

The Equalisation Levy and Income Tax in India: Overlap, Conflicts, and Legal Challenges in Digital Economy Taxation

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Abstract

India's Equalisation Levy (EL), introduced in 2016 and broadened in 2020, generated substantial overlap and conflict with the Income Tax Act, 1961. At its core, the tension arose from the EL's architecture as a gross-basis turnover tax applied to digital transactions, whereas the income tax framework operates on net profits. Structural exclusion of the EL from the Income Tax Act rendered Double Taxation Avoidance Agreement (DTAA) protections and foreign tax credits inapplicable, precipitating juridical double taxation for non-resident digital service providers. Additional frictions included questionable legislative competence, concerns over extra-territorial jurisdiction, procedural inadequacies under Article 14, and overlapping compliance obligations with Section 194-O TDS and GST. These cumulative tensions, compounded by international trade pressures—particularly a U.S. Section 301 investigation—culminated in the levy's phased abolition in 2024–2025, transferring digital taxation to the Significant Economic Presence (SEP) framework within the Income Tax Act.

Keywords: Equalisation Levy, Digital Taxation, Double Taxation Avoidance Agreement, Significant Economic Presence, Permanent Establishment, BEPS, Extra-Territorial Jurisdiction, OECD Two-Pillar Framework

Introduction

The proliferation of digital business models has fundamentally disrupted the foundational principles of international taxation, which were originally constructed around the concept of physical presence—most significantly, the Permanent Establishment (PE) doctrine. Global technology enterprises can now generate substantial revenues from a jurisdiction without maintaining any taxable physical presence within it, creating a structural mismatch between where economic value is created and where tax liabilities arise.

India recognised this mismatch early and responded with the introduction of the Equalisation Levy through the Finance Act, 2016. The levy initially targeted non-resident entities providing online advertising services to Indian businesses. Its scope was then substantially widened by the Finance Act, 2020, to encompass non-resident e-commerce operators supplying goods or services to Indian residents, capturing a significantly larger volume of cross-border digital commerce. The stated policy rationale was to equalise the effective tax burden between foreign digital service providers—who could operate profitably in India without income tax liability—and domestic businesses already subject to the full weight of the Income Tax Act, 1961.

However, the EL's structural design produced a range of unintended legal and economic consequences. By situating the levy outside the Income Tax Act, India forfeited the treaty protections that would otherwise mitigate double taxation. Simultaneously, the introduction of the Significant Economic Presence (SEP) provisions in 2018 created a parallel digital nexus framework within the income tax system, raising the prospect of overlapping liabilities on identical transactions. These tensions were ultimately irreconcilable through administrative guidance alone, contributing to the EL's phased withdrawal by 2025.

This paper examines the conceptual evolution of the EL, analyses its conflicts with the income tax framework, scrutinises the constitutional and international law challenges it generated, and assesses the economic implications of its abolition and the transition to the SEP regime.

Objective of the Study

The research will seek to determine whether any overlap in the provisions of Equalisation Levy with traditional Income Tax exists or not and whether conflicts of any nature arise in taxing the digital businesses including foreign digital firms in India. It also aims to examine the legal issues surrounding the topic of digital taxation and assess the suitability of the existing tax system in responding to the increasing digital economy. Lastly, the paper will also propose potential changes to create a fair and transparent taxation of a digital transaction in India.

Review of Literature

Arun Ghosh and D. P. Sengupta (2016)¹ explained that digital businesses could not be taxed using traditional tax systems with physical presence and India has therefore introduced the Equalisation Levy using the Finance Act, 2016. The tax was meant to deal with this issue of foreign online businesses that make huge profits in India without necessarily having a physical presence of the business in India, according to the Committee on Taxation of E-Commerce, Ministry of Finance. They highlighted in their report that digital transactions could not be taxed easily according to the provisions of existing provisions of the Income Tax Act, 1961 that necessitated an independent taxation.

The functionality and the effect of the Equalisation Levy have been looked into by a large number of researchers as well. According to Rohit Jain and Karan Batra (2019), Equalisation Levy was implemented to establish a reasonable playing field between local and international providers of digital services. They however highlighted how the levy expansion by the Finance Act, 2020 with the 2% levy on e-commerce operators, had caused potential overlap with the Income Tax Act. On the same note, Rajendra Nayak (2021) was of the view that the presence of Equalisation Levy, Significant Economic Presence (SEP) and withholding tax provisions may create uncertainty and the possibility of double taxation to digital companies in India.

The topic of digital taxation has also found its way in the discussion by international scholars and organizations. As noted by Pasquale Pistone and Yariv Brauner (2020), such unilateral digital taxes like Equalisation Levy in India might pose a contradiction to international tax treaties and global tax regulations. The OECD/G20 (2021) articles further elaborate the fact that economies have been considering the possibility of coming up with coordinated solutions globally using Pillar One and Pillar Two solutions in order to deal with taxation of digital multinational enterprises. According to these reports, unilateral action could be a temporary solution but the world needs to act in unison in order to bring out fairness and prevent tax wars.

The constitutional and treaty-based issues relating to the Equalisation Levy have also been looked into by legal scholars. Another issue raised by Vikram Chand (2018) concerned whether the levy would be regarded as independent of income tax, or it has an indirect impact on treaty obligations in international tax agreements. Criminal law Judicial interpretations, such as a Supreme Court ruling in GVK Industries Ltd. v. Union of India (2011), have been mentioned in the debate about the constitutional principles of intercountry taxation. Besides, the Vienna Convention on the Law of Treaties (1969) emphasizes the need to respect the international treaty commitments, creating some concern over the possibility of unilateral taxes on digital taxation being inconsistent with bilateral tax agreements.

Methodology

This study adopts a secondary data drawn from peer-reviewed academic literature, official government publications, legislative instruments, judicial and quasi-judicial pronouncements, and authoritative commentary from legal databases and international tax bodies including the OECD. This approach is appropriate given the study's objective of systematically interpreting legislative conflicts, constitutional provisions, and treaty obligations.

Historical Evolution and Conceptual Foundations

Equalisation Levy 1.0 (2016)

The EL's genesis lay in a 2013 tribunal ruling which held that payments to non-resident search engine companies for online advertising were not taxable in India, owing to the absence of a PE. This created a visible gap in the domestic tax net. Acting partly on the OECD/G20 BEPS Action Plan 1's suggestion of an equalisation levy as a permissible interim measure, India introduced a 6% levy on gross consideration paid by Indian residents to non-resident entities for specified online advertising services, effective 1 June 2016. A threshold of ₹1 lakh aggregate annual payments applied. Compliance was structured as a withholding obligation on the Indian payer. Critically, the levy was housed in a standalone chapter of the Finance Act rather than within the Income Tax Act—a deliberate design choice intended to insulate it from DTAA obligations, though one that would later generate profound legal complications.

Expansion: Equalisation Levy 2.0 (2020)

Impatience with the slow progress toward a global consensus led India to substantially expand the levy's reach through the Finance Act, 2020. The revised EL—at a 2% rate—applied to non-resident e-commerce operators whose annual receipts from India exceeded ₹2 crore, covering the online sale of goods, provision of services, facilitation of such transactions, sale of advertisements targeting Indian users, and sale of data collected from India. Compliance responsibility shifted directly to the non-resident operator, requiring quarterly deposits. The 2020 expansion was notable for its extraterritorial character: it captured certain transactions between two non-residents where advertisements targeted an Indian IP address, a feature that attracted immediate criticism from the United States Trade Representative (USTR).

Abolition and Transition (2024–2025)

The 2% e-commerce levy was withdrawn effective 1 August 2024, and the 6% online advertising levy was discontinued from 1 April 2025. The government cited alignment with the emerging OECD/G20 Two-Pillar Solution—particularly Pillar One's framework for reallocating taxing rights to market jurisdictions—as well as the need to ease trade tensions and reduce compliance friction. The abolition transferred digital taxation to the operationalised SEP regime within the Income Tax Act.

Constitutional and Legal Challenges

Legislative Competence

The most fundamental challenge to the EL concerned the constitutional authority under which Parliament enacted it. The Committee on Taxation of E-Commerce originally proposed relying on Entry 92C (taxes on services) and Entry 97 (residuary powers) of the Union List. Entry 92C, however, was never notified and was subsequently removed by the 101st Constitutional Amendment Act, 2016, which introduced GST. Entry 97, while providing residuary legislative competence, is available only where the subject matter is not covered by other enumerated entries. Since online information and database access services were already subsumed within the GST framework under Article 246A—which opens with a non-obstante clause—the scope for invoking residuary powers was legally contested. The committee's own assertion that the EL was not an income tax simultaneously undermined any claim to authority under Entry 82 (taxes on income).

Extra-Territorial Jurisdiction

The EL's application to transactions between non-residents—triggered solely by the use of an Indian IP address—raised serious questions about extra-territorial jurisdiction under Article 245 of the Constitution. The Supreme Court's decision in *GVK Industries v. Union of India* established that laws with extra-territorial operation must demonstrate a genuine and substantial nexus with India. Critics contended that transactions wholly originating and concluding outside India, facilitated by a platform merely accessible via an Indian IP address, satisfied only an 'illusory and tenuous' nexus test, making such provisions constitutionally vulnerable.

Arbitrariness and Due Process Under Article 14

The EL's procedural architecture drew criticism on grounds of arbitrariness. Designated officers possessed authority only to verify the arithmetical accuracy of taxpayer statements, not to determine the correctness of the levy itself. Appeals were available solely against penalty orders, not against the underlying imposition of the levy or interest

charges. This structure meant that a tax liability could be imposed and enforced without any substantive quasi-judicial assessment of its validity in individual cases—an arrangement that arguably contravened the due process principles embedded in Article 14's prohibition on arbitrary state action.

Overlap and Conflicts with the Income Tax Framework

Gross-Basis Levy vs. Net-Basis Income Tax

The most fundamental structural tension between the EL and the Income Tax Act arose from their divergent tax bases. Income tax applies to net profits after allowable deductions, reflecting a business's genuine economic capacity. The EL, by contrast, was levied on gross consideration without any deduction for operating costs. For a company operating on a 5% profit margin, a 2% EL on gross revenue translated into an effective tax rate of 40% on actual profits—a burden capable of exceeding applicable corporate tax rates and antithetical to the income tax system's foundational principle of taxing economic capacity rather than turnover.

Treaty Override and Double Taxation

DTAAs apply to 'taxes on income.' Because the EL was positioned outside the Income Tax Act and explicitly characterised as something other than an income tax, it was argued to fall beyond the scope of India's bilateral treaty network. This created two interconnected problems. First, non-resident businesses subject to the EL on Indian gross receipts could not invoke DTAA provisions to offset this liability against income tax obligations in their home jurisdictions, producing classic juridical double taxation. Second, the EL was designed to operate precisely in cases where non-residents lacked a PE in India—the very threshold DTAAs use to delimit source-country taxing rights over business profits. By imposing tax in the absence of a PE, the EL effectively nullified a core treaty protection through unilateral domestic legislation.

Section 10(50) Exemption: Timing Mismatch

To prevent domestic double taxation, Section 10(50) was inserted into the Income Tax Act to exempt income already subject to the EL. However, the expanded 2% EL on e-commerce supply or services took effect from 1 April 2020, while the corresponding Section 10(50) exemption was made applicable only from 1 April 2021. This legislative oversight created a one-year window during which the same income could theoretically attract both the EL and regular income tax, exemplifying the coordination failures that characterised the EL's coexistence with the income tax framework.

Overlap with Section 194-O and GST

The Finance Act, 2020 simultaneously introduced Section 194-O into the Income Tax Act, mandating a 1% TDS on e-commerce transactions by Indian payers. A single digital transaction could therefore attract both the 2% EL (on the non-resident operator) and the 1% TDS under Section 194-O (on the Indian payer), creating overlapping compliance obligations. Additionally, the EL's application to the 'sale of data' and other digital services overlapped with IGST levied on OIDAR services. Although the government defended this by distinguishing a tax on income from a tax on supply, the EL's transactional basis made this distinction difficult to sustain in practice.

Treaty Override and International Law Implications

Juridical Double Taxation

The EL generated juridical double taxation—defined by the OECD Model Tax Convention as comparable taxes imposed in two or more states on the same taxpayer in respect of the same income for identical periods—through multiple mechanisms. It taxed non-residents on gross Indian receipts in circumstances where their home jurisdictions simultaneously taxed the same revenues as business profits. Because the EL was excluded from DTAA scope, non-residents had no mechanism to claim foreign tax credits for EL payments against home-country income tax liabilities.

Vienna Convention and Pacta Sunt Servanda

India's DTAA obligations are governed by international law principles codified in the Vienna Convention on the Law of Treaties (VCLT). Article 26 of the VCLT (*pacta sunt servanda*) requires that every treaty in force be performed in good faith. By introducing a tax that circumvented the PE protections embedded in its bilateral treaties, India effectively

overrode treaty obligations through domestic legislation—a course of action that Article 27 of the VCLT expressly prohibits. Approximately 31 Indian tax treaties contain Article 24(6) non-discrimination provisions applying to taxes of every kind, making the EL's exclusive application to non-residents challengeable under those instruments.

U.S. Section 301 Investigation and Trade Tensions

The USTR's Section 301 investigation concluded in January 2021 that India's expanded EL was discriminatory against U.S. companies, unreasonable in its contravention of prevailing international tax principles, and a burden on U.S. commerce. The USTR's report noted that EL 2.0 had the broadest scope among comparable digital services taxes globally, extending to advertising, platform services, data sales, cloud computing, SaaS, and financial services. These findings threatened retaliatory tariffs. In response, India and the U.S. reached a transitional arrangement in late 2021 under which India agreed to credit excess EL collections against future tax liabilities under the anticipated Pillar One solution, while the U.S. suspended tariff actions.

Economic and Compliance Impact

Compliance Burden on Non-Resident Operators

The EL imposed considerable compliance costs on non-resident digital businesses. The 2020 expansion required non-residents to track India-sourced revenues and user data across complex transaction types, invest in systems to segregate the value of raw data from processing-related intangibles, and file direct quarterly deposits with Indian tax authorities. Non-compliance attracted severe penalties equivalent to the unpaid levy amount, plus interest. The obligation to ascertain customer residency status—without access to definitive verification mechanisms and without legal recourse if customer declarations proved false—created particular uncertainty for smaller operators.

Impact on Indian Consumers and Businesses

The compliance and tax costs generated by the EL were routinely passed through to Indian consumers in the form of higher prices for subscriptions, software licences, online advertising, and digital services. This cost pass-through effectively transformed the EL into an indirect consumption tax on Indian users, notwithstanding its formal classification as a levy on non-resident suppliers. For Indian businesses relying on international digital platforms—particularly SMEs and freelancers—the levy raised transaction costs and reduced competitiveness relative to domestic providers who faced no equivalent burden on equivalent services.

Post-Abolition Framework: The SEP Regime

The phased abolition of the EL transfers digital taxation to the Significant Economic Presence regime, operationalised within the Income Tax Act. A non-resident is deemed to have a SEP in India if aggregate payments from Indian transactions exceed ₹2 crore in a year, or if it systematically engages with 300,000 or more Indian users. Table 1 below contrasts the EL and SEP frameworks across key parameters.

Table 1: Comparative Analysis — Equalisation Levy vs. Significant Economic Presence Regime

Parameter	Equalisation Levy (EL)	Significant Economic Presence (SEP)
Nature of Tax	Separate levy on gross revenue under Finance Act	Business income under Income Tax Act, 1961
Tax Base	Gross consideration / receipts	Net income attributable to Indian operations
Tax Rate	2% (e-commerce) / 6% (online advertising)	Corporate tax rate for foreign companies (~40–42%)
Treaty Benefits	Not available (outside DTAA scope)	Available, subject to applicable DTAA provisions
Compliance Mechanism	Quarterly deposit (EL 2.0) or withholding by Indian payer (EL 1.0)	TDS under Section 195 by Indian payer on attributable income

Source: Compiled by the authors from Ministry of Finance publications and Tax Guru (2024)

The SEP regime's integration within the income tax framework represents a substantive improvement in treaty accessibility: eligible non-residents may now invoke DTAA benefits—potentially defeating Indian taxation altogether if they lack a PE as defined in the relevant treaty. However, the shift from a predictable gross turnover tax to net-income attribution introduces new complexity. Determining profits attributable to Indian operations requires sophisticated functional analysis and transfer pricing documentation, increasing costs for businesses with intricate digital value chains. The removal of the Section 10(50) exemption means income previously exempt from income tax under the EL regime is now potentially exposed to SEP taxation.

Discussion

The EL's trajectory from its 2016 inception to its 2025 abolition encapsulates the broader tension between a developing country's sovereign right to tax digital value generated within its market and the constraints imposed by international treaty obligations, constitutional requirements, and geopolitical trade dynamics. The levy's structural design—gross-basis, treaty-excluded, Finance Act-housed—was simultaneously its greatest administrative virtue and its most profound legal vulnerability.

From a public law perspective, the EL tested the outer boundaries of Parliament's legislative competence over digital services and exposed procedural gaps in administrative adjudication that fell short of constitutional due process standards. From an international tax perspective, it illustrated the practical limits of unilateral measures in a treaty-governed international order: by bypassing the PE doctrine and excluding DTAA coverage, India achieved short-term revenue capture at the cost of juridical double taxation, treaty friction, and trade retaliation.

The transition to the SEP regime is conceptually more coherent, integrating digital nexus principles within the established income tax and treaty framework. Yet the regime's dependence on profit attribution methodologies still under development by the CBDT leaves significant interpretive uncertainty for non-resident businesses. The full operationalisation of OECD Pillar One, which would redistribute taxing rights through a multilateral instrument, remains the longer-term solution toward which India is now aligned.

Future scope of Study

The research on the Equalisation Levy and its correlation with the Income Tax system in India provides some potential for future research. Digital economy is increasingly becoming a booming business across borders with new business operating models including digital marketplaces, streaming services, cloud computing, and online advertising. The future research can analyze how these new digital practices are developing new tax issues, and whether the current tax system in India is in a position to adequately govern them. Scholars can also examine the potential of the ability of emerging technologies like artificial intelligence, blockchain, and digital payment systems to make digital taxation even more challenging.

The other relevant field of future research is how global tax reforms will have an effect on the digital taxation policy in India. International organizations like the OECD/G20 global tax project are trying to develop a system of coordinated taxation of multinational digital corporations. Future researches can be conducted to find out how India can conform their tax policies with these international regulations and whether such policies as the Equalisation Levy will be continued or will be substituted by some other international taxes. It is also possible to research the way other nations handle the issue of digital taxation and compare it with the policies in India.

Legal and administrative issues of businesses and tax authorities in the implementation of the Equalisation Levy can also be the basis of further research. Research may be done to study matters concerning the costs of compliance, interpretation of tax regulations, and the double taxation disputes. An example can be described as the examination on how multinationals operate their tax liability when they are incurred to the native tax provisions as well as those established by international treaties. Knowledge of these practical challenges would enable policymakers to come up with better and more effective regulations.

Conclusion

Finally, the proposal of the Equalisation Levy is an initiative of India to respond to the taxation problems that have appeared due to the digital economy developing at a rather high pace. The traditional tax regulations under Income Tax Act, 1961 were largely based on the traditional business where the company is physically present in a country, and it was thus hard to tax the foreign digital companies using online platforms. The Equalisation Levy was hence initiated so that such companies can pay their due to the Indian taxation when they get their income out of Indian users. This move assisted the government in increasing the tax base and the disparity among the local businesses and the foreign digital services providers.

Nevertheless, the introduction of the Equalisation Levy too caused a number of issues and concerns. There is the fact that the levy overlaps with the current provisions of the Income Tax Act which is one of the major challenges. There are situations where digital businesses might find themselves in a difficult position as to whether their revenues should be subject to tax under the Equalisation Levy or taxation under the income tax (Significant Economic Presence or withholding tax). Such overlap can potentially worsen the risk of this taxation and present compliance challenges to multinational companies doing business in India.

The other critical issue is associated with international taxation concepts and tax concessions. Because most tax treaties are made on the concept of permanent establishment, the use of the Equalisation Levy without the need to be physically present has created some doubts over its compatibility to treaty obligations. Other nations have also voiced that unilateral digital taxes will impact the international trade relations and cause conflicts among countries. This has seen international talks convened by bodies like the OECD to come up with a global payment system to solve the digital taxation issues in a more coordinated approach.

Nonetheless, the Equalisation Levy has contributed largely to the creation of policy debate on digital taxation in India. It has pointed at the shortcomings of the traditional tax systems to address the new digital business models. The experience in the implementation of this levy offers significant lessons to the policy makers in making more effective tax regulations in future.

Thus, in the future, India should develop an effective and transparent taxation system that minimizes the overlaps of various tax policies and achieves simplicity in business. Increased liaison with foreign tax programs and frequent revisions of domestic tax policy will assist in dealing with legal difficulties and the encouragement of a fair tax system

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