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USTR 301 Investigation of EL 2.0 – A Storm in a Teacup

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India's Equalisation Levy was the subject matter of investigation under Section 301 of the Trade Act of 1974 by the USTR and the USTR has given its report on 06.01.2021 through which the investigation concludes that

(i) India's DST is discriminatory against US Companies;

(ii) India's DST contravenes prevailing international tax principles and is therefore unreasonable; and

(iii) India's DST burdens or restricts US Commerce.

USTR investigation would support a finding that India's DST is actionable under Section 301.

Is India's DST discriminatory against US companies?

The report has identified that discrimination takes two forms namely, explicitly targeting non-domestic firms while exempting Indian companies and taxing digital services but not taxing the same or similar services provided non-digitally.

The DST is identified as discriminately targeting a select group of digital service providers most of which are US companies. The USTR's analysis states that it has identified 119 companies likely to subject to the DST of which 86 are US Companies and the next most common nationalities are China, UK, France and Japan.

Without going into the constitutional aspects of the equalization levy, a cursory reading of Section 165A of the Finance Act, 2016 as amended by the Finance Act, 2020 w.e.f. 01.04.2020, would show that the levy is on e-commerce operators who are defined as non-residents who own or operate or manage digital or electronic facility or platform for online sale of goods or online provision of services or both. There is nothing in this provision which indicates that the levy is confined to US Companies. Merely because significant number of US companies are in the space that is covered by this levy would not make the levy a targeted one. The Report itself recognizes that companies from China, France, Japan and UK would also be hit by the levy. Once the applicability is across all non-residents, it is not clear as to how it can be considered as discriminatory only against US companies.

Digital Economy and Society Index (DESI) is a composite index and presents the weighted average of dimensions namely connectivity, human capital, internet use, integration of digital technology and digital public services. The EU studied the performance of other nations on these dimensions to create a reliable metric to determine digital inclusion in all nations in a standard metric. I-DESI combines 5 dimensions and 24 indicators and uses a weighing system to rank each country based on its digital performance. The Average scores across all dimensions for I-DESI 2015 to 2018 as per the Final Report by the European Commission on International Digital Economy and Society Index 2020[1] is given below:

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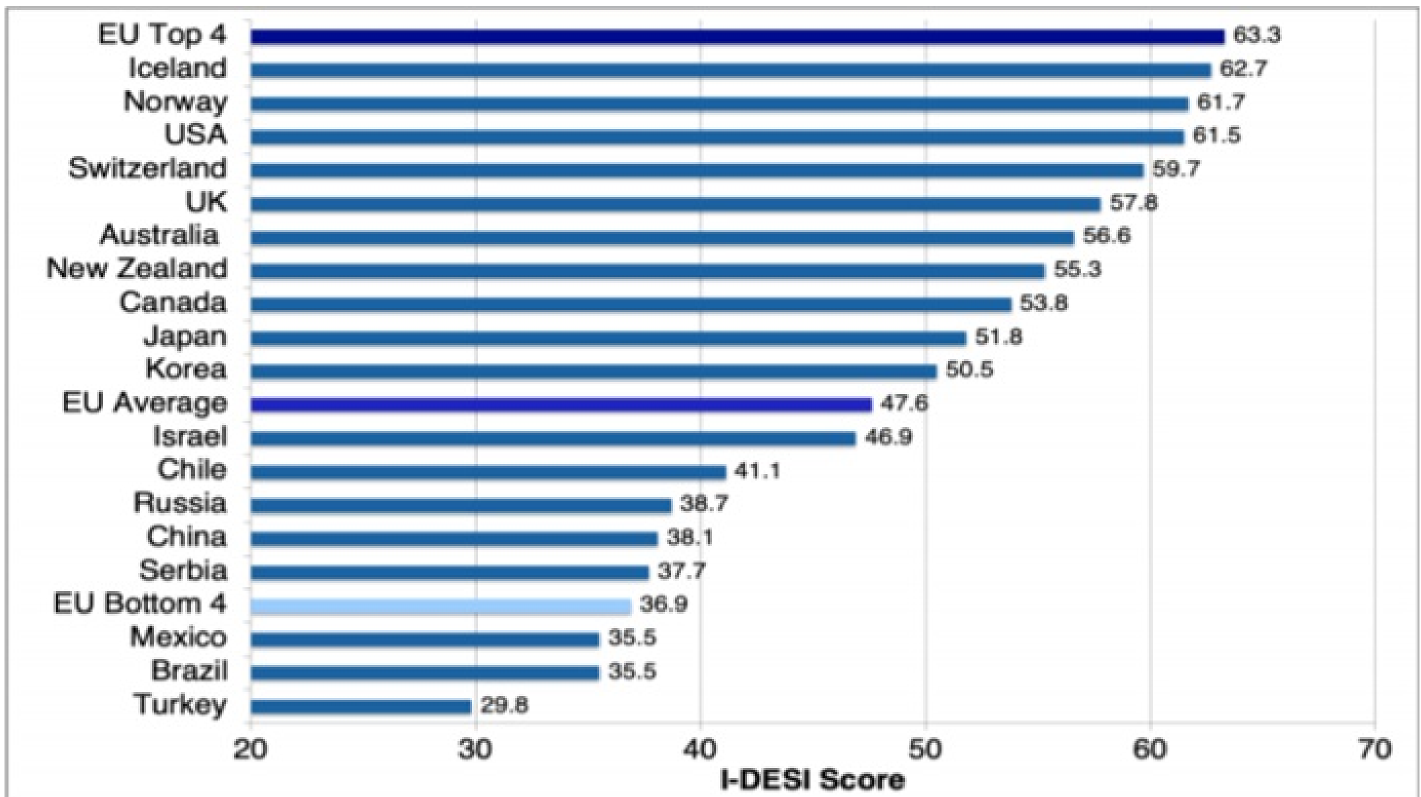

Figure 3 Non-EU countries normalised performance scores for I-DESI

As can be seen from the chart, there are a number of countries which are active in the digital space and are competing with comparable scores. It is not as if only US companies operate in the digital space and hence the suggestion that the equalization levy is discriminatory against US companies, may not be correct.

Whether taxing digital services but not taxing the same or similar services provided non-digitally is discriminatory?

Initially, internet was identified with email communications but over a period of time its true potential was discovered. Business and commerce embraced this new medium initially to provide information about goods and services. Slowly and steadily, e-commerce became a reality. Today, there is a digital twin for almost every commodity or service that is known to the physical world. In some cases, the digital twin has made the other sibling irrelevant or obsolete.

The USTR Report gives an example. *Under the DST if a company were to sell a movie to an Indian customer and deliver the content digitally, the proceeds of the sale would be taxable. If a second company were to sell that very same movie to the very same Indian customer but do so in a store on a DVD, that sale would not be taxable under the DST. This differential treatment of like transactions is a textbook example of discrimination*.

The example given clearly does not recognize that times have changed. Movies have moved from reels to discs and have now become content that is streamed. Music has moved from records to tapes to discs to downloads and is now streamed live.

In Q2 2020, US home entertainment spending was $7.94 billion. For the first half of 2020 it was $15.1 billion, meaning that US home entertainment now far surpasses revenue from the US box office, which came in at $4.64 billion (-8.7%). In the first half of 2020, digital movie sales, or EST, ($1.61 billion) also soared past DVD/Blu-ray sales ($1.275) for the first time in the US[2].

The growth of e-commerce is in a sense a natural progression and is not a model developed to avoid taxes in market jurisdiction. When the physical presence test was established, there was no internet. Due to developments in technology, customer preferences change in buying pattern, ease of

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transactions, reduction in costs, global access, data analytics and a host other reasons, e-commerce grew and continuous to grow exponentially. Discrimination is possible when there are two competing activities and one is subject to tax. However, if one mode of doing business is no longer relevant or has become archaic, then comparing an existing version of doing business to a dated version of doing business may not be correct.

Whether India's DST convenes prevailing international tax principles and is therefore unreasonable?

The USTR states that India has failed to provide tax certainty to stakeholders and thus has unreasonably contravened an important principle of international taxation. When Parliament has enacted a legislation and the legislation has been duly passed in accordance with the Constitution of India, stakeholder participation cannot be insisted upon or identified as a contravention of an important principle of international taxation.

There are no codified laws on international taxation. The laws may have to pass the test of validity in the country in which it is enacted. The source versus residence debate has always been there in the context of taxing rights. There are number of instances such as royalties or fees for technical services, interest. when the source state taxes the income. If digital economy is considered as a new form of doing business where existing rules are inadequate, then ownership of intellectual property rights and knowhow and licensing of the same for use, were clearly new developments at the relevant point of time. Prior to 1976 in the US ownership of copyright could be transferred only in full and partial transfers had the character of licence. Only under the US Copyright Act, 1976 transfer of ownership of any of the exclusive rights in the copyright was recognized. Therefore, failing to recognize the development in business and the prevalence of the digital economy and insisting upon old rules of taxation is not correct.

Consensus among nations on directed action on the digital economy has been elusive and has resulted in unilateral action taken by nations in order to safeguard their interests. While one cannot deny that the action is unilateral, it is not as if there are any international codified taxation principles which prohibit or restrict domestic legislation sans treaty provisions.

An interesting observation in the US Report is that *unilateral laws like India's DST undermine progress in the OECD by making an agreement on a multilateral approach to digital taxation less likely. If unilateral measures proliferate while negotiations are ongoing, countries lose incentives to engage seriously in the negotiation.*

US is not an active participant in the OECD exercise to tax digital businesses or part of the Pillar 1 and Pillar 2 discussions. The USTR concludes that the DST's extra territorial application to revenues not connected to physical presence in India contravenes international taxation principles. Even when the BEPS project resulted in MLI, US has not chosen to adopt the MLI and the treaties remain as such. In fact, Article 12, 13 and 14 of the MLI seeks to broaden the PE definition though not in the context of digital economy.

On one side when the country refuses to engage in discussions to bring about an effective mechanism to tax digital economy and to redistribute taxing rights, it is a matter of irony that the very same OECD discussions are quoted to find fault with India's DST.

As a developing nation, the consequences of an eroding tax base prove significant to the economic interests of the nation. With the advent of the digital economy, more and more businesses are being conducted in India through foreign enterprises without any physical presence in India and lacking any such nexus to India, the value of transactions or the income that is generated, i.e. accruing or arising in India goes untaxed, denying the nation its rightful share of the proverbial pie.

Whether India's DST burdens or restricts US commerce?

The USTR reports states that the DST has an inordinate discriminatory impact on US firms as US firms are market leader in the digital services sector and the additional tax liability represents a burden on US companies. While the report recognizes the DST as an additional levy, it does not factor Section 10(50) of the Income Tax Act which provides that any income arising from any e-commerce supply or services

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and chargeable to equalization levy would not form part of the total income. Without going into the effective date issue, the fact that equalization levy would be the only tax applicable by virtue of this provision has not been considered.

The AAR in the case of ***Mastercard Asia Pacific Pte Ltd., Singapore*** [TS-5011-AAR-2018-O] [3] had ruled that Mastercard had a fixed PE, service PE and dependent agency and that even an automatic equipment can create a PE. On a challenge to equalization levy, before the High Court, the Revenue conceded that equalization levy is not applicable since the AAR had ruled that the Company had a PE in India and reserved its right to levy the tax in case ***Mastercard*** succeeds in its Writ Petition against the AAR ruling.

The Bangalore ITAT in the case of ***Google India Pvt. Ltd***.[4] had held that payment of advertisement fees is not a payment simpliciter towards purchase of Adword space to be treated as business profits, but it is a payment of royalty.

Taking the movie provided as a content example in context, the Madras High Court in the case of Modern Theatres Ltd. [TS-5088-HC-1951(MADRAS)-O] [5] had held that even though the contracts were concluded in British India, nothing accrues to the assessee until the film was put in possession of the exhibitor with a view to exploit the same and that was done wholly in a native state. It therefore follows that the profits of the business accrue wholly in the native state.

While it may not correct to say that the entire profits should be taxed in the market jurisdiction, the taxing rights of the market jurisdiction cannot be ignored. If the aforesaid decision is read in the context of digital economy and specifically with reference to streaming of films and digital content from outside market jurisdiction, it may be possible to infer that the supplier is entitled to income only at the point when the customer views the film or download the content by making the payment.

Given the potential for debate as to what constitutes the PE and protracted litigation on the subject, payment of equalization levy till the point of time when nations agree upon a methodology of taxing the digital economy would atleast ensure that equalization levy remains the only tax and the income of the overseas corporation is not taxed through any nexus by virtue of the protection in Section 10(50). In effect, India’s DST is more of a commercial certainty in so far as tax is concerned and foreign corporations are likely to find that a simple levy of 2% as against an uncertain determination of whether there is a PE or not on account of the nexus to the market jurisdiction; the significant economic presence; and attribution of profits to the PE.

Conclusion

With the US crying foul over this matter, it only adds to the protracted trade disputes that exist between both nations. However, given the depth of the relationship between both countries and the huge potential for trade one cannot but speculate as to whether the entire exercise is positioning of some sorts which would ultimately result in a free trade agreement between the countries.

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[1] https://ec.europa.eu/digital-single-market/en/digital-economy-and-society-index-desi (Last Accessed 26.01.2021)

[2] Digital movie sales soar past DVD/Blu-ray in 2020 by Rasmus Larsen. https://www.flatpanelshd.com/news.php?subaction=showfull&id=1598597088 (Last Accessed 26.01.2020)

[3] (2018) [TS-5011-AAR-2018-O] AAR

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[4] (2018)

[5] (1951) [TS-5088-HC-1951(MADRAS)-O]

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