

Evolution and impact of digital permanent establishment concept

The 2018 budget proposes to amend clause (i) of sub-section (1) of Section 9 of the Income Tax (I-T) Act, 1961, to provide that “significant economic presence” in India shall constitute “business connection”. This has purportedly been done to bring the digital economy (wherein businesses are footloose and can run without any physical presence in a country such businesses make money from) into the tax ambit.

However, by proposing this inclusion in the definition of business connection, policymakers in India have opted for a marked change in the concepts of situs and nexus.

Concepts of situs and nexus in I-T Act

Situs is the Latin word for position or site. In law, situs of a business is where the business is located for legal purposes. Situs is critical in determining the jurisdiction of a business.

The concept of situs is incorporated in the definition of “business connection” in the Indian I-T Act and in the definition of “permanent establishment” in double taxation avoidance agreements (DTAAs).

A business is taxable in a source country (i.e. the country in which income is generated) if it has a physical presence in the country; only the income accruing to the permanent establishment is taxable in the source country. However, if the concern does not have a permanent establishment in the source country, the business income is taxable in country of residence. This is the crux of taxing business income under most DTAAs and is based on the idea of territorial nexus of business.

Shortcomings of traditional concepts of situs in taxing e-commerce

In the past few decades, new business models that run their business remotely through the digital medium have mushroomed. Such e-commerce businesses have no territorial nexus with the country in which they operate and earn revenue. The only physical presence of an e-commerce business is the server. The country of residence is wherever the server is physically present (whether server constitutes territorial nexus is also a big area of debate in tribunals and courts), and the server can be conveniently placed in a tax haven. The source country can never tax business income of e-commerce firms because websites do not have any physical presence in the source country.

New business models such as software as a service (SaaS) pose even greater challenge to tax authorities. SaaS is a service delivery model, based out of a cloud storage system, that is fast replacing software-based business applications such as customer relationship management, management information system, human resource management and enterprise resource planning.

Digital economy is disruptive in the sense that the laws of taxation made earlier cannot be used to tax the new business models evolving in digital economy. It is “characterised by an unparalleled reliance on intangible assets, the massive use of data (notably personal data), the widespread adoption of multi-sided business models capturing value from externalities generated by free products, and the difficulty of determining the jurisdiction in which value creation occurs”.

The new criteria of ‘significant economic presence’

The Akhilesh Ranjan Committee on taxation of e-commerce set up by the central government had

highlighted that traditional norms of situs fail to tax new businesses run through the digital medium. The committee argued for a relook into definition of “business connection” in the I- Act and “permanent establishment” in tax treaties based on the logic that economic allegiance hold primacy over physical location in determining situs of a business for tax purposes. Physical presence is important only to the extent it represents economic location.

The Organisation for Economic Co-operation and Development had proposed several options to address the tax challenges of the digital economy under its BEPS (base erosion and profit shifting) action plan 1. One such option was a nexus rule based on “significant economic presence”. Budget 2018 has picked this idea and incorporated the concept of “significant economic presence” in the definition of “business connection”.

Consequently, if passed in the present form, any 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 a prescribed amount) will constitute significant economic presence of the non-resident in India and its business income will be taxable under the I-T Act. A non-resident engaging in systematic and continuous soliciting of its business activities or interaction with users in India above a benchmark figure through digital means will also be considered to have significant economic presence in India and its business income from India will be taxable under the I-T Act.

Impact on digital economy of India

This new amendment in the Finance Act 2018 will not have any immediate impact on the digital economy in India. Section 90(2) in the I-T Act provides that of the domestic law and DTAA, whichever is more beneficial to the taxpayer will prevail. The concept of “significant economic presence” as a criterion to determine permanent establishment has not been included in any of the DTAA signed by India with other countries. After the amendment to the definition of “business connection” in I-T Act, the DTAA will become more beneficial and will automatically become applicable to non-resident e-commerce firms.

International opinion on taxation of digital economy is divided and amendments to DTAA or multilateral instruments to introduce the concept of digital permanent establishment is not coming anytime soon. However, by bringing about this amendment, India has made its stand clear and has taken up a lead role in directing international policymaking on taxation of the digital economy.

Smarak Swain is an officer of the Indian Revenue Service. The views expressed are personal.

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