Revamping the Business Connection

The Union Budget 2018 has mainly focused on rural economy development, agriculture sector, social spending and job creation. Significant reforms have been proposed in the health, rural sector and medium, small and micro enterprises (MSME). While the budget did not offer anything special for individuals other than some incentives for senior citizens, the domestic companies having a turnover up to ₹ 250 crores are extended the benefit of concessional corporate tax rate of 25 per cent.

The most anticipated amendment of tax on long term capital gains is finally introduced which appears to have cast a big blow to the Indian capital markets. To bring certainty on the applicability of the Income Computation and Disclosure Standards (ICDS) in wake of the decision of the Delhi High Court in the case of Chamber of Tax Consultants vs. Union of India (2017)[1], the Finance Bill bequests a legislative nod by proposing suitable amendments to the Income Tax Act, 1961 ('the Act') with retrospective effect from Assessment Year ('AY') 2017-18. Further, there are certain other amendments in respect of Dividend Distribution Tax, Deemed Dividend, Taxation of Start-ups, Health and Education Cess etc.

Some noteworthy amendments have also been made in the international taxation with an effort to align the domestic tax laws with the initiatives of Organisation for Economic Development and Co-operation (OECD), Base Erosion and Profit Shifting (BEPS) and Multilateral Instruments ('MLI'). The endeavour of this article is to briefly discuss some of the key budget amendments in international taxation.

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Amendments in the Definition of Business Connection

Looking at the amendments made in the last 2-3 years, India has demonstrated that they are leading at an accelerated pace, in terms of the adoption of the principles of BEPS initiatives. This can be seen from the conscious and timely steps

[1] *Chamber of Tax Consultants vs. Union of India (2017) (299 CTR 137) (Delhi)*

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taken, such as roll-out of General Anti-Avoidance Rule ('GAAR'), inclusion of Equalisation Levy ('EL'), adoption of limitation on interest deduction, Intellectual Property (IP) regime for royalty income, implementation of master file and country by country reporting (CbCR) etc.

The latest inclusion as proposed by Finance Bill 2018 is alignment of scope of business connection with the modified Permanent Establishment ('PE') rule in lines with MLI and inclusion of the concept of significant economic presence. The Budget has proposed to expand the scope of business connection through two sets of changes:-

A. Change in the purview of dependent agency PE; and
B. Embracing within the tax net new business models in the digital space by having the significant economic presence test.

A. Purview of dependent agency PE

BEPS Action Plan 7 recommended modification to agency PE definition under Article 5 of the OECD Model Convention('MC') to include not only a person who habitually concludes contracts on behalf of the non-resident but also to include a person who habitually plays a principal role leading to conclusion of contracts. With respect to anti-fragmentation rule as per paragraph 4.1 of Article 5 of the OECD MC, BEPS has made recommendations to prevent the tax payer from fragmenting functions which may otherwise be considered a whole business activity.

Further, the recommendations of BEPS Action Plan 7 were implemented under Article 12 of the Multilateral Convention. The existing provisions of Explanation 2 to section 9(1)(i) of the Act are narrower in scope and more beneficial as compared to the provisions of India's tax treaties. By virtue of the narrower scope of section 9(1)(i) of the Act, and on the basis of the provisions of section 90(2) of the Act, the tax payer can avail the provisions of domestic law which are more beneficial. In order to make the provisions of tax treaties effective, it is proposed to amend the provisions of section 9 (1)(i) of the Act.

There are two pivotal aspects which are proposed to be amended by the Act which are discussed in the ensuing paragraphs:-

1. <u>Replacing 'habitually concludes contract' with the words 'habitually plays the principal role leading to conclusion of contracts'</u>
   - The phrase 'habitually concludes contracts' focuses on situations where a contract is legally concluded. A contract may be concluded in a state even if the contract is signed outside that state. The fact that the key ingredients of the contractual relationship are determined in the relevant state is sufficient to treat these contracts in the same way as if they have been formally concluded in that state.
   - Further, the OECD MC explains the phrase *"habitually plays the principal role leading to conclusion of contracts that are routinely concluded with material modification by the enterprise"* as a case where a person solicits and receives orders but does not formally finalise it. The orders are sent directly to the warehouse from which the goods belonging to the enterprise are delivered and the enterprise merely approves such transactions.
   - The ambit of the provision is expanded to situations where a person may not have an authority or the power but may be deemed as a dependent agent even if he habitually plays a principal role leading to conclusion of contracts.

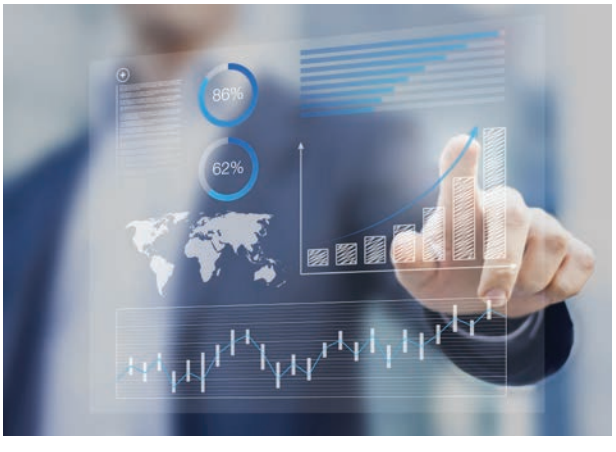
2. <u>Replacing the term 'contracts in the name of the enterprise' with contracts that are:</u>
   a) in the name of the enterprise; or
   b) for transfer of ownership or granting right to use the property owned by that non-resident or that non-resident has a right to use; or
   c) for provision of services by that enterprise.
   - The proposed changes clarify that, the agency PE may be triggered even in a situation if the contract entered relates to services provided by foreign principal or relates to the transfer of property, or

permits the use of property which is owned by the foreign principal.

The Explanatory Memorandum to Finance Bill states that the definition of 'PE' is reviewed by OECD *"with a view to preventing avoidance of payment of tax by circumventing the existing PE definition by way of commissionaire arrangements or fragmentation of business activities"*. The Finance Bill has proposed amendments to section 9(1)(i) with respect to conclusion of contracts by the agent. However, it may be worthwhile to note that though there is a mention in the Memorandum to Finance Bill with respect to anti-fragmentation rule as referred in BEPS Action Plan 7, no amendment in Section 9(1)(i) finds place to this effect.

Commissionaire Arrangements and Effect of the Amendment

A commissionaire model is an arrangement recognised by the European Civil Law concept of agency. In the commissionaire structure, the local agent concludes contracts in its own name but on behalf of and at the risk of its foreign principal. The title of goods, control over the business activities, associated risks are retained by the foreign principal. The local agent is not considered as a seller but a service provider of its principal and is taxable for the commission received from the principal. Through such an arrangement a foreign enterprise is able to sell its good in the source state without creating a PE. The condition under most of the treaties for constitution of a PE through dependent agent is that an enterprise is deemed to have an agency PE only if a person acting on its behalf, habitually exercises authority to conclude contracts in the name of the enterprise. The contract entered between the commissionaire and the third party is not legally binding on the principal since it is in the name of the commissionaire instead of the principal.



The amendments proposed in lines with BEPS Action Plan 7, would deem a business connection to exist if an agent is engaged in habitual conclusion of contracts or habitually plays a principal role in conclusion of contracts, which are the activities of the foreign principal. Further, the exception with respect to purchasing goods/merchandise in India for a foreign enterprise is also removed thereby enlarging the existing scope.

Commissionaire arrangement is not prevalent in India, being a common law country where principal is legally bound to a third party by a contract made by an agent acting within its authority. The business connection provisions under Section 9(1)(i) of the Act currently, deem foreign enterprises to be taxable in India in respect of business activities undertaken by the agent who exercises an authority to conclude contracts in India/maintains a stock of goods for regular delivery on behalf of the foreign enterprise or habitually secures contracts in the name of the foreign enterprise. Further, the Indian tax treaties also contain dependent agency PE provisions covering additionally negotiating of contracts, soliciting of contracts, etc. Indian tax authorities have taken a stringent view on the role played by the agents *vis-a-vis* negotiation of contracts/securing contracts etc. and have on various occasions held these activities to have constituted a PE.

Thus, the amendments proposed in lines with BEPS Action Plan 7, would deem a business connection to exist if an agent is engaged in habitual conclusion of contracts or habitually plays a principal role in conclusion of contracts, which are the activities of the foreign principal. Further, the exception with respect to purchasing goods/merchandise in India for a foreign enterprise is also removed thereby enlarging the existing scope.

B. Significant Economic Presence Test

The new and dynamic business models in the current scenario enable the foreign enterprises

to interact with customers without being physically present in a particular jurisdiction. The advancement towards digital economy has resulted in the concept of physical PE becoming obsolete. The BEPS Action Plan 1 provides measures to tackle the loopholes which exist owing to the traditional PE concept. It may be worth taking a note that the BEPS Action Plan 1 report provides significant economic presence test as one option, the MLI currently does not prescribe any recommendations as regards the digital economy taxation. In anticipation of the future work to be done on BEPS Action Plan 1 in terms of consultation with stakeholders (as stated in the BEPS report) and keeping in mind the existing restrictive provisions of Section 9(1)(i) (which essentially provides for a physical presence based nexus for taxation of business income), India has proposed to introduce to the concept of significant economic presence in its domestic law.

BEPS Action Plan 1 suggests that the significant economic presence may be determined basis the factors that evidence a purposeful and sustained interaction with the economy of that country via technology and other automated tools. The essence of the concept may be that it may be possible for an enterprise to be substantially involved in the economics of other country, even though it does not have a place of business or a dependent agent in the other country.

The concept of significant economic presence as proposed to be introduced under the Act from 1 April 2018 includes the following-

a. Transactions in respect of any goods in India above a specified value, including digital goods; or
b. Transactions in respect of any services in India above a specified value, including digital services; or
c. Transactions in respect of any property in India above a specified value, including download of data or software; or
d. Systematic and continuous solicitation of business from India from a prescribed number of users through digital means; or
e. Systematic and continuous engagement with prescribed number of users through digital means.

While the concept of significant economic presence is discussed in line with BEPS Action Plan 1 i.e. digital economy, one may consider that the term significant economic presence as proposed under the Finance Bill 2018 is broad enough to cover non-digital goods and services also. A transaction with respect to goods when carried out in India may accrue or arise in India even as per the existing provisions of the Act. The need to have a new explanation in this regard is unclear. Similarly, the 'transfer of all or any rights in respect of computer software' being already covered under Section 9(1)(vi) of the Act, an ambiguity to this effect may arise whether the specific provisions of Section 9(1)(vi) would prevail over the proposed amendment in Section 9(1)(i)?

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There are several challenges which may be posed by virtue of the proposed amendment, some of which are mentioned as under:-

- In the absence of a similar concept of significant economic presence under MLI or the existing tax treaties signed by India, unless corresponding modifications are made to the PE rules in the tax treaties, the tax payer will be able to avail the beneficial treatment under the tax treaties.
- A typical challenge in case of significant economic presence is with respect to attribution of income. The present attribution

mechanism is based on allocation with respect to functions, assets and risk. A business connection derived through significant economic presence but with absence of functions, assets and risk may lead to complex and subjective attribution of income.

- Till the time, the threshold limit for specified value in terms of revenue and users may be prescribed in consultation with the stakeholders, the amendment poses a lot of uncertainty.
- For giving effect to such changes, it is essential to have consensus from the other treaty countries. Pendency of the other treaty countries provide their assent, it may practically ineffectuate the proposed amendments. Further, it may be noted that this issue is also acknowledged in the Explanatory Memorandum to Finance Bill.

The above proposed amendments are at a very nascent stage and it would be interesting to see how the provisions evolve over the period of time and becomes effective in the current framework of India's treaties.

Other Miscellaneous Provisions

- Income earned by a non-resident by way of royalty and fees for technical services rendered to National Technical Research Organisation ('NTRO') would be exempt from tax in India. Accordingly, NTRO would not be liable to deduct TDS on payments made to such non-residents.
- Provisions under section 47, 115JC and 115JF have been proposed to promote International Financial Services Centre (IFSC). The transfer of a bond or global depository receipt referred under section 115AC(1), or rupee denominated bond of any Indian company, or derivative executed by a non-resident on a recognised stock exchange located in an IFSC may not be considered as transfer under section 47(viiab), where consideration for such a transaction is paid or payable in foreign currency. Further, the unit located in an IFSC, which derives its income solely in convertible foreign exchange shall be liable to Alternate Minimum Tax at a reduced rate of 9 per cent.
- The income earned by Foreign Institutional Investors ('FII') from transfer of securities

were liable to capital gains tax under the provisions of section 115AD. The section is now amended to provide that long term capital gains arising from transfer of capital asset specified under proposed section 112A, exceeding ₹1 lakh, will be chargeable to tax at the rate of 10%. Further, as per the *Frequently asked questions (FAQ) regarding taxation of long-term capital gains proposed in Finance Bill, 2018-reg,* released by Central Board of Direct Taxes on 4 February 2018 the following aspects relating to FII's were clarified-

- There will be no tax deduction at source from payment of long term capital gains to FII's in view of the provisions of section 196D(2) of the Act.
- The benefit of grandfathering on gains accrued up to 31 January 2018 will be available to FII's.

The changes proposed by the Finance Bill to the definition of business connection would have far reaching effects. The multinational enterprises operating from outside India and having some economic activity in India would need to carefully study the changes proposed and its impact on the business models. We expect the investments to grow with the economic reforms being carried out by the Government. Let us hope that the investing companies and tax authorities understand and appreciate the changes, its impact and this should not lead to increase in litigation. ■