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Indian equalisation levy – progressive or regressive?

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Change is the only constant! As businesses find new ways to operate, tax authorities are finding new ways to tax. All is fair in the world of taxes!

The tax world has been brimming with, news and claims of tax avoidance. Tax has become representative of responsible corporate behaviour, governance and citizenry, and some big multinationals have learnt this the hard way.

As digital businesses leapfrog with advancement of information and communication technology, physical boundaries are unrecognised, remote presence has taken centre stage and data exchange has become the lifeline. Such emerging dimensions strain the historical taxation principle based on source of income, determining nexus or presence, characterisation of income, etc.

Equalisation levy in India

Rules around taxation of digital businesses have been nebulous as it is widely accepted now that the historical rules on taxation do not address the peculiarities that characterise the digital economy. Countries and tax administrations world over are treading with caution since it is well recognised that the digital economy is fast becoming the real (or material) economy itself and in a lot of ways does not alter or give rise to a new business, but only gives rise to a new way of doing the same business i.e., buying and selling of goods and services.

To address in some part the challenge to tax such businesses, India has taken a decisive first step in ushering in a framework outside of its regular taxing statutes – i.e., not in the form of income tax or service tax (an indirect tax such as a GST or VAT on services), but as equalisation levy through a special annual amending legislation of Finance Act in 2016. Notably, the service tax was also introduced similarly, way back in 1994, where constitutional challenges to the legality of the service tax were rejected by the Indian judiciary. The positioning of the equalisation levy too is being made as outside of Indian income tax or service tax, giving it a unique form. Some elementary aspects relating to the levy are noted below:

- **Effective date:** June 1, 2016.
- **Charge:** At the rate of 6 percent on consideration received/ receivable by non-resident for specified services from: a) Indian resident carrying on business or profession; or b) PE of non-resident in India.
- **Services covered:** Specified services include online advertisement, any provision for digital

advertising space or any other facility or service for the purpose of online advertisement. More services may be specified through Government notifications.

- **Exemption from the levy:** a) Non-resident providing specified service has PE and such services are effectively connected with that PE; or b) aggregate consideration for specified services in year is upto INR 100,000; or c) payment by Indian resident or PE of non-resident is not for purpose of carrying out business or profession.
- **Exemption from income tax:** No income tax applies to a non-resident service provider for income on which equalisation levy is chargeable.
- **Collection:** to be collected by way of withholding by the payer; non-withholding results in disallowance of expenditure for the payer.
- **Procedural and compliance provisions:** Made part of the chapter on equalisation levy.

Interestingly, equalisation levy currently covers only online advertising services, and its roots can be traced to the inability on the part of the Indian Revenue to bring them within the Indian tax net based on current provisions of the income tax law.

Some recent Indian Court rulings

Taxation of revenues from on-line advertising is a vexed issue in India and has been a subject matter of some litigation. This issue has been gaining in significance since digital businesses earn significant revenues from online advertising around the world, including in India. With India being a large geography, and a young population that is rapidly adopting the internet, the scope of this business in India is immense.

The Indian Revenue has been adopting the stand that payment for on-line advertisement falls within the category of passive incomes specifically "royalty" or "fees for technical services" ("FTS") and is hence taxable in India under the payer sourcing principles of the tax treaties. However, the Income-tax Appellate Tribunal ("ITAT") in a few cases[1] has held that payment for on-line advertisement is not in nature of royalty or FTS but is in the nature of "business Income" and in absence of a permanent establishment ("PE") of the service provider, such advertising revenue is not taxable in India.

Further, with respect to PE on account of presence of website, Indian Courts have been adopting the established OECD principles on digital presence. The ITAT, in a case[2] held that a search engine which has only its presence through its website cannot be held as a PE unless its web server is also located in the same jurisdiction.

Various attempts have been made in past to override tax treaties. The draft Direct Taxes Code ("DTC") had specific tax treaty override provisions. However, the DTC never saw the light of the day and failed to be passed as a law in India. Separately, under Finance Act 2012 retrospective amendments were made to the scope of the term 'royalties' for non-residents, with an object to override tax treaties. However, Courts in India have recently held that such amendments will not apply to cases which are covered by tax treaties signed prior to 2012.

Accordingly, based on the present structure of the Indian income tax law, Courts in India appear to be inclined to hold that merely having a virtual presence in India does not give taxing rights to India.

Base Erosion and Profit Shifting ("BEPS") initiative

Distress regarding avoidance of taxes by multinational companies in economies from where they derive profits resulted in adoption of BEPS project by the Organisation for Economic Co-operation and Development ("OECD"). OECD with patronage of G-20 launched BEPS project in 2013, wherein 15 action plans were published. In October 2015, the OECD released its final report on action plan 1[3]. The report identified 3 plausible options namely: (a) new nexus based rules on significant economic presence; (b) a withholding tax; and (c) an equalisation levy, although none of these options were recommended by the OECD. The report further stated that more work needs to be done and leaned onto other action plans to address tax issues exacerbated by digital economy. The report also provided discretion to countries in introducing any of these options in their domestic tax laws, as additional safeguards as long as existing treaty obligations are respected.

Taxing digital businesses – disparate actions world over

While India has introduced equalisation levy to address taxation of digital businesses, other countries are similarly venturing with other alternates – such as PE taxation, VAT, etc. Japan, Argentina and Australia have taken steps to tackle taxation issues related to digital economy. Japan has introduced a consumption tax at 8 percent on provision of cross border digital services to Japanese residents. Argentina has introduced a turnover tax withholding system for revenues derived by non-residents from rendition of online services, wherein 3 percent of the net price is to be withheld at the time of remitting funds abroad. Australia has issued guidance on a new law that will apply GST to international sales of services and digital products from July 1, 2017. A few other countries have also taken steps, early amongst all was the UK, which introduced the famous 'diverted profits tax' that applies to structures that seek to abuse the concept of PE or are not backed by commensurate substance.

While aggressive tax planning by multinational companies may have been the cornerstone for the recent upswing in activity to prescribe rules for taxation of digital businesses, there is need for parallel circumspection. An aspect that needs to be understood is that the very nature of digital businesses, allows them to operate from remote locations and reach remote audience. This reality seems to bury under the overarching vociferous concern raised by tax administrations around the world.

At the heart of the existing framework of tax treaties was the principle that while cross border trade was on the rise, a business operating as such should not suffer the incidence of double taxation. Tax treaties were evolved with this relief objective in mind. The manner in which countries are seeking to adopt regimes to tax digital businesses seems to be headed to a pre-tax treaty world where cross border trade was expensive due to double taxation on the same income. For instance, equalisation levy has been introduced in India after an Indian Government formed committee on taxation of e-commerce made recommendations with reference to Action Plan 1 of OECD BEPS initiative. The committee notes that equalisation levy is not in the form of income tax and hence is not covered by the provisions of the tax treaties. The committee further notes that resident countries are free to enact laws to allow credit for the levy or for India to have reciprocal arrangements to allow relief. However, notably no such arrangement is in place and the revenues would be subject to tax for the service provider in the home country which would also bear the gross level equalisation levy. A reciprocal arrangement would by itself not take away the double taxation impact on the income. Aside of being economically unfair, this is likely to cause tax cost

escalation on these services, with some part (if not most) of the burden being transferred to the payer and ultimately to the consumers. Other countries would apply VAT or consumption tax but India already collects a service tax on reverse charge basis on such services. The levy therefore is further beyond what countries are seeking to collect on these services.

Giving Vienna Convection a *go by*

Another aspect that merits attention here is the discipline amongst countries to impose taxes similar in form to taxes covered by tax treaties outside of the income tax legislation. This is leading to situation of possibly allowing countries to override tax treaties unilaterally. Whether tax treaty benefits can be unilaterally overridden by domestic law is a vexed issue. Tax treaties signed between signatories to the Vienna Convention are governed by the interpretation principles enshrined in the Convention. While India is not a signatory to the Convention, however, on principles of fairness, these should be applied to Indian tax treaties also on good faith. Indian courts have consistently upheld treaty provisions.

Article 18 of the Vienna Convention provides that a state, which is party to a treaty, is obliged to refrain from acts, which would defeat the object and purpose of the treaty. Article 26 of the Vienna Convention lays down the principles that every treaty in force is binding upon the parties to it and must be performed by them in good faith. Further, Article 27 provides that a party may not invoke the provisions of its internal law as justification for its failure to perform a treaty. It is pertinent to note that Article 27 is without prejudice to Article 46, which provides that a state may not invoke the fact that its consent to be bound by a treaty has been expressed in violation of a provision of its internal law regarding competence to conclude treaties as invalidating its consent unless that violation was manifest and concerned a rule of its internal law of fundamental importance. Article 46 further provides that a violation is manifest if it would be objectively evidenced to any state conducting itself in the matter in accordance with the normal practice and in good faith.

In view of established principles under the Vienna Convention, India should have ideally refrained from introducing laws which would have an impact on its obligations under a tax treaty. Further, Article 51 of the Constitution of India *inter-alia* also provides that "*the state shall endeavor to foster respect for international law and treaty obligations in the dealings of organised peoples with one another; and encourage settlement of international disputes by arbitration*". Thus, the Constitution of India also considers the obligations under the tax treaty and any act of overriding these should be seen as a violation. Accordingly, the introduction of equalisation levy (in a way which overrides the tax treaties) does not align with the Vienna Convention and with Article 51 of the Constitution of India.

In Conclusion, tax administrations of countries must join together to evolve a fair system of taxing digital businesses. Isolated actions that are fraught with double taxation and overarching compliances are likely to throttle business, and hence would be regressive. This is particularly important for growth driver economies such as India with its leadership under dynamic Prime Minister Sri Narendra Modi propagating flagship schemes such as Make in India, Digital India etc. If the economic result of an activity is not in accordance with the arm's length principle, the transfer pricing principles need to be strengthened to address the challenges rather than engaging in disparate actions at the level of each country.

[1] Pinstrom Technologies (P) Ltd (24 Taxmann.com 345); Yahoo India (P) Ltd (46 SOT 105)

[2]Right Florist Private Limited (32 Taxmann.com 99)

[3] Address the tax challenges of the digital economy

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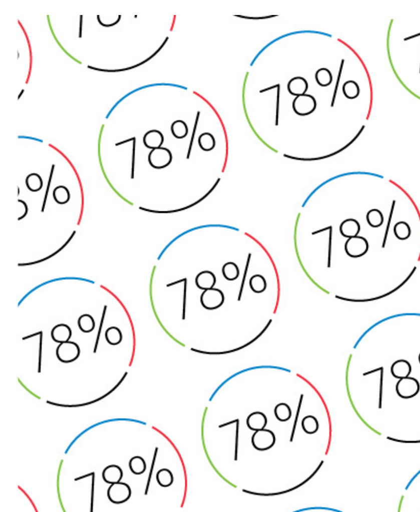

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