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## India's new 2 percent equalisation levy on the digital economy enters into force

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By **Vinita Krishnan & Jugal Mundra, Khaitan & Co, Mumbai**

On April 1, India ushered in a new era of taxation in the digital age. In a significant move to widen its tax net on the digital economy, India announced that an equalisation levy at the rate of 2% will apply to e-commerce sales and services by non-resident operators to Indian customers, among others.

This equalisation levy is wide in its scope, covering both B2C as well as B2B transactions.

In 2016, India had first introduced an equalisation levy on payments received by non-residents (subject to certain conditions) for online advertising and allied services at the rate of 6%.

The equalisation levy, which has now been widened, is in the backdrop of efforts by OECD (Organisation for Economic Co-operation and Development) and G20 nations to arrive at a consensus-based solution on taxing the digital economy appropriately.

Notably, other countries, like the United Kingdom, Austria, and Italy, have also introduced unilateral measures to tax the digital economy in recent months.

Now, what exactly does the widening of this equalisation levy in India mean for e-commerce players, and what are the challenges that are likely to arise in the implementation process? Let us dive deeper.

### India's 2% equalisation levy

The equalisation levy will be chargeable at 2% on consideration receivable by a non-resident "e-commerce operator" for "e-commerce supply or services" provided or facilitated by it on or after April 1, 2020.

An "e-commerce operator" is anyone who owns, operates, or manages a digital/electronic facility/platform for the online sale of goods or the provision of services or both. "E-commerce supply or

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services" is defined to mean the online sale of goods or services (including facilitation of the sale of such goods or services) by an e-commerce operator.

The applicability of this 2% equalisation levy has also been defined to cover as wide a range of transactions as possible.

The equalisation levy will apply when a sale is made, or service is provided to either an Indian resident, or to any person who buys goods or services using an internet protocol (IP) address located in India, or to a non-resident in 'specified circumstances.'

These 'specified circumstances' include firstly, the sale of advertisement targeting an Indian resident customer or a customer accessing the advertisement through an Indian IP address, and secondly, the sale of data collected from Indian residents or from persons who use an Indian IP address.

### Compliance obligations

The responsibility for ensuring compliance with the 2% equalisation levy provisions (including payment) lies with the non-resident e-commerce operator.

For the 6% equalisation levy on online advertising activities, the resident service recipient is responsible for all related compliances.

The equalisation levy is required to be paid on a quarterly basis, and prescribed statements must be furnished annually.

Accordingly, the equalisation levy on e-commerce supplies or services from the April-June quarter this year is payable by July 7.

Non-compliance with payment of the equalisation levy would attract interest at 1% per month and a penalty equal to the amount of the equalisation levy. Also, it is noteworthy that the payer can also be treated as a representative assessee (essentially like an agent) in the case of non-compliance with the equalisation levy.

Therefore, in contracts for e-commerce supply or services (chargeable to the equalisation levy), especially in the case of B2B transactions, payers would need to ensure enough safeguards are considered.

### Exclusions from equalisation levy

An "e-commerce operator" is specifically excluded from the 2% equalisation levy charge when the e-commerce operator has a permanent establishment (PE) in India and the e-commerce supply or service is effectively connected with this PE; the transaction is of online advertisement and related activities where equalisation levy is leviable at 6%; or if the turnover of the e-commerce operator (on which the 2% equalisation levy is otherwise leviable) is less than INR 20 million (approx. USD 260,000) during the financial year.

### Scope of 2% equalisation levy

The India equalisation levy provisions apply very broadly. Businesses within the scope of the 2% equalisation levy include, inter alia, online marketplaces; subscription-based platforms, including social media; cloud services; search engines; streaming services; and online gaming.

The tax may also cover digital/online services provided by MNEs to their Indian group companies. Further, the equalisation levy is chargeable even on e-commerce transactions executed by non-residents if it is from an IP address located in India and on transactions between two non-residents for data collected from Indian customers.

### Income tax vis-à-vis 2% equalisation levy

Notably, the equalisation levy is not a part of the domestic income-tax law and is also levied beyond tax treaty provisions.

Technically it is neither an income-tax nor indirect tax. Therefore, whether the equalisation levy will be considered as qualifying for a foreign tax credit will need to be evaluated based on the domestic law provisions of the country in which the foreign tax credit is sought to be claimed.

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Also, while payments chargeable to the new equalisation levy are also exempt from income tax, the exemption is applicable only from April 1, 2021. Therefore, in the absence of any clarification, transactions at least until March 31, 2021, would be subject to both income-tax and equalisation levy, resulting in a double whammy.

### India's 2% equalisation levy – issues

Considering the nascent nature of the 2% equalisation levy and the absence of any accompanying guidance or clarifications, several issues and concerns have arisen. Let us examine some of the key concerns.

First, the exact interplay between India's equalisation levy and the income-tax provisions needs further clarification.

For example, historically, there has been a constant debate on whether the characterisation of income from a software license arrangement is royalty or business income. On the one hand, courts have held that in the case of a license of software, the right to commercially exploit the product is not transferred and only a limited right to use the 'copyrighted product' (i.e., the software) for end-users' internal use is granted and, therefore, in the absence of a definition specifically including the usage of software, the income is the nature of 'business income' and not a 'royalty.'

On the other hand, some courts have held that under a software license arrangement, the right to reproduce the work including storing it in any medium by electronic means is deemed to have been conveyed to the end-user and hence there is a transfer of rights in respect of a copyright in software and the income therefrom is in the nature of 'royalty'.

In such cases, if the software is provided online, clarity is needed regarding whether it should be subject to only equalisation levy at 2% or would it be taxed as royalty at 10% (excluding surcharge and cess) or both (at least until March 31, 2021).

This is pertinent even for the payers, as it can have a bearing on their ability to claim expenses or be chased either for a shortfall in withholding tax or as an agent of the foreign entity, particularly if proper withholding tax is not done and if it is taxed as royalty as against equalisation levy.

Therefore, it is imperative that adequate contractual safeguards are plugged in, especially from the payer's perspective.

Second, clarification is required concerning the applicability of the equalisation levy to transactions wherein some part of the transaction is executed online, and the remaining part is executed offline. For instance, a room in a Singapore hotel may be booked online by accessing the hotel's website from India, but the service is provided offline. It is debatable whether the entire consideration received in such cases is for 'online provision of services' that is chargeable to equalisation levy.

Third, e-commerce supply or services provided to a resident in India by a non-resident e-commerce operator are subject to equalisation levy. Going by a literal interpretation of the law, would services availed online by an Indian resident on his/her visit to a foreign country also be subject to equalisation levy? Perhaps, it may not be intended and, thus, requires clarity.

Fourth, in the case of marketplace models, while the marketplace may initially receive the full sales consideration from the buyer, most of it is eventually passed on to the actual seller, and the marketplace retains only a facilitation fee. Clarification could be provided on whether the equalisation levy is to be paid on the entire sales consideration or only the facilitation fees received by the non-resident e-commerce operator. As of now, it seems that equalisation levy is applicable to the entire sales consideration and not limited to the facilitation fee.

Fifth, guidance is required on the applicability of the equalisation levy to B2B arrangements that are modeled on a master service agreement or inter-service agreement.

For instance, assume that A Co (an Indian company) is a subsidiary of FCo1, a foreign company. FCo1 enters into a master service agreement with FCo2, another foreign company, whereby FCo1 pays consideration to FCo2 in lieu of FCo2 providing certain online software services to A Co and other subsidiaries of FCo1. FCo1 subsequently cross-charges A Co and its other subsidiaries for the amount paid to FCo2. Now, whether the equalisation levy is payable, either by FCo1 or FCo2, is a matter of



deeper evaluation depending upon exact terms of the contractual arrangement and whether the relationship between A Co, FCo1, and FCo2 is on a principal to principal basis or as an agency.

Sixth, one hopes that the compliance mechanisms (as the forms are yet to be announced) would factor any adjustments/refunds of equalisation levy for transactions that are subsequently reversed (for instance, the sale of a product on an online marketplace that is subsequently returned after few days of purchase).

Last but not least, an appeal mechanism has been provided only for the penalty amount levied in the case of non-payment of equalisation levy, and not for equalisation levy assessed by the assessing officer. The Indian government could consider extending the appeal mechanism to an equalisation levy assessment as well, since the only remedy available for appeal against the assessment of the equalisation levy appears to be the filing of a writ to the jurisdictional High Court.

## The way forward

Businesses based offshore and engaged in online supply of goods or services must swiftly evaluate the impact of the new equalisation levy provisions, including reassessing their business model, and evaluating if the creation of a business presence in India is a better alternative. Pricing of India-centric products and services should also be reviewed.

Businesses must take necessary action to reconfigure systems and processes to ensure compliance, considering that among other things, the equalisation levy applies when goods or services are bought online using IP address located in India. Where necessary, businesses must also engage in policy dialogue with the government.

Given that the equalisation levy is technically not an income-tax nor indirect tax, it is important to look into the contractual terms, especially while conducting a due diligence, and also assess if there is any possibility to claim any foreign tax credit in the home country jurisdiction, as otherwise, it can result in a sunk cost.

In conclusion, it is noteworthy that while several countries have imposed unilateral measures for taxing the digital economy, countries that are part of the OECD/G20 Inclusive Framework (which includes India) have agreed to withdraw unilateral measures upon reaching a consensus-based solution for taxation of the digital economy.

However, for now, businesses in the digital economy catering to customers based in India must factor in the impact of equalisation levy and take necessary steps to ensure compliance.

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