

KIRTANE & PANDIT

Finance Bill 2018

Amendment to section 9(1) of ITA, 1961

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Background

Globalization

- In last over 100 years, world economy has totally transformed;
- With economical developments, Intangible assets emerged as a major force;
- With advent of science & technology, world has reduced to a global village;
- With emergence of computer & internet, technologies grew further with high speed;
- Commerce started getting replaced with e-Commerce ... and later ... digital economy;
- Economies & Markets increased and, also, integrated, & employment increased ..;
- Manufacturing base started getting shifted;
- FDI increased and so on..

Examples of e-commerce & digital economy ...

- Instead of going to grocery shops, go on e-retailers websites;
- Going to office (?) Work from home;
- Attend BOD meets from a different country;
- Travel to places for doing advertisement replaced by net Advt.;
- Education in class-room replaced by e-Learning now;
- Matrimonial match-making taking place through portals – shaadi.com;
- Free for any User – Charge for Advertiser
 - Facebook, Hangouts
 - Cricket live matches - Hotstar
 - Google search engine
- Easy barters – exchange server space against I-T enabled services;
- Free upload / download on YOUTUBE – Charge for Channel Users;

Examples of e-business ...

Physical activity subsuming into e-activity

- Music CDs replaced by e-Music downloads
- Software / Games / Anti-Virus tools, Books, etc. sold through portals
- Hoarding, Print media getting replaced with e-ADVT
- Train-tickets / Air-tickets / Movie-tickets replaced with e-tickets
- Post cards / In-lands getting replaced with emails / messages
- Physical photographs replaced by e-Photos
- Currency may get replaced by e-currencyBITCOIN?

Effects of e-commerce & digital economy

- What's App - sold for USD 19 Billion - for 450 Million+ subscribers - with near ZERO sales.
- Instagram - sold to Facebook for USD 1 Billion - for 100 Million subscribers - no sales revenue model.
- Flipkart and Snap-deal valued in range of USD 6-10 Billion, though, in heavy losses, Amazon.com – Valued at USD 700+ Billion, ALIBABA valued at USD 527 Billion, all these retailers so not posses an any inventory, sizeble fixed assets.
- 'UBER' valued @ USD 60 + billion, do not own any fleet of CARs.
- AIRBNB valued @ 30 + Billion, do not own a single Hotel property, compared to 'Hilton' valued @ USD 27 Billion owns USD 89+ Billion of tangible assets.

International taxation

- With globalization, a country's tax laws were inadequate to deal with varying situations;
- Thus emerged tax treaties;
- Bilateral treaties occupied the position for many years / decades;
- Primary rule was to understand and respect the treaties in good faith;
- Speed of technological developments was too fast;
- Situations of undue benefits started taking place;
- Treaty shopping became rampant;
- Many countries tax bases started shrinking;
- With growth of digital economy, need felt to stop harmful practices

International Taxation

- Right to taxation was understood as activity taking place on soil of a country;
- This was and is, considered as a sovereign right of a country;
- That is why, a NR's business is taxed in a country through a PE such as
 - Fixed place PE (as opposite to a temporary place)
 - Construction, etc. sites PE (if no of days test passed)
 - Dependent Agent PE (as against Independent Agent, etc.)
 - **All these were (again) physical measures**
- Concept was, a NR is to be taxed once he becomes part of a state's economy;
- Now, in present digital world, MNCs are omnipresent with portals / websites, mobile apps, etc.
- If they exist in economy, why they should not be taxed?
- Physical presence starts yielding to digital presence..



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OECD & Base Erosion Profit Shifting Action Plans

BEPS Concept

- Base Erosion started creating uncomfortableness;
- Inequity in taxation leads to unfair trade practices;
- States became sensitive to tax fairness;
- Possibility of states actions of impose harsh measures existed;
- Hence, collective action was thought of as a right measure;
- MULTILATERISM considered as life blood of global peace & economic stability;
- Hence, G-20 called upon OECD to devise BEPS action plans on a totality basis;

BEPS started ...

BEPS started releasing action plans

In the very first Action Plan, following resolve was reached

*“Identify the main difficulties that the **digital economy poses** for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation.*

*Issues to be examined include, but are not limited to, the ability of a company to have a **significant digital presence** in the economy of another country, without being liable tot taxation, due to **lack of nexus** under current international rule, the attribution of values created from the generation of marketable locations-relevant data through the use of digital products and services, the characterization of income derived from new business models, the application of related source rules, and how to ensure the effective collection of VAT / GST w.r.t. the **cross border supply of digital goods and services.**”*

BEPS Expectations ...

- BEPS expects a three-fold responsibility package for the various States
- Firstly, expects that, the domestic laws / rules will be aligned to BEPS Action Plans
- Secondly, expects countries to enter into Multilateral Arrangements
- Thirdly, expects countries to share data on an automatic & voluntary basis

BEPS – Events Chart

Date / Month / Year	Event
Year 2008	G-20 resolve for papers regarding base erosion
Feb 2013	Release of Action Plan on BEPS by OECD
Sep-2013	15 points BEPS Action Plans by OECD + G-20
Oct-2015	Release of final BEPS Action Plans
Jun-2017	MLI signed by 68 countries
Jan-2018	MLI signed by 10 more countries
Feb 2018	Canada ratifies MLI (others to follow after completion of procedures)

BEPS Action Plans – Listing

Action Plan No.	Summarised Name	Action Plan No.	Summarised Name
Action 1	Address the tax challenges of the digital economy	Action 8-10	Transfer Pricing
Action 2	Neutralize the efforts of hybrid mismatch arrangements	Action 11:	Establish methodologies to collect and analyse data on BEPS and the actions to address it
Action 3	Strengthen controlled foreign company rules	Action 12:	Require taxpayers to disclose their aggressive tax planning arrangements
Action 4	Limit base erosion via interest deductions and other financial payments	Action 13:	Re-examine transfer pricing documentation
Action 5	Counter harmful tax practices by transparency and substance	Action 14:	Make dispute resolution mechanisms more effective
Action 6	Prevent treaty abuse	Action 15:	Develop a multilateral instrument
Action 7	Prevent the artificial avoidance of permanent establishment status		

BEPS – Response of countries ...

Action Plan 1 – Digital economy challenges

All EU countries + New-Zealand + Russia, etc. levy VAT / GST / EL

Action Plan 2 – Hybrid mismatches

All EU countries have adopted Anti Tax Avoidance Directives (ATAD)

Germany has also adopted anti-double-dip measures

Action-Plan 4 – Interest

Japan, Korea, UK have implemented Thin-cap rules

Action-Plan-5 – Substance

Germany permits Royalty deduction provided patents have nexus

Action-Plan-8 – Transfer Pricing

Singapore has decided to look at the value creation for deciding ALP

(.....and so on)



3

Multilateral Instruments

MLI ..

- Consider SANOFI ruling of Honorable A.P. High Court, as per which, meaning of terms in DTAA is that, which existed when DTAA was signed;
- Amending over 90 DTAA's will be a very tough task for India;
- Same tough task for various countries;
- Then emerged the concept of MLIMULTILATERALISM;
- MLI expects all countries to join into a common pool and, restrict unfair practices;
- MLI works in a mechanical manner by defining articles which are to be amended;
- MLI sets some minimum standards (Articles) and permits flexibility for rest of the Articles;
- Options and reservations can be made while executing an MLI;

MLI

MLI execution has following filters

- Filter-1 – All countries having DTAA may not enter into MLI pool (e.g. USA)
- Filter-2 – Countries signing MLI may not stipulate a DTAA (e.g. Mauritius)
- Filter-3 – Choice of optional articles may not be compatible to each other
- Filter-4 – Reservations may exist qua some Articles
- Filter-5 – Options may be exercised while executing MLI

..... Then what emerges is an MLI applicable to a DTAA (CTA)

..... Such an MLI will sit side by side with the DTAA (CTA)

..... For options exercised, DTAAs will apply qua such respective options

MLI – Listing of Article

Article No.	Summarised Name	Article No.	Summarised Name
Article 1 & 2	Scope of the Convention & Interpretation of Terms	Article 12	<i>Avoidance of PE Status- Artificial Avoidance of PE Status through Commissionaire Arrangements and Similar Strategies</i>
Article 3, 4 & 5	<i>Hybrid Mismatches- Transparent Entities, Dual Resident Entities & Elimination of Double Taxation</i>	Article 13	<i>Avoidance of PE Status- Artificial Avoidance of PE Status through the Specific Activity Exemptions</i>
Article 6	Treaty Abuse-Purpose of a Covered Tax Agreement	Article 14	<i>Avoidance of PE Status- Splitting-up of Contracts</i>
Article 7	Treaty Abuse- Prevention of Treaty Abuse	Article 15	<i>Avoidance of PE Status-Definition of a Person Closely Related to an Enterprise</i>
Article 8	<i>Treaty Abuse- Dividend Transfer Transactions</i>	Article 16	<i>Improving Dispute Resolution – Mutual Agreement Procedure</i>
Article 9	<i>Treaty Abuse-Capital Gains of Shares – Predominant value from Immovable Property</i>	Article 17	<i>Improving Dispute Resolution Corresponding Adjustments</i>
Article 10	<i>Treaty Abuse-Anti-abuse Rule for Permanent Establishments Situated in Third Jurisdictions</i>	Article 18 to Article 26	<i>Arbitrations related</i>
Article 11	<i>Treaty Abuse-Application of Tax Agreements to Restrict a Party's Right to Tax its Own Residents</i>	Article 27 to Article 36	<i>Notification, entry in force, ratification <u>etc</u></i>

MLI – Article-6

- Article-6 of MLI = Minimum standard Article (i.e. compulsive article)
- As per this article, countries have to add following preamble to the DTAA
- The preamble (sort of GAAR) reads as under

*“Intending to eliminate double taxation w.r.t. the taxes covered by this agreement, **without creating opportunities** for non-taxation or reduced taxation through **tax evasion or avoidance** (including **through treaty shopping** arrangement aimed at obtaining relief under the agreement for the indirect benefit of residents in third jurisdiction)”*

Surprisingly, India did not opt for the optional statement i.e.

“that treaty objects can also be to develop economic relationship and enhance co-operation in tax matters”

Non-inclusion of above optional statement is contrary to section 90(1)(a)(ii)

MLI – Steps in execution..

Applying the MULTILATERAL INSTRUMENT Step-by-Step

Key documents to assess modifications by the MLI

The MLI

Specific tax agreement

The MLI position of a Contracting Jurisdiction

The MLI position of the other Contracting Jurisdiction

Five steps for application of the MLI

Step 1

- Entry into force of the MLI

Step 2

- Covered Tax Agreement

Step 3

- Reservations and choice of optional provisions

Step 4

- Notifications of existing provisions

Step 5

- Entry into effect of the MLI

MLI – India position ...

MLI Article	Scope of emerging PR article	India position	DTAA (i.e. CTA) exists and no reservations by such countries	DTAA (i.e. CTA) exists but reservations expressed by such countries	DTAA exists but such countries not in MLI list
12	Commissionaire arrangement	No reservations	Netherlands, France	Singapore, Sweden, UK	USA
13	Specific Activity Exemptions	Opted for Option A	Option A- Netherlands Australia, Japan Option B- France, Singapore	Cyprus, Canada, Sweden	(Same)
14	Splitting-up of contracts	No reservations	Netherland, France	Singapore, Sweden	(Same)
15	Closely related Person defined		Netherland, France, UK	Singapore, Sweden	(Same)



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Amendments to section 9(1)

Amendment to section 9(1) ...

- Budget 2018 amendments
- Replaced Explanation-2 increasing scope of BC through Commissionaire
- New Explanation-2A leading to BC through 4 types of SEP
- Rationale of Budget 2018 amendments (FM speech)
 - *It is proposed to amend section 9 of the Act to align the scope of "business connection" with the modified dependent agent permanent establishment rule as per Multilateral Instrument signed by the Government.*
 - *It is proposed to amend section 9 of the Act to provide that significant economic presence of a non-resident shall constitute "business connection" with India. It is also proposed to define the phrase 'significant economic presence'.*

BC amendment ...(DAPE)

- Rationale of amendments given in Explanatory Memorandum

.....However in many cases, with a view to avoid establishing a PE under Article 5(5), the person acting on behalf of the NR negotiates the contract, but does not conclude the contract...

....The OECD under BEPS Action Plan 7 reviewed the definition of PE with a view to preventing avoidance of payment of tax by circumventing the existing PE definition by way of Commissionaire arrangement of fragmentation of business activities

.....Further, with a view to preventing base erosion and profit shifting, the recommendations under BEPS Action Plan 7 have now been included in Article-12 of MLI.....

.....In view of the above, it is proposed to amend the provisions of section 9 so as to align them with the provisions in the DTAA as modified by MLI so as to make the provisions in the treaty effective

BC amendments .. (SEP)

- Rationale of amendment (contd..)

.....Under these new business models, NR enterprises interact with customers in another country **without having any physical presence** in that country resulting in avoidance of taxation in source country.

Therefore the existing **nexus rule** based on physical presence do not hold good any more for taxation of business profits in source country. As a result, the rights of the source country to tax business profits that are derived from its economy is unfairly and unreasonably eroded.

...The scope of existing provisions of clause (i) of sub-section (1) of section 9 is **restrictive** as it essentially provides for physical presence based nexus rule for taxation of business income of the NR in India...

..The proposed amendment in the domestic law will **enable** India to negotiate for inclusion of the new nexus rule in the form of SEP in the DTAA.....

...Further, it is also clarified that unless corresponding **modification to PE** rules are made in DTAA, the cross border business profits will continue to be taxed as per the existing treaty rules ...

BC amendment...

- How the amendment made to section 9
- Replacement of Explanation-2(a) to enhance scope of DA becoming BC
 - *Situation of a DA playing principal role leading to conclusion of contracts added ..*
 - *Exception of no BC in case of mere purchase activity of DA removed ...*
 - *Scope increased (to include TRF of ownership and use rights, etc.) ..*
- Insertion of Explanation-2A to provide for SEP becoming BC
 - *Revenue linked SEP to lead to BC*
 - *User linked SEP to lead to BC*
- In future, these amendments are expected to align the new PE articles

Section 9: Scope of BC / DAPE widened

Section	Earlier Provisions	Proposed Amendment
Expl. 2 of section 9	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,—	
Clause (a)	has and habitually exercises in India, an authority to conclude contracts on behalf of the non-resident, unless his activities are limited to the purchase of goods or merchandise for the non-resident; or	<p>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—</p> <p>(i) in the name of the non-resident; or</p> <p>(ii) 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</p> <p>(iii) for the provision of services by the non-resident;</p>

Amendment to Explanation 2(a)

- PE rules of a DAPE already getting modified due to MLI (Article-12 to article-15 of MLI);
- DAPE is to include such agent who plays a principal role in contract negotiation, etc.
- To align with this, BC section amended;
- Said amendment is in line with BEPS Action Plan which expects domestic law changes;
- Preparation for the future.... As so said in the Explanatory Memorandum
- Other parts of Explanation-2 retained as it is

Effects –

- a) For non-treaty countries**
- b) For treaty countries without MLI**
- c) For treaty countries in MLI**

- To be immediately effective**
- No effect at present**
- Effective provided matching done, etc.**

Section 9: New Concept of Business Connection Significant Economic Presence (SEP)

Section	Explanation 2A
Expl. 2A of section 9	<p>For the removal of doubts, it is hereby clarified 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 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</p> <p>(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:</p> <p>Provided that the transactions or activities shall constitute significant economic presence in India, whether or not the non-resident has a residence or place of business in India or renders services in India:</p> <p>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.</p>

Enlarged scope of BC through SEP

Expl.	Provision	Examples
Clause (a) of Expl. 2A: Revenue linked clause	Limb 1: Transaction in respect of any <u>goods, services or property</u> carried out by NR in India if aggregate payment arising from the transactions in the previous year exceeds Rs.X	Amazon, eBay
	Limb 2: Transaction in respect of <u>provision of download of data or software</u> carried out by NR in India if aggregate payments arising from transaction in the previous year exceeds Rs.X	Netflix, Kindle, iTunes, Saavn
Clause (b) of Expl. 2A: User linked clause	Limb 1: <u>Systematic and continuous soliciting</u> of NR's business activities with Y no. of users in India through digital means	Bookings.com, Paypal
	Limb 2: <u>Engaging in interaction</u> with Y no. of users in India through digital means	Google Maps, Facebook, Whatsapp

Insertion of Explanation-2A

- Most striking feature of the entire NR related amendments
- Missing Nexus assumed, with emergence of virtual PE concept
- India has been advocating similar situation through various reservations to the model commentary
- India took a position that, a website, etc. may lead to a PE
- India also claimed right to tax a NR providing services from outside India
- **Effects –**
 - a) For non-treaty countries** - **To be immediately effective**
 - b) For treaty countries without MLI** - **No effect at present**
 - c) For treaty countries in MLI** - **Effective provided matching done, etc.**



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Issues / challenges

Issues regarding “BC” through “DAPE” (as amended...)

Meaning of “Principal”

Principal = Key / Main / Substantial

Principal = One contributing most value compared to others

Principal = > 50%

For PE meaning under MLI, principal (role) means something contrary to routine conclusion without material modification

Issues

1. In **absence** of any mention of **role of NR** in the definition of BC, situation as same of MLI to be assumed? In other words, should the words, “.....contracts that are routinely concluded without material modification” to be understood ?
2. Who should carry the **onus** of substantiating existence (or not) of the principal role and existence (or not) of the NR’s role of routine conclusion without material modification?

Issues regarding “BC” through “SEP” (as amended...)

3. Whether any cross border transaction in respect of goods / services / property will be the same as one **carried out in India by the NR?**
4. Whether BC through SEP takes place **only** in cases which involve provision for download of software or data?
5. Assuming that BC through SEP is to take place for provision of download of software or data, and, in fact, **no any actual download** of software or data happens, whether any BC triggers?
6. Whether BC through SEP takes for owner of software **or** for the NR who carries out a transaction through such software?
7. BC through SEP is deemed, but, a transaction in India carried by a NR is **not deemed**. In such a case, is entire exercise not futile?
8. Whether a **single transaction** of the nature covered in clause (a) can lead to BC?

Issues regarding “BC” through “SEP” (as amended...)

9. How a payer should know **factum of crossing** of Threshold of “revenue”?
10. How a payer to ensure TDS in such situations, where, no opportunity exists for **effecting** TDS?
11. Once BC taken place through SEP, whether charge of Equalization Levy will **abolish**? If not, only one of the two levies ought to prevail so that double taxation is avoided.
12. Whether this clause **overlaps** cases of (say) provision of license of software leading to ROYALTY u/s 9(1)(vi)?
13. Whether the 1st proviso wording (...whether or not .. Services rendered in India ...) is **contrary** to express clause (a) of Explanation 2A which includes (...carried out by a NR in India)?

Issues regarding “BC” through “SEP” (as amended...)

14. In **absence of clear meaning** of systematic and continues soliciting of business activities, may lead to litigation.
15. Engaging in interaction with prescribed (or more) number of users may or **may not be a business activity** or such activity giving rise to any revenue.
16. Whether these terms should be confined to business activity scenarios alone? Or it could go to other areas (say charitable activity, etc.)
17. If Payer does not effect TDS, whether he may be considered as **representative assess** u/s 160 r.w.s. 163?

Further Issues regarding “BC” + PE (as amended...)

18. Now, BC is to align itself with PE (read Memorandum + FM speech). As per E-Fund decision, **no PE to take place if no customers** in India. What could be the fate accompli?
19. As per decision in the case of Morgan Stanley, no any income attribution is necessary if the DAPE is paid an **Arm’s length commission**. Whether any further exercise is necessary in such a case?
20. How far it is apt to make **substantive amendments** of such nature through **Explanation**?

THANK YOU