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TECHNOLOGY & TAX SERIES – ISSUE XI: INDIA-USA AGREE ON THE FUTURE OF 2% EQUALIZATION LEVY (2020)

- India not required to withdraw the 2% equalisation levy before implementation of Pillar One
- USTR to terminate its proposed trade action under Section 301 for imposition of tariffs on goods imported from India
- MNEs subject to Pillar One to get a credit for the 2% equalisation levy paid during a specified period prior to implementation of Pillar One, which could be set off against their Pillar One liability.
- No credit available for the 6% equalisation levy.

BACKGROUND

The tax challenges of digitalisation of economy have been the cornerstone of debate at the Organisation for Economic Co-operation and Development (“OECD”) level since 2015. One of the interim measures discussed to tackle direct tax challenges arising from digital economy by the OECD Action Plan 1 Report (“AP 1 Report”) was imposition of equalisation levy (“EL”) on certain specified services by countries in their domestic laws or in its bilateral tax treaties.

Since then OECD along with members of the Inclusive Framework (“IF”) have been working to reach on a consensus-based solution. Meanwhile, in the absence of global consensus, countries such as India, France, Italy, Spain, United Kingdom resorted to adopt independent unilateral measures through digital services tax (“DST”), and EL to tax digital businesses participating in their economies which do not meet the current physical nexus requirements. In response to the DSTs and EL, the Office of the United States Trade Representative (“USTR”) initiated investigations under Section 301¹ of the Trade Act of 1974 (“Section 301 Investigation”) against 11 DSTs including India’s EL. The USTR concluded that these DSTs and EL are unreasonable or discriminatory and burdens or restricts U.S. commerce, consequently, the USTR decided to impose tariffs on certain imports from Austria, France, Italy, Spain, Turkey, United Kingdom and India. However, the USTR suspended imposition of these retaliatory tariffs for 180 days to provide additional time to complete the ongoing multilateral negotiations.

On October 2021, 136 IF members reached an agreement on the two-pillar approach to address the tax challenges arising from the digitalisation of the economy (“IF Agreement”).² As part of the IF Agreement, all the IF members are required to remove DSTs and other relevant similar measures with respect to all companies.

Pursuant to the IF Agreement, Austria, France, Italy, Spain, the United Kingdom and the US on October 21, 2021 issued a joint statement on a political compromise reached regarding DSTs and related unilateral measures (“Joint Statement”).³ Under the Joint Statement, Austria, France, Italy, Spain, and the United Kingdom undertake to withdraw their DST for all companies once Pillar One takes effect. The same countries also agreed that DST liabilities accrued in their territories in the specified period would be credited against the tax liability arising from the introduction of Amount A under Pillar One. In return, the US agreed to terminate proposed trade actions, and not to impose any new trade actions, until the end of the specified period.

DETAILS OF INDIA-US AGREEMENT

The Ministry of Finance recently released a statement⁴ declaring that the terms of the Joint Statement will also apply on India’s 2% EL applicable on e-commerce supply or services and USTR’s trade action against EL (“MoF Statement”). We have summarised below the implications on India’s 2% EL pursuant to the MoF Statement read with the Joint Statement:

- Withdrawal of EL:** India will not be required to withdraw 2% EL applicable on e-commerce supply or services until Pillar One comes into effect in India. The OECD has currently indicated that the multilateral convention through which Amount A will be implemented will be developed and opened for signature in 2022, with Amount A coming into effect in 2023;
- Credit of excess EL paid:** Excess EL paid by MNEs subject to Pillar One will be available as credit for set off against their corporate tax liability determined under Pillar One. The credit will be given for EL paid by MNEs subject to Pillar One from April 1, 2022 till implementation of Pillar One or March 31, 2024, whichever is earlier (“Interim Period”).

Excess EL paid will be computed as a difference between (i) the EL paid by MNEs subject to Pillar One during

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the Interim Period and (ii) the Pillar One corporate tax liability of the MNEs subject to Pillar One in India for the first year in which Pillar One is in effect, which will be prorated for the Interim Period (meaning that the Pillar One liability in the first year of implementation will be assumed to be the Pillar One liability for each year of the Interim Period, assuming the taxpayer has paid EL for the entirety of the Interim Period).

- c. **Year in which credit available:** The credit of excess EL paid will be applied in the first taxable year in which a taxpayer is subject to Amount A tax liability after the Interim Period. In case Pillar One is not applicable on the taxpayer in the first year of implementation, the credit will be determined on the basis of the first year in which Pillar One applies to such taxpayer and shall become available at such time. However, the credit will not be available for taxpayers that first become subject to Pillar One more than four years after Pillar One comes into effect in India.
- d. **Carry forward of credit:** The credit so determined can be carried forward for set off against Pillar One corporate tax liability until exhausted.
- e. **USTR Action:** The US will terminate USTR's action against India regarding imposition of tariffs and will not impose the tariffs in relation to 2% EL until the end of the Interim Period.

The MoF Statement also provided that the final terms of the agreement will be finalised by February 1, 2022.

OUR COMMENTS

The MoF Statement is a much-awaited positive move and should pave the way for successful implementation of Pillar One. It comes in the backdrop of expiry of the 180-day period (due to end on November 29, 2021) for which the USTR had suspended imposition of retaliatory tariffs pursuant to Section 301 Investigation. The MoF Statement decides the fate of the much debated 2% EL which was introduced in 2020. The lack of such agreement between India and US on the 2% EL may have impacted trade between India and US decreasing overall investment, trade and economic activity or at the very least increased costs of doing business.⁵ Further, the MoF Statement should also provide relief from double taxation given that US had proposed rules preventing US companies to take credit of DSTs paid outside USA.⁶

Pursuant to the MoF Statement, MNEs subject to Pillar One paying 2% EL in India should be able to obtain credit of the excess 2% EL paid for financial year 2022-2023 and financial year 2023-24 or when Pillar One takes effect, against their Pillar One corporate tax liability in India. The credit mechanism will ensure that tax liability of MNEs subject to Pillar One is limited to their Pillar One corporate tax liability during the Interim Period even if Pillar One is implemented at a later point in time. However, it is important to note that the credit is likely to be available only to those MNEs which are subject to 2% EL. No credit will be given to MNEs that are subject to 2% EL but do not fall within the scope of Amount A of Pillar One during the Interim Period. This is crucial as the revenue threshold for applicability of 2% EL as low as INR 2 crores (~Eur 240,000) vis-a-vis Pillar One threshold of Euro 20 billion. Hence, the MoF Statement may not benefit offshore small and medium companies engaged in online services or sale of goods.

While the MoF Statement is an agreement between US and India, the language of the Joint Statement suggests that any entity which is part of MNE group and pays EL should get credit of the excess EL paid. It is unclear how a non-USA entity may be given credit pursuant to an agreement between Indian and USA. Further, there may be a situation wherein the entity discharging the EL liability and the entity discharging the Pillar One tax liability may be different. In such cases, it is unclear how the credit mechanism will work.

The MoF Statement seems to be a reaction to the USTR Section 301 Investigation as it does not cover the 6% EL which was introduced in 2016 applicable on revenue earned by non-residents from online advertising services. This does not seem to be in line with the IF Agreement which require the IF members to remove DSTs and other relevant similar measures with respect to all companies and arguably goes against principles of tax neutrality from a tax policy perspective. Therefore, while the tax impact of the 2% EL paid by US MNEs will be neutralised during the Interim Period, the tax impact of the 6% EL will not be neutralised. This may be counter intuitive for foreign advertisers who were not passing the cost of 6% EL to Indian companies.⁷ To this extent, the credit mechanism provides only partial relief.

As next steps, it will be useful to see how the MoF Statement is implemented by the Indian government, whether through amendment in the Income-tax Act, 1961 ("ITA"), amendment to the India-US tax treaty or both. This is even important as EL is not part of the ITA, and accordingly, it is not clear if it qualifies as *covered tax* for the purpose of Article 2 of the India-US tax treaty. Any amendment in India-US tax treaty to provide credit of excess EL paid may seem to suggest that EL qualifies as *covered tax* under the India-US tax treaty. It seems that these changes may be ultimately implemented along with Pillar One and legislative changes in the ITA.

The MoF Statement is an expression of intent between Indian and USA and currently, does not change anything with respect to applicability of both 2% EL and 6% EL. The US MNEs companies will be required to pay Indian EL until withdrawn by India. Any relief to US MNEs hinges on implementation of Pillar One – the OECD has currently indicated that the multilateral convention through which Amount A will be implemented will be developed and opened for signature in 2022, with Amount A coming into effect in 2023. Unless Pillar One is implemented, EL may not be withdrawn and MoF Statement will be of no significance. Although the IF Agreement has been backed by 136 IF members including US, the fate of the implementation of two pillar solution rests with the vote in the US Senate.⁸

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You can direct your queries or comments to the authors

¹ Section 301 of the Trade Act sets out three types of acts, policies, or practices of a foreign country that are actionable: (i) trade agreement violations; (ii) acts, policies or practices that are unjustifiable (defined as those that are inconsistent with U.S. international legal rights) and burden or restrict U.S. Commerce; and (iii) acts, policies or practices that are unreasonable or discriminatory and burden or restrict U.S. Commerce.

² Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy. Available at: <https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf>

³ Joint Statement from the United States, Austria, France, Italy, Spain, and the United Kingdom, Regarding a Compromise on a Transitional Approach to Existing Unilateral Measures During the Interim Period Before Pillar 1 is in Effect; Available at: <https://home.treasury.gov/news/press-releases/jy0419>

⁴ Press release by Ministry of Finance dated November 24, 2021 <https://pib.gov.in/PressReleseDetail.aspx?PRID=1774692>

⁵ Meyyappan N and Dr. Neha Pathakji, Tax, Trade and Investments An Indian Policy Perspective, September 2021. Available at: https://www.nishithdesai.com/fileadmin/user_upload/pdfs/Research_Papers/Tax_Trade_and_Investments_An_Indian_Policy_Perspective.pdf

⁶ Altson & Bird. *Digital Services Taxes and Nexus for Foreign Tax Credit Purposes*. 2021, February, 17. Available at: <https://www.jdsupra.com/legalnews/digital-services-taxes-and-nexus-for-4133741/>

⁷ Bureau, India Bl.. *LinkedIn won't pass on equalisation levy to companies. Google, Facebook are you listening?*. Business Insider. 2016, July 15. Available at: <https://www.businessinsider.in/linkedin-to-become-the-only-mnc-that-will-not-pass-on-equalisation-levy-to-companies/articleshow/53222991.cms#:~:text=LinkedIn%20plans%20to%20absorb%20the,permanent%20establishment%20in%20the%20country>

⁸ Fessenden, Helen. *Global tax deal risks having US half in, half out*. Politico. 2021, October 22. Available at: <https://www.politico.eu/article/global-tax-deal-us-facebook-google-congress/>

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