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EQUALISATION LEVY

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Equalisation Levy

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Abstract

The equalisation levy in India from June 1, 2016 is a presumptive tax on some specified services provided by non-residents in the 'hard to tax' digital sector. In a market dominated by a few big players, because of the network effect and cost characteristics, it corrects the obviously unfair advantage that some non-resident companies without permanent establishments (PEs) enjoy over domestic players tempting even resident digital companies to become non-residents. The paper argues that the government should examine whether the levy can be made into a rebuttable presumptive one to avoid possible double taxation. Second, the impact of the levy on cum tax price is far from clear. The burden on buyers and sellers need to be studied to calibrate the rate. The argument for reducing the rate becomes stronger the higher the pass-through to resident buyers. Third, the tilt in the division of tax jurisdiction in favour of 'home' countries relative to 'source' countries has been accentuated by the digital economy. Pursuit of second best policies such as the equalisation levy may play an important role in exerting pressure on 'home' countries for a more equitable distribution of tax jurisdictions, which is the ultimate goal.

Foreword

Digital technologies are transforming societies and creating opportunities as never before. They are changing the content and structure of markets, facilitating provision of government services (including those aimed at social objectives), and transforming the scale and scope of skills and business practices that have a huge impact on existing operational conditions and potential for growth.

This is a global phenomenon, strongly evident in India as well. India's private sector has given a major momentum to digital based activities, and the Indian government, through its Digital India programme and several related initiatives, is rapidly expanding the scope and basis of digital transactions in India. The ability to provide services from any location facilitates inclusiveness and generates conditions for positive network effects for creating multiplier effects for economic and social transactions. The potential in India is huge, both, because of the growth in digital technologies and the significant segment of population that is yet to become an active part of this growth.

For national and international policy makers, these developments present both exciting opportunities as well as immense challenges as the landscape of issues changes immensely and even continuously.

Achieving the large potential of digital technologies requires establishing the relevant networks, institutions, skills, and the range of services which form the composite bundle which enables efficient provision of digital services. Importantly, the same factors which create an large potential for a positive impact of these technologies on productivity, social services, new market opportunities, also generate policy related concerns. These technologies enable bundling several services together, which could lead to regulatory bypass and certain competition policy related issues when composite service bundles are provided at a package price. Similarly, transaction in large data raises the issue of privacy. The growth in productivity due to digital has a flipside in terms of job losses; the ease of linking up to work stations from different locations will lead to new forms of employment contracts as well as regulatory issues. Significantly, the possibility of providing services from any location, domestic or abroad, implies a need to address the limits of the "jurisdictional reach" of policy makers in any single country. Thus, digital transactions have created a need to re-examine existing policies that were established under the premise of a fixed establishment of service provider within the domestic territory

In this background, Brookings India has begun a number of research initiatives relating to digital services, such as implications of new technologies and business models for regulatory policy, tax policies and digital services, digital and health, application of new technologies to education, smart grids, improving productivity of small and medium technologies, creating domestic capacities in international value chains, implications of the app economy, financial inclusion, and facilitating the

implementation of government services. The range of policies being examined under these research topics cover macro-level policies as well as micro (or sectoral) level policies.

Taxation policy applied to digital service providers has be one of the more far-reaching set of policies that have concerned national and international policy makers, in particular taxation policy for enterprises with no permanent establishment within the territory of a nation applying the tax. This issue has occupied the minds of international experts for several years at the Organisation for Economic Co-operation and Development (OECD) and the G20. A number of suggestions have emerged as a result of this exercise. India has been a pioneer in addressing one aspect of this issue through an equalisation levy. This policy has raised both concerns as well as voices of support. The importance of the policy and the growing scope of digital services, require a closer independent and objective examination of the basic features and the concerns relating to this policy.

This topic is the focus of this working paper under the initiative by Brookings India. Prepared under the overall coordination of the Executive Director of Brookings India, this working paper is part of a series of papers to be prepared by scholars at Brookings India as well as by special experts identified to examine the policy issues relating to digital technologies in the areas mentioned above. This paper is prepared by experts invited to write the paper: Ashok Lahiri, Gautam Ray and D. P. Sengupta are experts with long relevant experience on the issues covered. The paper is a result of considerable discussion amongst us, though the views expressed in this paper, as usual, remain the independent views of scholars or experts writing the paper produced by Brookings India.

This discussion in this paper addresses a tax policy implemented by India to create a "level playing field" between service providers with and without a permanent establishment in India. In specific, the paper examines the "equalisation levy" implemented by India from June 1, 2016 on some specified digital services provided by non-residents. The broad issues is similar to the conventional concern relating to Base Erosion and Profit Shifting (BEPS), but the problem become more complex due to the flexible location possible for digital service providers. This indeterminate location creates a need to address the possible unfair advantage enjoyed by some non-resident companies without permanent establishments (PEs) in comparison to the domestic firms.

India's equalisation levy has been questioned on a number of points. Given the immense and growing potential of digital activities, it is important to examine the questions raised with respect to this levy and consider whether and how the established policy may be improved. This paper examines the various arguments for and against the equalization levy and concludes that many of the questions raised with respect to the levy are not valid. It does however reach the conclusion that though a tax such as the levy is required, further examination of the underlying conditions is required to better calibrate and improve the policy. A more specific conclusion regarding the possible improvement for the tax policy is that the equalisation levy could result in double taxation

of a firm without a permanent establishment, and that the government should examine whether the levy could be made into a rebuttable presumptive one to avoid possible double taxation.

This working paper has been released as a basis for further discussion and consideration of the policy issues or conclusions reached by the authors. We look forward to developing these ideas further, and also to get insights for other work that will be undertaken on the topic of taxation policy and digital services. The effort is to create a policy environment which facilitates the trajectory of digital growth and availability of digital services in India under broadly accepted regulatory objectives and operational conditions.

Harsha Vardhana Singh
Executive Director, Brookings India

I. Introduction

The Government of India's Finance Act 2016, in Chapter VIII, introduced an equalisation levy of 6 per cent applicable "…to consideration received or receivable for specified services provided on or after the commencement of this Chapter."[1] It applied only on business-to-business (B2B) transactions. The Finance Act clarified that 'specified service' means online advertisement and any provision for digital advertising space or any other facility or service for the purpose of online advertisement. It also provided that such specified services include any other service as may be notified by the Central Government in this regard.

The levy applies to specified services for more than Rs. 100,000 supplied by non-residents not having permanent establishments (PE) in India. The levy has to be deducted by a recipient, who is resident in India or has a PE in India, "from the amount paid or payable to a non-resident in respect of the specified service" and paid to the Central Government by the seventh day of the month immediately following the calendar month in which the sum has been deducted. The levy came into force from June 1, 2016.[2] The tax is administered by the Central Board of Direct Taxes. According to the Committee report that proposed the equalisation levy "The word 'equalization' represents the objective of ensuring tax neutrality between different businesses conducted through differing business models or residing within or outside the taxing jurisdiction."[3]

The Equalisation Levy, which is a new tax imposed in the context of base erosion and profit shifting (BEPS), has raised several issues of concern. For example, is it a direct or an indirect tax? Is it imposed to improve equity or for augmenting efficiency? For foreign suppliers, who are not based in tax havens, who genuinely do not need to have a PE for supplying the relevant services, will it not result in double-taxation? Is the burden of the levy going to be on non-resident suppliers of specified services not having a PE in India or on the domestic users of such services in general and start-ups in particular? Will the ambit of the levy be widened across other digital services or even non-digital services? Does the equalisation levy go against the OECD recommendation to wait for a holistic resolution of the BEPS problem with international consensus? Why not put a withholding tax instead of the equalisation levy? Is it legally valid to put the same tax on the same base at two different rates and call them by different names? This paper argues that while some of these concerns are misplaced, others are not. India is the first country to impose an equalisation levy on specified digital services, and other countries may follow. Analysis of the equalisation levy and its effect on producers and consumers is important not only for India, but also for other countries that may follow in Indian footsteps.

Presumptive taxation is a traditional tool used for the 'hard to tax.' This paper argues that the equalisation levy is a presumptive tax attempting to correct two fundamental problems associated with digital services—the problem of double non-taxation and the problem of an equitable distribution of taxation jurisdiction between the origin and the source country.[4] This simple single instrument for two targets fails the basic Tinbergen rule of correspondence between number of targets and instruments. Furthermore, the use of such indirect means to ascertain tax liability,

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[1] The Gazette of India, Extraordinary, Part II, dated May 14, 2016. http://www.cbec.gov.in/resources//htdocs-cbec/fin-act2016.pdf;jsessionid=86D93EE8B8EE9D549BFE78A773DF79D9

[2] See notification on May 27, 2016.http://www.incometaxindia.gov.in/communications/notification/notification372016.pdf

[3] http://incometaxindia.gov.in/news/report-of-committee-on-taxation-of-e-commerce-feb-2016.pdf. P.75

[4] The two problems can reinforce each other in some cases.

rather than on the basis of the taxpayer's account, this paper argues, can only be a stop gap arrangement until some broader issues are satisfactorily resolved. Unfortunately, international consensus for such a resolution does not seem to be immediately forthcoming.

The plan of the paper is as follows: Section II provides the background to the equalisation levy. Section III describes and analyses the concerns about the levy. Section IV follows with summary and concluding observations.

II. A New Levy – The Background

When legitimate taxing rights on income exist in more than one country, normative tax principles are required to resolve conflicting claims of jurisdiction to tax cross-border income. The two basic issues are—first, which country should tax how much of the income and on what basis, and, second, how to avoid double taxation of the same income. The issue had been examined for long and came to a head in the 1920s with the Economic Experts' Report of 1923 to the League of Nations. The Report recommended vesting the primary taxing jurisdiction in the country to which the taxpayer owed its "economic allegiance."[5]

Economic allegiance, in turn, was to be determined by four factors: (1) origin of wealth, (2) situs of wealth, (3) place of enforcement rights to wealth, and (4) where wealth was consumed.[6] In a world divided between imperial powers and poor colonies, these foundational principles led to such allegiance resting mostly with the imperial powers and not the colonies. The imperial powers, mainly in Europe and North America, were the 'origin' countries, and the colonies in Africa, Asia and South America the 'source' countries providing raw materials and markets.

A profit-split or formulary apportionment might have been difficult and inexact, but more fair and reasonable. But, the Experts' Group classified income into various categories and then assigned taxing jurisdiction based on the classification. The source countries were left with only the right to tax income from the operations in these countries. This has been described as "*emblematic* of the economic relationships of the time."[7] The major reason offered, however, was to prevent countries from trying to ease the burden of taxes on residents by increasing such taxes on non-residents, who could not vote, and to promote international trade.[8] Furthermore, this classification and assignment system also mitigated international double taxation by preventing such double taxation from interfering with efficiency enhancing cross-border investments and transactions. Source countries could impose withholding taxes on the various classes of income, while the country of residence would provide foreign tax credit (FTC) for such withholding taxes.

Protection from double taxation and excessive or unjust withholding taxes for which the country of residence would have to provide FTC was also ensured through the formulation and modification

[5] Bret Wells & Cym Lowell (2011):"Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin," Tax Law Review, Vol. 65, pp. 535- 618.

[6] Report on Double Taxation submitted to the Financial Committee — Economic and Financial Commission, http://adc.library.usyd.edu.au/view?docId=split/law/xml-main-texts/brulegi-source-bibl-1.xml;chunk.id=item-1;toc.depth=1;toc.id=item-1;database=;collection=;brand=default p.24.

[7] Wells and Lowell (2011), p. 547

[8] Report on Double Taxation, League of Nations Doc. E.F.S.73 F.19, at 40 (1923), reprinted in 4 Staff of Joint Comm. on Tax'n, Legislative History of United States Tax Conventions 4003, 4044 (1962)

of the concept of 'permanent establishment' (PE).[9] The model tax conventions issued in 1928 by the experts under the League of Nations defined a PE and enshrined the principle that there would be zero taxation on business income unconnected with a PE. A non-resident company operating through an independent agent could not be considered as having a PE. The 1928 model tax conventions became the template for tax treaty negotiations in future. The model conventions were revised over time to exclude foreign subsidiaries and 'non-contract concluding' dependent agents from the ambit of PE. The Organisation for Economic Cooperation and Development (OECD) Model treaty convention is intended to serve as a model for countries to use in negotiating bilateral tax treaties to help settle issues of double taxation as well as to avoid inappropriate double non-taxation. OECD countries use the OECD Model. Developing countries generally follow the UN Model, which while very similar to the OECD Model, gives somewhat more taxing rights to 'source' countries.

a) Problem of double non-taxation

Over time, however, with aggressive tax planning by the multinational enterprises (MNE), these international rules of distributing taxation rights were found to be unsuitable for not only the developing countries but the advanced developed countries as well. The problems of developed countries were, however, on balance, different from those faced by developing countries. For developing countries the main issue was the right to tax in the source country, while developed countries faced the problem of profits and income being parked in intermediary tax havens.

Many MNEs had started reporting profits in jurisdictions different from where investments and activities (identified by factors such as sales, workforce, payrolls and fixed assets) are located. This they did partly by channelling investments through tax haven conduits. Tax havens, such as Bermuda, Cayman Islands, Ireland, Isle of Man, Jersey, Luxemburg, Mauritius, Monaco, are countries or jurisdictions that, along with offering a stable political environment, allow setting up of offshore companies with a low tax rate or no tax. In 2010, such activities were manifest in British Virgin Islands as the second largest foreign direct investor (FDI) in China, and Mauritius as the single largest FDI in India.[10] In effect, with movable capital, MNEs chose their country of residency through a de-facto tax election.

Double non-taxation and 'homeless income' of MNEs in the digital sector attracted considerable attention. For example, in the US, where it is headquartered, in 2012, Google – the giant MNE specialising in internet-related services – paid corporate income tax effectively at the rate of 19.6 per cent, compared to the combined federal and state statutory rate of 39 per cent.[11] According to Forbes (2016): "A portion of Google's profits are paid to an Irish affiliate as royalties on its patents (which are taxed at a lower rate). To further avoid taxes, this money is then routed to the company's Dutch subsidiary, Google Netherlands Holdings BV. From there, the company transfers its revenue to another affiliate, Google Ireland Holdings, which is based in the notorious tax haven of

[9] Bret Wells & Cym Lowell (2011):"Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin," Tax Law Review, Vol. 65, pp. 551- 554. For an authoritative view on how PE definition changed over time and shifted taxation from source countries, see Arvid A Skaar (1991): "Permanent Establishment – Erosion of Tax Treaty Principle." Dordrecht (etc.), Kluwer Academic, 1991.

[10] OECD (2013): Addressing Base Erosion and Profit Shifting," p. 17. http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/addressing-base-erosion-and-profit-shifting_9789264192744-en#.WF_a01V97Dc#page19

[11] https://www.bloomberg.com/news/articles/2013-06-12/u-k-lawmakers-slam-google-over-contrived-tax-strategy

Bermuda—but registered in Ireland… So there you have it—double Irish with a Dutch sandwich."[12] Google was not alone in such 'tax avoidance', the list included Apple Inc., Yahoo! Inc., Dell Inc., Merck & Co., Cisco Systems Inc., Microsoft Corp. and Forest Laboratories Inc. [13]

The problem was soon identified as base erosion and profit shifting (BEPS). At the G20 Leaders Summit in Los Cabos, Mexico, in June 2012, world leaders expressed the "need to prevent base erosion and profit shifting" and voiced support for the work being done in that area by the OECD.[14] The dangers from BEPS were manifold. With the danger of double taxation superseded by double non-taxation, BEPS was not restricted to source countries alone any more. It had embraced de-facto home countries as well. So much so that in the context of outbound investments or transactions, experts in the US suggested a revision of the US transfer pricing principles to require that cross-border payment from a US payor to a related foreign entity obtain a base-clearing certificate from the Internal Revenue Service, in the absence of which it would be subject to a base-protecting surtax.[15]

Following the endorsement from G20, OECD released a report "Addressing Base Erosion and Profit Shifting" in February 2013.[16] OECD also drew up a 15-point "Action Plan for Base Erosion and Profit Shifting" with timelines and published it in July 2013, and it was endorsed by the G20 summit in September, 2013 in St. Petersburg.[17] The final reports on each of the 15 action items identified in the Action Plan were delivered to the G20 leaders. The G20 leaders, at their summit at Antalya, Turkey, in November, 2015, endorsed the package of measures drawn up under the OECD Action Plan, and noted that widespread and consistent implementation will be critical to reach a globally fair and modern international tax system.[18] "To monitor the implementation of the BEPS project globally", it called on the OECD "to develop an inclusive framework by early 2016 with the involvement of interested non-G20 countries and jurisdictions which commit to implement the BEPS project, including developing economies, on an equal footing."

b) Problem of limited taxation rights in source countries

The taxation rights of source countries, where the customers are located and profits are generated, has remained a thorny problem for a long time and only got exacerbated by MNEs. Many of them, through aggressive tax planning, avoided payment of taxes to the source countries. Apart from choosing their country of residence, partly, they did so also by adjusting their transfer prices and capital structure, for example, charging high prices and interest for inter-corporate transfers and loans to high income tax jurisdictions and funding activities in such jurisdictions through debt rather than equity. Not only developing countries, many developed countries were suffering the 'source

[12] "Google Moved Billions Of Dollars To Bermuda To Avoid Taxes... Again," Forbes, February 19, 2016. http://www.forbes.com/sites/abigailtracy/2016/02/19/google-moved-billions-of-dollars-to-bermuda-to-avoid-taxes-again/#55e2021022a2

[13] https://www.bloomberg.com/news/articles/2013-01-23/yahoo-dell-swell-netherlands-13-trillion-tax-haven

[14] G20 Leaders Declaration, para 48, p. 9. http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/131069.pdf

[15] 15 Bret Wells & Cym Lowell (2011):"Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin," Tax Law Review, Vol. 65, pp. 535- 618. P.

[16] http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/131069.pdf

[17] https://www.oecd.org/ctp/BEPSActionPlan.pdf

[18] http://www.mofa.go.jp/files/000111117.pdf p. 3, para 15.

country problem' as well. The advent of the digital economy worsened the problem. For example, in 2011, Google paid only £6 million on sales of £4.1 billion in the U.K.[19]

With BEPS, in source countries, governments lost revenues, resident companies suffered a tax handicap, fair competition was harmed, and ownership and production got distorted. BEPS affected the integrity of the tax system, the public and the media considered the low taxes paid by MNEs to be unfair, and to the extent that some MNEs did not pay their due taxes, others who paid had to pay more. With heavy reliance on intangible assets, massive use of data, including personal data, and multi-sided business models to capture value from externalities generated by free products, MNEs in the digital sector made it difficult to determine in which jurisdiction value was being created and profits generated.[20]

The taxation rights of source countries appeared stronger in the digital economy than in other sectors. Personal data of users is a key resource in the digital sector. Such data are not only used to measure and improve performance of applications, customise services, and recommend products to customers, but also licensed to third parties for a consideration. In a way, as Collin and Colin (2013) have put it, customers become 'virtual volunteer workers for the companies providing the services that they use.' 'The data from the users' with their "free labour" are collected, stored and processed to be integrated into the production chain in real time, blurring the dividing line between production and consumption.'[21]

c) TFDE recommendations

Characterisation of some items provided by companies in the digital economy posed considerable challenges. Take for example, cloud computing. Are payments for cloud computing payment for royalties or rentals, for technical services or business profits? Lastly, there was the issue of VAT collection on goods or services in a B2C that is business to consumer mode, or acquired by consumers from suppliers abroad through intermediation by a digital company.

In September 2013, a Task Force on the Digital Economy (TFDE) was established under the Committee on Fiscal Affairs (CFA) of the OECD to identify the issues raised by the digital economy and possible actions to address them. The TFDE published a draft report in March 2014, which emphasised the following four tax challenges posed by the digital economy—nexus, data collection, characterisation of its business, and collection of VAT. PE is the critical element in determining taxability in a jurisdiction, but the need for physical nexus had been rendered unnecessary in the digital economy.

TFDE adopted the Ottawa framework principles of neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility, and in its public discussion draft report released in March 2014 asked for inputs on BEPS including on three options – modifications of the exceptions to the PE status contained in paragraph 4 or Article 5 of the OECD Model Tax Convention, a final withholding tax on certain payments made by residents of a country for digital goods or services

[19] https://www.bloomberg.com/news/articles/2013-05-23/apple-tax-rate-ignores-profit-shifting-offshore
[20] https://www.oecd.org/ctp/BEPSActionPlan.pdf P. 10.
[21]Pierre Collin and Nicolas Colin (2013): "Task Force on Taxation of the Digital Economy," France, January 2013, pp. 50-54, http://www.hldataprotection.com/files/2013/06/Taxation_Digital_Economy.pdf

provided by a foreign e-commerce provider, and imposition of VAT on B2C transactions in the digital economy.[22]

TFDE noted that the BEPS project had 15 action areas and some of these will ameliorate the taxation problems in the digital economy. For example, appropriate taxation in the source jurisdiction should be restored by preventing treaty abuse (Action 6), and preventing the artificial avoidance of PE Status (Action 7). Appropriate taxation in the ultimate residence jurisdiction will be restored by strengthening controlled foreign company (CFC) rules (Action 3). Similarly; appropriate taxation in both source and residence countries will be restored by neutralising the effects of hybrid mismatch arrangements (Action 2), by limiting the base erosion via interest deductions and other financial payments (Action 4), by countering harmful tax practices more effectively (Action 5), and by assuring that transfer pricing outcomes are in line with value creation (Actions 8-10). The OECD came out with a Report on *Addressing the Tax Challenges of the Digital Economy, Action 1: 2014 Deliverables* in September 2014.[23] In this report, TFDE, after noting how the other actions will affect taxation of the digital economy, suggested, apart from VAT on B2C transactions, modification of the exemptions from PE status, and a final withholding tax on certain payments made by residents of a country for digital goods or services provided by a foreign e-commerce provider, a bandwidth or Bit tax dependent on the website's bandwidth use.

In October 2015, OECD published "Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report." [24] According to it, TFDE had also examined three options, namely *(i)* a new nexus in the form of a significant economic presence, *(ii)* a withholding tax on certain types of digital transactions, and *(iii)* an equalisation levy.

OECD endorsed the imposition of VAT/GST on cross-border transactions, particularly in B2C transactions. But, it said "None of the other options analysed by the TFDE, namely *(i)* a new nexus in the form of a significant economic presence, *(ii)* a withholding tax on certain types of digital transactions, and *(iii)* an equalisation levy, were recommended at this stage."[25] This is "...because, among other reasons, it is expected that the measures developed in the BEPS project will have a substantial impact on BEPS issues previously identified in the digital economy, certain BEPS measures will mitigate some aspects of the broader tax challenges, and consumption taxes will be effectively levied in the market country." Furthermore, OECD advised countries adopting such options in their domestic laws as additional safeguards against BEPS, to respect existing international legal commitments.[26]

d) Service tax on OIDAR and equalisation levy in India

The OECD released its final report on all 15 focus areas of BEPS on October 5, 2015 with the TFDE recommending imposition of VAT on B2C transactions in the digital economy. After little more than a year, on November 9, 2016, the Indian Central Government withdrew the exemption

[22] https://www.oecd.org/ctp/tax-challenges-digital-economy-discussion-draft-march-2014.pdf Chapter VII.
[23] http://www.pmstax.com/intl/OECD-BEPS/BEPS_Digital_Economy_140916.pdf
[24] http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report_9789264241046-en#.WGqaglV97Dc Also available in "OECD/G20 Base Erosion and Profit Shifting Project -- 2015 Final Reports."
[25] "Addressing the Tax Challenges of the Digital Economy", p. 13.
[26] OECD (2015): "Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report; p.148. http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report_9789264241046-en#page150

from service tax of cross border business to consumer (B2C) provision of online information and database access or retrieval (OIDAR) services, for any purpose other than commerce, industry or any other business or profession and provided online/electronically from a non-taxable territory to consumers in the taxable territory in India.[27] Such consumers are also called 'non-assessee online recipients.' The exemption was withdrawn with effect from December 1, 2016.

The notification clarified that OIDAR included:

i. advertising on the internet;
ii. providing cloud services;
iii. provision of e-books, movie, music, software and other intangibles via telecommunication networks or internet;
iv. providing data or information, retrievable or otherwise, to any person, in electronic form through a computer network;
v. online supplies of digital content (movies, television shows, music, etc.);
vi. digital data storage; and
vii. online gaming.

Services received by business, i.e. persons other than Government, a local authority, a governmental authority or an individual, called *cross border B2B (business to business) services,* were and are taxable under reverse charge. Such service recipients in India were and still are required to pay service tax.

There were practically no protests against the imposition of service tax on B2C OIDAR transactions. The heated discussion came in the context of the imposition of the 6 per cent equalisation levy applicable under Chapter VIII of Finance Act, 2016 "to consideration received or receivable for specified services provided on or after the commencement of this Chapter."

In India, the Central Board of Direct Taxes had also set up a *Committee on Taxation of E-Commerce*, which submitted its report on February 3, 2016.[28] Of the three options discussed in the OECD report, namely a new nexus based on significant economic presence, a withholding tax on digital transactions, and Equalisation Levy, the Committee recommended a 6 to 8 per cent equalisation levy on the gross payment made for specified digital services and facilities including 'online marketing and advertisements, cloud computing, website designing hosting and maintenance, digital space, digital platforms for sale of goods and services and online use or download of software and applications.'[29] It recommended that 'only payment exceeding Rs. one

[27] Notification Nos. 46/2016-ST, 47/2016-ST, 48/2016-ST and 49/2016-ST were issued on November 9, 2016 to appropriately change the statutory and legal provisions, including the Place of Provision of Services Rules, 2012.

[28] http://incometaxindia.gov.in/news/report-of-committee-on-taxation-of-e-commerce-feb-2016.pdf. The report, however, was released after the Budget presentation.

[29] In India, in 1999 a High Powered Committee on Electronic Commerce and Taxation was constituted under Kanwaljeet Singh to study the various aspects of e-commerce and suggest measures relating to taxation. It suggested the abolition of the concept of permanent establishment and introduction of a low withholding tax on all base-eroding payments. However, this was never implemented because there was no international consensus. In fact, in 2005, the OECD Technical Advisory Group's "Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-commerce? Final Report" concluded that "…it would not be appropriate to embark on such changes at this time. Indeed, at this stage, e-commerce and other business models resulting from new communication technologies would not, by themselves, justify a dramatic departure from the current rules. Contrary to early predictions, there does not seem to be actual evidence that the communications efficiencies of the internet have caused any significant decrease to the tax revenues of capital importing countries." (Paragrah 350 of the report) See www.oecd.org/ctp/treaties/35869032.pdf .

lakh made by a person resident in India or a permanent establishment of a non-resident person to a non-resident enterprise' be covered under the levy. Furthermore, income arising from such transactions, on which equalisation levy has been paid, may be made exempt from income tax.

The Committee recommended that deduction of equalisation levy by payment gateways and by authorised foreign exchange dealers may be encouraged to significantly reduce the obligations on payers. Furthermore, it also urged continuous monitoring of further developments in digital economy and in international taxation rules.

India was not alone in responding to the OECD G20 report on BEPS with new taxation initiative. United Kingdom was the first to react by introducing the 'diverted profit tax' on structures that seek to abuse the PE concept. Japan introduced a consumption tax at 8 per cent on provision of cross-border digital services to its residents. Argentina introduced a turnover tax withholding system for revenues derived by non-residents from rendition of online services, wherein 3 per cent of the net price is to be withheld at the time of remitting funds abroad. Australia has issued guidance on a new law that will apply GST to international sales of services and digital products from July 1, 2017.[30] In Australia, the Multinational Anti-Avoidance Law (MAAL) also came into effect on December 11, 2015.[31] It applies to foreign entities supplying goods and services to residents on or after 1 January 2016, or resident entities, which are associates of or are commercially dependent on a foreign entity, undertake activities directly in connection with the supply and some or all of the income derived by the foreign entity is not attributable to an Australian permanent establishment. While many other countries did initiate measures to tax the digital sector, India was the first in pioneering the use of equalisation levy for taxation of the digital sector.

III. Concerns about the equalisation levy

Several concerns have been expressed about the equalisation levy. The levy on the hard-to-tax digital sector is of a presumptive nature, with all the attendant infirmities of a presumptive tax. These concerns and their analysis can be classified into the following six categories.

a) Lack of clarity about its nature – direct or indirect?

The equalisation levy in the Finance Bill, 2016 is under a separate chapter and hence there is lack of clarity as to whether it is in the nature of an additional income tax, or an indirect tax as it is on consideration for services. The *Committee on Taxation of E-Commerce* had not recommended the first two options recommended by TFDE, namely redefining PE on the basis of a new nexus based on significant economic presence and the withholding tax on digital transactions, because these would require changes in a number of tax treaties. The option of equalisation levy, according to the Committee, provided a simpler option under domestic laws without needing amendment of a large number of tax treaties. It added "The Equalization Levy imposed on the payment for digital transactions, would not be a tax on income, and hence would not be covered by tax treaties. As

[30] Indian equalisation levy – progressive or regressive? Mukesh Butani and Sumeet Hemkar http://kluwertaxblog.com/2016/06/27/indian-equalisation-levy-progressive-regressive/

[31] https://www.ato.gov.au/Business/International-tax-for-business/In-detail/Doing-business-in-Australia/Combating-multinational-tax-avoidance---a-targeted-anti-avoidance-law/

Equalization Levy is not proposed as tax on income, it would need to be imposed outside the Income-tax Act, 1961."[32]

More generally, it is asked whether the equalisation levy is a direct or an indirect tax. Economists agree that given the difficulties of classifying a tax as direct or indirect, it is best to abandon such a distinction.[33] After all, when the US Constitution prohibited the federal government from imposing direct taxes, with the benefit of 'the economics of clever lawyers in a tight place,' the US Supreme Court declared income tax as an indirect tax![34] Yet, because of the importance of the distinction in popular parlance and even legal proceedings, the distinction cannot be given up altogether.

Let us consider four, among many, alternative definitions of a direct and an indirect tax – administrative, classificatory, design and in terms of incidence. Administratively, a direct tax is levied "…at stated periods by means of assessment rolls of names; while indirect are levied only under certain circumstances or situations, and by means of tariffs or schedules of charges."[35] Thus, under the administrative view, the equalisation levy is an indirect tax, but this administrative classification is of very limited use because of its little relation with the intrinsic nature or economic effects. A second definition relies on the classification of what is being taxed. "A direct tax reaches in the payer taxable elements which are of a durable, constant and continuous character, such as existence, possession or profession. To exist, to possess, to carry on trade or industry, these are permanent facts. . . . Indirect taxes do not reach qualities or possessions, but circumstances, particular or intermittent facts."[36] Equalisation levy kicks in only when a B2B transaction of a particular type takes place, and hence under the classificatory approach, it is an indirect tax.

The third definition is on the basis of design. A direct tax by design "…can be adjusted to the individual characteristics of the taxpayer, whereas indirect taxes are levied on transactions irrespective of the circumstances of the buyer or seller."[37] Even by this design criterion, the equalisation levy is an indirect tax.

The fourth and most important definition of direct and indirect taxes is in terms of incidence. Traditionally, taxes on income and wealth are considered as direct taxes, because it is popularly believed that they are collected, in the first instance, from the persons who are to bear them, while indirect taxes are those which are collected from persons who shift the burden upon others.[38] But, with the well-known shifting of the tax burden even in the case of income tax, say to labour market, the definition becomes infructuous. One of the valid ways of classifying taxes into direct and indirect is "…the supposition or intention of the taxing authorities" about incidence. John Stuart Mill, an early advocate of the legislative intention view for classification of taxes into direct and indirect wrote "A direct tax is one which is demanded from the very persons who, it is intended or desired, should pay it. Indirect taxes are those which are demanded from one person in the

[32] http://incometaxindia.gov.in/news/report-of-committee-on-taxation-of-e-commerce-feb-2016.pdf, p.5.
[33] Charles J. Bullock (1898): "Direct and Indirect Taxes in Economic Literature," Political Science Quarterly, Vol. 13, No. 3 (Sep., 1898), pp. 442-476. Pp. 475-476.
[34] A.B. Atkinson (1977): "Optimal Taxation and the Direct versus Indirect Tax Controversy," Canadian Journal of Economics, Vol. 10, No. 4, November 1977, pp. 590-606. P. 591.
[35] Bullock (1898), p. 463.
[36] Bullock (1898):, p. 465
[37] Atkinson (1977), p. 592.
[38] Bullock (1898):, p. 460.

expectation and intention that he shall indemnify himself at the expense of another. . ."[39] Even if a part of the incidence is shifted on to others, for a direct tax the major part of the incidence stays with the person who pays it at the first instance.

The only tax that applies to resident businesses within India and not the non-residents without PEs is the Indian income tax.[40] The Report behind the equalisation levy unambiguously stated that "The word 'equalization' represents the objective of ensuring tax neutrality between different businesses conducted through differing business models or residing within or outside the taxing jurisdiction."[41] There can always be some residual uncertainty about legislative intention, but this intention behind the equalisation levy appears to be that of a 'direct tax', namely income tax. Though it is intended to have the effect of a direct tax, it is collected as an indirect tax with the hope that the burden is shifted by the buyers of the specified services from whom it is collected to the sellers. So, the equalisation levy is more akin to a presumptive Indian income tax in the form of a turnover tax, which is an indirect tax.[42]

In final analysis though, by itself, whether the levy is a direct tax or an indirect one is not of critical importance, what is important is the implication of the presumptive nature of the tax on factors such as equity versus efficiency, incidence, and modes of doing business. We turn now to equity versus efficiency.

b) Equity versus efficiency

i. Equity

The equalisation levy has the triple advantages of clarity, certainty and predictability. But, its role in promoting equity and efficiency needs a careful analysis.

There is clear inequity in resident providers of 'specified services' bearing the burden of corporate income tax while some MNEs providing the same services not paying any such corporate income tax in their relevant tax jurisdiction. But the problem becomes complicated when a foreign company, which does not have a PE in India and supplies such services, and is subject to corporate income tax in its relevant tax jurisdiction is subject to the equalisation levy.

The equalisation levy is on transaction, and hence different from income tax and has been imposed through statutory provisions outside the existing Income-tax Act. Since it is not an income tax, if a non-resident company supplying the 'specified services' and paying equalisation levy is also

[39] Quoted in Bullock (1898), p. 461.

[40] Under Section 165 of the Finance Act, 2016 introducing the equalisation levy, this B2B levy applies to the amount of consideration for any specified service received or receivable 'by a person, being a non-resident' and not only by non-resident corporate. So, the levy is described in this paragraph as a presumptive income tax and not presumptive corporate income tax. Since, in reality, it will probably apply mostly to payments to non-resident corporates, the term corporate income tax instead of income tax is used liberally.

[41] http://incometaxindia.gov.in/news/report-of-committee-on-taxation-of-e-commerce-feb-2016.pdf, p.75.

[42] "It is urged correctly that the intention of the legislator is " too uncertain an element for the characterization of a scientific conception." It is asked whether Congress intended to burden the producer or the consumer by the tax formerly imposed on bottles of patent medicine, and for whose benefit the tax was repealed. We must concede that the legislator often has considered not at all the incidence of taxes, but merely the easiest or quickest way of raising money." See Bullock (1898):, p. 462.

paying income tax in its residence country, it will not be able to claim income tax credit for the equalisation levy paid and this will result in double taxation.[43]

Such companies will suffer from double taxation and their existence cannot be ruled out as impossible.

Furthermore, two foreign companies without PEs and supplying such services to Indian resident businesses may have very different incomes. Subjecting their sales to the same rate of equalisation levy violates the principle of equity that the levy implicitly tries to achieve. As discussed more fully below, the monopolistic market structure in digital services is likely to result in such cases particularly with very different mark-up rates for the dominant players and new entrants.

Even if it is assumed that overall equity of taxation, especially across resident and non-resident companies in the digital sector, will improve with the equalisation levy, the efficiency effect of the levy has to be weighed in, and that is what we turn to now.

ii. Efficiency

When a tax is imposed on a sector, both the supply and demand sides are affected.[44] The players on the supply side of online advertisement include not only internet search companies (e.g., Google and Yahoo), but also social media companies (e.g., Facebook, Twitter and You Tube), digital marketing companies (e.g., Webchutney, Sparrowi and Techshu), website App developers (e.g., OpenXCell and Konstant Infosolutions), and website App marketplace companies (e.g. Android and ITunes). They derive revenues from hosting advertisement (ad) banners, sidebar ads of related contents, target ads, ad word searches, pre-roll videos based on user preferences, etc. Telecom companies are also on the supply side of the market since all digital advertisement, as a matter of fact the entire digital economy, runs on their network.

On the demand side of online ad are thousands of domestic companies. Ad spending in India was estimated to have grown by 15.5 per cent in 2016 to Rs.57,486 crore, with digital ad expanding at the fastest pace of 47.5 per cent to Rs. 7,300 crore and accounting for 12.7 per cent of all ad spending.[45] Advertisement budgets as a proportion of total revenue can be anywhere between 10 per cent for manufacturing companies and as high as 50 per cent for software as a service company. Start-ups tend to spend a relatively larger proportion of their revenues on ads to popularise their products and services. There are concerns that, with their high ad budgets, any

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[43] http://blogs.economictimes.indiatimes.com/et-commentary/government-needs-to-come-clear-on-new-tax-equalisation-levy/ "Assocham wants 'equalisation levy' as part of Income Tax Act," https://in.news.yahoo.com/assocham-wants-equalisation-levy-part-income-tax-act-133219857--finance.html

[44] In polar cases, the effect can be only on the demand or supply side. But, as discussed below, such cases are extreme.

[45] Group M: "This Year Next Year – 2016 India Report." http://bestmediainfo.in/mailer/TYNY2016IndiaReport.pdf According to the Press Release for their 2017 report, "India remains, by far, the fastest growing market in the world's ten, $10B plus ad markets. Growth is forecast at 13.8 per cent in 2016 and 12.5 per cent in 2017, with an economy fueled by low interest rates, sustained urban demand and the impact of key reforms."

pass-through of the equalisation levy burden to them will create a 'huge problem' for these start-ups.[46]

Efficiency impact of the levy will depend on how much of the burden of the equalisation levy is passed through to the domestic companies and how much of their output and growth will be affected as a result. There may be second round impact of this levy on the economy through the backward and forward linkages of the users of online ads, which for simplicity can be ignored.[47] Similarly, given the limited government revenues from the levy, estimated at Rs. 146.5 crore in the first half year of its application, the beneficial effect of government expenditure financed by these additional revenues are also ignored.[48] The neglect of these two effects is equivalent to the assumption that the second round adverse effect of the levy is neutralised by the beneficial impact of additional expenditure financed by the revenues from the levy.

Thus, what is critical for determining the efficiency effect is how much of the burden of the equalisation levy is passed on by the suppliers to Indian businesses that use such services and how much is absorbed by the non-resident suppliers of services without PEs. This can be judged only by studying the likely incidence of the equalisation levy, to which we now turn..

c) Incidence of the equalisation levy

The impact of a tax, that is who physically pays it to the government, is often taken as the burden of a tax in popular parlance. But this can be a mistaken conclusion. For example, if the government collects the sales tax from the seller (cum producer) that does not necessarily mean that it is the seller who pays it all. A part of it may be passed on to the buyers. Similarly, if the tax is collected from the buyers, it does not mean that the buyer pays it all, to protect the quantity demanded, the seller may reduce the price before tax and absorb a part of the tax.

There are reports that some non-resident online advertising companies have decided to absorb the equalisation levy on all cross-border digital transactions and not pass it on to Indian firms advertising on their platform.[49] In sharp contrast, on the assumption that the levy will not only be passed on but more than passed on through grossing up, there are analyses of how the levy is going to create 'huge problems' for start-ups and kill innovation.[50] It has been said that with the levy outside the Income Tax Act, foreign companies in their home country will not get tax credit for the levy and pass on the entire tax to Indian consumers. Indian companies will have to gross up the fee so that the foreign online company receives the original fee.[51]

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[46] 'Equalisation Levy is going to create a huge problem for startups,' Forbes, December 21, 2016. http://www.forbesindia.com/article/special/equalisation-levy-is-going-to-create-a-huge-problem-for-startups/45175/1

[47] An example of such linkages is resident e-commerce companies, online travel and hotel sites, who though not primarily but rely partly on revenues from product advertising, promotions, etc.

[48] http://www.live-news-today.com/2016/12/11/government-gets-rs-146-crore-from-equalisation-levy-till-dec-2016-17-446085

[49] "LinkedIn won't pass on equalisation levy to companies advertising on its platform ," Economic Times, July 15, 2016, http://economictimes.indiatimes.com/tech/internet/linkedin-wont-pass-on-equalisation-levy-to-companies-advertising-on-its-platform/articleshow/53220911.cms

[50] If the 6 per cent levy is fully passed on and grossed up by the resident users of online advertising, a company which was paying Rs. 100 before the levy was imposed will have to show an invoice of Rs. 106.38, deduct 6 per cent of this grossed up amount paid for the service, which is Rs. 6.38 as equalisation levy, and pay the same unchanged Rs. 100 net of the levy to the foreign supplier. The burden of the levy at Rs. 6.38 is more than Rs. 6!

[51] "Equalisation Levy: Google, Facebook unlikely to foot the bill" http://www.businesstoday.in/opinion/perspective/equalisation-levy-google-facebook-unlikely-to-foot-the-bill/story/233285.html

The combined effect of the equalisation levy and the newly imposed service tax of 15 per cent on start-ups has been estimated to be as high as 22.3 per cent.[52] For registering consistent rapid growth, digital advertising is the backbone of start-ups. It has been argued that start-ups and small businesses in India have little negotiating powers and will have to bear the final cost of the equalisation levy. They rely heavily of foreign giants such as Google and Facebook as 'windows to the outside world'. With cost going up, they will have to cut down on their digital advertising budgets, and this will affect their customer acquisition and growth.[53] It has been said that "At a time when India is riding on a startup & digital wave, Government has decided to punish those who attempt to embrace the new digital media..."[54]

This fear has been heightened by the apprehension that the list of specified services will be extended over time by a simple notification by the government. Ever since its introduction, there has been speculation that the ambit of equalisation levy is likely to cover more online transactions in the future.[55]

It has been admitted though that "Nobody is sure about the degree of impact of this levy. However, this is something that is worrying the startup world, especially as it heavily relies on digital advertising to get the word out."[56]

As is well-known, the burden of taxation, under perfect competition, is physically neutral in the sense that it is independent of who 'physically' pays the tax. Furthermore, letting ρ denote the pass-through rate or the rate by which the price paid by consumers rise when the tax increases by one per cent, the burden of the tax is shared between consumers and producers in the ratio $\frac{\rho}{1-\rho}$, which we will call incidence, where

$$\rho = \frac{1}{[1 + \frac{\epsilon_D}{\epsilon_S}]} \qquad (1)$$

Where ϵ_D and ϵ_S are the elasticities of demand and supply.[57] They measure the percentage change in demand price and supply price to a percentage change in quantity.

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[52] http://www.nishith.tv/?videos=webinar-equalisation-levy-impact-on-start-ups-nov-08-2016

[53] Equalisation Levy (Google Tax): Impact for Startups; FAQs, Compliances & Penalties http://blog.startupmoksha.in/2016/07/11/equalisation-levy-google-tax-impact-for-startups-faqs-compliances-penalties/

[54] http://trak.in/tags/business/2016/03/02/governments-anti-startup-anti-digital-move-6-equalisation-levy-digital-advertisements-india/

[55] See, for example, Livemint March 21, 2016, http://news.vikral.com/ambit-of-equalization-levy-likely-to-cover-more-online-transactions-livemint/

[56] https://yourstory.com/2016/06/digital-ads-levy-indian-startups/

[57] See E. Glen Weyl and Michal Fabinger (2013): "Pass-Through as an Economic Tool: Principles of Incidence under Imperfect Competition," Journal of Political Economy, Vol. 121, No. 3 (June 2013), pp. 528-583. Note the demand and supply functions are taken as the inverse demand and supply functions, or price, p, as functions of quantity. Furthermore, $\epsilon_D = -\frac{q}{p}\frac{\partial p}{\partial q}$, where q is quantity demanded. The inverse demand function is the willingness to pay function

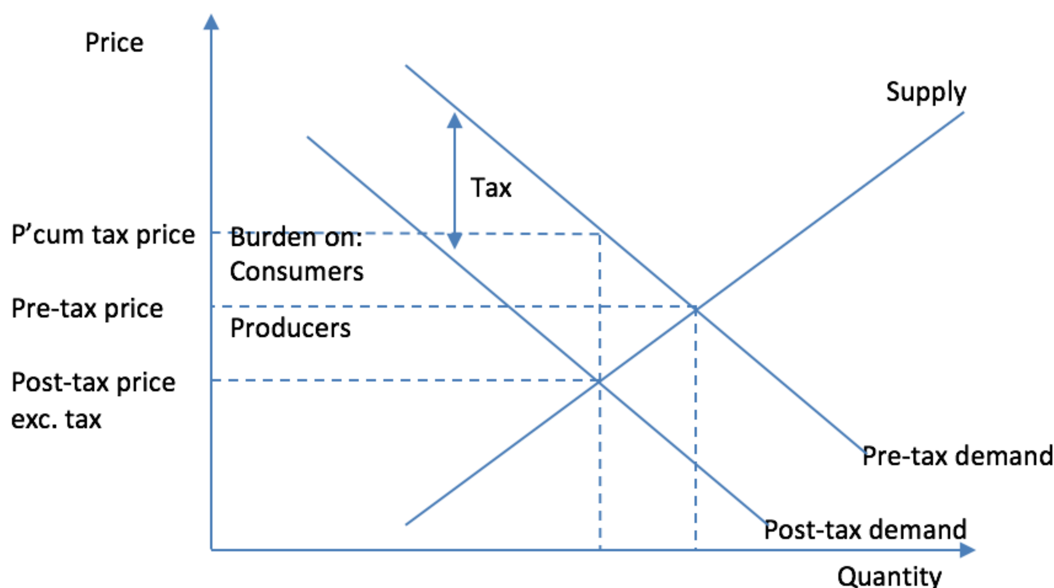

Figure 1. Perfect Competition -- Burden of tax shared between suppliers and consumers

Figure 1 illustrates this distribution of the tax burden of a per unit nominal tax. The presumption that the equalisation levy of 6 per cent collected from the consumers of specified goods supplied by non-resident entities without a PE falls entirely on the consumers is valid if and only if the market for such specified services is perfectly competitive, and either demand is completely inelastic (the demand curve is a vertical line) or their supply is perfectly elastic (supply curve is a horizontal line). The market structure of digital services, which is the target of the equalisation levy, is far from perfectly competitive. Furthermore, the cost structure of this sector also has its peculiarities.

Production of digital services involves a lot of fixed cost, but marginal cost of producing extra units of services is very low.[58] Equality of marginal cost under perfectly competitive conditions would tend to drive prices down to zero, and the firms would be unable to recover their fixed costs and become bankrupt. Instead, what is found is that the market gets dominated by one or two large firms, with a disproportionately low share for the others. According to January 2016 US desktop search rankings from comScore, Google had 63.8 per cent share of such searches, followed by 21.3 per cent of Microsoft, 12.4 per cent of Yahoo, 1.7 per cent of Ask Network and others with less than 1 per cent share each.[59] Google is dominant in nearly every country, other than China (Baidu), Russia (Yandex), Korea (Naver) and the Czech Republic (Seznam).[60].

[58] 'Information is costly to produce but cheap to reproduce.' See Hal R. Varian (1998): "Markets for Information Goods,"University of California, Berkeley, October 16, 1998.
http://people.ischool.berkeley.edu/~hal/Papers/japan/japan.pdf
[59] http://searchengineland.com/since-2013-bings-share-5-points-ask-aol-going-way-blackberry-242759
[60] Eric Enge (2016): "Competitive threats to Google, and what they mean for you," Search Engine Land, May 24, 2016, http://searchengineland.com/competitive-threats-google-means-249772

There is also the network effect, whereby as the number of users increases, the value of the firm's services increases as the square of the number of such users.[61] Growth, feeding on itself, tends to reinforce the increasing returns to scale and hence the emergence of one or two firms dominating the market.

Had the digital services market been dominated by just one seller, the impact of the equalisation levy would have been relatively easy to determine. Figure 2 illustrates the case with constant marginal cost, a plausible assumption for the digital economy.

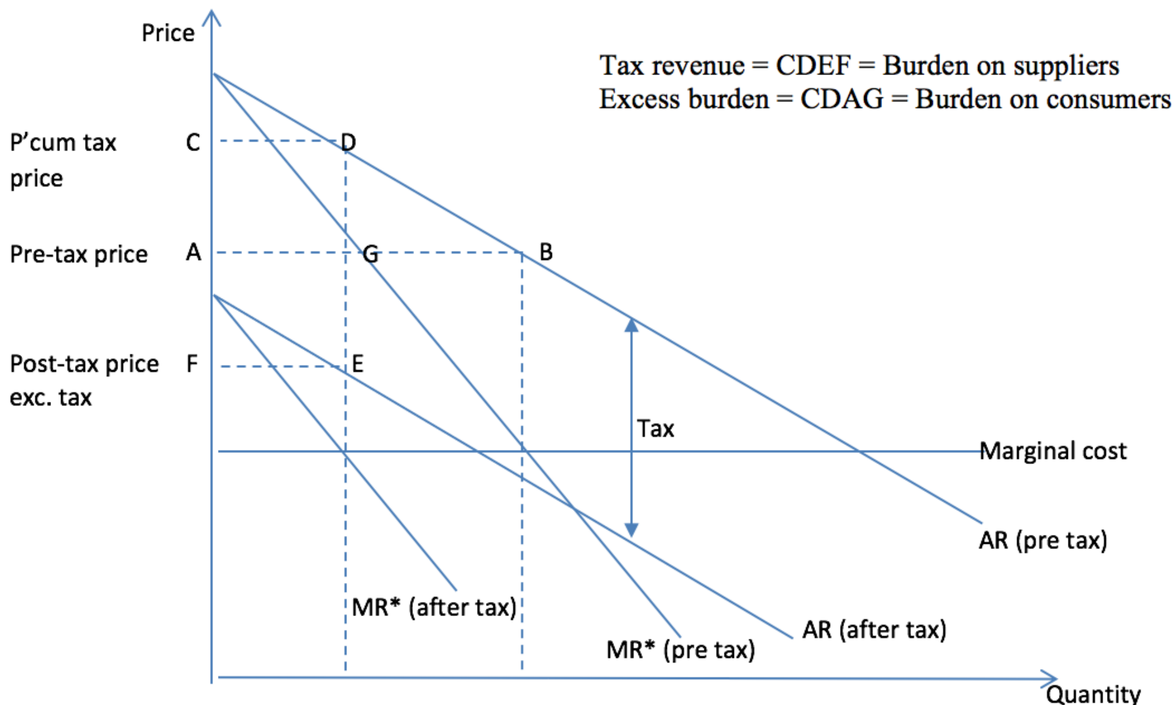

Figure 2. Excess burden under Monopoly with constant marginal cost

- MR denotes marginal revenue

Under monopoly, the seller determines the quantity to be sold by the equality of marginal cost with marginal revenue. With a per unit fixed tax, there is a parallel shift of the demand curve by the amount of the tax without changing its curvature. The burden of the tax falls on both consumers and suppliers, but the burden is more than fully shared by the consumers and suppliers. The tax revenue is equal to the burden on the producers, and the consumers' burden or pass through is equivalent to an excess burden of the tax. .

The tax can be seen as an additional cost for the monopolist supplier, and the intuition is that she contracts output so that marginal revenue (MR) rises by the amount of the tax. Let 'p' denote price. Following Bulow and Pfleider (1983), when marginal cost is constant for a monopolist, the pass through rate can be expressed as

[61] This is popularly known as Metcalfe's law, whereby the value of a network is proportional to the number of users.

$$\rho = \frac{\in_D}{[1 + \in_D + \frac{p}{\in_D}\frac{\partial \in_D}{\partial p}]} \qquad (2)$$

and this pass through rate is the excess burden.[62]

The digital services market is more complicated than a perfectly competitive or a monopolist market. A specified service is not an undifferentiated, homogenous service necessary to sustain a perfectly competitive market. Take the example web advertising and Google's AdWords, which is the main revenue earner for the digital giant. On online advertising service, advertisers pay to display their brief advertising copy to web users. AdWord, partly based on cookies, offers many versions by combining defining keyword, scheduling, geo-targeting and device-targeting.[63] Web pages from Google and from partner websites are designed to allow Google to select and display the advertising copy selected. Advertisers pay when users divert their browsing to seek more information about the copy displayed, and partner websites receive a portion of the income that is generated. The price charged is per click, termed PPC, and is determined through an auction.[64]

Firms tend to *version* the information service.[65] They offer a service line of variations on the same underlying service. The service line is designed so as to appeal to different market segments, and thereby sell at a high price to those who have a high value for the service, and a low price to those who value it less. Versioning is a common strategy for digital services. With versioning, the market is neither of perfect competition nor of monopoly, but that of monopolistic competition.

In the digital services market with monopolistic competition, substitutes are available from competing sources, but with differentiated properties. There are no barriers to exit or entry, except for the large fixed cost, which is a sunk cost. Large companies market highly differentiated services in order to practise price discrimination and maximise revenue and profits. Ordinary customers find it difficult to fully comprehend all the features of the service being offered. The prices charged by competitors are also difficult to fully compare with the price being offered by competitors because of the differentiated nature of the products. Each company enjoys limited monopoly powers in their niche product segments. For maintaining this market power, the companies periodically also issue new updated version of their services to existing and new consumers. The firm's technology is the source of its market power. The threat of competition from this technology becoming available to its rivals or the rivals introducing a new technology acts as a disciplining device to restrain the firms from earning super normal profits in the long run. They do not want to earn 'too much' in the short run to jeopardise profits in the long run.

The incidence of a tax in an imperfectly competitive market is a complex issue. With constant marginal cost almost equal to zero, consider the simple case of a symmetric imperfect competition

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[62] Jeremy I. Bulow and Paul Pfleiderer (1983): "Note on the Effect of Cost Changes on Prices," Journal of Political Economy, Vol. 91, No. 1 (Feb., 1983), pp. 182-185

[63] Cookies are small files stored on a user's computer. They and are designed to hold a modest amount of data specific to a particular client and website, and can be accessed either by the web server or the client computer.

[64] Quality score is a weighted average of the click-through rate (CTR, which is number of clicks received per number of impressions), the relevance of each keyword to the ad group, landing page quality and relevance, relevance of the ad text, and past account performance. The PPC is the ratio of ad rank of the entity below the advertiser and the advertiser's quality score plus a US cent.

[65] Hal R. Varian (1999): "Market Structure in the Network Age," University of California, Berkeley,August 30, 1999. http://people.ischool.berkeley.edu/~hal/Papers/doc/doc.pdf

analysed by Weyl and Fabinger (2013). There are many firms selling a single product. The product of different firms may be distinct from the consumer's point of view, but the demand system is symmetric in the sense that demand for a firm's product depends on the aggregate of what the other firms are selling. This model nests many symmetric model of imperfect competition, including some models of monopolistic competition.[66]

Weyl and Fabinger (2013) show that, with constant marginal cost, the pass-through rate is given by

$$\boldsymbol{\rho} = \frac{\mathbf{1}}{\mathbf{1} + \frac{\in_{\boldsymbol{D}}}{\in_{\boldsymbol{MS}}}\frac{\boldsymbol{MS}}{\boldsymbol{p}}} \qquad (3)$$

where 'q' denotes quantity, $MS \equiv -\frac{\partial p}{\partial q} q$ is marginal consumer surplus that consumers earn when quantity expands, $\in_{MS}$ is the elasticity of the inverse marginal surplus function, and $\in_D$ is the elasticity of the inverse demand curve. The pass through to consumers depends on concavity or convexity of the demand function and $\rho \leq 1$ when demand is log concave, and $\rho > 1$ when demand is strictly log convex. Many demand functions are log concave, including those that are strictly concave, linear and exponential.[67] Essentially, log-concavity means that the demand is no more convex than an exponential function. Without log concavity of demand, the burden of a tax on consumers may be more than the revenue raised. With monopolist fully bearing the tax, the pass-through rate ρ indicates the excess burden of the tax and the deadweight loss ratio.

The above analysis demonstrates that though the allocation of the tax burden is not yet clear, the assumption that the domestic buyers of 'specified digital services' will bear the full burden of the levy is difficult to justify. While more work needs to be done to examine the sharing of the burden of the levy between the buyers and sellers, a priori, the burden is likely to be shared between the two. The smaller the share of the burden on buyers, the lower will be the adverse impact on start-ups and innovation.[68] Whether the sharing ratio is uniform or different across size of buyers will also be a matter of considerable interest.

d) Goes against OECD recommendation for a holistic resolution of BEPS problem

As already mentioned, TFDE had noted that the BEPS project had 15 action areas and some of these will ameliorate the taxation problems in the digital economy. Apart from VAT/GST on cross-border B2C digital transactions, the TFDE had considered, the three additional instruments of modification of the exemptions from PE status, a final withholding tax on certain payments made by residents of a country for digital goods or services provided by a foreign e-commerce provider and an equalisation levy. While the OECD final report of October 2015 had added "Countries

[66] For example, Avinash K. Dixit and Joseph E. Stiglitz. (1977). "Monopolistic Competition and Optimum Product Diversity," American Economic Review, Vol. 67, No.3, June 1977. Pp. 297–308.

[67] See Simon Cowan (2004): "Demand Shifts and Imperfect Competition," Department of Economics Discussion Paper Series, Number 188, March 2004, University of Oxford, UK. http://www.economics.ox.ac.uk/materials/working_papers/paper188.pdf

[68] When foreign sellers without PE are affected because of the equalisation levy, the adverse impact on innovation by domestic start-ups on the supply side of such services is likely to be negligible. Such start-ups in business relationships with foreign firms are covered under 'any provision for digital advertising space or any other facility or service for the purpose of online advertisement' – services of an ancillary nature. The decline in demand for their services from foreign players is likely to be made up by the additional demand from domestic suppliers of online advertisement.

could, however, introduce any of the options in their domestic laws as additional safeguards against BEPS, provided they respect existing treaty obligations, or in their bilateral tax treaties,"[69] it had not recommended any of these three alternatives.[70]

So, is the equalisation levy against the OECD recommendation? Strictly speaking, no. The OECD itself had allowed its imposition as long as treaty obligations are respected. Moreover, there are three additional factors to be considered in favour of its imposition. First,
the reason given by the OECD against adoption of any of the three alternatives was that various other measures being developed under the 14 other Action Plans would have mitigating influence on the taxation of the digital economy. Indeed, other measures are being developed, but this is turning out to be a long-drawn process. Take for example, Action 7 which deals with prevention of artificial avoidance of PE status in Double Taxation Avoidance Agreements (DTAAs). PE plays a pivotal role in determining tax jurisdictions of countries. The definition cannot be changed unilaterally without agreement from the counterparty in the DTAA.

There are more than 3,000 comprehensive DTAAs in the world. India itself has 95 in the last count. To expedite the amendments to the DTAAs, Action 15 of OECD's BEPS project stipulated the development of a 'Multilateral Instrument to Modify Tax Treaties' to modify the bilateral treaties. This multilateral instrument, with its text and related explanatory statements, was released by OECD on November 24, 2016. It is open for signature from December 31, 2016 and a first high-level signing ceremony will take place in the week beginning June 5, 2017. Governments can select lists of treaties to be covered by the multilateral instrument, and exercise options to select and reservations to make. "The multilateral instrument will enter into force after five countries have ratified it and will apply for a specific tax treaty after all parties to that treaty have ratified the multilateral instrument and a certain period has passed to ensure clarity and legal certainty." [71]

Waiting for solutions to emerge after detailed consensus at OECD/G20 may be a long wait and involve revenue loss, prolonged handicap for resident companies from unfair competition, distortion of ownership and production. The wait has been compared to "Waiting for Godot", Samule Beckett's famous play, in which the protagonists wait for the arrival of someone named Godot who never arrives, and while those waiting engage in a variety of discussions.[72]

Second, BEPS Action Plan does not satisfactorily address the issue of source country jurisdiction over digital services. At the root of this jurisdiction problem is the definition of PE enshrined in the Model Tax Treaty Conventions. As Skaar (1991) comments: "The history of the tax treaties since 1899 shows a tremendous shift from source-state taxation. The principle of source-state taxation was used by the League of Nations in the 1927 draft to a larger extent than is the case under the OECD model treaties. This trend is particularly evident with regard to the PE definition, but it also applies to other classes of income... Most of the changes in the definition of PE have been to the

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[69] http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report_9789264241046-en#page150

[70] www.rashminsanghvi.com/.../Equalisation_Levy–An.../VI%20Equalisation%20Levy%2.

[71] http://www.ey.com/gl/en/services/tax/international-tax/alert--oecd-releases-multilateral-instrument-to-modify-bilateral-tax-treaties-under-beps-action-15

[72] "However, there are worrying signs that this G20 performance will be more like Waiting for Godot than the rallying cry from Henry V. Like Vladimir and Estragon, the audience remains waiting for the arrival of our metaphorical Godot, who is both omnipresent and yet conspicuously, and traditionally, absent in delivery."
" WAITING FOR GODOT?: THE THEATRE OF THE G20," GLOSS, University of Sheffield, November 19,2015. https://glosssheffield.wordpress.com/2015/11/19/waiting-for-godot-the-theatre-of-the-g20/

detriment of the source country. In general, the scope of PE taxation has been narrowed down, although changes in international business have caused significant PE fictions. Most important in this respect is the construction clause, which came during the 1930s. However, this continuous development towards residence-state taxation from approximately 1920 seems to have culminated with the OECD Model treaties. Recent bilateral tax treaties, model treaties and policy statements from international organisations suggest that the principles for international taxing jurisdiction over business profits adopted in the OECD model treaties ought to be reconsidered, even among industrialised countries." [73]

For taxation purposes, at least in theory, Schanz–Haig–Simons income is often taken as a measure of economic income.[74] The same Georg von Schanz as in Schanz–Haig–Simons income had argued that "…at least three-quarters of the profits derived from the source country should be taxed by the source country and that only a minority of the profits should be taxed in the country of residence."[75] But, what was adopted by the League of Nations, and subsequently by the OECD and the United Nations, was the classification and assignment approach, with the scales tilted in favour of home countries.

Third, the problem of limited source country jurisdiction has got exacerbated with the advent of the digital economy. The current definition of PE has become obsolete as 'brick and mortar' establishments are no longer needed for carrying on business. It is possible to claim though that under the benefit principle, a foreign supplier benefits from the physical infrastructure such as roads and social infrastructure such as law and order that the government provides. To the extent that this benefit principle applies, source countries should have a part of the income tax jurisdiction over foreign companies. Furthermore, to the extent that digital companies make their consumers work for free in expanding the network and adding to its value, the government of the source country should have a part of the income tax on such companies.

The BEPS Action Plans propose to make some changes in the PE definition. But these are minor -- the first a change in the agency PE, and the second is some limitation in the preparatory and auxiliary exemption. These provisions are contained in Article 5(5) and Article 5(4) of the OECD Model 2014. These changes leave the issue of the taxing right of the source states unaddressed. For redrawing the appropriate limits of such jurisdiction with the agreement of all important home and source countries requires some pressure on home countries and the equalisation levy may be a good measure in this context. An equalisation levy, if necessary with suitable amendments, may be desirable because waiting for the OECD-proposed holistic resolution of the BEPS problems may not only take a few years but also leave the root cause of the problem in source countries unresolved through a very truncated redefinition of PE.

e) *Why not put a withholding tax instead?*

Section 195 of the Income Tax Act, 1961 provides that any person responsible for paying to a non-resident any income chargeable under the Act has to withhold tax at source. In case of default,

[73] Arvid A Skaar (1991): "Permanent Establishment – Erosion of Tax Treaty Principle." Dordrecht (etc.), Kluwer Academic, 1991. P. 101.

[74] It is defined as I = C + ΔNW, where C = consumption and ΔNW = change in net worth Named after German legal scholar Georg von Schanz, and American economists Robert M. Haig and Henry C. Simons

[75] Bret Wells & Cym Lowell (2011):"Tax Base Erosion and Homeless Income: Collection at Source is the Lincpin," Tax Law Review, Vol. 65, pp. 535- 618. P.550.

apart from other consequences, the amount itself may be disallowed in the hands of the business concerned in terms of section 40(a)(i). The question is: why not put a withholding tax on digital goods and services?

Court decisions have laid down that the liability to withhold arises only in case the income is chargeable to tax in India.[76] Because of the interaction of the domestic law with tax treaties, income from sale of some 'specified services' may not be chargeable under the Income Tax Act and it may not be possible to withhold tax from expenditures relating to some such as online advertisements.

A case in point is Right Florist.[77] It involves a florist in Kolkata who advertised his business through Google and Yahoo and paid advertisement fee without deduction of tax at source to Google Ireland and Yahoo, USA. The tax department disallowed the expenditure in the hands of the taxpayer.

The Income Tax Appellate Tribunal, however, relying on the OECD Commentary pointed out that a mere website would not constitute a PE, so the amount could not be taxed as business income in the hands of the non-resident. The Tribunal nonetheless observed: "Clearly, conventional PE tests fails (sic) in this virtual world even when a reasonable level of commercial activity is crossed by foreign enterprise. It is a policy decision that Government has to take as to whether it wants to reconcile to the fact that conventional PE model has outlived its utility as an instrument of invoking taxing rights upon reaching a reasonable level of commercial activity and that it does fringe neutrality as to the form of commercial presence i.e. physical presence or virtual presence, or whether it wants to take suitable remedial measures to protect its revenue base. Any inertia in this exercise can only be at the cost of tax certainty."

The Tribunal also pointed out that since the taxpayer had no right to use any industrial, scientific or commercial equipment, it could not also be taxed as royalty.

The next question was whether the amount paid could be characterised as fees for technical services (FTS) in which case, the amount could be taxed both under the domestic law as also under the treaties. Here again the Tribunal pointed out that the service rendered by Google involved only generation of certain texts on the search engine through a wholly automated process and there was no human intervention. In view of the same, following earlier precedents, the amount could not also be taxed as FTS.

Thus, under the present dispensation, compulsory withholding obligation from payments made to non-residents will not be of much use.

As mentioned earlier, one of the options considered by the TFDE was the imposition of a final withholding tax on a standalone gross basis from payments made to non-resident providers of goods and services. In order not to be burdensome, the report suggests a low rate. The report

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[76] See for example GE India Technology Centre Pvt. Ltd V CIT (327 ITR 456)

[77] D. P. Sengupta: "India: The Right Florist Case: Online Advertisement Revenues and the Legal Effect of India's Position on the OECD Model," in Eric C. C. E. Kemmeren (ed) "Tax Treaty Case Law around the Globe 2014: Schriftenreihe IStR Band 89, Chapter 19.

however cautions that the scope of the transactions to be covered needs to be clearly defined for effective compliance by all concerned. The report also flags another important issue in that while domestic suppliers of similar goods are taxed on a net basis, such a provision may fall foul of the provisions of both GATT and GATS that require national treatment. Although GATS provides broad exceptions for the application of provisions of tax treaties and for imposition of direct tax provisions to ensure effective imposition of direct taxes, there is no such exception in the case of GATT, and when the digital products are considered as goods, there may be a problem.

The Committee on Taxation of E-commerce considered the proposal for withholding tax to be viable particularly in the B2B context. However, it pointed out that the proposal will be feasible only when tax treaties are amended to include such a provision since under the Indian law [Section 90(2) of the Income Tax Act, 1961], tax treaties take precedence over the domestic law.

f) Same tax in two names -- service tax and equalisation levy

Concerns have been raised about the Constitutional validity of the equalisation levy. Is it not the same as the service tax with applicability at a different rate and to a specific subset of businesses?

The Constitutional validity of the equalisation levy has been examined by the Committee on Taxation of E-Commerce. The Report states "Equalization levy on gross amounts of transactions or payments made for digital services appears to be in accordance with the entries at Serial Number 92C and 97 of the First List in the Seventh Schedule of the Constitution of India. The existing precedent in the form of the Service Tax appears to remove any ambiguities and doubts in this regard."[78] As the Report points out, there is a precedent as well in the Securities Transaction Tax (STT) imposed by Chapter VIII of Finance No. 2 Act of 2004.

The STT followed service tax with a lag of ten years. Service tax had been introduced by the Finance Act, but in 1994. The base of STT was the value of securities (excluding commodities and currency) transacted through a recognised stock exchange. Thus, it was a turnover tax. Service Tax has been applicable on securities transactions from 1994, but only with respect of brokerage, transaction charges, SEBI turnover charges and stamp duty.[79]

One major difference between STT and the equalisation levy stems from the fact that while the service tax on securities transactions had a different base than STT, the service tax on 'specified services' will have the same base as the equalisation levy. The question is: can there be two different taxes on identical bases – albeit with different rates?[80] Legally, there does not seem to be a problem.

[78] http://incometaxindia.gov.in/news/report-of-committee-on-taxation-of-e-commerce-feb-2016.pdf, pp. 86-87. Article 246 of the Constitution of India divides the powers to makes laws between the Union and the States. List I in the Seventh Schedule lists the items on which the Parliament has the exclusive powers of legislation.

[79] http://www.smartpaisa.in/charges-other-than-brokerage-stock-exchange-share-future-options-transactions-stt-transaction-charges-sebi-turnover-charges-stamp-duty/ Service tax is not applicable on STT.

[80] The question whether the equalisation levy is a direct tax or an indirect tax is of little practical interest. Even 'direct taxes' have indirect effects. Pertinent it is to note that the corporate income tax in the US was originally an excise tax on corporations based on income! A corporate income tax enacted in the US in 1894, was soon held to be unconstitutional in one of its key aspects. The Congress enacted excise tax on corporations based on income in 1909, after ratification of the Sixteenth amendment to the US Constitution, became the corporate provisions of the federal income tax.

Article 245 (2) of the Constitution provides that no law made by Parliament shall be deemed to be invalid on the ground that it would have extra-territorial nexus and may not be effectively enforceable beyond the territories of the Republic. The Courts have also held that the nexus in question must be rational and that it would be impossible to accede to the argument that sufficiency of nexus can be a matter for adjudication of the Courts.

Article 246 gives the power to legislate. The various entries in the three lists of the Seventh Schedule of this article are fields and not powers of legislation. The power to legislate is derived from Article 246 and other Articles of the Constitution. Competence to enact a tax law is derived from the nature of the tax, for example, whether it is a tax on income or business, to ascertain the Entry under which the legislative power has been assumed. In the case of Central Government, so long as the subject matter is not in List II, the presumption is that it is within the competence of the Central Government. Equalisation levy is not in List II, and thus its constitutional validity is assured.

Furthermore, once it is held that a legislature has the power to enact a law over a particular subject, its competence is not to be limited by the manner in which the power is exercised. Thus, a taxing statute may be amended by incorporating a provision in an annual Finance Act. It is also possible that there may be overlaps and a transaction may get taxed under different statutes. The relevant Court judgments and observations are contained in the Appendix to this paper.

In the case of equalisation levy which is meant to tax the consideration for specified digital transactions, the legislature has provided that the payments should be taxed at six per cent. The nexus is established and collection of the tax is also administratively convenient. It may be a coincidence that service tax is also levied on the same base. But it does not anyway detract from the legislative competence to charge the equalisation levy and the measure prescribed for this purpose. The desirability of having the equalisation levy on the same measure as the service tax has to be judged on the basis of its economic effects, including compliance cost, administrative convenience, and effects on economic efficiency.

IV. Summary and concluding observations

The equalisation levy has been imposed in India as a presumptive income tax on some specified services provided by the 'hard to tax' digital sector. It corrects the obviously unfair advantage that some non-resident companies without PEs enjoy from double non-taxation. By aggressive tax planning and treaty shopping, some MNEs had been able to defer their tax liabilities, if not practically avoid taxation altogether. The advantage of such avoidance and deferral had made them cash rich and allowed them to grow faster. The digital services market is already dominated by one or two big players because of the 'network effect.' The customer base needs a minimum critical mass before it becomes useful. Acquiring this critical mass is the challenge in this sector. Furthermore, digital service providers need to incur a lot of fixed capital, but once the service is established, scaling up is relatively costless. These characteristics, even though there are no barriers to entry, act as handicaps for new players. Giving a tax advantage to the already established players violates the principle of both fairness and market efficiency.

As already mentioned, though Google is dominant in nearly every country, Baidu dominates in China, and so does Yandex in Russia, Naver in South Korea and Seznam in the Czech Republic.[81] The dominance of Google and Yahoo in the Indian market for digital services may continue, but it is difficult to argue that the domestic companies on the supply side of this market should be left with handicaps to compete in this market. This is particularly so because in many fields of information and telecommunication technology, because by growing to be giants of today, Indian start-ups of yesteryears have shown the potential in this field .

India is a large market for digital services. India was expected to reach 402 million internet users by December 2015, registering a growth of 49 per cent over 2014 and surpassing the United States in terms of number of users.[82] Overall, the e-commerce market was expected to reach $24 billion by 2015, with both online travel and e-tailing contributing equally.[83] In such a large market, there are already stories of domestic companies successfully competing with MNEs, for example, Snapdeal and Flipkart with Amazon. The equalisation levy aims to level the playing field between foreign and domestic e-commerce companies.[84] Moreover, the extant system without an equalisation levy may even prompt the resident companies in the digital market to become non-resident companies without PEs

However, like all presumptive taxes, the equalisation levy suffers from some obvious infirmities. First, there is the question of double taxation. Although the BEPS project was launched when the problem of double taxation was superseded by the problem of double non-taxation, the existence of some foreign suppliers without a PE and without resort to a tax haven paying corporate income tax in their country of residence, while possibly rare, cannot be ruled out. The equalisation levy does not allow for any tax credit in the country of residence. However, tax credit is possible only with a revision of the tax treaties and suitable amendments of taxation rights between home and source countries.

Second, on the only plausible assumption that the equalisation levy is a substitute for income tax, it assumes that the rate of profit or income is uniform for all non-resident companies and no such company incurs losses.

As it stands, the equalisation levy is a non-rebuttable presumptive tax. It is important for the government to examine whether both these infirmities can be avoided by making the levy a rebuttable presumptive one. The Diverted Profit Tax (DPT) imposed in the UK is a case in point. It arises when profits are diverted from the UK either through the involvement of entities or transactions that lack economic substance or through an *'avoided PE'*. It provides "The recipient would have 30 days to make representations and the designated HMRC officer may consider certain specified matters within a further 30 day period before either issuing a charging notice on the original or a revised amount, or confirming that no charge arises." It may be useful to examine whether the DPT provides for a rebuttal of the '*avoided PE'* clause.

The rate of the equalisation levy needs to be calibrated in terms of the sharing of its incidence between resident buyers and non-resident suppliers without PEs. The argument in favour of

[81] Eric Enge (2016): "Competitive threats to Google, and what they mean for you," Search Engine Land, May 24, 2016, http://searchengineland.com/competitive-threats-google-means-249772

[82] http://incometaxindia.gov.in/news/report-of-committee-on-taxation-of-e-commerce-feb-2016.pdf p.14

[83] http://incometaxindia.gov.in/news/report-of-committee-on-taxation-of-e-commerce-feb-2016.pdf p.15

[84] https://thewire.in/23563/modis-google-tax-is-a-good-start-but-more-is-needed-to-tame-tech-mncs/

reducing the rate becomes stronger the higher the pass-through to resident buyers. The burden of the levy on buyers and sellers need to be studied after a year of operation of the levy to calibrate the rate.

The impact of the equalisation levy on specified services with effect from June 1, 2016 on cum tax price is far from clear. There are reports that the full burden of the tax has been passed on to the consumers. For example, one non-resident company has claimed that "…the terms and conditions applicable to… require customers to bear any tax or Government charges on services availed of by them. Accordingly with respect of invoices raised by…for online advertisement and service for the purposes of online advertisement provided on or after 1 June, 2016, you will need to deposit 6% Equalisation Levy (as applicable)."[85] As already mentioned, there are also reports of suppliers absorbing the levy.

The Internet and Mobile Association of India (IAMAI) has said "Considering that the incidence of 6 per cent levy will be passed on to the advertisers by the ad platforms, the total burden to SMEs and tech startups on account of equalisation levy would be an additional burden of Rs 429 crore, ..."[86] This is nearly a 50 per cent hike over Rs. 906 crore of service tax of 14.5 per cent they pay to use the ad platforms, it added.

Even if the customers are paying the equalisation levy to the government, and are being asked by foreign suppliers of specified services to do so, it is far from clear that the price before tax has not been adjusted downwards for the company to pay a part of the levy. The opacity in prices resulting from 'versioning' makes it difficult to decipher the response of prices to the equalisation levy.

With marginal cost close to zero, the price for such services is dependent only on the consumers' willingness to pay. Are the Indian users of specified services willing to buy the same unchanged volume of service as before and pay the equalisation levy on top of the price they were paying before the equalisation levy? That is unlikely because in that case the suppliers with considerable market power would have charged the cum tax price post equalisation levy as the net price before the levy.

It is important to remember that the lead players in the sector may also react strategically. They may not absorb as much of the burden as they would have otherwise done, in fear of the government increasing the levy further. They may have sufficient market power to reduce their margins without incurring losses. But if they do, they may be afraid that there will be further increase in the rate of the levy to siphon off part of their surpluses. Thus, it will be important to distinguish between how sticky the price net of the levy is because of genuine cost considerations and how much is because of strategic reasons.

The division of tax jurisdiction between 'home' countries and 'source' countries continue to be tilted in favour of the former. Pursuit of second best policies such as the equalisation levy may play an important role in exerting pressure on 'home' countries for a more equitable distribution of tax jurisdictions.

[85] Email from Google Asia Pacific Pte Ltd. Singapore. http://www.charteredclub.com/equalisation-levy/ In a separate email, Google explained that payments to Google India Private Limited (Indian Company) was not subject to the equalisation levy.
[86] http://www.iamai.in/media/details/4696

Indeed, in the digital economy, it is possible for a foreign company to have a significant presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules. It can avoid the attribution of value created from the generation of marketable location relevant data from users through the use of digital products and services. There are problems with the characterisation of income derived from new business models and the application of related source rules. Non-residents can be heavily involved in the economy of the source country without creating the nexus that is currently required for the source country to tax any part of income generated. Equalisation levy avoids some of the difficulties of creating new profits attribution rules for purposes of a nexus based on significant economic presence.

The equalisation levy is a second best solution to the BEPS problem. For a durable and satisfactory solution to the problem what is needed is a significant economic presence criterion for defining a PE, and its incorporation both in the domestic law as also in the treaties. In the absence of this durable solution, the equalisation levy has even been called 'an attempt at treaty dodging.'[87] An interim solution could be for the government to make the equalisation levy a rebuttable presumptive tax.

[87] "Equalization Levy Proposal in Indian finance bill 2016: Is it legitimate tax policy or an attempt of treaty Dodging?" Dr. Amar Mehta (Asia-Pacific Tax Bulletin, 2016 (Volume 22), No 2

Appendix

Court judgments on manner of legislative exercise of power to enact a law over a particular subject

In Federation of Hotel & Restaurant Assn. of India v. Union of India, (1989) 3 SCC 634, a Constitution Bench of the Supreme Court observed:

"31. Indeed, the law "with respect to" a subject might incidentally "affect" another subject in some way; but that is not the same thing as the law being on the latter subject. There might be overlapping; but the overlapping must be in law. The same transaction may involve two or more taxable events in its different aspects. But the fact that there is an overlapping does not detract from the distinctiveness of the aspects. Lord Simonds in Governor General-in-Council v. Province of Madras - AIR 1945 PC 98 in the context of concepts of Duties of Excise and Tax on Sale of Goods said:... The two taxes, the one levied on a manufacturer in respect of his goods, the other on a vendor in respect of, his sales, may, as is there pointed out, in one sense overlap. But in law there is no overlapping. The taxes are separated and distinct imposts. If in fact they overlap, that may be because the taxing authority, imposing a duty of excise, finds it convenient to impose that duty at the moment when the excisable article leaves the factory or workshop for the first time on the occasion of its sale..."[88]

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Thus, the view that it may not be 'legally' permissible for the service tax and the equalisation levy to have the same measure may be misplaced. What is relevant is the nexus between a levy and its measure. There are many judicial pronouncements to this effect. In a case relating to excise duty, which is on production or manufacture but the duty is charged on the transaction price, the issue was whether the value of an article for the purposes of the excise levy must be determined by reference exclusively to the manufacturing cost and the manufacturing profit of the manufacturer or can be represented by the entire wholesale price charged by the manufacturer. The judicial pronouncement was as follows.

"A duty of excise", according to the Federal Court in The Central Provinces and Berar Sales of Motor Spirit and Lubricants Taxation Act, 1938 - (1939) F.C.R. 18 = 1978 E.L.T. (J 269) "is a duty ordinarily levied on the manufacturer or producer in respect of the manufacture or production of the commodity taxed. A distinction was drawn between the nature of the tax and the point at which it was collected, and Gwyer, C.J. observed that theoretically "there can be no reason why an excise duty should not be imposed even on the retail sale of an article, if the taxing Act so provides. Subject always to the legislative competence of the taxing authority, a duty on home-produced goods will obviously be imposed at the stage which the authority find to be the most convenient and the most lucrative, wherever it may be; but that is a matter of the machinery of collection, and does not affect the essential nature of the tax. The ultimate incidence of an excise duty, a typical indirect tax, must always be on the consumer, who pays as he consumes or expends; and it continues to be an excise duty, that is, a duty on home-produced or home-manufactured goods, no matter at what stage it is collected."

[88] 1983(14)ELT 1896 (paragraph 11)

In Governor-General in Council v. Province of Madras - (1945) F.C.R. 179 = 1978 E.L.T. 280, the Privy Council affirmed that "when excise was levied on a manufacturer at the point of the first sale by him that may be because the taxation authority imposing a duty of excise finds it convenient to impose that duty at the moment when the excisable article leaves the factory or workshop for the first time on the occasion of its sale. But that method of collecting the tax is an accident of administration; it is not of the essence of the duty of excise, which is attracted by the manufacture itself."

It has long been recognised that the measure employed for assessing a tax must not be confused with the nature of the tax. In Ralla Ram v. The Province of East Punjab - (1948) F.C.R. 207, the Federal Court held that "…a tax on buildings under Section 3 of the Punjab Urban Immovable Property Tax Act, 1940 measured by a percentage of the annual value of such buildings remained a tax on buildings under that Act even though the measure of annual value of a building was also adopted as a standard for determining income from property under the Income-tax Act. It was pointed out that although the same standard was adopted as a measure for the two levies, the levies remained separate and distinct imposts by virtue of their nature. In other words, the measure adopted could not be identified with the nature of the tax."[89]

[89] ELT 1983(14)1896 para 13.

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