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## Potential Direct Tax Implications for Digital Economy

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## Potential Direct Tax Implications for Digital Economy

Multinational companies such as Google, Facebook, Airbnb etc., engaged in providing digital services in different countries, without any physical presence, are likely to be adversely impacted by the changing international tax regime. The tax challenges arising from digitalisation of the economy were identified as one of the main areas of focus of the Base Erosion and Profit Sharing (**BEPS**) Action Plan, leading to the 2015 BEPS Action 1 Report on 'Addressing the Tax Challenges of the Digital Economy'. Thereafter, the focus of the countries has been to draw up a conclusive plan for the governments' right to tax multinationals, through the Organisation for Economic Cooperation and Development (**OECD**), which is currently working on releasing a methodology for such taxation, by 2020.

OECD has prepared a proposed "Unified Approach", designed to address the tax challenges arising from digitalisation of the economy and to grant new taxing rights to the countries where users of digitalised services are based. It has been suggested that the allocation of a new taxing right to countries, through new nexus and profit allocation rules, should recognise that in the new globalised and digitalised economy, a range of businesses can project themselves into daily lives of the users, interact with their consumer base and create meaningful value without traditional physical presence in the market. Let us briefly assess the two fundamental rules being considered by OECD:

- Nexus Rule: Presently, in any jurisdiction, a non-resident company is subject to tax on its business profits only if such company has a 'permanent establishment' in such jurisdiction. Digitalisation of economy or provision of digital services have strained the applicability of the 'permanent establishment' rule, as companies are now increasingly doing business







across jurisdictions and interacting with customers from remote locations, without having a physical presence within the respective jurisdiction(s).

It is thus proposed to introduce a new 'nexus' rule by defining a 'revenue threshold' within a market which would address the issue where a business has a sustained and significant involvement within a jurisdiction's economy irrespective of the extent of its physical presence in such jurisdiction.

- Profit Allocation Rule: Upon determination of a country's right to tax profits of a non-resident enterprise, the next pertinent question is determining the quantum of profits allocated to a jurisdiction, i.e., the profits of the non-resident enterprise as would be taxable in such country. This issue is presently governed by Article 7 (Business Profits) of the Double Taxation Avoidance Agreement (**DTAA**) as is executed between two countries. Considering that the new 'nexus rule', which would entitle a country to tax profits based on revenue threshold, as opposed to physical presence, it would not be possible to use the existing profit allocation rules and mechanism laid down under the DTAA.

  It has thus been proposed that the new 'profit allocation rule' would go beyond the arms' length principal as well as the limitations on tax implications being determined by reference to physical presence only.

While the aforesaid principles are presently being contemplated to arrive at a consensus-based solution by 2020, there are a number of issues/questions which need to be considered for imposing the new tax including:

- making amendments to the DTAA, to include the new principles for imposing tax on companies engaged in providing services without having physical presence;

- amending the domestic tax laws by each jurisdiction based on the consensus-based approach, as would finally be formulated; and

- defining the formula for determining the 'revenue threshold', which would be a significant component for the proposed 'nexus rule'.

**Amendments to the Indian Tax Laws:**

Interestingly, the Indian Government vide the Finance Act, 2018 introduced the concept of *'significant economic presence'* within the Indian Income Tax Act, 1961 (**IT Act**) with an intention of covering the companies providing services in India, without physical presence, within the ambit of the IT Act.

In terms of section 9 of the IT Act, any and all income accruing or arising, 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 through the transfer of a capital asset situated in India, is deemed to be arising or accrued in India and is subject to imposition of tax under the IT Act. Presently, the term 'business connection' has *inter alia* been defined to include any business activity carried out through a person, who acting on behalf of the non-resident has and habitually exercise 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.

However, section 9 of the IT Act has been amended vide the Finance Act, 2018 but with effect from April 1, 2019, to include Explanation 2A which clarifies that the '*significant economic presence*' of a non-resident in India shall constitute '*business connection*' in India and the term '*significant economic presence*' has been defined to mean:

- transaction in respect of any goods, services or property carried out by a non-resident in India 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

- systematic and continuous soliciting of business activities or engaging in interaction with such number of users as may be prescribed, in India through digital means:

  Provided that the transactions or activities shall constitute significant economic presence in India, whether or not:

  (i) the agreement for such transactions or activities is entered in India; or
  (ii) the non-resident has a residence or place of business in India; or
  (iii) the non-resident renders services in India.

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| | It is noteworthy that this is not the first instance when the companies even without having their physical presence in India, are subjected to compliance implications in India. Section 2(42) of the Companies Act, 2013 has defined the term 'foreign company' as any company or body corporate incorporated outside India, which:<br><br>a. *has a place of business in India* whether by itself or through an agent, physically or *through electronic mode*; and<br>b. conducts any business activity in India in any other manner.<br><br>Thus, it appears that the Companies Act, 2013 intends to regulate a company incorporated outside India but is conducting business in India through electronic mode, irrespective of such company having a physical presence in India or not.<br><br>Similarly, under the Goods and Service Tax Act (**GST Act**), 'Online Information Database Access and Retrieval' (**OIDAR**) services have been classified as category of services provided through the medium of internet and received by the recipient online without having any physical interface with the supplier of such services. OIDAR services have been defined to mean services whose delivery is mediated by information technology over the internet or an electronic network and the nature of which renders their supply essentially automated and involving minimal human intervention and includes electronic services, such as advertising on the internet, providing cloud services, provision of e-books, movie, music, software and other intangibles through telecommunication network or internet.<br><br>As regards taxability of the OIDAR service, it has been clarified that where the supplier of such service is located outside India and the recipient of such service is a business entity (registered person) located in India, GST would be imposed under the reverse charge mechanism and the recipient in India who is a registered entity under the GST will be liable to pay GST under reverse charge and undertake necessary compliances. Where the recipient of service in India is not a business entity and is an individual consumer, the supplier of services located in a non-taxable territory shall be the person liable for paying GST on supply of such services.<br><br>Thus, even the GST Act covers the entities which may be located outside India but would be engaged in providing services in India through digital mode.<br><br>It is evident that the Indian Government has already taken significant steps in imposing tax on profits being generated by a company without having physical presence in India. However, the concept of '*significant economic presence*' for the direct tax purposes has not yet been made effective as the rules for imposition of tax are yet to be formulated. It is likely that the said rules will be made effective only pursuant to the consensus-based approach being formulated to ensure that the Indian tax principles are in tandem with the approach proposed to be followed globally. |

**Feedback**