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Equalization Levy, 2016
Is it equitable?

Technology, Media, and Telecommunications

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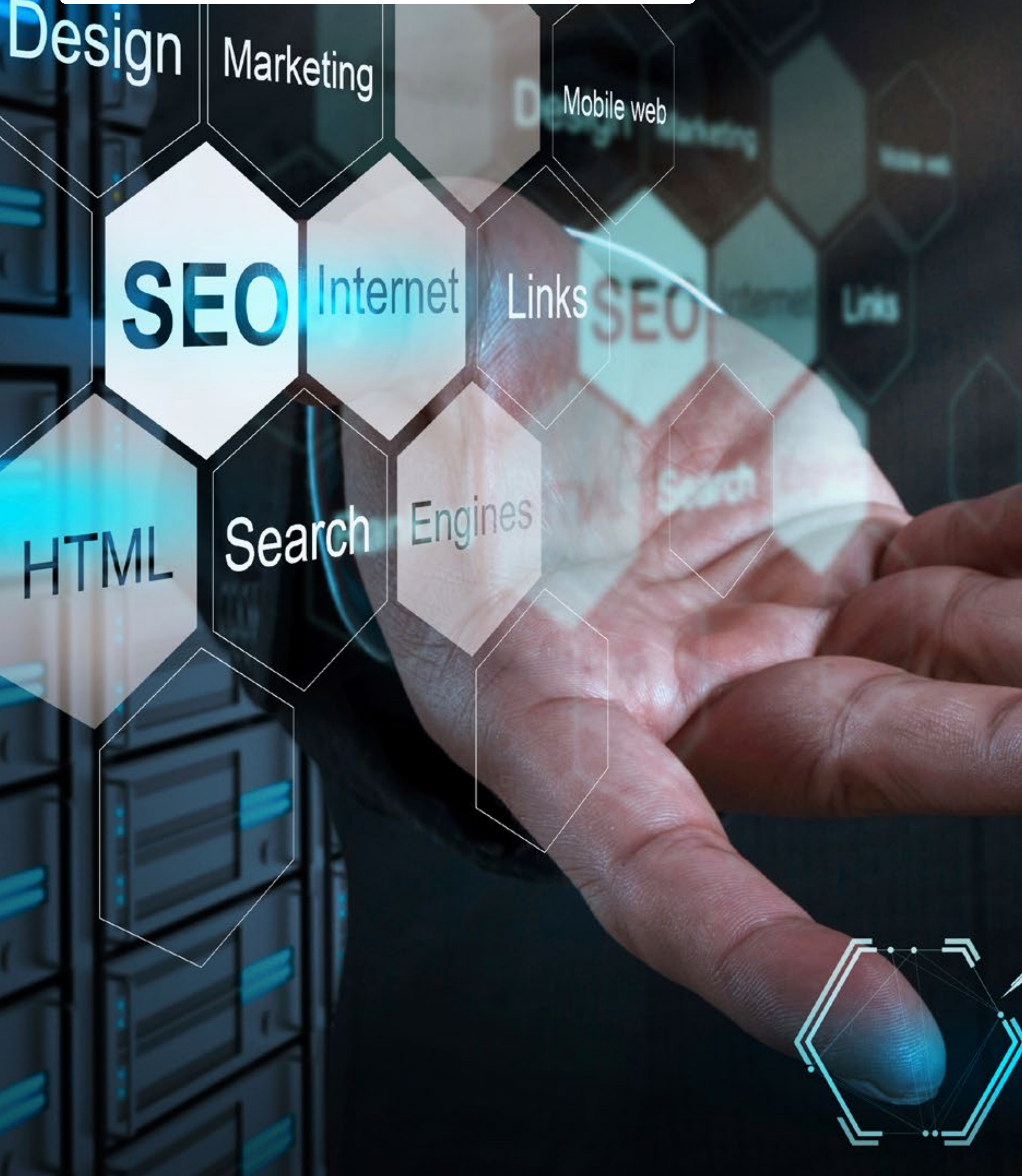
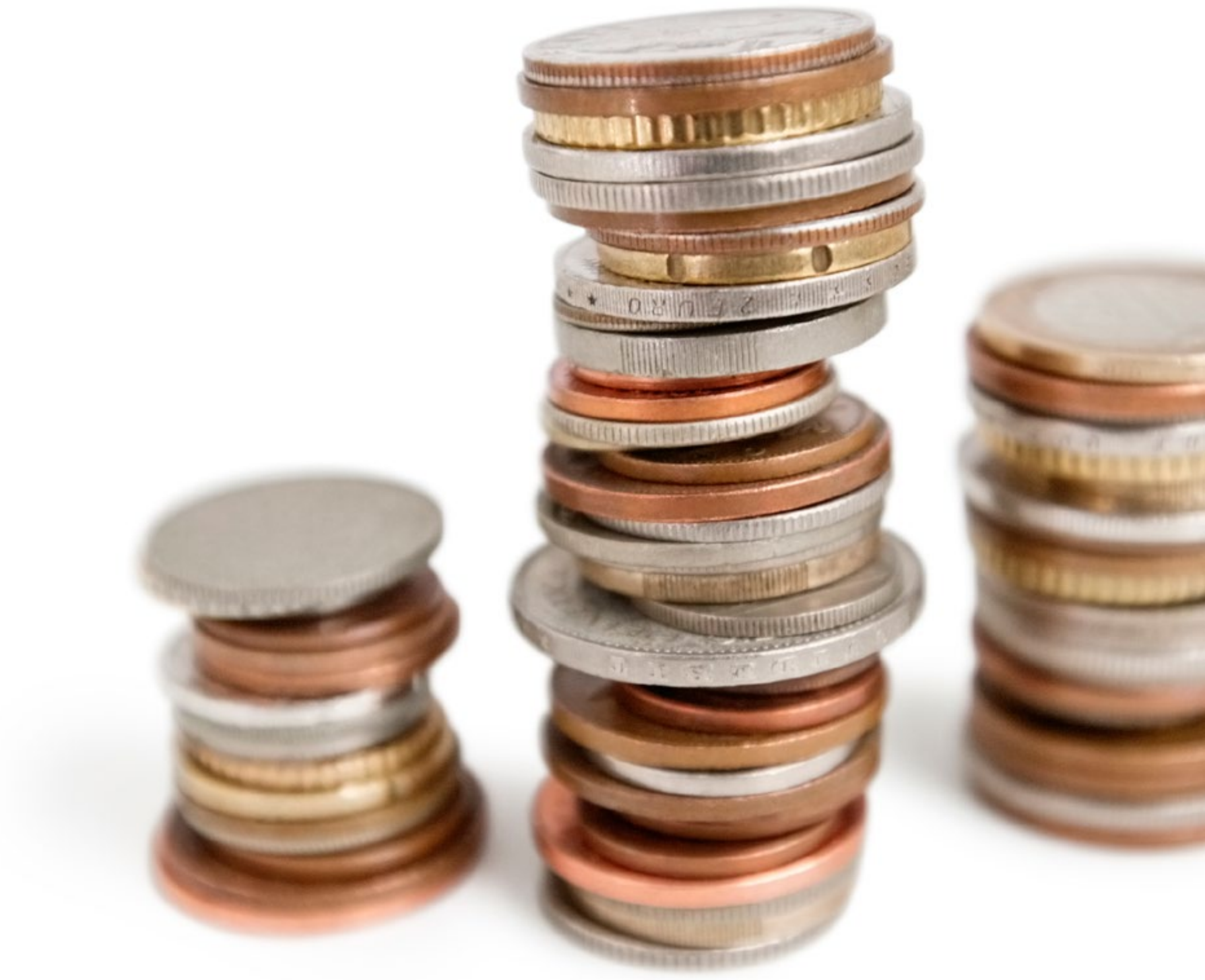


Content

Introduction

Finance Act, 2016 has introduced a new tax aimed at internet advertising providers that earn income from India, and do not have a permanent establishment for tax purposes in India.

This article examines the contours of this tax and its impact on the Technology, Media, and Telecommunication (TMT) industry vertical.



Background - Digital Advertising

India's online advertising spend though not substantial, as compared to global numbers, is expected to grow at a high trajectory compared to the previous decade largely due to the increasing global footprint of Indian MNCs, an increase in the number of internet users and the booming e-commerce market. The Indian digital advertising market is expected to cross the US$ 1 Billion mark in 2016 and is expected to grow in double digits.

The relevance of digital marketing for companies operating across the TMT industry vertical varies.

Technology

Social media companies, Internet search companies, Digital media, websites App developers and App marketplace (Android) derive significant revenues from digital advertising on their websites, mobile sites, mobile apps, etc. These companies derive advertisement revenues from hosting ad banners, related content ads (sidebar ads), target ads, ad word searches, pre-roll videos based on user preferences, etc. E-commerce companies/ online travel/hotel sites though not primarily dependent also rely partly on revenues from product advertising, promotions, etc.

Media

Foreign and regional media companies have embraced the digital space to reach out to the newer generation audience who find lessser time to read or watch TV and are continuously on the move. The print media has moved from traditional paper format to websites and e-journals whereas TV channels have also moved to the Internet and video-on-demand TV format. Further, television in the present times function via digital transmissions (whether terrestrial, DTH, cable, IPTV, cellular).

Telecommunications

Though the telecommunication industry is not dependent on digital advertisement, the entire digital economy runs on their networks and hence it is a direct beneficiary of the rise of the digital world. Telecom companies have started to mop up more revenues from data and broadband, and the traditional voice and SMS revenues have to started to decline with the rise of WhatsApp, Skype, etc.

The telecom industry realizing the potential of the digital economy have started to re-align themselves by partnering with e-commerce / online companies like specialized data rates for apps, free data for downloading apps, ad promotions based on user data, caller tunes, etc.

Rationale behind the introduction of this new levy

E-commerce is an innovative way of conducting business, and the entire setup runs on intangible media using the digital telecom network without any physical presence. Actions taken by tax authorities to tax these digital transactions have drawn flak as they do not have any permanent establishment nor do these payments qualify as royalties or fees for technical services under tax treaties. The Indian Tax Tribunals in case of Yahoo India Pvt. Ltd. and Right Florists have held in favour of Yahoo and Google stating that advertising income received by such companies is not taxable in India in the absence of physical presence in India and further held such payments are not taxable as royalty or fees for technical services as per tax treaty. Further, the Mumbai Tribunal in the case of ebay International AG has held that user fee received by it for operating India-specific website providing online auction is not taxable in the absence of permanent establishment in India. In this regard, the Committee on Taxation of E-Commerce ("panel") in its report recommending the imposition of an equalization levy has observed that - *"these new business models have also created new tax challenges in terms of nexus, characterization, valuation of data and user contribution."*

The issue of taxing digital economy has been considered in the Base Erosion and Profit Shifting (BEPS) project and taxation of the digital economy is the first of 15 action items under the BEPS project. One of measures suggested in the report was the equalization levy. Though, the OECD did not agree for imposition of such a levy at this stage, it did mention that individual countries could impose such a levy provided they respect their existing tax treaty obligations.

India is the first country to introduce an equalization levy under its domestic tax legislation based on the recommendations of the committee formed by the apex tax body. The panel in its report has mentioned that the purpose of the levy is to equalize the income tax disadvantage faced by Indian digital companies and facilitate an environment, where Indian digital companies can compete with foreign players without having to locate outside India.

Equalization Levy, 2016

The Finance Bill, 2016 has proposed an equalization levy of 6% on specified digital services and is currently applicable only for specified payments made for online digital advertisements. This levy is applicable on specified payments made on or after 1 June, 2016. The Government has also left the window open to include other digital services as may be notified by it. Further, the levy is applicable only on payments made in excess of ₹1 lakh (US$ 1,500) in a financial year to a particular foreign enterprise which does have any permanent establishment in India. The payer is required to withhold the equalization levy from the consideration payable to the non-resident. Further, the non-resident is not liable to income tax if the payments received by it is subject to equalization levy.

The Government has notified the Equalization Rules, 2016 which provides the mechanism for remitting equalization levy, annual return filing form which needs to be uploaded on or before 30 June immediately following the financial year and the relevant forms for filing appeal with the Commissioner of Income tax (Appeals) and Income Tax Appellate Tribunal.

India’s equalization levy versus Global Approach

Countries like the UK and Australia have amended their domestic tax legislations by bringing to tax digital business models under the anti-avoidance regulations. Japan for instance has introduced a consumption tax on digital transactions. The UK and Australia have also been quick to introduce tax regimes for taxing such situations.

UK

The UK government through the Finance Act 2015 imposes a levy on company profits—excluding those of small and medium-sized enterprises—that are routed via "contrived arrangements" to tax havens.

The arrangements can concern either those that involve entities or transactions lacking economic substance or efforts by a non-UK company to avoid a UK taxable presence.

The levy termed as a “diverted profits tax”, whereby tax payers are hit with a 25% levy on profits generated in Britain but "artificially shifted" overseas. This levy is outside the tax laws and hence tax treaty benefits would not be available.

Australia

The Australian Government has introduced Multinational Tax Avoidance Act, which focuses on arrangements that attempt to avoid establishing a permanent establishment presence in Australia. Further, the Australia government has levied GST on offshore supplies of digital products and services. It is applicable on B2C transactions.

Japan

Japan under 2015 tax reforms has introduced a consumption tax on digital transactions. It is applicable on distribution of e-books via the internet, downloading music or video, use of online software, e-commerce (online space to sell products),online advertisements, consulting services rendered continuously through phone/ email.

The levy is applicable under a reverse charge mechanism for B2B digital services. In case of B2C digital services, the overseas supplier needs to mention his overseas business registration number and would remit consumption tax arising on the invoice.

Further, a number of European countries, New Zealand, Korea, South Africa have started taxing digital transactions under their domestic VAT / GST laws. These were earlier not taxable due to these foreign players not having a local presence or due to the fact that the laws being based on Place of Service (POS) rules had limited taxing rights. An interesting thing to note is recently, Italy has passed legislation that requires Italian companies to purchase their Internet ads only from locally registered companies.

Globally, nations have attempted to tax the digital economy through a combination of anti-avoidance rules and the levy of consumption tax However the Indian approach is different as it is in the nature of final withholding tax without assuming the character of an income tax.

Impact on the TMT sector

The proposed move is targeted at foreign internet companies who earn substantial revenues from digital advertisement. The following are the key players can be impacted because of equalization levy:

Foreign Internet companies such as social media companies, internet search engines, media websites, e-commerce companies, apps and games developers that do not have any presence in India

Foreign broadcasting network companies that derive revenue from Indian companies for advertisement in television and radio

Digital advertisement intermediaries that render digital ad-related services such as ad management, website management, uploading of ads, ad trading agencies, etc., as it may also get covered under the residuary clause "*any other facility or service for the purpose of online advertisement*"

Small Indian companies, startups, and e-commerce entities may be impacted as the foreign digital media companies hold the market and they may dictate that the Indian companies have to absorb tax costs which eventually leading to grossing up of the payments

Currently, the scope of levy is proposed only on digital advertisements but based on the panel report the levy could be extended to other services. Potential services that could be targeted in the future may include the following

- Web developers, server management companies
- Service providers engaged in the field of uploading, storing or distribution of digital content
- Online data processing & collection companies
- Payment gateways
- Apps market place such as Android, iTunes selling music, online games, online books, online software etc
- Online software applications

Accordingly, one may have to wait to see what categories of services would get notified by the Government. However, the question that remains unanswered is that some of these services are in the nature of B2C and therefore such services may not fall within the coverage of equalization levy. However, a suggestion of the panel for foreign recipients earning more than Rupees 100 million to file returns may plug this loophole.

Are these payments excluded?

The levy is applicable only on B2B payments and hence non-commercial and personal payments get excluded. In this regard, a question arises whether the following payments are covered:

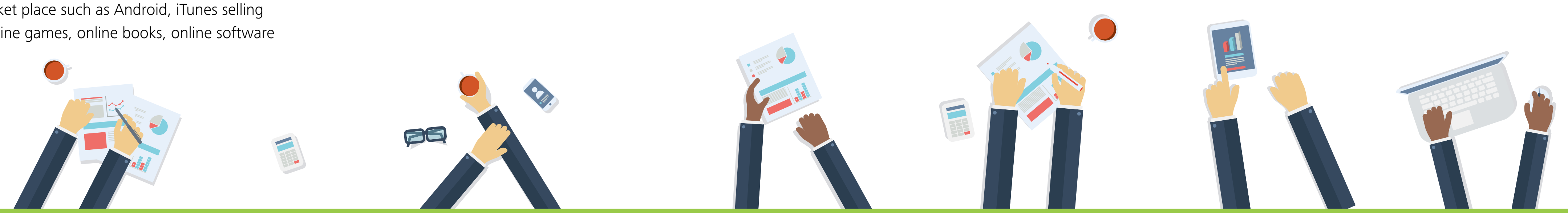
- Payments made by companies for job recruitments the reason being though the same is B2B transaction, however, the intent of the advertisement is non-commercial
- Are payments made to intermediary companies for online advertisement covered
- Payments made to classified service companies like covered
- Payments made for publishing business information
- Payments made for bulk mailing services
- Payments made to foreign media companies publishing news item about an update etc.
- Amounts paid to e-commerce companies for commission fee for listing of their products for sale

In this regard, it is interesting to note that the panel has clarified in its report that goods and services imported / procured online will not be impacted, for example buying a book from an e-commerce website site or making a hotel or flight booking.

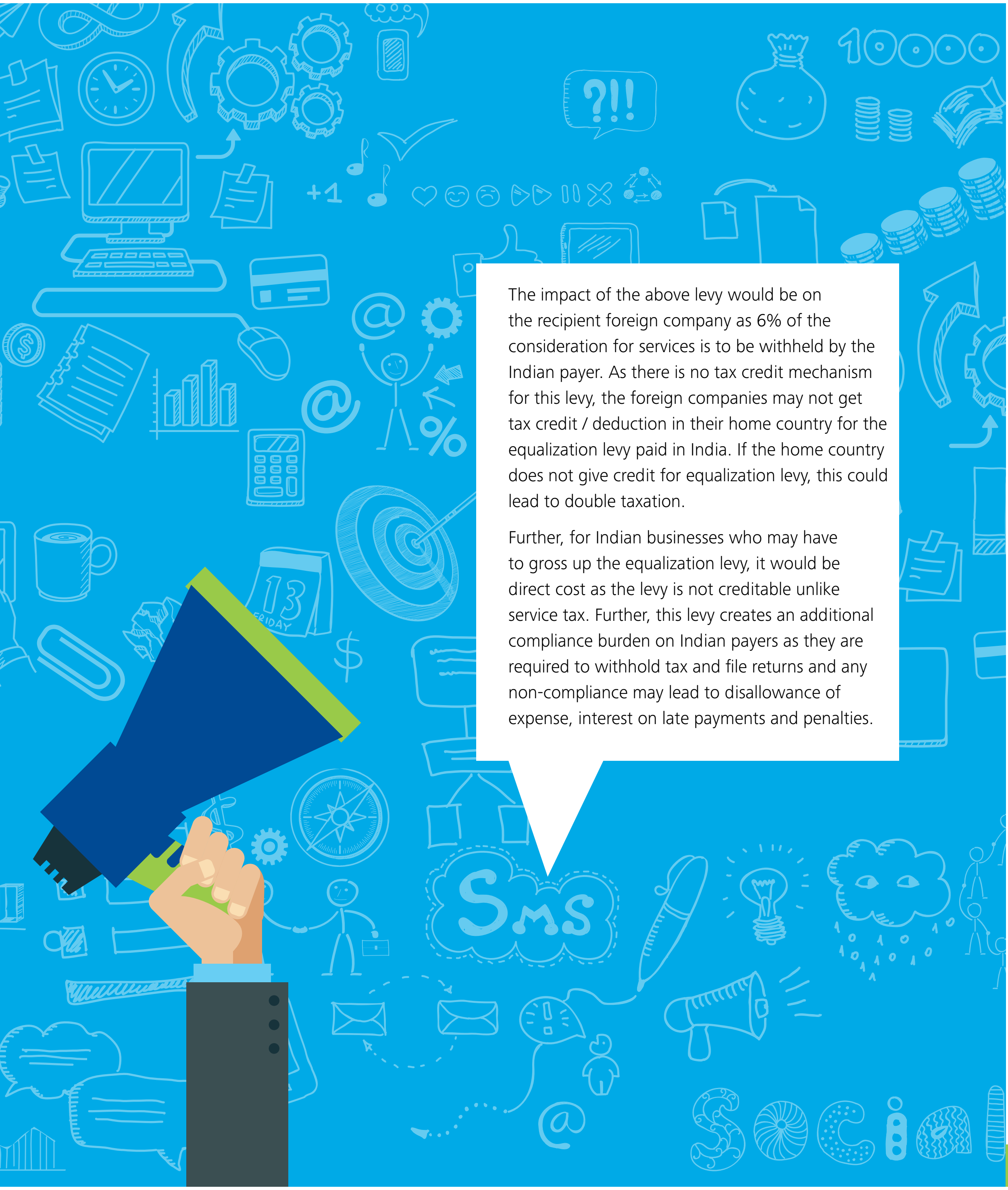
Excluded payments

As the equalization levy is applicable only on B2B transactions therefore the following may potentially be outside its purview:

- Payments made by individuals for posting blogs, job seekers etc.
- Payments made by Government Departments to sensitize the public
- Payments made by Non-Government Organizations (NGOs)



Tax impact of the above levy



The impact of the above levy would be on the recipient foreign company as 6% of the consideration for services is to be withheld by the Indian payer. As there is no tax credit mechanism for this levy, the foreign companies may not get tax credit / deduction in their home country for the equalization levy paid in India. If the home country does not give credit for equalization levy, this could lead to double taxation.

Further, for Indian businesses who may have to gross up the equalization levy, it would be direct cost as the levy is not creditable unlike service tax. Further, this levy creates an additional compliance burden on Indian payers as they are required to withhold tax and file returns and any non-compliance may lead to disallowance of expense, interest on late payments and penalties.

Open Issues

Is the equalization levy in the nature of income tax?

The amendment is proposed in the Finance Bill, 2016 under a separate chapter and therefore there is a question whether the levy is in the nature of an additional income tax, or an indirect tax as it is tax received on consideration for services or altogether a new form of tax. However, the panel in its report has clearly mentioned that the levy should be kept outside the scope of Income tax.

Is this levy applicable on payments made by Indian company to non-residents which are consumed outside India like its branch, etc.?

The levy is applicable on any payment made by Indian payer to a non-resident towards online advertisement. Let's say an Indian company has a branch outside India (USA) and Indian company pays certain amount to a USA-based Internet company for online advertisement for increasing its USA branch sales. In this scenario, the service provider, recipient, and source of income are all located outside India. However, as no exemption is provided therefore levy is applicable on services consumed by the foreign branch of the Indian company.

Is a tax credit available to foreign company?

The term income tax is defined in tax treaties to be mean 'Indian income tax' or surtax (which was applicable in the past). As the levy is not in the nature of income tax,tax credit may not be allowed in home country. Alternatively, the recipient foreign company can explore the option of claiming tax deduction as an expense under their domestic tax laws.

In this regard, the panel in its report has mentioned that the levy is currently imposed under domestic tax laws and hence no credit is available under tax treaties. However, the Government can examine the possibility of entering into reciprocal agreements for credit with countries that impose a similar levy.

Foreign companies earning income which is subject to equalization levy are required to file income tax returns in India.

Though, the Government has mentioned there is no further tax liability for the foreign company in India, there is no clarity whether a foreign company is required to file income tax returns or any other returns in India.

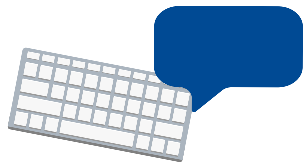
However, the panel has mentioned that in case the payments received by the foreign enterprise exceed ₹100 million then it has to file returns in India and where no deduction is made by Indian payers it has to remit such sum. Accordingly, large players who derive significant ad revenues from India may have to shell out 6% of their gross earnings including for small remittances received.

Can the foreign company apply for an advance ruling?

Though the administration of the levy falls under the Income tax Act, there is no provision for seeking an advance ruling regarding the equalization levy.

Impact on Service tax liability?

Already Indian companies pay service tax at the rate of 15% under reverse charge mechanism for online advertising services as they same fall under Rule 3 of Place of provision of services rules, 2012. Therefore, both service tax and the equalization levy would be applicable.



Concluding Remarks

The introduction of the equalization levy is a step by the Indian Government to tax digital transactions, and it will help the Indian Government increase its tax revenues. On the surface, the impact on the domestic economy may be less as it is targeted at foreign players who derive significant revenues from India without having a tax base. The levy has the potential to impact Indian businesses as foreign players may simply slide the burden onto the Indian payer (requiring grossing up the invoice), though the panel report seems to suggest this should not affect significantly as the rate of 6% is lower than the 10% withholding tax applicable on 'royalties'/'fees for technical services'.

What could be significant in the future however, would be the new categories of services that get included through notifications, and the approach of the Government to resolve issues arising on actual implementation.

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