JUDICIAL LIMITS AND FISCAL INNOVATION: ANALYSING DIGITAL TAXATION IN INDIA THROUGH "EQUALISATION LEVY" AS A TAXING REGIME WITH THE HELP OF THE CASE "ENGINEERING ANALYSIS CENTRE OF EXCELLENCE PVT LTD V. COMMISSIONER OF INCOME TAX & ANOTHER"

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ABSTRACT

Before the introduction of modern methods to tax the digital economy, international taxation was based on traditional methods such as "Permanent Establishment" and "Source-based Rules of taxation". These rules focused on physical presence, factories, offices and physical trade. Over the passing of time, digitalization of economy and emergence of E-commerce has been rapidly increasing by 10% every year[1], causing a threat to the government as it affects tax collection and revenue generation. Huge enterprises like Google and Facebook earned revenue from market jurisdiction without having any physical presence such as office and employees to satisfy the criteria to fit in the classic rule of "Permanent Establishment". This led to tax gap, base erosion and profit shifting. India lost its revenue, and the profits generated from India were shifted to low tax jurisdiction. Source rule of taxation was not effectively effectuated due to DTAAs (Double Taxation Avoidance Agreements). OECD formally addressed the issue by introducing 15 Action Plans, out of which the Action Plan 1 came up with three major tools to tax the digital economy; SEP (Significant Economic Presence) for challenges faced regarding physical presence, With-holding of taxes for challenges faced regarding nexus, Equalisation Levy for challenges faced regarding characterization of income[2].

India adopted all of the above mechanisms, out which this case study will be focusing on the role of equalisation levy as a taxing regime. Equalisation levy was introduced in India, since it is a country with huge user market and

[1]Prabhu Govindhan, Equalisation Levy - Indian version of 'Google Tax'!, Taxsutra, https://database.taxsutra.com/articles/274c6bbeb88d3bd5fb14d7d7a7d21e.

[2] OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (2015).

large digital consumption. India, like any other developing country could not afford to wait until a uniform, mutually agreed, global tax consensus to be formed to tax the digital economy due to the increased income generation by MNEs. It was officially brought in as a taxing statute under the Section 165, Finance Act 2016[3] – 2% levy on online advertising and Section 165A, Finance Act 2020[4] – 6% levy on e-commerce supply of goods and services.

Engineering Analysis Centre of Excellence Pvt Ltd v. CIT & Anr[5] is yet another case that deals with difficulties faced in taxing of the digital economy. This case will help us understand if Equalisation levy attempted to overcome the limitations.

Engineering Analysis Centre of Excellence Pvt Ltd v. Commissioner of Income Tax & Another:

Facts:

Foreign companies sold software to Indian distributors, and the Indian distributors resold it to Indian customers (end users). According to the companies, buying and reselling software was just like buying and selling regular goods. However, the revenue department argued that, the transactions between the parties were copyright for right to use the software, making the payment as royalty for which TDS is attracted.[6] The Karnataka High Court in *CIT v. Samsung Electronics Co. Ltd. & Others*[7] upheld the appeal saying that royalty fell under section 9(1)(iv) of Income Tax Act 1961[8] making it taxable. Whereas the Delhi High Court in *DIT v. Infrasoft Ltd*[9] held that buyer does not buy the right to reproduce or exploit the copyright but rather the right to use. It should be treated as sale of goods and not copyright, therefore the importers need not deduct TDS under section 195 of Income Tax act[10]. Multiple appellants from different cases approached the Supreme Court due to the contradicting rulings from different High Courts.

[3] Finance Act, 2016, § 165
[4] Finance Act, 2020, § 165A
[5] *Engineering Analysis Centre of Excellence (P.) Ltd. v. Commissioner of Income Tax*, (2021) 432 ITR 471 (S.C.).
[6] Khaitan & Co., *Engineering Analysis Centre of Excellence Pvt. Ltd. v. Commissioner of Income Tax & Anr.* (Mar. 22, 2021), https://www.khaitanco.com/sites/default/files/2021-03/Engineering%20Analysis%20Centre%20of%20Excellence%20v.%20CIT_Ergo_22032021_0.pdf
[7] *Commissioner of Income Tax v. Samsung Electronics Co. Ltd.*, (2011) 245 ITR 481 (Karn.).
[8] Income Tax Act, 1961, § section 9 (1) (iv)
[9] *Director of Income Tax v. Infrasoft Ltd.*, (2014) 264 CTR 329 (Del.).
[10] Income Tax Act, 1961, § section 195

Issues:

Due to multiple appeals, the Supreme Court decided to categorise each case based on four categories, among which the instant case fell under the second one; Indian companies buying from foreign companies and reselling it to Indian end users.

The case was taken in, the issue being,

Whether the current transaction falls under royalty as per explanation 2 of section 9 (1)(iv) of the Income Tax Act, 1961?

(or)

If royalty should be defined according to DTAAs?

Whether tax must be deducted under section 195 of the act?

Arguments:

Appellants:

The appellants argues that it was mere sale of goods and not transfer of rights. They also established that DTAA narrowly defined royalty, confining it to use of copyrights and not sale of copyrighted product. They further contended that, 2012 amendment cannot apply retrospectively. Though the judgment was passed in 2021, the transaction dates back to assessment years 1990-2012. They further argued that as per the Indian Copyrights Act 1957, *first sale doctrine* applies to them. Therefore, a product once sold, cannot be controlled by the seller. The seller no longer possesses the right to control what the buyer does with the product after sale.

Respondents:

The respondents argued that, explanation 2(v) was not a new rule and that it has always been the definition of royalty. They relied on *PILCOM v. CIT*[11] to substantiate that TDS must be deducted even if the taxability is unclear. They also argued that *first sale doctrine* does not

[11] *PILCOM v. Commissioner of Income Tax*, (2020) 425 ITR 312 (S.C.).

apply to resellers and distributers but only to end users. Finally, they relied on *Tata Consultancy Services v. State of Andhra Pradesh*[12] to establish that software is considered as goods for the purpose of Sales Tax Law and not Income Tax Law.

Judgement:

The Supreme Court held that, DTAA will prevail over domestic law if it benefits the tax payer. The Court also clarified that using of software does not amount to transfer of rights. Further, the court also rejected the reliance on PILCOM v. CIT and held that TDS must be collected only when the taxability arises. The court also clarified that the 2012 amendment cannot have a retrospective effect. Thereby, holding that the transaction in the instant case does not amount to royalty and cannot be taxed for the same.

Evaluating the effectiveness of Equalisation Levy:

With the reference to the above case, it is evident that the Indian government cannot tax the income under royalty since the amount falls under business profit if the sale of software was considered as sale of goods. To tax business profits, the companies must have Permanent Establishment making it impossible for the government to tax such income. Which is why Equalisation Levy was introduced exclusively under the Finance Act and not the Income Tax Act. Anything under Income Tax Act is subject to be overridden by DTAAs, therefore the government introduced it separately under Finance Act in order to avoid treaty conflicts. It was introduced in two phases, one in Finance Act 2016 wherein digital services such as online advertisements were charged with 6% from the consideration amount and later on in Finance Act 2020, e-commerce supply or services were charged with 2% from the consideration amount. Provided, the same would not apply if the annual payments are under Rupees One Lakh.

Even though Equalisation Levy was a great alternative form of taxing regime for the government, it was not so for foreign companies. The levy despite not being a form "income tax" still caused double taxation, and the DTAAs had no right over the Finance Act. This caused major treaty conflicts and trade barriers. Because of which, Equalisation Levy as of 01.04.2025 is now rolled back and is no longer a charging provision. India agreed to remove the levy and also agreed to a different global tax consensus that effectively taxes the digital economy while

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[12] *Tata Consultancy Services v. State of Andhra Pradesh*, (2005) 1 SCC 308 (S.C.).

also ensuring treaty boundness.

Conclusion:

Equalisation Levy was a quick witted pull through for the revenue department however the actual execution of the same can be quite controversial and risky. Equalisation Levy is not the most ethical form of taxing since it can easily bypass DTAAs, treaties and conventions even while actively causing double taxation. Hence removed for being a lost cause for a solution. However, India has only agreed to abolish it upon the word that there will be better form of taxing regime, so it could technically make a comeback if OECD Pillar One fails negotiations. Then India might reintroduce it to tax foreign digital revenue.