

# The BEPS Monitoring Group

## Submission to the Government of India

on

### FRAMING OF INCOME TAX RULES RELATING TO SIGNIFICANT ECONOMIC PRESENCE

These comments have been prepared by the [BEPS Monitoring Group](#) (BMG) in response to the [request for comments](#) from the Central Board of Direct Taxes of the Ministry of Finance of the Government of India. The BMG is a network of experts on various aspects of international tax, set up by a number of civil society organisations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. These comments have not been approved in advance by these organisations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives. They have been drafted by Suranjali Tandon, with contributions and comments from Jeffery Kadet, Mustapha Ndajiwo, Sol Picciotto and Attiya Waris.

We appreciate the opportunity to provide these comments, and we are happy for them to be published.

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#### SUMMARY

We support India's initiative in establishing new criteria for taxation of foreign companies based on a 'significant economic presence' (SEP). In the digital age, international agreement is clearly needed to reform the rules developed a century ago, including the tax threshold of a 'permanent establishment' (PE) which requires a physical presence. India's lead has now been followed by others, especially the European Union (EU), and this should help persuade reluctant states to accept the need for change.

We also endorse the criteria chosen in India, which rest mainly on transactions producing revenue from India, as well as systematic and continuous solicitation of business or engagement with users in India. The proposals under debate in the EU are similar, but include a test based on the number of concluded contracts, which in our view is impractical and inappropriate. Profits require sales, so revenues should be the main test. Users are also important, but are not directly linked to revenues, and should be regarded as assets.

However, the numerical tests for defining a SEP should not be set so low as to require tax registration for small and medium businesses which may have some customers in many countries around the world. An internationally agreed definition of SEP should leave flexibility for states to agree thresholds bilaterally, based on the size of their economies and

cross-border flows. India's GDP is similar to that of the largest member states in the EU, so we suggest that India's thresholds for revenue and users could be in line with those proposed for the EU, to ensure some convergence.

## GENERAL COMMENTS

The issue of reform of international tax rules to respond to the impact of digitalization is now under intense examination internationally. The Task Force on the Digital Economy set up under the G20/OECD project on base erosion and profit shifting (BEPS), and now working under the Inclusive Framework for BEPS, has produced an interim report this year, and is due to produce another next June and a final report by 2020.

In the meantime, there have been several national and regional initiatives, which include both short-term and longer-term measures and proposals. The Indian government has been in the forefront, going back to the report on *Electronic Commerce and Taxation* of 2000. Although a multilateral approach is clearly preferable, the Task Force report of 2018 showed that there are still major differences in national positions. In this context, it is important for countries which consider that change is necessary to adopt suitable measures, which can help ensure fair taxation, as well as encouraging countries which are reluctant to accept change to face up to this need.

In this context, we support the initiative by the Government of India to amend the tax threshold, which is currently defined by the concept of a permanent establishment (PE). The PE concept is over a century old and based on a physical presence, which is clearly outdated in view of the enormous changes in transport and communications technology, accentuated by the digital revolution. It is important for India, as well as other countries, to adopt a tax threshold which is appropriate for its own situation, while remaining compatible with India's international obligations, and as far as possible in line with other initiatives.

## SPECIFIC COMMENTS

### 1. Test for significant economic presence in India

In 2018, an amendment to the Income Tax Act was proposed through the Finance Act. This amendment sought to bring the domestic Indian law definition of dependent agent PE in line with the provisions of double taxation agreements (DTAs) as modified by the multilateral instrument on treaty-related BEPS measures (the MLI). Further, Section 9(1)(i) was amended to add explanation 2A of *business connection* to include 'significant economic presence' (SEP). As per the definition significant economic presence in India would, for the purpose of establishing business connection, mean:

‘(a) 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

(b) 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,—

the agreement for such transactions or activities is entered in India; or

the non-resident has a residence or place of business in India; or

the non-resident renders services in India:

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.’

The definition of SEP has some differences with that proposed by the European Commission, and that adopted by Israel.

The European Commission in 2017 put forward proposals for tax changes in the digital economy, which include the concept of the virtual PE. As per the draft directive a company would be considered to have a significant digital presence in a Member State if it fills *one* of the following criteria

- It exceeds a threshold of Euro 7 million in annual revenues from digital services in a Member State
- It has more than 100,000 users who access its digital services in a Member State in a taxable year
- Over 3000 business contracts for digital services are created between the company and business users in a taxable year.

On the other hand, Israel's digital PE is based on the online contract conclusion, user base, localised website and revenues that are closely related to the volume of online activity. As per the circular issued<sup>1</sup> by the Israeli tax authorities the digital presence will be determined on a case-by-case basis.

While on the one hand the thresholds are clearly specified in the case of the EU, in the case of Israel, the thresholds are discretionary. India seeks to apply threshold values that must be based on an economic rationale.

## **2. Thresholds**

### *2.1 Users*

Among the criteria specified in the SEP is the number of users. It is assumed that the user base of a platform allows a corporation to generate economic value in the economy. The manner in which the value is generated in each business model will vary. For example, in the subscription-based model the user consumes content, in the e-commerce platform the user buys and sells whereas in the multi-sided platform the user generates data which is sold to third parties. The user base that will be necessary to generate considerable value may be different across models. The SEP attempts to set thresholds such that businesses that do not have any economic presence in the present regime under the current definition of PE will have a PE once the SEP is implemented.

Examples of the size of the user base for recognized large platforms in India are given in Table 1.

The tax department will have to specify when considerable value is considered to have been added by the business and for that what kind of user base must exist. As can be seen different business models are at different stages of market penetration and in different segments have a wide range of user base. A threshold similar to that proposed by the European Commission i.e. of 100,000 users, given the wide user bases in India, will cover most substantial businesses operating in India.

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<sup>1</sup> Administrative circular no4/2016

**Table 1 User base of platforms in 2018**

| <b>Platform</b>                 | <b>Users in India</b>                |
|---------------------------------|--------------------------------------|
| Netflix <sup>2</sup>            | 0.5 million                          |
| Facebook <sup>3</sup>           | 270 million                          |
| Amazon Prime <sup>4</sup>       | 10 million                           |
| Amazon marketplace <sup>5</sup> | 0.3 million sellers                  |
| Apple <sup>6</sup>              | 10 million                           |
| Tez (Payment app) <sup>7</sup>  | 22 million                           |
| YouTube <sup>8</sup>            | 225 million                          |
| Uber <sup>9</sup>               | 450,000 drivers and 33 million users |

The kind of business model and the associated value generation through user participation may need to be considered prior to determining thresholds. Users do not directly drive profits. A relatively high threshold on users may be preferable for India. It does not seem necessary to impose a requirement for registration for tax on foreign entities which have less than 100,000 users, who may not be producing significant revenues or profits.

There is of course some clarity required with respect to the definition of users. For example, a multi-sided platform has a supplier as well as a customer. Take for example Uber. If the user is the driver and the threshold has been set relatively high then there will be no PE in India. On the other hand, if the threshold is the passenger, then there will be a PE in India. Therefore, a clarification will have to be issued by the CBDT on who is a user.

Similarly, the users of Facebook are free users as well as advertisers. Given that economic value may be realised through sales of advertisements, the nexus may arise where advertisers are located. In some business models, it may be difficult to distinguish between users and customers. For example, Amazon began as an online sales platform, but has aimed to convert its customers into users of its many other services, including streaming of movies and other content, online storage, etc. In some business models, users and also consumers, indeed the

<sup>2</sup> <https://www.hindustantimes.com/business-news/why-netflix-isn-t-keen-to-expand-to-regional-languages-in-india/story-15BIUoXJJ1hZ8pAx5E8WQJ.html>

<sup>3</sup> <https://www.statista.com/statistics/268136/top-15-countries-based-on-number-of-facebook-users/>

<sup>4</sup> <https://entrackr.com/2018/04/10-mn-prime-subscribers-india-amazon/>

<sup>5</sup> <https://economictimes.indiatimes.com/small-biz/startups/newsbuzz/amazon-india-crosses-3-lakh-sellers-mark-on-its-marketplace/articleshow/62969808.cms>

<sup>6</sup> <https://economictimes.indiatimes.com/tech/hardware/number-of-iphone-users-in-india-to-soon-cross-10-million/articleshow/63435673.cms>

<sup>7</sup> <https://www.blog.google/technology/next-billion-users/google-for-india-2018/>

<sup>8</sup> <https://yourstory.com/2018/03/youtube-monthly-user-base-touches-225-million-india-reaches-80-pc-internet-population/>

<sup>9</sup>

term ‘prosumer’ has been used. Thus, the threshold must be based on the clear understanding of who are the users.

Further, the number of users may have to be well defined as per the understanding of users’ economic relation with revenues. Users may contribute value, but are not necessarily a direct source of sales revenue, for example with free platforms such as Facebook, Google Maps, or WhatsApp.

From the economic viewpoint, users are assets and the value of a user base is reflected in a company’s profitability, and ultimately in a company’s share price. A significant user base within India means that a foreign company has assets within India. This may be more relevant to taxation of capital gains than of profits.

## *2.2 Revenue threshold*

In our view, the level of revenue is the most relevant test for deciding whether a foreign enterprise is deriving significant profit from a jurisdiction. Until a foreign enterprise is generating a significant amount of actual revenue from a country it does not seem necessary or desirable to treat it as having a taxable presence. In this regard, it should be pointed out that if the economic nexus is established based on the sales generated, the profits can be attributed in accordance with the location of objective factors such as customers, activities undertaken (e.g. personnel including agents), and assets (including the user base).

The setting of thresholds based on revenue is an economic exercise. Thresholds set by international agreement should be proportionate to the size of economy and general economic activity. Hence, thresholds set unilaterally should be broadly in line with other comparable countries. The threshold proposed for the EU by the Commission is 7m euros of sales in any one of its member states. India’s GDP is around the same as the largest of the EU member states (e.g. Germany, France, Italy). This suggests that India’s revenue threshold should be around the same level as that proposed for the EU.

## *2.3 Definition of transaction*

A SEP is said to exist in the Indian law if *any* transaction in respect of goods and services or property is carried out by a non-resident in India, provided that the revenue threshold is met. This is different from the EU’s proposed virtual PE, which has a separate threshold of a minimum of 3000 business contracts. Although this makes the definition of the term ‘transaction’ in the Indian legislation less important than that of ‘business contracts’ in the EU, nevertheless some clarification may be necessary.

The SEP appears to cover transactions in respect of any goods, services or property between associated enterprises of a multinational corporate group. For the purpose of transfer pricing, an international transaction<sup>10</sup> has been defined such as to include the purchase, sale or lease of tangible or intangible property, the provision of services, lending or borrowing money, or any other transaction having a bearing on the profits, income, losses or assets of such associated enterprises. Such transactions include an agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such associated enterprises. This broad definition covers far more than just sales and services. Clarity is necessary on how to define ‘transaction’.

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<sup>10</sup> For the purposes of sections 92, 92B 92C, 92D and 92E; a transaction between two or more associated enterprises, either or both of whom are non-residents.

It should also be recognized that practical problems will arise in establishing a digital nexus in India based on transactions, customers or users, due to the use of masked IP addresses and even the ‘dark web’.

#### *2.4 Uniformity or convergence in defining thresholds*

India’s adoption of the SEP, and the definition of thresholds, will clearly have some international implications. Such a unilateral measure can only apply subject to India’s existing international obligations, in particular its tax treaties. Hence, it would apply at this stage only to foreign entities resident in countries with which India does not have a tax treaty. This could nevertheless have a significant effect in deterring attribution of profits to entities resident in low-tax countries.

More broadly, it is relevant to the international discussions currently taking place, through the Inclusive Framework for BEPS, on reforming international tax rules in response to digitalization of the economy. It seems likely that these will include a definition of SEP, and also that it could include numerical thresholds. Clearly the SEP definition would have to be internationally agreed to be included in tax treaties. However, the setting of numerical thresholds could more appropriately be specific to the jurisdiction, i.e. size of the economy and scale of operations. Hence, such thresholds could be left for bilateral negotiation between states, as occurs with other treaty provisions, such as withholding tax rates.

### **3. Attribution of profits to SEP**

It is important to mention that with the adoption of the new test for taxable presence based on SEP the concerns of attribution of profits will be more pronounced. In our view, the work done so far as part of the BEPS project on attribution of profits to PEs has been inadequate. Discussion of this issue clearly is beyond the questions posed in this consultation. Nevertheless, we would like to draw attention to the arguments we made in our submission in 2017 to the BEPS project on attribution of profits to a PE, which can be accessed [here](#). In particular, we argued that even under the current rules, a holistic approach should be adopted to attribution of profits. This should consider all the activities carried out in the country by the relevant entities forming part of a multinational corporate group in conjunction.