India's Abruptly Expanded Digital Tax

by Anshu Khanna

Anshu Khanna

Anshu Khanna is a partner with Nangia Andersen LLP in San Francisco.

The author thanks her colleague Amit Gupta, associate director with the firm, for collaborating on this article with her.

In this article, the author discusses India's recent and unexpected update to its equalization levy — the country's unilateral effort to tax the digital economy. She offers some background and provides suggestions for technology companies about how to respond.

On March 27 India surprised the international community by releasing a second iteration of its equalization levy (EL 2.0) in a rushed and unusual manner.[1] Normally, all finance bill proposals are sent by the Finance Ministry to the Parliament in February for review and debate; they are subsequently submitted for formal presidential approval, to eventually become the Finance Act effective April 1 (the start of the new financial year). However, EL 2.0 provisions were instead added at the eleventh hour directly for presidential approval.

Discussed in greater detail below, EL 2.0 has a very broad ambit — any nonresident e-commerce operator with an Indian consumer base must pay a 2 percent levy on its gross transaction value. The tax caught the technology sector by surprise since there was no prior notice or consultation. The new digital tax has raised concerns on multiple fronts, including that it generates a heavy commercial and compliance burden, overlaps with other taxes, and (last but certainly not least) is being rolled out at a time when the world is dealing with a pandemic of epic proportions.

The U.S.-India Business Council, Information Technology Industry Council, Japan Electronics and Information Technology Industries Association, Asia-Pacific MSME Trade Coalition (representing micro, small, and medium enterprises), and DigitalEurope penned a joint letter to the Indian finance minister opposing the levy and seeking deferral of the tax to allow for consultations with stakeholders. Further, numerous technology companies have asked the U.S. government and global business groups to step in and pressure India to remove the levy immediately.

This article will discuss the need for digital taxes in a rapidly changing world and India's prior attempts to impose a levy on digital transactions before turning to examine the key features of EL 2.0 and some of the technology companies' key concerns with the tax. Finally, this author offers some suggestions for companies going forward.

Changing Taxes for a Changing World

Digital business models are evolving rapidly, and global tax laws have not been able to keep pace. Key challenges for those seeking to tax the digital economy include defining nexus, attributing value to data and intellectual property, characterizing payments and income, and identifying the situs of a transaction. Absent revised presence or nexus rules that allow for taxes to be imposed on digital businesses, jurisdictions that provide the consumer base or

[1] Stephanie Soong Johnston, "India Expands Equalization Levy Net to Tax Foreign E-Commerce," *Tax Notes Int'l*, Apr. 6, 2020, p. 91.

marketplace for online companies are often left starved for tax revenue.

Market jurisdictions, including India, argue that user participation — and therefore user location — is the key driver of value for digital companies. India is the world's second largest online market. In particular:

- India has 670 million internet users, representing 12 percent of the global user base. The United States only accounts for 8 percent.
- The size of India's online retail market is $33 billion. It is expected to reach $187 billion by 2027.
- India's online spending per buyer is high compared with the spending levels in many developed economies. Online spending in India approximated 8 percent of India's per capita GDP in 2018. The same figure was 5 percent in the United Kingdom and 3 percent for Japan, Korea, and the United States. The much-publicized investments in Reliance Jio, an Indian telecommunications company, by Facebook and top private equity firms are a harbinger of tremendous digital growth.
- India is the fastest-growing consumer of media in the world. In March people in India spent 591 minutes per person on YouTube, moving ever closer to the 1,048 minutes consumed per person in the United States.
- India is likely to become a $10 billion market for software as a service this year, accounting for nearly 8 percent of the global market.

The already high levels of internet usage and involvement in the digital economy, combined with the market's growth potential, have attracted global technology companies of all sizes and prompted them to make significant investments in India. Given the rapid growth of the technology sector, Indian tax laws are necessarily evolving to account for the changing digital landscape.

The OECD's Work on Digital Taxes

The EL 2.0 is, in part, a response to the OECD base erosion and profit-shifting project's final report on action 1, "Addressing the Tax Challenges of the Digital Economy." Paving the way for a consensus-based approach to taxing the evolving digital economy was — and remains — a top priority for the BEPS project and the inclusive framework. The action 1 report presented three options for taxing digital transactions:

- a new form of nexus based on significant economic presence (SEP) — this approach would find a taxable presence exists when a nonresident enterprise has an SEP based on evidence of a purposeful and sustained interaction with a country's economy using technology or automated tools;
- a withholding tax on digital transactions — this would target payments for goods and services that residents purchase online from nonresident providers; and
- an equalization levy — this would address the broader direct tax challenges of the digital economy and ensure equal treatment of foreign and domestic suppliers.

A global consensus could not be reached in favor of any of these options. While the multilateral instrument began to incorporate the results of several of the other BEPS action plans into many tax treaties, debates regarding action 1 continued and some jurisdictions took unilateral action.

On January 31 the OECD released a statement presenting a two-pillar approach to the challenges of the digital economy. The statement focuses on a so-called unified approach, with pillar 1 addressing nexus and profit allocation challenges arising from digitalization and pillar 2 focusing on the development of a global anti-base-erosion proposal. Pillar 1 acknowledges the importance of market jurisdictions and seeks to provide them with additional taxing rights. It also offers changes to the arm's-length standard for allocating profits related to distribution and marketing functions. Pillar 2 presents a global minimum tax for multinational corporations and introduces several measures to prevent the shifting of profits to low-tax jurisdictions, including the income inclusion rule, the undertaxed payment rule, the switchover rule, and the subject-to-tax rule. The unified approach would bring about a paradigm shift in the international tax landscape. In its present form, it can only be enacted if there is consensus among countries.

The world is keeping close tabs on the OECD's work on pillars 1 and 2. The OECD originally set a deadline to finish this work by the end of 2020, but that may be pushed back to 2021. The inclusive framework jurisdictions are scheduled to meet, virtually, in July to discuss their progress, and a release addressing some technical nuances of the unified approach proposal is expected to follow.

For now, it's a wait-and-watch situation.

The History of India's Digital Tax

In response to the final report on action 1 — and in the absence of a global consensus — many countries adopted one of the three approaches presented therein. Countries including Australia, France, Italy, Spain, and the United Kingdom introduced digital services taxes. Conversely, Malaysia, Mexico, and Turkey opted for a withholding tax on digital transactions.

Through the Finance Act, 2016, India became the first country to introduce an equalization levy (EL 1.0), with the rate set at 6 percent. The scope was limited: EL 1.0 only applied to payments from Indian residents to nonresidents for online advertisements, any provision for digital advertising space, and any other facility or service for the purpose of online advertising. The levy was to be collected and deposited by the payer who receives the specified service.

In the Finance Act, 2018, India incorporated the concept of an SEP into the tax statutes, establishing a taxable nexus or business connection in India. In the Union Budget, 2020, India widened the scope of the SEP but deferred the application of the changes until April 1, 2022, awaiting the end of ongoing discussions on the thresholds for the SEP.

EL 2.0

Key Features

As noted above, India recently introduced EL 2.0, which significantly widens the scope of EL 1.0 to cover a wide array of e-commerce transactions and adapts the levy to ensure efficacy. EL 2.0 imposes a tax on revenues that nonresident e-commerce operators derive from Indian customers, on or after April 1.

Specifically, EL 2.0 imposes a 2 percent tax on revenue a nonresident e-commerce operator obtains from e-commerce supplies or services that it makes, provides, or facilitates to:

- Indian residents;
- persons buying goods or services using an Indian IP address; or
- nonresidents under specified circumstances including the sale of advertisements targeting Indian residents or customers using an Indian IP address and the sale of data collected from Indian residents and others using Indian IP addresses.

The term "e-commerce operator" is defined fairly broadly to mean "a non-resident who owns, operates, or manages [a] digital or electronic facility or platform for online sale of goods or online provision of services or both." The term "e-commerce supply or services" can mean any of the following:

- the online sale of goods that the e-commerce operator owns;
- the online provision of services by the e-commerce operator;
- an online sale of goods, a provision of services, or both, that the e-commerce operator facilitates; or
- any combination of these activities.

In practice, EL 2.0 applies to online content providers, online marketplaces or aggregators, online entertainment services, cloud computing services, online software sales or service transactions, online payment networks, online training providers, software-as-a-service companies, and more.

EL 2.0 applies to nonresident e-commerce operators if their aggregate sales, turnover, or gross receipts from the aforementioned covered supply or services exceed INR 20 million (approximately $260,000) annually. It is the responsibility of the nonresident e-commerce operator — not the buyer of the relevant supplies or services — to deposit the levy quarterly and meet all compliance obligations. The revenue that is subject to EL 2.0 is exempt from income tax; however, this exemption only applies to e-commerce transactions that take place on or after April 1, 2021.

EL 2.0 does not apply when the e-commerce operator has a permanent establishment in India and the e-commerce supply or service is effectively connected to the PE. Also, EL 2.0 does not apply if EL 1.0 already covers the transaction.

Digital Companies' Concerns

In addition to uncertainties regarding the structural viability and constitutional validity of EL 2.0, there are several other concerns regarding the measure including the limited details on coverage, definitions, modality, and so forth.

EL 2.0 is an additional cost to companies. Notably, it is a separate, transaction-based levy that is not part of the Indian Income Tax Act. This is important because tax treaties only cover income taxes and substantially similar taxes. Thus, a foreign company will not be able to get a corresponding tax credit in its residence jurisdiction.

EL 2.0 has a broad scope, significantly broader than EL 1.0. The newer levy seems to cover almost all digital companies. It is not limited to just nonresident-to-resident transactions; it also covers specified nonresident-to-nonresident transactions. For example, it applies to the sale of advertisements targeted at residents of India and the sale of data collected from residents in India (or accessed through an IP address located in India) — even if both parties to the transaction are nonresidents. EL 2.0 also covers business-to-consumer transactions. Moreover, the threshold for the levy is extremely low.

It is also important to remember that EL 2.0 is a tax on revenue — a levy on gross transaction value. Therefore, businesses with lower profit margins will face a higher marginal tax rate than businesses with higher profit margins.

The responsibility for complying with EL 2.0 and paying the appropriate taxes falls on the nonresident e-commerce operator. This makes it the nonresident e-commerce operators' responsibility to develop systems and processes to correctly identify transactions that are subject to the levy, quantify the levy outlay, and fulfill compliance obligations such as timely payment and accurate reporting. Such systems and processes will prevent adverse actions by the Indian tax authorities for any noncompliance.

Potential taxpayers must also understand EL 2.0's interplay with other tax rules, such as those regarding royalties or fees for technical services. Revenues that are subject to EL 2.0 are exempt from income tax — but only for transactions occurring on or after April 1, 2021. This rule gives rise to two concerns. The first is the proper characterization of income. After April 1, 2021, transactions will be subject to either EL 2.0 or Indian income tax. Companies must carefully consider the characterization of income; for example, distinguishing things like royalties and fees for technical services from transactions covered by EL 2.0. Once the characterization is made, it cannot be undone. It is an important decision, and transactions must be analyzed to determine the proper categorization and assess the interplay of the various regimes. The second concern is that it appears that transactions made between April 1, 2020, and March 31, 2021, could be subject to both income tax and EL 2.0.

Key Take-Aways and Next Steps

EL 2.0 is a complex law and has been in full effect since April 1. The law significantly changes how technology companies operate. Technology companies now have to evaluate their coverage and involvement in India. Here are some actions technology companies should take as soon as possible:

- evaluate whether their business model qualifies as an e-commerce operator;
- determine if the company's service offerings fall within the array of covered transactions;
- consider whether income streams of the digital companies with an Indian nexus would be subject to income tax provisions or the EL 2.0 based on characterization of the transactions;
- perform a cost-benefit analysis to see if they are better off forming a PE in India or maintaining their business models; and
- review pricing and commercial models and adapt systems and processes for compliance with EL 2.0 if necessary.

Conclusion

There is active pushback against EL 2.0. Businesses are calling for the law to be amended, or at least deferred. There is a chance that this resistance will be successful. However, companies must still prepare for the possibility that EL 2.0 functions as intended — after all, EL 2.0 is in effect.

Digital taxes have caused bilateral and regional rifts. Global economies, including India, are seeking to unilaterally impose levies to protect their interests. My hope is that the OECD and major countries will begin to actively drive global consensus on taxation of digital transactions and minimize the friction caused by unilateral levies. ■