

Dr R B Krishna

Advocate Karnataka High Court and Former Member of Income Tax Appellate Tribunal, India

Santosh Kumar Jaiswal

PhD Research Scholar, Jain University, Bangalore, India

ABSTRACT

The Electronic commerce has challenged the very fundamentals of tax principles. The Tax principles relating to Permanent Establishment are based on the physical presence test. However, the Electronic Commerce do not require any physical presence, thus resulting in difficulty in tax administration. This difficulty has led to the introduction of a new Levy called "Equalisation Levy". Equalisation Levy is on payments made to non-residents for providing specified services, who do not have a Permanent Establishment in India. OECD in its report on Action Plan 1 - "*Addressing the tax challenges of the Digital Economy*", has put forth three proposals as an interim measure. The Central Board of Direct Taxes ("CBDT") constituted a committee on taxation of e-commerce. The Constitution of India does not list the Equalisation Levy in any of the specific entries that deal with taxing powers in Lists I, II or III of the Seventh Schedule. The Government of India has taken an uncharted step by introducing the Equalisation Levy which none of contemporary Government across world has taken. This levy of Government of India seems to be in correct direction keeping in mind the taxation and regulatory framework of international tax law.

Keywords: Equalisation Levy, Income Tax, BEPS, OECD, OIDAR, Digital economy, e-commerce

1.0 BACKGROUND

1.1 The Equalisation Levy was introduced in India by the Finance Act 2016. The basis for the introduction of such a levy was to tax certain online transactions which were earlier escaping taxation. To formulate this new Levy, it took into consideration the recommendation of the Report on Action Plan-1 of Organization for Economic Cooperation and Development (OECD's) BEPS Project¹.

1.2 OECD in its report on Action Plan 1- "*Addressing the tax challenges of the Digital Economy*", has put forth three proposals as an interim measure:

- ❖ A new Nexus based taxation on the significant economic presence,
- ❖ Withholding tax on digital transactions, and
- ❖ Equalisation levy, to address the broader direct tax challenges of the digital economy.

¹ "Base Erosion and Profit Shifting" <http://www.oecd.org/ctp/beps/>

- 1.3 After the issuance of the OECD interim Report, UK and Australia, have initiated steps to plug the concerns raised by OECD's BEPS project, by introducing "Diverted Profit Tax"² and "Multinational Anti Avoidance Law"³ in their respective countries. India has also taken the lead by introducing 'Equalisation Levy' as a self-contained code to tax e-commerce transactions under a new Chapter VIII of Finance Act, 2016.
- 1.4 The Central Board of Direct Taxes ("CBDT") constituted a committee⁴ on taxation of e-commerce with the following objectives: -
- ❖ to detail the business models for e-commerce
 - ❖ to identify the direct tax issues with regards to e-commerce transaction and
 - ❖ Suggesting various approaches to deal with these issues under different business models.
- 1.5 The CBDT Committee on taxation of e-commerce noted that taxing by way of equalisation levy is an operationally simpler option. The Committee in its report dated February 2016 proposed that the equalisation levy may be levied on specified digital services and facilities including online marketing, online advertisement, cloud computing, website designing, hosting and maintenance, digital space, digital platforms for sale of goods and services and online use or download of software applications.
- 1.6 On the recommendation of the aforesaid Committee report, a new levy called "Equalization Levy" was introduced. The Equalization levy was introduced with effect from 01st June 2016. A levy of 6% on the gross amount of consideration for specified services⁵ received by a non-resident not having Permanent Establishment ('PE') in India, from a resident in India who carries on business or profession, or from a non-resident having PE in India, was introduced.

2.0 ABOUT EQUALISATION LEVY

- 2.1 The Electronic commerce industry has created a new class of transactions, which are dependent on digital and telecommunications network. They do not require any physical presence and derives its value from data generated and collected within its networks.
- 2.2 The Electronic commerce has challenged the very fundamentals of tax principles, i.e., right to taxation across jurisdictions and the very concept of Permanent Establishment ("PE"). While the present principles on Permanent Establishment are based more on the physical presence test, the evolution of the new business models seem to have made the need for physical presence superfluous, resulting in difficulty in tax administration. It has led to the introduction of Equalisation Levy.

² Introduced by United Kingdom w.e.f. 01-04-2015. It imposes a levy on company profits that are routed via "contrived arrangements" to tax havens and lacking economic substances.

³ Introduced by Australian Government w.e.f. 01-01-2016

⁴ Report of **Committee on taxation of e-commerce** <http://incometaxindia.gov.in/news/report-of-committee-on-taxation-of-e-commerce-feb-2016.pdf>

⁵ The Equalization levy, currently, only covers online advertisements and related services and that the Central government has powers to notify other services

2.3 THE SALIENT FEATURES OF THE EQUALIZATION LEVY

- ❖ It seeks to levy 6% tax on the gross amount of consideration for specified services.
- ❖ The consideration for specified services received/receivable by a non-resident not having a permanent establishment in India,
- ❖ From a resident engaged in business or profession or from a non-resident having a permanent establishment in India.
- ❖ The tax would be levied not through the Income-tax Act, but by inserting a new Chapter – Chapter VIII, in the Finance Act, 2016.
- ❖ The threshold limit to trigger the equalisation levy was fixed at one lakh rupees.

2.4 The Equalization levy would be administered by the Income Tax Department and would be subject to assessment, appeals, etc., as applicable to income-tax levied under the Income-tax Act, 1961.

2.5 As mentioned above, the provisions are not applicable in the following situations:

- ❖ Where the non-resident providing the specified service has a permanent establishment in India and such service is effectively connected with the permanent establishment; or
- ❖ The aggregate amount of consideration for specified services received or receivable in a financial year by the non-resident from the resident carrying on business or profession or from the non-resident having a permanent establishment in India does not exceed one lakh rupees.

3.0 PROVISIONS OF THE INCOME TAX ACT, 1961 ('THE ACT')

3.1 Consequent to the introduction of the equalisation levy, vide the Finance Act 2016, the following amendments were carried out in the Act:-

- ❖ Section 10(50) of the Act has been introduced to provide that any income arising from a specified service and chargeable to equalisation levy, shall be exempt from tax; and

The Memorandum Explaining the provisions of the Finance Bill, 2016 explains the purpose of the provision as follows:-

"In order to avoid double taxation, it is proposed to provide an exemption under section 10 of the Act for any income arising from providing specified services on which Equalisation Levy is chargeable."

- ❖ Section 40(a)(i b) of the Act has been introduced to disallow the consideration paid or payable to a non-resident for specified services on which equalisation levy is deductible and such levy has not been deducted or after deduction has not been paid on or before the due date for filing the return of income.

However, where the deduction for equalisation levy is made in any subsequent financial year or made during the financial year but paid after the due date for filing the return of income, then the related consideration shall be allowed as a deduction in computing the income of the financial year in which such levy is paid.

4.0 PROVISIONS OF THE DOUBLE TAX AVOIDANCE AGREEMENT (“DTAA”)

4.1 There is no ambiguity that the Equalization levy is in the form of withholding tax. The levy of Income tax is on Income which is chargeable to tax in India. In the present scenario, the levy is on payments made to non-residents for providing specified services, who do not have a Permanent Establishment in India.

It is pertinent to note that the Government of India is levying Equalization Levy, not through the provisions of the Income-tax Act, 1961 but by introducing a new Chapter in the Finance Act 2016. It implies that the Government of India does not believe that the levy, would be able to withstand the test of constitutional validity if it becomes a part of the Income-tax Act.

4.2 Furthermore, in case of a non-resident having a permanent establishment in India, the deduction for expenditure is ordinarily allowable under Article 7(3) of the relevant DTAA between India and the country of which the non-resident is a resident. Certain DTAA's permit deductibility of expenses '*by the provisions of and subject to the limitations of taxation laws of the Contracting State*'. Certain other DTAA's based on the language of the OECD Model do not have these limiting words.

4.3 In respect of aforementioned DTAA's; there is a controversy as to whether the limitation in the Income-tax Act, 1961 is applicable in the computation of business profits of a non-resident.⁶ In other words, if a non-resident fails to pay the equalisation levy, will he be assessed under the provision of the Income-tax Act or the relevant provision of the DTAA?

4.4 Further, attention is drawn towards Vienna Convention about the interpretation of tax treaties. According to the provisions of the Vienna Convention, it can be argued that Equalization Levy is a unilateral step on the part of Government of India (though proposed by OECD's BEPS project). The levy has been introduced without any corresponding changes/amendment initiated into the existing tax treaties. This tantamount to treaty override and is contrary and in violation of internationally recognised principles. India, on the contrary, is not a signatory to Vienna Convention. However, a question may come up, that whether the principles laid down by Vienna Convention would apply to India.

The Indian Judiciary from time to time has embraced the Vienna Convention on the Law of Treaties and recognised that the Vienna Convention codifies many principles of customary international law. So, though India is not a signatory to Vienna Convention yet the principles laid down therein may be applied for interpretation of tax treaties signed by India with several countries.

Further, Article 51(c) of the Constitution of India provides that India shall endeavour to foster respect for international law and treaty obligations and unlike some other countries India does not permit treaty overriding through its domestic law. Further, section 90(2) of the Income Tax Act 1961 provides that the provisions of the Act will apply to the extent they are more beneficial vis-à-vis treaty provisions.

⁶ State Bank of Mauritius Ltd. v. DDIT 2012-TII-179-ITAT-MUM-INTL and Sate Bank of Mauritius Ltd. v. DDIT 2012-TII-230-ITAT-MUM-INTL; Mashreqbank PSC v. Dy. DIT [2007] 14 SOT 1 (Mum.); Asstt. DIT v. Dalma Energy LLC [2012] 136 ITD 208 (Ahd.).

In view of the above discussions, one may argue that the imposition of Equalisation Levy is a clear case of treaty override as it takes away the benefit otherwise provided by tax treaties.

5.0 CONSTITUTIONAL VALIDITY OF EQUALISATION LEVY

5.1 The Constitution of India does not list the Equalisation Levy in any of the specific entries that deal with taxing powers in Lists I, II or III of the Seventh Schedule. The Equalisation Levy on the online advertising can be linked with Entry 55 of List II of the Seventh Schedule to the Constitution of India. However, the same could be challenged based on two reasons:

- i) The scope of the Equalisation Levy is not limited to only online advertising – it is just that this service is the first to be specified, and
- ii) The tax or the levy or the charge is not on profits from advertisements, but it is on the gross consideration received for such online advertisement services by the non-resident.

5.2 We may also add that the Equalization Levy cannot be treated as a Goods and Service Tax (“GST”) either, for the following two reasons:

- i) It already attracts GST as per Integrated Goods and Service Tax Act 2017 (IGST) under the OIDAR services; and
- ii) The taxable event, in this case, is not the supply of service. The taxable event is the consideration received/receivable by the non-resident for the specified services.

To sum up, it appears that the Equalisation Levy has been levied as per Entry 97 of List I of the Seven Schedule of the Constitution of India, which empowers the Union to enact laws on any matter not covered by Lists II or III.

6.0 ADMISSIBILITY OF FOREIGN TAX CREDIT

6.1 Article 2 of India-USA tax treaty defines "taxes covered".

Paragraph 2 of the said Article 2 provides that:

"The Convention shall also apply to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any significant changes which have been made in their respective taxation laws and of any official published material concerning the application of the Convention."

Further, Paragraph 1 of Article 25 of India-USA tax treaty which deals with "Relief from Double Taxation" provides as under:-

"In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall allow to a resident or citizen of the United States as a credit against the United States tax on income –

(a) the income-tax paid to India by or on behalf of such citizen or resident; and

*(b) ***

alternatively, the purposes of this paragraph, the taxes referred to in paragraphs 1(b) and 2 of Article 2 (Taxes Covered) shall be considered as income taxes."

- 6.2 On a conjoint reading of Articles 2 and Article 25 of India-USA Tax Treaty, it is clear that this tax treaty is also applicable to taxes which are **identical or substantially similar to income tax**. Given this, the USA may grant its residents the credit of such taxes paid in India. Thus, even if Equalisation Levy is not a tax on income, yet it falls under the extended definition being **identical or substantially similar to income tax**. On this analogy, USA may provide to its residents the credit of "Equalisation Levy" paid in India.

The law laid down in these Articles forms part of many other Tax Treaties signed by India with other countries, and thus, the benefit of such credit may be availed by residents of many other countries as well.

7.0 CONCLUSION

- 7.1 The introduction of the Equalization Levy can be construed as a small step in the right direction by the Government of India towards taxing digital transactions. However, whether it is right step by Government is a debatable issue. Further, the allow ability of the foreign tax credit on the Equalization levy in their respective country of residence is not free from doubts.
- 7.2 Currently the specified services notified by Government only include services relating to an online advertisement provided by the Non-resident who does not have a Permanent Establishment in India. However, the specified services could be widened by the Government over time to include other services as well so that it covers all gamuts of e-commerce transactions done for or by e-commerce consumer in India.
- 7.3 To conclude, the Government of India has taken an uncharted step by introducing the Equilisation Levy which none of contemporary Government across world has taken. This levy of Government of India seems to be in correct direction keeping in mind the taxation and regulatory framework of international tax law.

8.0 REFERENCES

- 1) Report of **Committee on taxation of e-commerce** <http://incometaxindia.gov.in/news/report-of-committee-on-taxation-of-e-commerce-feb-2016.pdf>
- 2) "Base Erosion and Profit Shifting" <http://www.oecd.org/ctp/beps/>
- 3) Constitution of India. <http://lawmin.nic.in/olwing/coi/coi-english/coi-4March2016.pdf>
- 4) The Integrated Goods and Services Tax, 2017
- 5) Relevant section of the Income Tax Act 1961