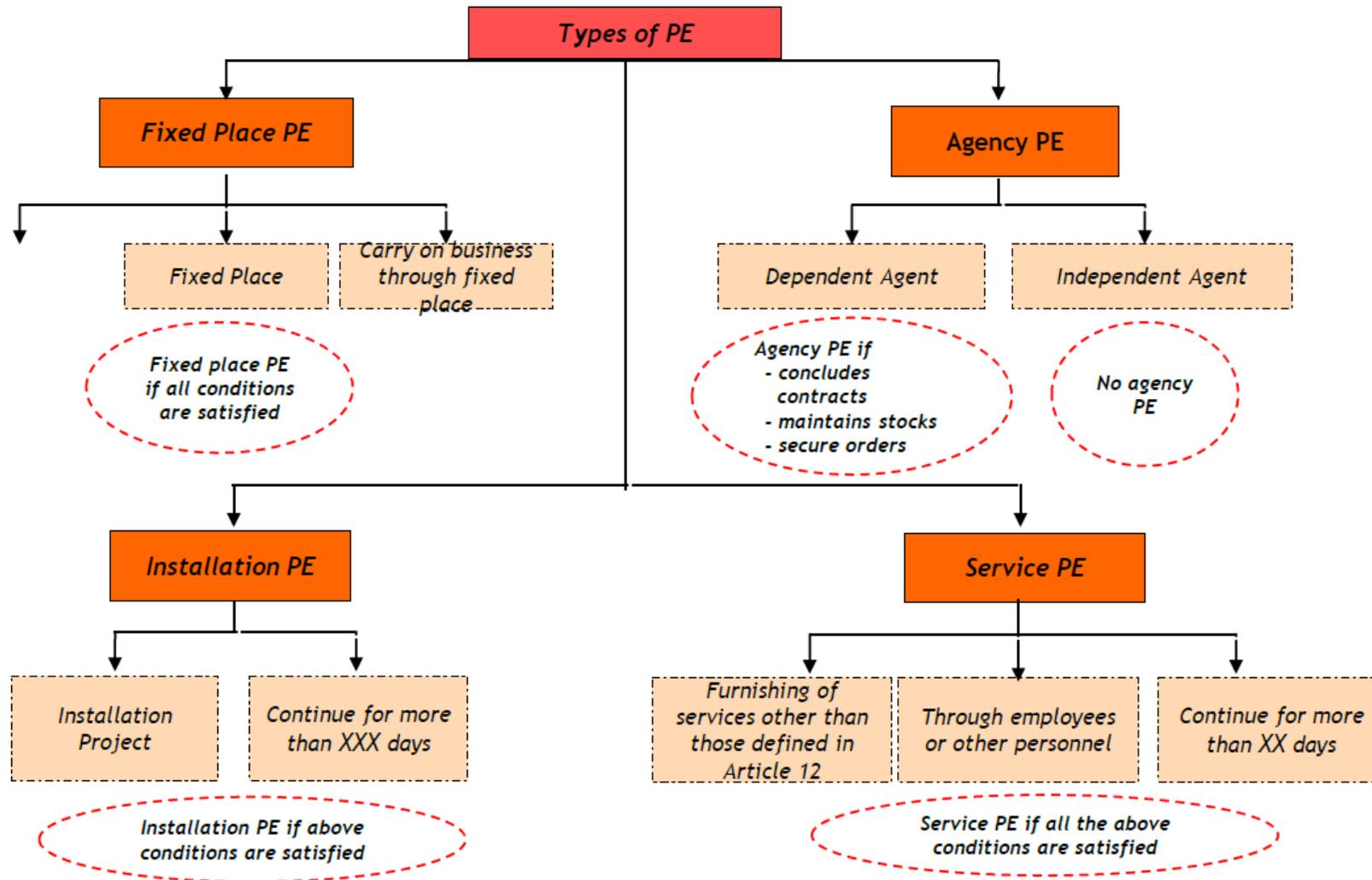
- Explanation 2A would not apply in respect of 94 DTAA's where taxation triggers on account of PE
- However, it may apply in respect of 60 CTAs if MLI 7/GAAR is invoked and CTA benefit is denied
- Explanation 2A would apply to balance 101+ jurisdictions

# Basic Rule PE – Article 5(1)

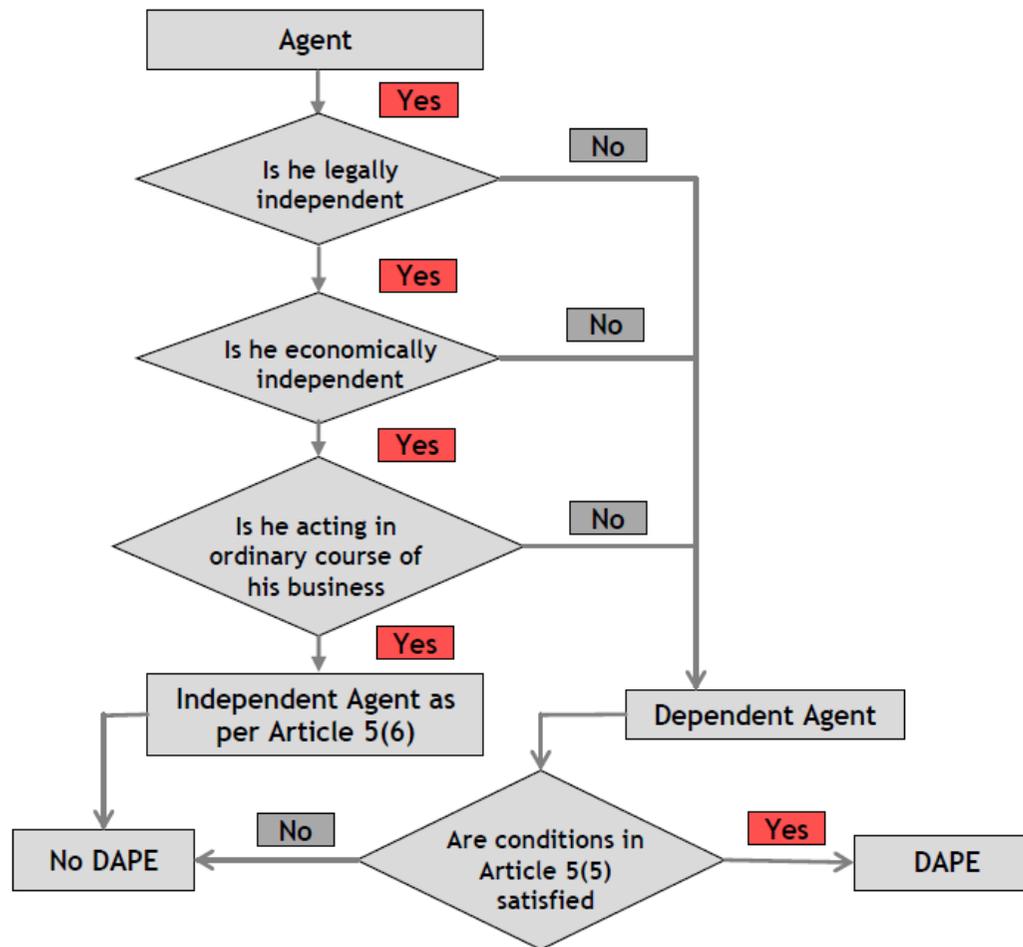
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- For the purpose of this Convention, the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on”
- Five Essential ingredients of Basic Rule PE
  - There must be a place of the business. (place of business test)
  - The place of business must be located at a certain area.(location test)
  - The taxpayer must have a certain right to use the place of business (right to use test)
  - The use of the place of business must last for a certain period of time. (permanence test)
  - The activities performed through the place of business must be a business activity as per treaty or domestic law (business activity test)

# Philosophy of PE



# Independent Agent exception

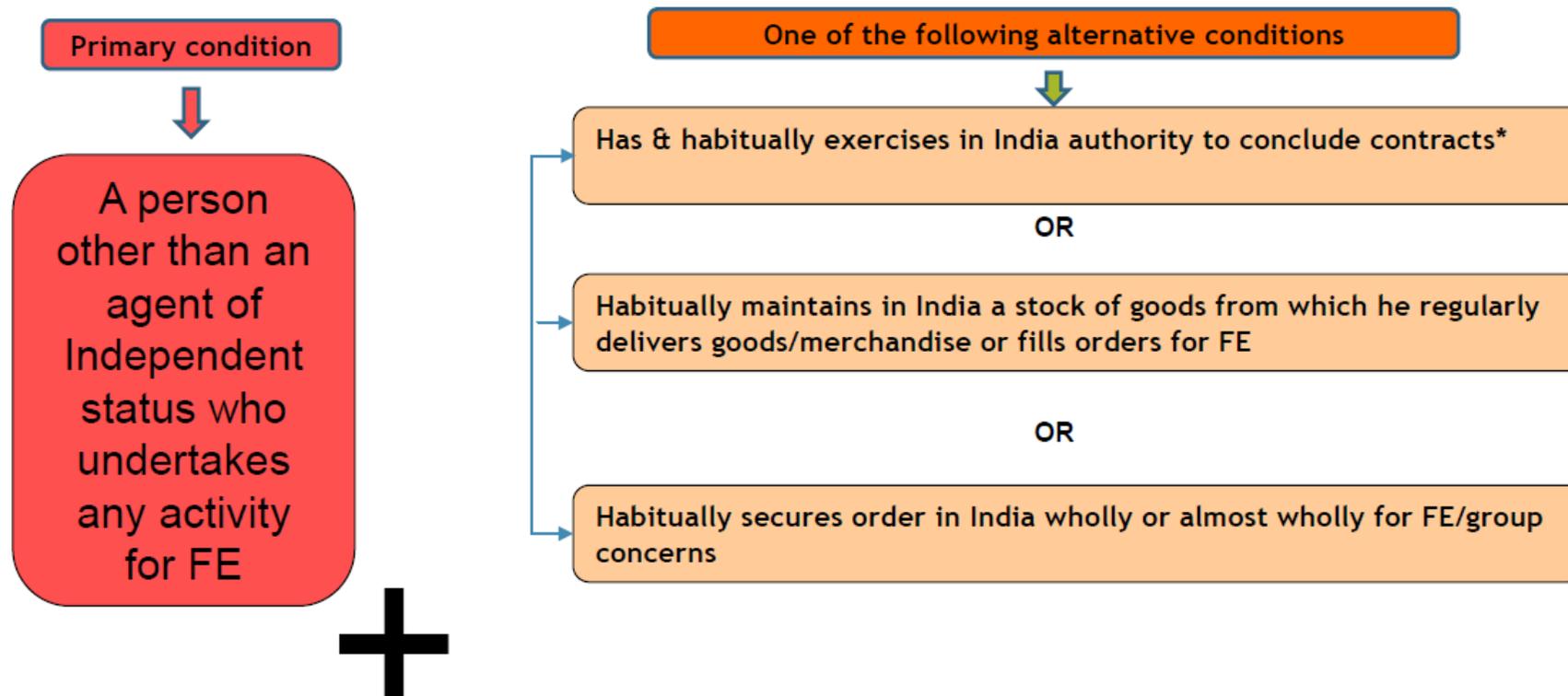


Factors relevant for legal and economic independence

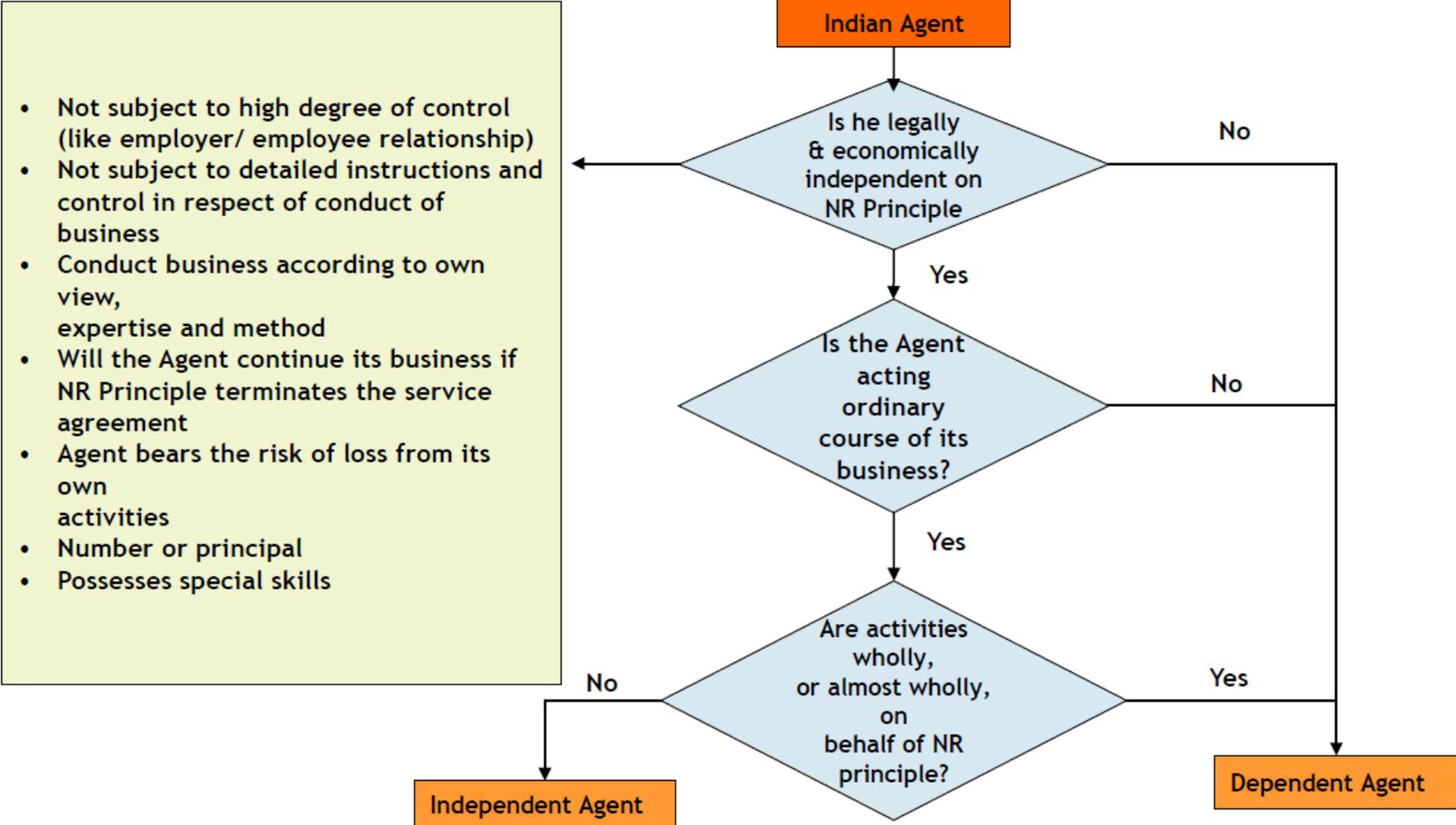
- Not subject to high degree of control (like employer-employee relationship)
- Not subject to detailed instructions and control in respect of conduct of business
- Conduct business according to own view, expertise and method
- Will the agent continue its business if principal terminates the service agreement
- Agent bears the risk of loss from its own activities

# Deemed PE : Person other than an IA (DAPE)

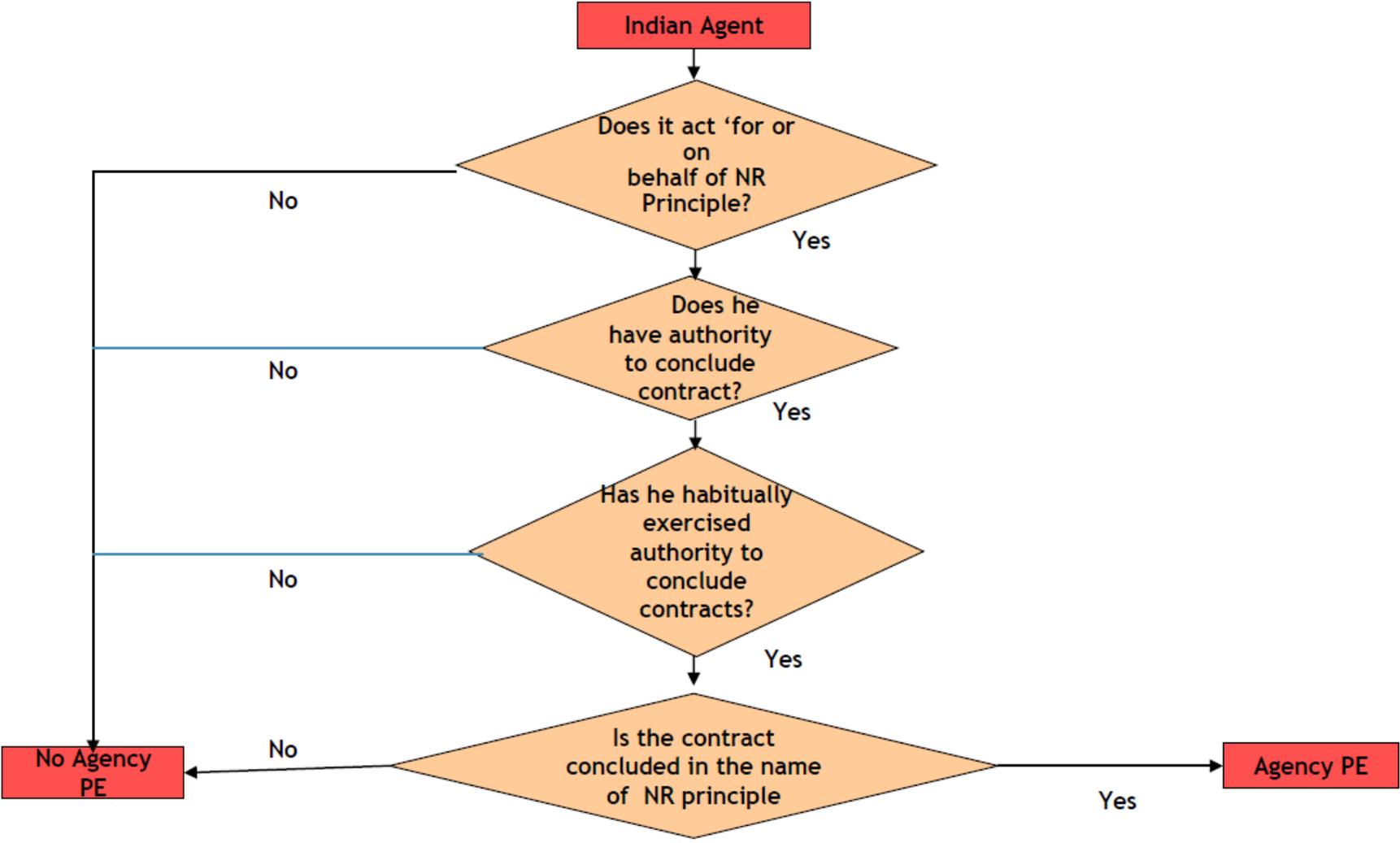
- Agent' is a person employed to do any act for another or to represent another in dealing with third parties (S. 182 of Contract Act)



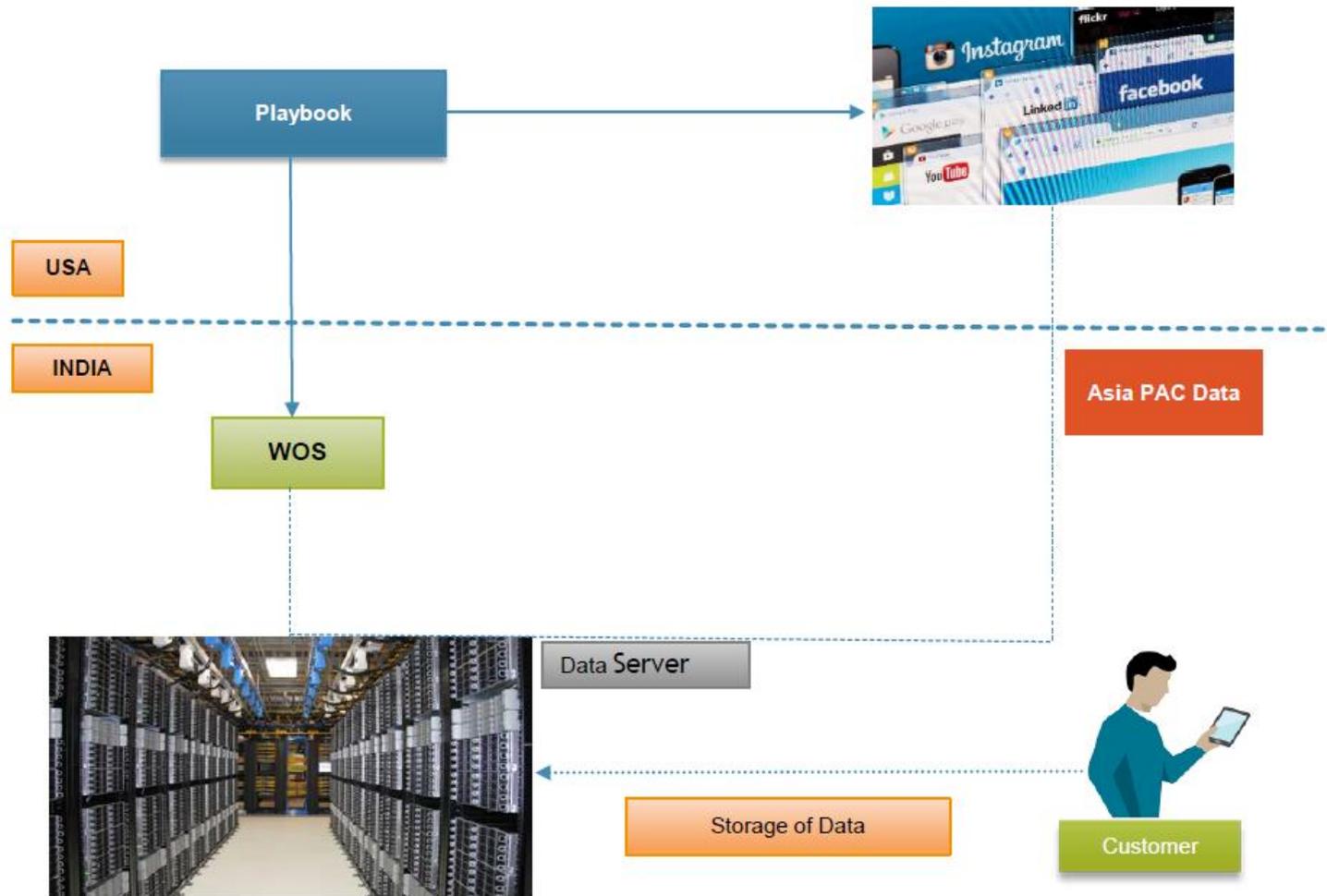
# Independent agent test



# Agency PE test



# Server as PE



# Server as PE

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- Playbook is leading social networking website. It stores Indian user data in server owned by WOS ICO. Following are terms of contract
  - Data will be owned by Playbook
  - ICO cannot provide access to data to any third party
  - ICO will use all data security software as approved by Playbook
  - Employees of Playbook will have remote access to server and have full access right
  - Playbook can visit premises of ICO to check server security only on prior intimation
  - Playbook has taken global insurance against security infringement
  - ICO do not have access to data hosted on server

Evaluate whether server gives rise to fixed place PE of Playbook in India