

## Equalization Levy: Understanding the subtleties between the letter of the law and the spirit of the law

*'It is the spirit and not the form of law that keeps justice alive.'* - Earl Warren, American lawyer



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### Background

The digital economy is gaining traction globally, with reduced dependence solely on a pure brick and mortar business model. The proliferation in the online provision and sale of services and goods respectively has increasingly caught the attention of tax policymakers as a sizeable tax base that could be harnessed for realization of tax revenues.

Further, with the ongoing lockdowns and COVID-19 stay-at-home precautions, it is expected that India will witness an e-commerce boom in the coming days. An increasing number of households are opting for e-commerce purchase of daily groceries, medicines and other essentials with convenient home deliveries. Reports suggest that the e-commerce business opportunity is expected to touch a whopping \$200 bn by 2026. The burgeoning digital economy presents a substantial taxable revenue pool for the Indian exchequer.

### Overview

With technology making rapid inroads into every sphere of our daily lives, bringing with it the convenience factor, several new business verticals emerged, with e-commerce being the most prominent. Further, the Central government's laudable move to proactively support and encourage the Digital India movement aided in the digital transformation of transactions via a digital platform. In hindsight, with the continuing onslaught of the COVID 19 pandemic, one can say with surety that this digital thrust and reduced dependence on solely physical channels was truly a blessing in disguise. Alongside, all these developments have resulted in the creation of new, potential tax avenues.

## **The bone of contention: The growing consensus on the need to tax profits from the digital economy**

The Organisation for Economic Co-operation and Development (OECD) has been in active discussions to resolve this dispute regarding the tax avoidance by foreign companies that do not pay tax in countries from which a huge consideration by way of revenues or profits is realized from business transactions carried out in those nations. The OECD had suggested an equalization levy under the OECD's BEPS (Base Erosion and Profit Shifting) Action Plan 1, which was adopted by India in 2016.

The OECD, in a whitepaper, recommended an action plan towards the implementation of the digital tax as follows:

1. Tax amount to be mutually decided between countries to arrive at a consensus solution.
2. Tax liability to be determined as per prevailing transfer pricing rules, in cases where the e-commerce player functions as a distributor.
3. Establishment of a robust, functional dispute resolution framework for tax-related litigations.

However, there was a need for clarity on the characterization, valuation and chargeability of tax, given the absence of a tangible physical presence in most circumstances. Recognizing the need to continuously broaden the tax base and prevent any potential erosion to the tax revenues from the digital economy, the concept of equalization levy was introduced in Budget 2016, which brings within its ambit certain digital transactions. The levy is also popularly referred to as digital tax. Subsequently, in the Finance Act, 2020, the Indian government expanded the coverage of the levy.

### **Understanding the levy in the Indian context**

In 2016, India introduced an Equalisation Levy chargeable at the rate of 6 per cent on non-resident companies that operate in the business of online advertisement. With effect from April 2020, the ambit was enhanced to cover Equalisation Levy chargeable at 2 per cent on consideration received or receivable by non-resident e-commerce operators from the digital supply of goods or online provision of services or related facilitation to an Indian or India-based entity, conducted through an overseas e-commerce platform. Further, the net covers the entire gamut of B2B and B2C transactions.

Indian stakeholders, mainly start-ups that utilize such platforms for marketing, requested for reconsideration or a postponement of the tax implementation, citing additional tax burden. It also evinced an immediate reaction from several foreign technology behemoths such as Google, Facebook, Microsoft and Amazon, who approached the US Trade Representative office for intervention. This may be understood in the backdrop that most of the global technology players predominantly belong to the US. India has a strong case and can hold its ground as the levy is non-discriminatory and does not specifically discriminate against US businesses.

### **Salient features**

The Equalisation Levy falls under the purview of direct taxes, with a tax withholding clause at the time of payment by the recipient.

Broadly, the coverage of e-commerce supply or services includes

- Online sale of goods owned by e-commerce operators
- Online provision of services by e-commerce operators
- Facilitation of online sale of goods or provision of services or both by an e-commerce operator
- Any combination of the above activities.

Further, the tax coverage is not restricted only to resident Indians. Aligned to the objective of taxing transactions undertaken in the digital economy, the underlying rationale is to cover revenues realized from an IP address located in India.

The levy is applicable on consideration received by the e-commerce operator on the above transactions from:

- A person resident in India
- A non-resident in the following instances:
  1. Sale of advertising, with a target customer being a resident in India, or a customer with an IP address located in India who accesses the advertising.
  2. Sale of data, collected from a person who is resident in India or from a person who uses an IP address located in India.
- A person who buys goods or services, or both, and uses an IP address located in India.

### **Equalisation Levy: A step in the right direction**

On grounds of equitable taxation, it is fair to tax transactions carried out via foreign digital platforms, since Indian counterparts with a permanent physical establishment are taxed. This is aligned to the spirit of providing a level playing field to business entities within India with an e-commerce related tax responsibility. The intention behind the levy is justified.

Based on the tax principles of protection of tax base erosion and profit shifting concerns, taxing global MNCs that earn huge amounts of revenue from India but are not covered under a corresponding domestic tax net is fair. With the intention to reduce tax liabilities, MNCs are involved in the creation of multiple subsidiaries, especially in low tax regimes, often with the absence of a tangible physical set up. This results in shifting of profits, often to the tax disadvantage of the income source nation.

### **Reading the fine print: Bottlenecks in effective implementation**

However, there are grey areas in the current form of the law that need clarification as to the exact demarcation on the coverage. The concern is that the broadly worded law results in the inclusion of a wide range of digital platforms, making it susceptible to diverse interpretation with scope for tax disputes and litigation. There is need for clarity on the specified digital transactions that are taxable. Further, the mention of the use of an Indian IP address might result in operational challenges during implementation. Another area that needs clarification is that whether the levy is to be charged on the gross value of goods or services transacted via the portal or on the commission charged by the e-market operators or aggregators. Additionally, it must be kept in mind that the levy imposed falls under the jurisdiction of the Finance Act, 2016 as against the Income Tax Act, 1961. As per prevailing practice, bilateral tax treaties with India cover income tax and related taxes. Accordingly, in this case, a credit claim of the levy against a tax liability in the resident country may not be approved. This would result in a situation of double taxation for the ecommerce players.

### **The way forward**

It is worthwhile to keep in mind that India is not alone in the imposition of an equalization levy. Recognizing the digital tax revenue opportunity, several other nations namely Austria, Brazil, the Czech Republic, the EU, Indonesia, Italy, Spain, Turkey, and the U.K. have imposed similar levies, referred to as digital sales tax, to boost the earnings of their treasuries.

Many Indian start-ups use global digital platforms for advertising, towards brand building and marketing. It is believed that the tax burden of the levy is eventually passed on to these Indian

enterprises that bear the additional cost. In such a case, the imposition of levy would be counterproductive. On the one hand, the government is encouraging entrepreneurship under the Start Up India scheme and, on the other hand, the additional tax liability is ultimately percolating to the start-up ecosystem which would prove a constraint for their marketing initiatives. Given the current economic downturn triggered by the COVID 19 pandemic and its adverse financial impact on start-ups, it might be prudent to finetune the rules so that the tax burden does not fall upon the Indian start-ups.

Additionally, it might be prudent for the government to encourage global digital companies to set up and establish Indian legal entities or local offices with a registered address and pay GST and income tax from profits accruing within the Indian jurisdiction. Further, the government should also tighten regulations to ensure that these global digital companies raise invoices from their Indian legal entities and pay the applicable taxes to ensure that there is no undue benefit to them vis a vis an Indian company. This would also open up new job opportunities in the domestic economy.

Ultimately, the spirit or essence of the law should serve the intended purpose. The form may be suitably altered to align to the best interests of India and Indian start-ups. After all, it should not become a case of missing the woods for the trees.

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