

India Tax Insights

Issue 1

April-June 2014

Jeffrey Owens

speaks on how tax administrations are responding to the global challenges

Journey of tax administration from Arthashastra to TARC

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Addressing tax gaps in India
APA - New kid on the block
Role of ADR in India
Latest on BEPS and India tax

Managing tax risk

*How prepared is India Inc.?
2014 tax risk and controversy survey*

EY

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Welcome

This issue marks the launch of our new magazine - India Tax Insights. It is full of insightful articles, interviews and reports that will help business leaders have the most relevant information to make decisions.

Our first edition focuses on tax administration in India. Tax revenue collection is influenced by both tax policy and tax administration. While tax policy design ensures responsiveness of potential revenue to overall economic growth, tax base and tax rates, tax administration seeks to secure potential tax revenues effectively and efficiently. It is because the two are inextricably linked that reform in tax administration is as important as that in tax policy. In India, tax policy reforms have been accelerated since the economic liberalization unveiled in 1991. But no comprehensive reform in tax administration was undertaken in the same depth. Tax administration in India has therefore experienced modest improvement that does not necessarily reflect global movement.

Mr. Jeffrey Owens, Senior Tax Policy Advisor to the Global Vice Chair of Tax, EY and former Director, Centre for Tax Policy and Administration, OECD, Paris, talks to us on the growing pressures on the tax administrations and how they are responding to the challenges. Mr. Owens talks of how tax administrations are now moving towards developing a more behavioural response to compliance: shifting towards prevention rather than just detection of non-compliance and the structural changes that tax administrations are adopting to combat the challenges posed by the increasingly global and interconnected economic environment.

In our feature titled *Journey across decades*, we trace the path of the Indian tax administration. The article traces the milestones in the journey of tax administrative reforms in India, including the recent establishment of Tax Administration Reform Commission. The article also provides a summary of the recommendations from the recently released first report of the Commission.

India has seen significant international tax disputes in the recent past, many of which have made headline news globally. One immediate imperative on the agenda of the new Government is the need to find a faster and better way to resolve disputes. Our article titled *Moving from confrontation to cooperation* discusses the need to introduce alternate dispute resolution mechanisms in India to achieve the objective of making the tax regime non-adversarial. Our article on *Advance Pricing Agreements* profiles the new regime for resolving transfer pricing controversies in advance and the challenges the tax administration should be prepared for, as the regime evolves.

Our article titled *Mind the gap* highlights the significance of tax gap analysis by the Centre and State governments in India which could prove to be valuable for augmenting revenues, designing tax reforms, simplifying tax structures, reducing compliance costs, and improving the efficiency of tax administration.

In addition, the sections *Global news* and *EconoMeter* - provide a snapshot of important global tax developments and key economic indicators, respectively and promise to be a regular feature.

We hope you find this publication both timely and thought provoking, and we look forward for your feedback and suggestions.

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Global news

OECD project on BEPS

1

On 19 July 2013, the Organisation for Economic Co-operation and Development (OECD) released its Action Plan on Base Erosion and Profit Shifting (BEPS). It identifies 15 key pressure areas that will form the basis of OECD's work in this area over the next few years. OECD proposes to publish its final recommendations/output in seven of the identified actions, in September 2014. Following are some of the interim work done by OECD on key actions -

► **Discussion draft on preventing treaty abuse under BEPS (Action 6)**

On 14 March 2014, OECD released the first Discussion Draft in connection with Action 6 – “Preventing the granting of treaty benefits in inappropriate circumstances”. The Draft contains proposed tax treaty provisions and related commentary, together with proposed domestic law provisions, to address treaty shopping and other potential treaty abuse. The recommendations proposed in the Draft include incorporating in tax treaties both “limitations on benefits” (LOB) rules and broad anti-abuse rules similar to the “main purpose” tests.

► **Discussion draft on tax challenges of the digital economy (Action 1)**

On 24 March 2014, OECD released a discussion draft for public comments, in connection with Action 1 on “addressing tax challenges of digital economy” for public comments². The Draft discusses key features and business models in a digital economy, the opportunities that can arise for BEPS in a digital economy and some potential options to address tax challenges raised by digital economy. The options evaluated are to modify exemptions to permanent establishment (PE) status, provide alternative PE thresholds, impose a final withholding tax on payments for digital goods and services.

Action 1 also identifies the need to address indirect taxation and the effective collection of consumption taxes (e.g., VAT, GST) with respect to the cross-border supply of digital goods and services.

► **Public consultation on hybrid mismatch arrangements (Action 2)**

On 19 March 2014, OECD released two public discussion drafts in connection with Action 2 on hybrid mismatch arrangements³. The First draft provides recommendations for domestic rules to be adopted by countries to neutralize the difference in tax treatments of hybrid mismatch arrangements and the second draft discusses effect of rules on the Model Tax Convention (MC) and proposes changes to the MC to clarify treatment of hybrid entities. OECD has thereafter, in May 2014, entered a dialogue with the country tax officials and stakeholders on key issues raised in discussion drafts⁴.

► **Public Consultation on TP Reporting and country-by-country reporting (Action 13)**

On 19 May 2014, the OECD held a public consultation on the Discussion Draft on Transfer Pricing Documentation and country-by-country (CbC) reporting (Action 13 of the BEPS Action Plan)⁵. The agenda for the consultation was divided into three broad sections – the content of the CbC report, the filing and sharing of that report, and the content of the master and local files. The OECD representatives stressed that the best approach for filing and sharing of the CbC report is still being discussed and no final conclusion has been reached yet.



Some country-specific actions on BEPS

2

The OECD BEPS project is endorsed by G8 and G20 governments and major developing (non-OECD) countries, including China and India are actively participating in it. Several countries are taking specific actions under domestic laws, proposing amendments/new legislations and are engaging in public consultations on such proposed actions in light of OECD's BEPS project. For example:

- ▶ **Russia** has introduced a Bill proposing controlled foreign companies (CFC) rules, tax residence based on "place of effective management" and taxation of "indirect" sale of immovable property. This is in line with the overall plan of "de-offshorization" of the Russian economy⁶.
- ▶ In **France**, draft regulations on "anti-hybrid" financing provisions are released for public comments before the same are finalized⁷. These regulations provide that interest paid by a French enterprise to its related lender enterprise (French resident or non-resident) is no longer tax deductible for French tax purposes if the interest is not subject to tax at the level of the beneficiary company at a prescribed minimum rate of tax.
- ▶ The **UK** Government recently published a position paper explaining its view on various action points of the OECD BEPS project and also sets out the UK's priorities for the OECD BEPS project⁸. The paper clarifies that, while the UK supports the BEPS initiative, it would wish any changes being proposed by the OECD to be compatible with the Government's two objectives of ensuring that the UK remains an open competitive economy whilst working with international partners to prevent unfair tax avoidance and aggressive tax planning by multinationals.
- ▶ **China's** State Administration on Taxation has guidance administrative measures, which will be undertaken on International Tax Compliance⁹. The guidance clarifies, inter alia, that China tax authorities may apply a substance over form approach for treaty abuse and exercise jurisdiction to an overseas incorporated enterprise whose actual management is located in China. The guidance provides key risk areas of focus of tax authorities and states that a specialized anti-tax avoidance organization will be established for investigations and advance pricing arrangements.
- ▶ Curiously, in the **US**, administrative statements are issued expressing concern that the project is "now being used as a way for other countries to simply increase taxes on American taxpayers." They also identified as problematic the "extremely ambitious" time frame for the work on the 15 BEPS Actions.

Global news

Brazil Supreme Court rules Controlled Foreign Corporations regime not compatible with tax treaties¹⁰

3

The Superior Court of Justice, i.e., the highest court of the country in non-constitutional matters, ruled

that Brazil's CFC regime is not compatible with the business profits article of tax treaties concluded by Brazil with Belgium, Denmark and Luxembourg (Corresponding to Article 7 of the OECD MC) and held that profits of CFCs cannot be taxed on deemed distribution basis.

In the wake of BEPS, various countries are considering CFC provisions in its domestic laws. Currently, India does not contain CFC rules in its tax law; however, the Government of India is considering it and has mentioned it in the proposed Direct Tax Code 2013. The proposed legislation permits treaty override by operation of the CFC provisions as well as the provisions on General Anti-Avoidance Rules and Branch Profit Tax.

Tax treatment of virtual currency transactions: Administrative Guidelines issued in various jurisdictions

4

Recent years have been marked by the appearance and development of "virtual currencies,"

which means digital units of exchange that are not backed by government-issued legal tender. These currencies have taken various forms. One form is virtual currencies developed primarily to allow the purchase of real goods and services, i.e., "crypto-currencies", including in particular, bitcoin. Many private operators chose to accept payment in bitcoins.

As virtual currencies increasingly acquire real economic value, they raise substantial policy issues. From a tax perspective, the issue surrounding usage of virtual currency (such as bitcoins) is its characterization as either a "currency" or an "asset." Globally, in several countries such as the US, the UK, Canada, Denmark and Singapore administrative guidelines are issued to bring clarity on the treatment of virtual currencies in the jurisdiction. Currently, such guidance is not available in India.

Payment by Australian distributor for acquiring rights to commercially exploit a computer software regarded as "royalty"

5 Australian Federal Court, in case of Task Technology Pty Ltd. v. Commissioner of Taxation of the Commonwealth of Australia¹¹, held that the payment by an Australian distributor to a Canadian company for distribution of a software program would amount to "royalty" under the Australia-Canada treaty. The Court referred to OECD Commentary 2010 on Article 12 - Royalties [para 14 to 14.3] and in view of the specific language of the treaty, it concluded that the nature of the rights acquired by the Australian distributor were not limited to such rights as were necessary for the effective operation of the software, but the right to use included rights for the commercial exploitation of that software through the right to copy the said software for further sale and the right to use the copyright for the purposes of developing its own templates to sell in conjunction with software. This decision throws some light on the contentious issue of treatment of software payments, which is generally based on the nature and extent of rights granted.

References

- 1 Refer EY Global Tax Alert on "OECD releases discussion draft on preventing treaty abuse under BEPS Action 6", dated 24 March 2014
- 2 Refer EY Global Tax Alert on "OECD releases discussion draft on tax challenges of the digital economy" dated 7 April 2014
- 3 Refer EY Global Tax Alert on "OECD releases discussion drafts on neutralizing hybrid mismatch arrangements under BEPS Action 2" dated 8 April 2014
- 4 Refer EY Global Alert on "OECD holds public consultations on BEPS action on hybrid mismatch arrangements" dated 19 May 2014
- 5 Refer EY Global Tax Alert on "OECD holds public consultation on transfer pricing documentation and CbC reporting" dated 20 May 2014
- 6 Refer EY Global Tax Alert on "Russia publishes Controlled Foreign Companies Bill" dated 28 March 2014
- 7 Refer EY Global Alert on "French Tax Administration releases draft regulations on "anti-hybrid" financing provisions" dated 16 April 2014
- 8 Refer EY Global Tax Alert on "UK delivers Budget 2014" dated 21 March 2014
- 9 Refer EY Global Tax Alert on "China's Jiangsu provincial state tax authority releases guidance on international tax compliance administrative measures" dated 27 May 2014
- 10 EY Global Tax Alert on "Brazil's Superior Court of Justice rules CFC regime not compatible with tax treaties" dated 6 May 2014
- 11 [2014] FCA 38, dated 6 February 2014

The journey across decades

Tracing the path of Indian tax administration

Introduction

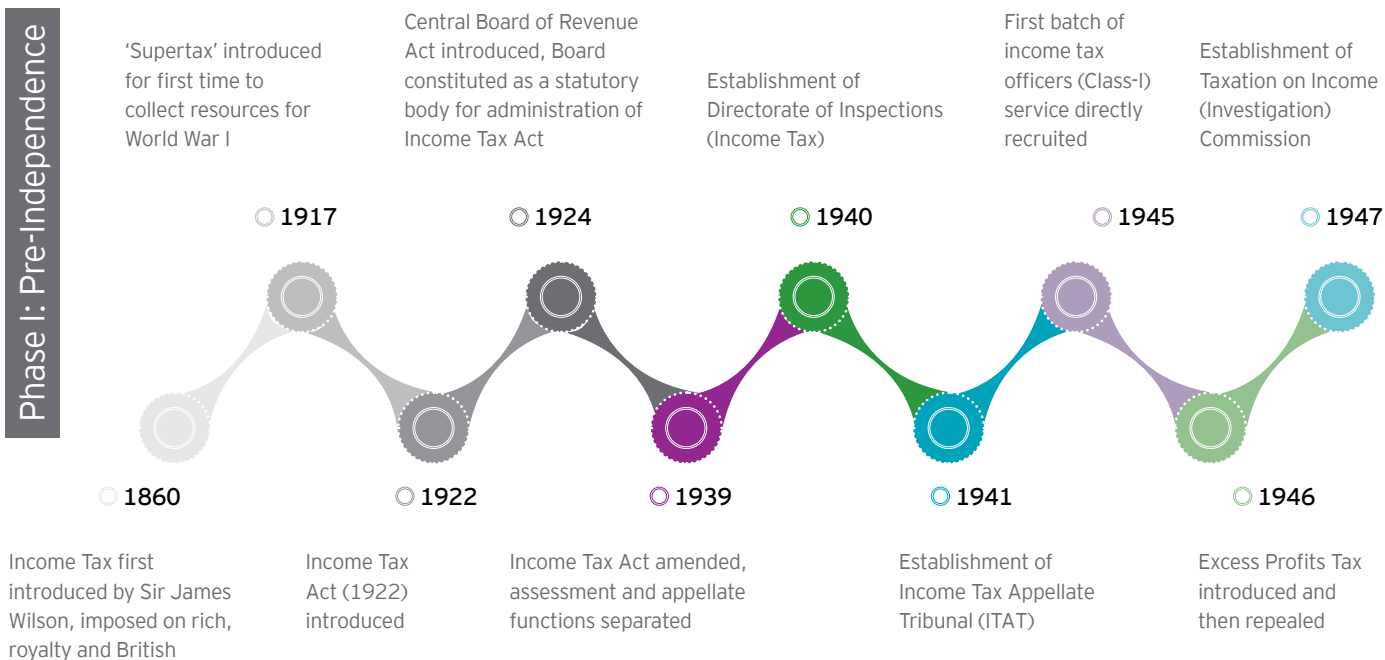
Tax administration has been at the centre of the Indian taxation system, since time immemorial. Perhaps the earliest reference to taxation-based governance is found in the mythological Indian epics of *Ramayana* and *Mahabharata*. Much later, during the Mauryan Empire, Kautilya wrote the *Arthashastra* that gave direct instructions to the king on how to tax and govern the state efficiently. Tax administration underwent several changes in the Mughal era and later under the colonial rule of the British Empire. However, it was only after half a century of introduction of the income tax in 1860 that a comprehensive legislation dealing with various levels of levy and administration came into existence. Since then, India has seen regular legislative and administrative reforms.

Milka Casanegra (1990) states that "*in developing countries tax administration is tax policy.*" No tax policy can be implemented without commensurate improvements in tax administration. While India has progressed in tax administration, to be able to keep pace with the demands of the fast changing, global environment, there is still a long way to go. In the last two years particularly, the accusations against the Indian tax administration for its arbitrariness, undue aggressiveness and the resultant rise in disputes, has pushed policymakers to deliberate on the next generation tax administration reforms. The latest outcome of these deliberations is the Report of the Tax Administration Reform Commission (TARC).

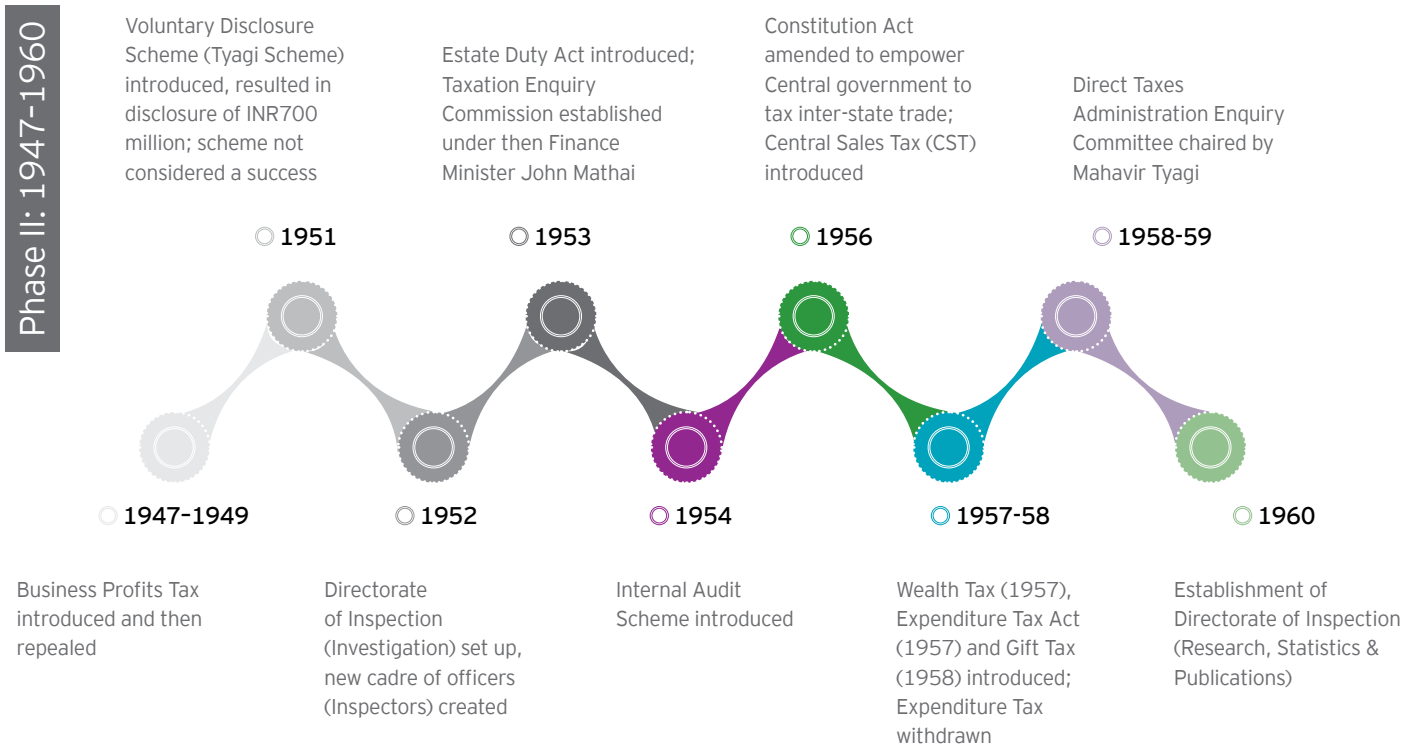
This section traces the milestones in the journey of tax administration, primarily direct taxes, in India.

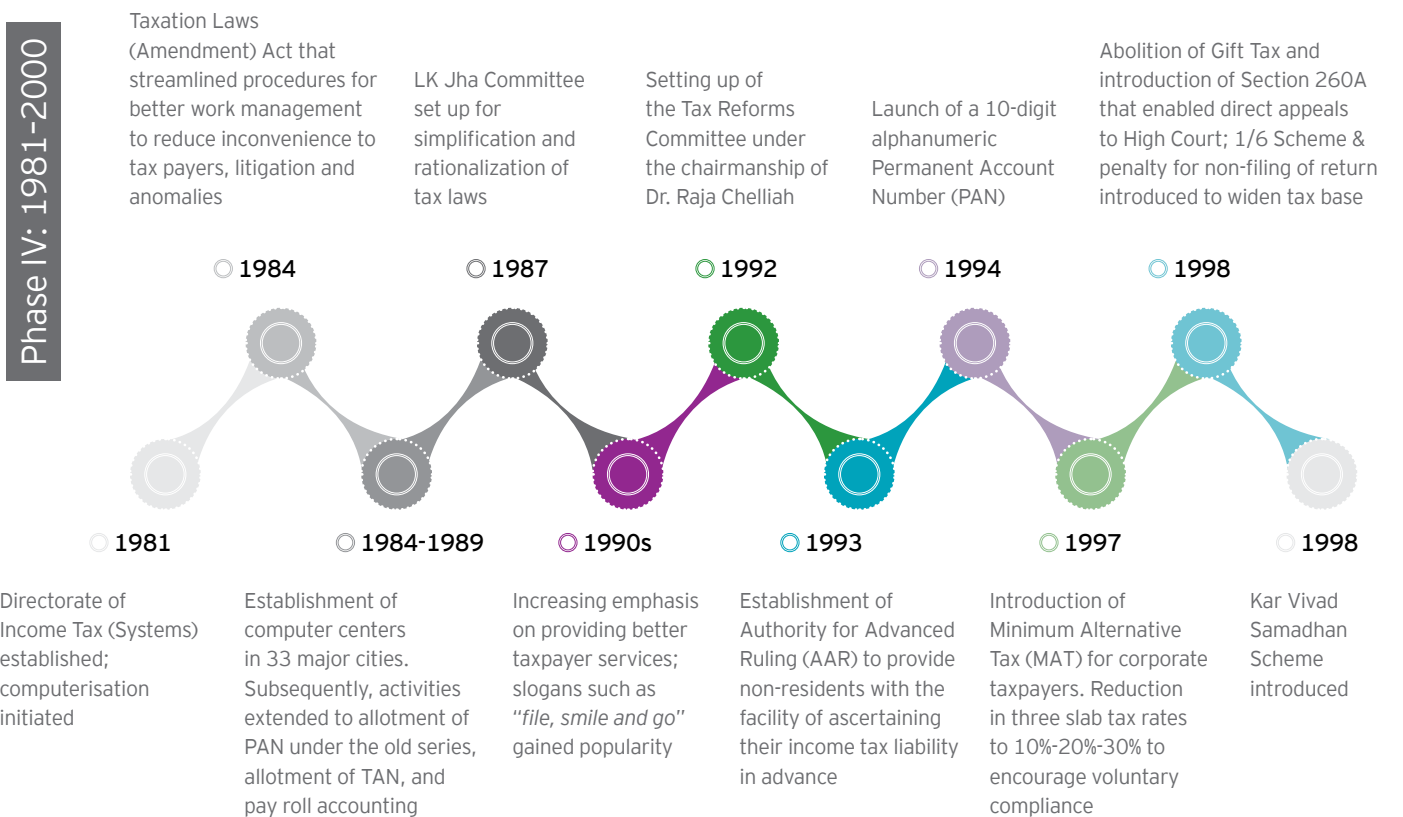
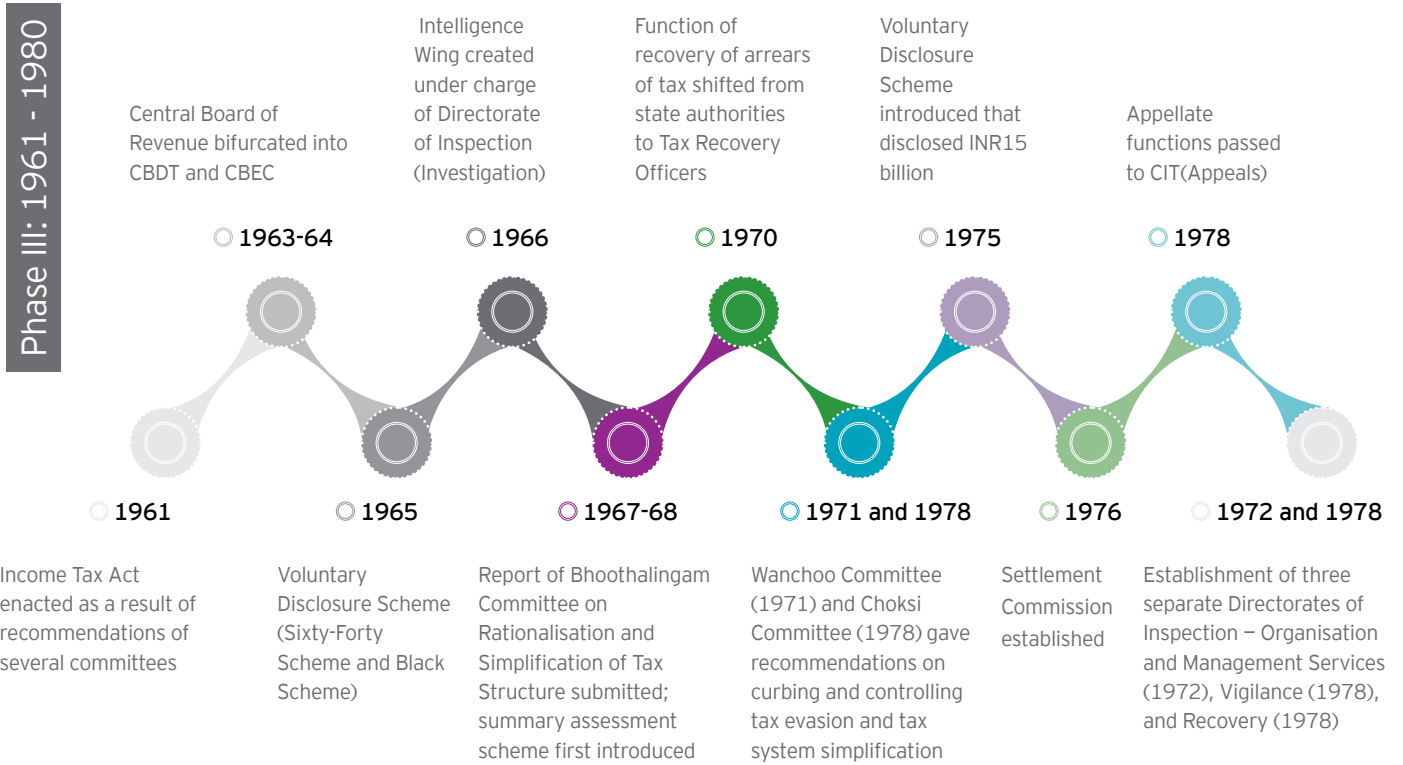


Phase I: Pre-Independence



Phase II: 1947-1960





Phase V: The Millennium (2000 onwards)

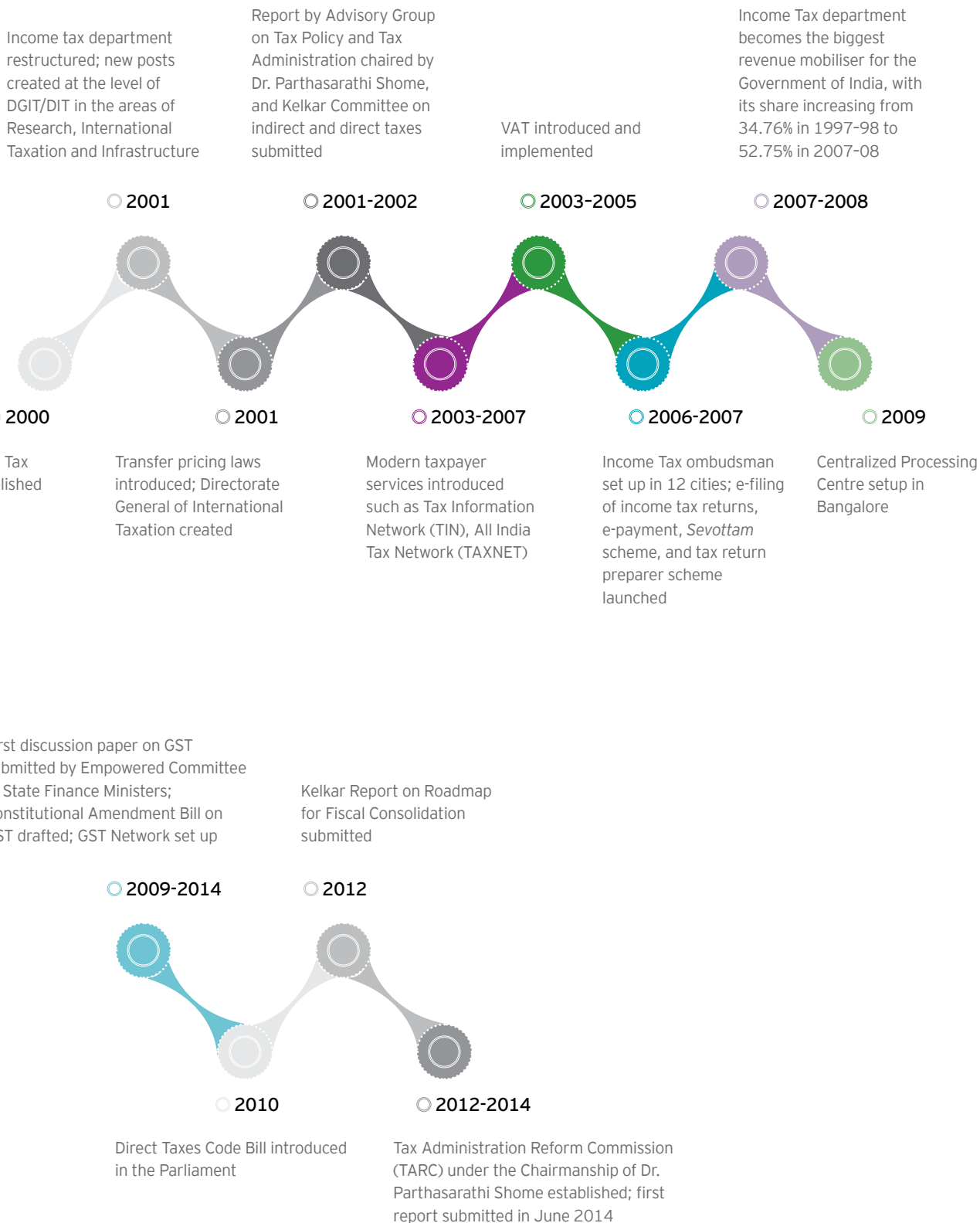
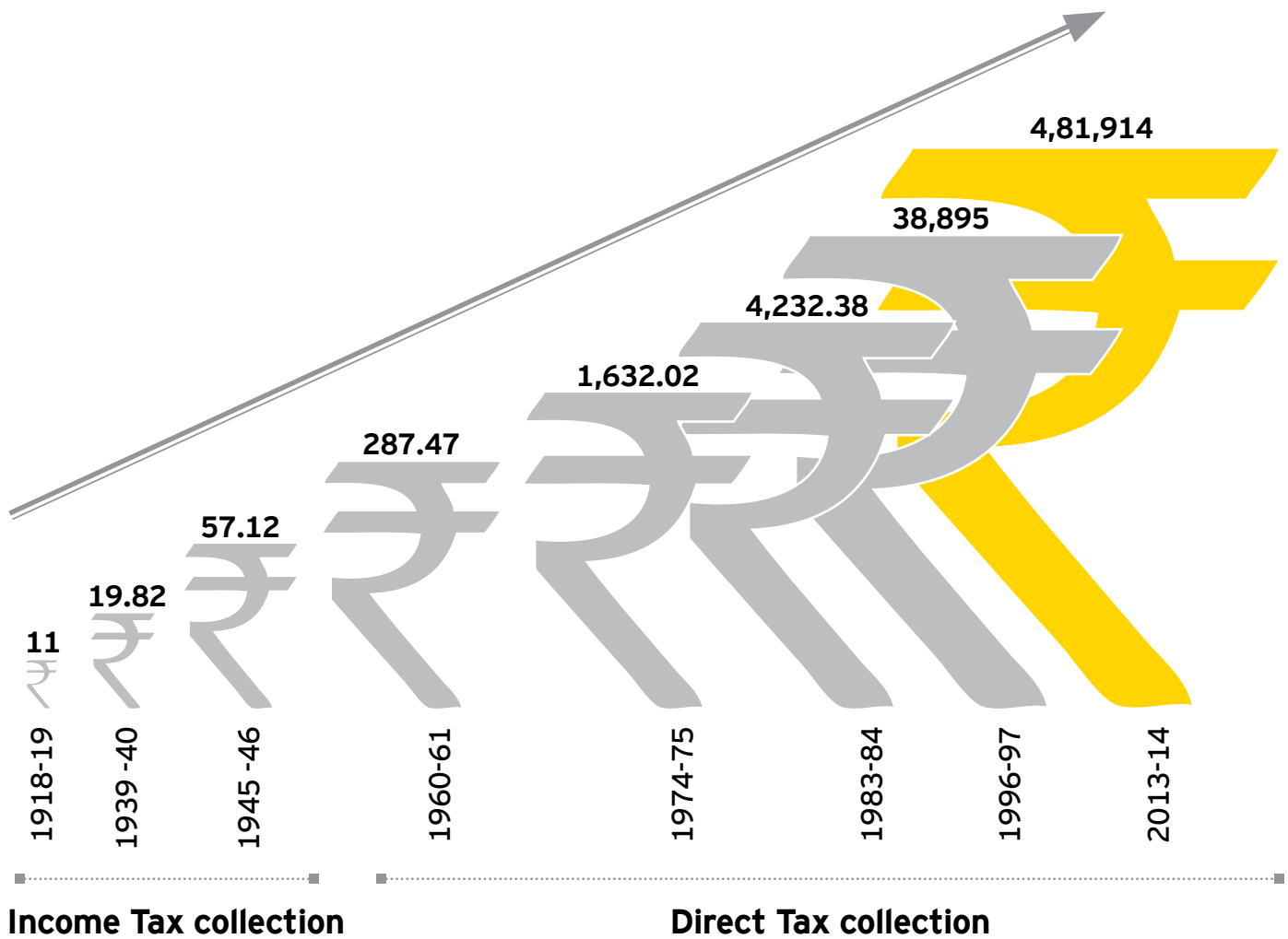


Exhibit 1. Income and Direct Tax collection from 1918 to 2014 (in INR crore)



Source: 'A Journey Across Three Centuries', Ministry of Finance, Government of India



Late Dr. Raja Chelliah

Tax Reform Committee under the Chairmanship of Dr. Raja Chelliah, 1991

The Tax Reform Committee under the Chairmanship of Dr. Raja Chelliah focused on tax administration in the first part of the Report. The Committee outlined measures for efficient tax collection, including improved taxpayer identification and focused efforts to combat tax evasion through better targeting of tax audits. It called for extending the scope of computerization to all

core functions, improve human capital in tax collection departments through increased pay, improved training, and selective promotion. The Committee also recommended that the two boards - CBDT and CBEC- should be given financial autonomy with separate financial advisers working under the supervision and control of respective chairpersons. Furthermore, the chairpersons of the two boards should be given the status of Secretary to the Government of India and the members the rank of Special Secretary. It also suggested that the post of Revenue Secretary should be abolished.

TARC recommendations

The Tax Administration Reform Commission (TARC) submitted its first report in June 2014. The comprehensive Report identifies key challenges faced by the Indian tax administration and makes recommendations that are practical and achievable. It extensively discusses the issues of need for customer focus, structure and governance of the tax department, people functions, internal processes, use of IT and Dispute Management.

It forthrightly brings out weaknesses of the Indian tax administration. In fact, TARC's overarching conclusion is - *"if an institution could have spirit, then the current Indian tax administration lacks that spirit. Functioning in a vacuum, it has lost its purpose as revealed in its behaviour, for its stated vision and mission are scarcely observed in its operational style. Its singular objective of protecting revenue without accountability for the quality of tax demands made is commonly believed to have severely affected the investment climate in India and in investment itself...overall, the Indian tax administration is at its nadir. A fundamental and deep reform is urgently called for"*

TARC's key recommendations include:

Customer focus

- ▶ There should be a dedicated organization for delivery of taxpayer services with customer focus for each of the boards. There should be an exclusive member in each board for taxpayer services
- ▶ Taxpayer service delivery should be located under one umbrella for large taxpayers
- ▶ Officers and staff at all levels of tax administration should be trained for customer orientation

- ▶ In redressing taxpayer grievances, the decision of the Ombudsman should be binding on tax officers
- ▶ There should be regular stakeholder consultations on issues of tax disagreements and tax law changes
- ▶ There should be a system for online tracking of 'dak' (mail)/grievances/applications for refund etc.
- ▶ Pre-filled tax returns should be provided to all individuals

Structure and governance

- ▶ Converge two boards (CBDT and CBEC) selectively to achieve better tax governance
- ▶ Have increased functional and financial autonomy of tax administration
- ▶ Abolish the position of Revenue Secretary and allocate the present functions of Department of Revenue to two Boards
- ▶ Establish a Governing Council, Independent Evaluation Office (IEO), Tax Council, and Tax Policy and Analysis (TPA)

People function

- ▶ Shift all key operations to digital platform to measure performance
- ▶ Make provision for lateral entry of experts in key roles and specialized areas
- ▶ Establish key performance indicators for both boards
- ▶ Promote specialization and accommodation of individuals' choices in professional growth

Key internal processes

- ▶ Develop Permanent Account Number (PAN) as Common Business Identification Number (CBIN) to be used by other government departments
- ▶ Include wealth tax returns in I-T returns to ease taxpayer compliance
- ▶ Common return for excise and service tax
- ▶ Separate budgetary head for refund of direct tax and indirect taxes in the annual budget
- ▶ Refunds sanctioned should be paid on time along with the applicable interest automatically as is done in the case of income tax and not on demand by taxpayers; rate of interest on refunds should be the same as the interest charged by the tax department
- ▶ Frame single detailed documentation requirements for transfer pricing as well as custom valuation by both boards

Dispute management

- ▶ Retrospective amendment should be avoided as a principle
- ▶ Fundamental approach should be collaborative and solution oriented
- ▶ Dedicated task force for review and liquidation of cases currently clogging the system
- ▶ Formulate clear interpretative statements on contentious issues that are binding on the tax department
- ▶ Establish the practice of pre-dispute consultation before issuing a tax demand notice
- ▶ Prescribe consequences of not adhering to timelines in resolving disputes
- ▶ Make DRP a full time panel and expand the mandate to include corporate cases of resident cases
- ▶ Change the present structure of Commissioner (Appeals) to two forums – single Commissioner (Appeals) and 3-member Commissioner (Appeals) panel
- ▶ Statutory introduction of ADR process, arbitration and conciliation
- ▶ Make the jurisdiction of AAR available for domestic cases
- ▶ Settlement Commission should act as part of taxpayer services, and be made available to the taxpayer to settle disputes at any stage
- ▶ Appeals to high courts and the Supreme Court should only be on a substantial question of law
- ▶ On disposal of cases by Supreme Court/High Court and if the judgement accepted by the Department an instruction should be issued to all authorities to withdraw appeal in any pending case involving the same issue

Information and Communication Technology

- ▶ Full realization of the potential of ICT; fully digitized environment with comprehensive ICT system
- ▶ Adopt a robust ICT governance framework and practices, and rigorous program and project management frameworks
- ▶ HR policies must be aligned with the need for specialization and officers should be allowed to grow in areas in which they specialize
- ▶ Establish a common special purpose vehicle (SPV) for servicing the ICT needs of the boards

Are tax administrations equipped for tomorrow?

Jeffrey Owens

Senior Tax Policy Advisor to the Global Vice Chair of Tax, EY and former Director, Centre for Tax Policy and Administration, OECD, Paris

Over the years, there has been unprecedented attention on the role of tax administrations in delivering the revenues needed by governments, and in a way which minimizes negative externalities and compliance costs. Much of this attention has been on the question of whether or not multinational enterprises (MNEs) and high net worth individuals (HNWIs) pay the right of amount of tax and how to deal with Small/Medium-sized Enterprises (SMEs) and the informal sector. There has been a renewed interest in many countries on how to close the overall tax gap.

The India Tax Insights talks to Jeffrey Owens, Senior Tax Policy Advisor to the Global Vice Chair of Tax, EY and former Director, Centre for Tax Policy and Administration, OECD, Paris, about the changing attitudes to tax compliance on the part of tax administrations, how they have responded to challenges posed by a rapidly changing global environment and the upcoming challenges that they need to prepare themselves for.

How has the role of tax administrations shifted in recent times?

Over the years, the role of tax administrations has changed. Many are now responsible for implementing social programs, for example, family credits and student loan schemes. Many governments also look to the tax administration to implement part of their structural programs to exit from the crisis. Increasingly, tax authorities are taking on the role of regulators, for example, in the environmental area. All of this has changed fundamentally the way that a tax administration operates, the profile of the staff needed and the political risks for tax administrations.

Moreover, tax administrations now have to live in a global environment where MNEs operate as global entities, with more tenuous links to their own countries. They operate and plan on a global basis and this also applies to their tax matters. Technology has enabled financial institutions to move substantial sums of money around the world at the click of a mouse. This globalization of national economies poses new challenges for tax administrations, since they continue to operate within national barriers. They are national, not global institutions and countries continue to protect their fiscal sovereignty, although the reality is that for small- to medium-sized countries, they have little real autonomy over the design of their tax systems.

Another transformation in the global environment is the growth of new types of HNWIs. We have always had the very rich, but what we are now seeing is a tendency to move towards what some investment bankers have termed as "ultra-rich." These are individuals who have much weaker ties to any jurisdiction; they are more aggressive and hands on in managing their wealth. And they are more "footloose" and more at ease with each other than their fellow citizens.

We have also seen governments putting more pressure on tax administrations to reduce compliance costs for taxpayers. This is not new, but it has taken on a new dimension with the recognition that compliance costs can be a factor in defining the competitiveness of a country.

The tax administrations of today are trying to follow a more behavioral response to compliance by focusing on prevention rather than just detection of non-compliance. What according to you is driving this change?

There are several reasons. First, there is a recognition that the majority of taxpayers want to voluntarily comply and tax administrations' main task is to help them do that. Second, taxpayers are becoming more assertive and insisting that they have rights as well as obligations. Tax administrations accept that different groups of taxpayers have different types of needs and this has led to increased taxpayer segmentation. This is a move away from a tax-by-tax approach to more of a taxpayer-by-taxpayer approach. Moreover, most tax administrations, certainly in the developed world, are now under severe pressures to do more with less. And finally, there is recognition that the informal economy cannot be dealt with effectively just by strict enforcement. Tax administrations need to provide an attractive path from informality to formality.

Are tax administrations making any structural changes in the new environment?

Tax administrations have moved away from a tax-by-tax approach to an integrated approach to dealing with the taxpayers. Today, there are very few OECD member countries that have not integrated direct and indirect tax departments and many, such as Columbia, have also brought in social security and customs. For large taxpayers, we increasingly see that VAT, corporate income tax and other taxes are dealt with in a highly integrated approach, with many countries having relationship managers that are dedicated to a particularly large company. We have also seen the move toward the creation of independent revenue services, especially in non-OECD countries, and this has minimized political influence, encouraged a move toward a more realistic pay scale and also made a clearer distinction between policy formulation and policy implementation.

In addition, we have seen most tax administrations establish special units to deal with groups of taxpayers, e.g., MNEs, small and medium-sized enterprises (SMEs) and HNWIs. We can expect this tendency toward taxpayer segmentation to continue.

How successful have tax administrators been in persuading the corporate boards to put tax compliance in the broader governance and/or social responsibility framework?

Today, tax commissioners are spending more time talking to Chief Executive Officers (CEOs), Chief Financial Officers (CFOs), corporate boards and audit committees to get them to see that good tax compliance should be part of their good corporate governance strategy. This is not an easy task at a time when the financial crisis is putting pressure on governments and corporations, and in a political climate characterized by mistrust of large corporations.

However, the attractiveness of this approach is that it forces corporate boards to discuss tax issues more frequently and to take ownership of a company's tax strategy. Boards are more likely than tax directors to weigh up the financial and reputation risks associated with an aggressive tax strategy against a potential saving in tax and they tend to place an increased emphasis on the need for stability in effective tax rates. Some boards may decide to continue to pursue an aggressive strategy, others may not.

Tax transparency is the new buzzword in today's context. What is your take on this issue?

Tax administrations have built on political support from the G20 countries and other groups toward more transparency in taxation and the elimination of bank secrecy as a shield behind, which tax evaders can hide. They are putting in place voluntary compliance initiatives to encourage taxpayers to come forward and declare their assets illegally held offshore. Some countries now require taxpayers to disclose uncertain tax positions. All of these initiatives recognize that we must deal with the legacy of the past if we are to move on to a new, more, cooperative future, which is why countries are putting in place tax amnesties.

Tax transparency, however, is not just an issue for taxpayers. If governments want taxpayers to be more transparent, they in turn must also be prepared to be transparent, both in policy formulation and in implementation. Better administrative transparency may also be an effective way to conquer harmful tax administrative practices.

Upcoming challenges

1. **The risks of breaches of confidentiality:** With the spread of tax net, information exchange agreements and the move toward automatic exchange, there is a risk that information will be leaked, which could jeopardize the move to better exchange of information.
2. **The increasing role of medium-sized enterprises in cross-border trade:** These enterprises are far less familiar with the international tax rules and, therefore, may find themselves in a situation of non-compliance, particularly in the area of transfer pricing.
3. **Working closely with other law enforcement agencies:** Tax administrations need to accept that they have a role in counteracting all forms of illicit activities and that the information shared with other government departments does not represent a breach of confidentiality.
4. **Emergence of MNEs from the BRICS on the global scene and other economies in transition:** Non-OECD-based MNEs have begun to go global and are now some of the fastest growing MNEs in the world. Inevitably, they have less familiarity with the international rules of the game whether in the area of treaties or transfer pricing and, therefore, perhaps may inadvertently or consciously non-comply with these rules. Some may have weak corporate governance cultures and some may be more prepared than OECD's MNEs to ignore tax and anti-money laundering rules.
5. **Pressure to produce a business-friendly tax environment:** Governments recognize that a competitive tax environment is not just a question of putting in place the right policy environment, but it is also a question of how the rules are administered in practice. The challenge for tax administrations is that a business-friendly tax environment should not become an excuse for weak tax compliance as a means of attracting business.
6. **Recruiting and maintaining high quality staff:** In the current scenario, we see many tax administrations with an aging workforce facing the risk of a generation gap. Morale is weak and training programs are being reduced. A worldwide shortage among qualified tax professionals is emerging and governments will find themselves competing with the private sector for this diminished pool.
7. **Maintaining taxpayers' trust in the system:** There must be a relationship between taxpayers, tax advisors and tax administrations that is based on trust – a mutual understanding. An inclusive and constructive dialog is the most effective way of preventing these issues becoming problems.
8. **Outsourcing of functions:** Besides information technology (IT) functions, there are other functions that are being outsourced. Financial institutions are being asked or required to play a more important role, not just in the collection of tax (the traditional role of withholding agencies), but also as assessors of tax due and verifiers that the tax obligations are met. We are also seeing the beginning of a process by which tax authority's role as the collectors of data becomes less important as they rely on the information stored in the "Cloud."
9. **Attitudes are changing towards tax disputes:** Tax administrations and taxpayers have a shared interest in minimizing and resolving quickly tax disputes. There is a need for new type of commitment from tax administrations and willingness to devote scarce and highly trained officials to avoiding and speedily resolving tax disputes.



One of the challenges that tax administrations are faced with, particularly in India, is the rise in tax disputes and adopting appropriate mechanisms to minimize and resolve disputes. What is your view on dispute management?

Globally, attitudes toward tax disputes are changing and there is a recognition that dispute management requires focussing not just on one particular issue, but on the whole process by which disputes arise. This requires engaging taxpayers in the process of policy formulation and implementation. It requires identifying and discussing issues before they become problems. It requires pre-filing resolution, the type of programs that we see in the US (the compliance assurance program CAP) or the horizontal monitoring programs in the UK and the Netherlands.

It also requires an increased use of informal mediation, particularly in the area of establishing the facts in transfer pricing case. And it requires a wider use of advance pricing agreement (APA) type of programs and mandatory arbitration. Governments also need to invest in improving mutual agreement procedures if we are going to deal with the tsunami of tax disputes that are likely to arise in a post-BEPS environment.

So, how can tax administrations of tomorrow resolve these challenges?

Better cooperation between tax administrations can help to resolve some of these challenges. Many of these challenges come about from the intensification of the process of globalization and that, in turn, requires an increased cooperation between tax administrations. We have to accept that this will be a messy process with different actors playing different roles. Those who advocate that the solution to this is to create a "World Tax Organization" have to recognize that whilst, in abstract, this may be desirable, in practice it is a political non-starter.

We also need to move from cooperation toward better coordination between tax administrations – moving beyond the exchange of information, with simultaneous examinations, joint audits all of which offer new and exciting opportunities for coordination. The legal framework is there in the Multilateral Convention on Administrative Assistance. We also need more effective mechanisms to share information on aggressive tax planning schemes. Therefore, tax administrations will remain national, but they can overcome these geographic barriers by better cooperation and better coordination.

Finally, for tax administrations to effectively implement tax laws and to ensure that MNEs and other taxpayers pay the right amount of tax, in the right jurisdiction and at the right time requires governments to provide a clear legal framework and resources that they need to achieve this.

Hopefully, governments and businesses will use the recently launched G20 projects on base erosion and profit shifting (BEPS) not just to develop this new framework, but to agree on how it can be implemented in a consistent manner. Achieving this will require compromises on the part of OECD countries and the BRICS, but the prize of a new world tax order is one which is worth making compromises to achieve.

Moving from confrontation to cooperation

Role of alternative dispute resolution mechanisms in India

In the recent past, India has seen significant international tax disputes, many of which have made headline news, globally. Existence of permanent establishment and attribution of profits, arm's length pricing of related party transactions, characterization of income and taxation of capital gains are the ongoing points of dispute on international tax issues. The recently released first report of the Tax Administration Reform Commission (TARC) mentions that that 239,336 direct tax cases were pending before various appellate authorities –5,808 with the Supreme Court, 31, 238 with High Courts, 31,015 with Income-tax Appellate Tribunals and 199,390 with Commissioner (Appeals) as at the end of Financial Year 2012-13. The TARC report also highlights the low success rate for the tax administration in litigation with the success of the tax administration at each level being substantially lower than the success rate of the taxpayer. The TARC report acknowledges that the credibility of the tax administration of a country depends to a very great extent upon the credibility of its dispute resolution mechanism. An environment of a large number of tax disputes - particularly in the areas of international taxation and transfer pricing - results in a perception of risk and uncertainty among investors

One immediate imperative on the agenda of the new Government is the need to find a faster and better way to resolve disputes. As a country, we have almost unparalleled tax litigation. It takes several years before a matter is finally resolved by a binding judgment of the Supreme Court. Until then, taxpayers carry a considerable burden of an uncertain tax position and the tax administration is unable to fully collect, what it believes

are, the just dues. Furthermore, the current system of judicial appeals does not provide an opportunity for either the taxpayer or the tax administration to consult and cooperate in a non-adversarial spirit. A settlement of tax disputes through a process of negotiation, something prevalent in most countries, is almost absent in India. As trade and investment have taken on an increasingly international character, the tax disputes that arise from such activities have likewise become increasingly international. Particularly, the disputes not only involve simply controversy between a taxpayer and its tax administration but also concern disagreement between two tax administrations. In many of these situations, the taxpayer is primarily a stakeholder and real parties in interest are the governments involved.

The recent instance where the Government of India considered the possibility of conciliation with *Vodafone* as well as the option explored by *Vodafone* and *Nokia* to initiate arbitration under bilateral investment protection agreements (BIPA), suggest the need for India to look at alternative dispute resolution (ADR) mechanisms for resolving tax disputes. The tax law currently provides for mechanisms such as the Settlement Commission, Authority for Advance Rulings (AAR), Dispute Resolution Panel (DRP) and Advance Pricing Agreement, which in the broad sense may be considered as forum for avoiding protracted litigation. However,

most of these mechanisms do not seem to have been useful in minimizing tax litigation for various reasons. For example, option of approaching the Settlement Commission may be considered mainly in cases where the taxpayer has "undisclosed income." Furthermore, an application may be made for settlement only when the matter is pending before the Assessing Officer. With regard to the AAR, while the option does provide upfront certainty on tax consequences of a proposed transaction, the time associated with getting a ruling has been a cause for concern, despite the law requiring the AAR to pronounce its ruling within a period of six months. There are a number of structural challenges with the DRP, which has only resulted in the form being considered as a fast track for litigation to the next appellate hierarchy. The recently launched APA program does offer some optimism on the ability to address transfer pricing controversies in advance. One would hope that the Government gives due attention to capacity building within the APA team to expeditiously deal with pending applications. The Government has also introduced one-time tax amnesty and tax dispute resolution schemes, which have met with limited success.

The basic duty of the tax administration is to administer tax law. This duty includes assessing and collecting taxes and delivering entitlements arising under that law. The general rule, therefore, is that the tax administration does not forego tax properly payable, and will, seek to collect

The Government of India could consider the option of including an arbitration clause in its tax treaties with countries with which it has significant investment and trade relations.

the full amount of that tax. However, in the exercise of the duty, there will be circumstances in which the strictness of that general rule must be tempered by the need for reasonable and sensible administration and good management of the tax system. Introducing a legal framework, which currently does not exist in the tax law, to enable the Indian tax administration to explore ADR as well enable settlement – would go a long way to achieve the objective of making the tax regime non-adversarial.

ADR is an umbrella term for processes, other than judicial or tribunal determination, in which an impartial person, assists those in dispute to resolve or narrow issues between them. ADR processes are usually classified as facilitative, advisory or determinative. In a

facilitative process, an ADR practitioner assists the parties to identify the issues in dispute, develop options, consider alternatives and endeavor to reach an agreement. Mediation is an example of a facilitative process. In an advisory process, an ADR practitioner considers and appraises the dispute and provides advice on possible or desirable outcomes. Advisory processes, by their nature, cannot be made binding on any party. In a determinative process, an ADR practitioner evaluates the dispute and makes a decision. Arbitration and

expert determination are examples of determinative processes.

Although, traditionally problems of double taxation under bilateral tax treaties have been sought to be resolved through the mutual agreement procedure (MAP) under respective tax treaties, relief is not guaranteed if tax administrations, after consultation, cannot reach an agreement on their own. In the 2008 update to the OECD Model Tax Convention, Article 25 dealing with MAP, was supplemented with

on their ability to unilaterally determine the tax base subject to domestic tax. However, given the long-term benefits, which stem from increased level of compliance with international obligations and the potential increase in economic activity, foreign investment and tax collection, the option does warrant a serious consideration. Furthermore, the existence of an arbitration clause in a bilateral tax treaty should make the MAP itself more effective even in cases where resort to arbitration is not necessary.

Once there is a formal dispute between parties, sometimes it may be highly desirable to resolve the dispute by means of settlement. Good management principle requires a tax administration to make sensible decisions with

“My government will create a policy environment which is predictable, transparent and fair. It will embark on rationalisation and simplification of the tax regime to make it non-adversarial and conducive to investment, enterprise and growth...”

Address to the joint session of Parliament by the President of India on 9 June 2014, spelling out the broad agenda of the new Government

a new paragraph, which provides that, in cases where the competent authorities are unable to reach an agreement within two years, the unresolved issues will, at the request of the person who presented the case, be solved through an arbitration process. The Government of India could consider the option of including an arbitration clause in its tax treaties with countries with which it has significant investment and trade relations. The main issue for governments from international arbitration is its effect on their sovereignty and the limits it places

regard to the best use of limited resources available. The tax administration therefore, should not be obliged to relentlessly pursue every last tax dollar where that would clearly be uneconomical or where the outcome is at best problematic. The affairs of the tax administration should be managed in a way that promotes efficient and effective use of government resources. Considerations such as uncertainty in the law and/or facts, and prospects of success are likely to be relevant in this regard. These considerations are likely

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to require the tax administration to have the authority to settle tax disputes, where appropriate. A settlement involves an agreement or arrangement between parties to finalize their matters in dispute in situations where it is in the best interests of the government to do so. There is considerable positive experience on such settlement schemes in the international context. UK drug major, *GlaxoSmithKline's* (GSK) settlement of its transfer pricing dispute with the US Internal Revenue Service (IRS) in September 2006 is one such example. Under the terms of the settlement agreement, GSK agreed to pay US\$3.4 billion in taxes and interest. This represents the largest tax settlement in the history of the US IRS. GSK conceded nearly 60% of the total amount put in issue by the two parties for the years pending in a Tax Court. The settlement exemplifies how a settlement mechanism can help in curtailing tax litigation.

A proper legislative and administrative framework would be necessary to ensure that settlements of tax disputes occur only in appropriate cases and in accordance with established practices that provide necessary checks and balances, with transparency and accountability in the process. Recent instances where some stakeholders have alleged illegality in certain settlements made by the UK HMRC highlights the importance of having proper institutional framework to administer such a program. Interestingly, an NGO, which alleged a "sweetheart" tax deal of £20 million between HMRC and *Goldman Sachs* lost its challenge in a UK High Court over the question of legality of the deal.

To encourage taxpayers to consider an ADR or settlement, all processes should be conducted in a confidential and "without prejudice" basis. Any communication by parties for the purpose of ADR or settlement process should be treated as privileged and should not be used in legal proceedings without the consent of the parties.

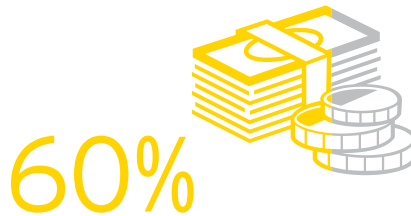
Resolving disputes through ADR or settlement does not mean that the Indian tax administration compromises on what it believes to be the right tax liability. It means securing the right tax liability consistent with the law, fairly and even-handedly across all taxpayers, in a way which minimizes unnecessary costs. Effective handling and resolution of tax disputes helps to maximize revenue flows both in ensuring that the right

tax is established in particular cases, and in acting to protect the tax base and to deter non-compliance and avoidance. However, a dispute inevitably involves costs for both the tax administration and the taxpayer. The TARC report recognizes that one of the causes for rampant litigation is the lack of accountability in the system which results in infructuous demands raised by the tax administration with impunity. The TARC makes several innovative recommendations which need due consideration. Minimizing the scope for disputes, and reducing costs of resolving disputes by the tax administrator is likely also to reduce taxpayer costs, improving the taxpayer's experience in dealing with the tax administration. This will make India a better place to work and do business and will create an environment that is conducive to investment, enterprise and growth.

Highlights from the 2014 Tax risk and controversy



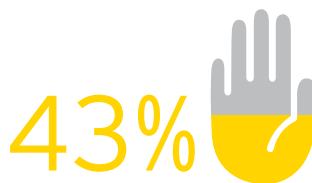
of the surveyed Indian companies believe that the tax risk and controversy would become important in the next two years



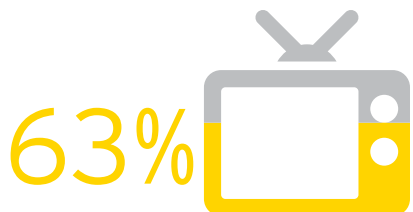
felt that having insufficient resources to cover tax-related activities is a potential cause of tax risk



of Indian companies feel tax administrators are now challenging existing tax structures



of Indian companies agree or strongly agree that their companies will be exposed to double taxation over the next three years

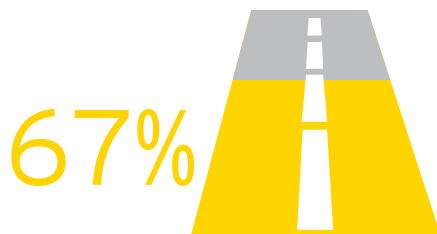


have become more cautious in their tax planning

Four major sources of tax risk identified by our survey

1. Reputational risk
2. BEPS and legislation-related risk
3. Enforcement-related risk
4. Operational risk

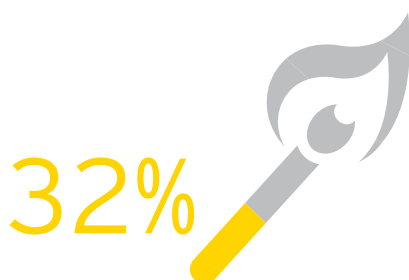
India survey



of Indian companies agreed that they will increase the use of unilateral APAs in the next two years



feel that their companies' CEOs and/or boards of directors' oversight relating to tax risk and controversy management has increased in the last two years



believe that BEPS will be adopted with a few recommendations of OECD at national level



830 tax and finance executives, representing more than **20** industry sectors in **25** jurisdictions participated in the survey. **112** respondents were from India.

Visit www.ey.com/IndiaTaxRiskControversySurvey2014

Mind the gap

Addressing tax gaps in India

Estimating tax gaps

Tax gap measures the difference between the tax revenue that the government should get and what it actually collects, for any tax, given its rate structure and legal provisions defining the tax liability. Therefore, tax gap is the excess of potential tax revenue over actual tax revenue. It indicates the revenue shortfall resulting from both tax evasion and tax avoidance. Tax gap measurement is now in vogue in many developed countries.

The two broad strategies for estimating the tax gap are the (a) top-down approach and (b) bottom-up approach. In the former, tax-base is constructed using macro data, such as national income data, supplemented by other data compiled independently of the tax departments. In the bottom up approach, micro-level data from tax departments and field offices and specific surveys are used to obtain direct estimates of revenue gaps.

Benchmarking summary measures of tax gaps with comparable countries offers valuable insights as to whether comparatively high tax gaps exist because of design deficiencies, lax administrative implementation, taxpayer behavior or policy inadequacies.

D.K.Srivastava

Chief Policy Advisor, EY India



International studies

The US, the UK, Sweden and Denmark officially estimate direct tax gaps. Many developed countries including Canada and the EU countries undertake tax-gap estimation periodically, both for direct and indirect taxes.

In the context of value added tax, several measures akin to tax gap analysis such as VAT revenue ratio (VRR), compliance efficiency ratio (c-efficiency) and variants of these ratios are being used extensively internationally. Decompositions of these ratios, for example, into policy gap and compliance gap and further decomposition of policy gap into rate gap and exemption gap (see, Keen, 2013) offer valuable insights into the working of VAT in a comparative framework. Exercises for estimating tax gaps for EU member countries are carried out periodically. Exhibit 2 gives an idea of the relative performance of EU countries with respect to the value added tax (VAT) for 2011.

High tax gaps usually happen because of a large unorganized sector, weak administrative structures, complex rate structure including excessive rate differentiation and a large list of exempted goods.

Exhibit 1. Grouping of EU member countries based on Tax Gap Ranking for VAT for 2011

Least gap	Sweden, Malta, Netherlands, Denmark, Ireland, Slovenia
Moderate gap	Germany, Austria, United Kingdom, Finland, Bulgaria, Poland
Average gap	Belgium, Portugal, Luxembourg, Estonia, France
Moderately high gap	Spain, Italy, Czech Republic, Hungary
High gap	Lithuania, Slovakia, Greece, Latvia, Romania

Source: Based on Center for Social and Economic Research (CASE) and CPB Netherlands Bureau for Economic Policy Analysis (2013)

Relevance for India

In India, in spite of the existence of large compliance gaps and administrative gaps, hardly any attempt has been made to measure tax gaps either at the central level or in the states for any of the major direct and indirect taxes. Such an exercise, undertaken on a regular basis by the Ministry of Finance at the centre and the finance departments in the states can be a valuable guide to augmenting revenues, designing tax reforms, simplifying tax structures, reducing compliance costs, and improving the efficiency of tax administration.

up a disaggregated re-construction of the tax base of a selected tax on which tax rates may be applied and relevant exemptions are provided for estimation of the potential tax revenue.

In a recent study, EY has estimated tax gaps for state level value added tax excluding petroleum products. VAT on petroleum was excluded, since it has least tax-gap, being produced and sold through formal sectors of the economy. For non-petroleum goods, there are major tax-gap issues in the levy of state VAT. In Exhibit 3, states are grouped in five broad categories according to the size of the estimated tax-gap.

Exhibit 2. Relative revenue performance of states in India for 2011-12: VAT excluding petroleum products

Least gap	Tamil Nadu, Kerala, Karnataka
Moderate gap	Punjab, Haryana, Andhra Pradesh
Average gap	Odisha, Gujarat, Chhattisgarh, Jharkhand
Moderately high gap	Uttar Pradesh, Maharashtra, West Bengal
Relatively high gap	Assam, Rajasthan, Madhya Pradesh, Bihar

Source: based on EY estimates

States in India have similar tax powers under the constitution and use similar tax provisions for major taxes providing scope for comparative benchmarking of tax gaps. In a comparative approach, tax potential can be measured against a benchmark, which may be either the best performing state or the average performance of other states selected for the study. A second approach is to take

These results are based on estimates of c-efficiency for 17 large states in India, which include 16 general category states including the undivided Andhra Pradesh and Assam from special category states. High tax gaps usually happen because of a large unorganized sector, weak administrative structures, complex rate structure including excessive rate differentiation and a large list of

exempted goods. Broad strategies for closing tax-gaps include functional reorganization of tax administration, comprehensive computerization of VAT-related database of dealers, collation of information among commercial tax departments with other related departments capturing transport, export, and inter-state trade details, and formula-based pre-determined audit strategies. More specific strategies call for detailed studies of individual states.

EY recommends that tax gap analysis should be done regularly by the Ministry of Finance and the finance departments in the central and state governments,

respectively with a view to simplifying tax structures, improving compliance and effectiveness of tax administrations, and increasing India's stagnating tax-GDP ratio.

The first step towards this endeavour will be to estimate the tax gaps for major taxes, utilize the insights offered by various decompositions of tax gaps, and begin compiling data relevant for this purpose on a regular basis both for the macro and micro approaches. The availability of modern IT tools and techniques of revenue modelling including panel models provide effective tools for bringing analytical rigor and insights in the tax gap analysis in the Indian context.

Some caveats

Reliable estimates of tax gap provide guidance to formulate strategies to deal with compliance gaps, administrative deficiencies and tax policy formulation. However, performance of individual officers should not be linked to tax gap estimates, since it has several shortcomings. One important shortcoming is that in most estimates that are undertaken periodically, the impact of tax payer response to additional administrative efforts and measures of compliance improvement are not taken into account.



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Vijay Iyer

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Transfer Pricing, EY India

Advance Pricing Agreement in India

Addressing the taxpayers needs

Transfer pricing (TP) - the means by which income is allocated between taxing jurisdictions - has emerged as the preeminent international taxation issue worldwide, including in India. Indian TP legislation was introduced with an effective date of 1 April 2001. Since its introduction, TP has emerged as a key tax challenge for multi-national enterprises (MNE) doing business in India. While this may be no different from what MNEs identify as their biggest challenge in other parts of the world, what has been a concern is the rigor and zeal with which TP is enforced by the tax authority. The nature of the transfer pricing controversies have ranged from mundane issues such as selection of comparable data to more complex issues involving intangible property (IP), business restructuring and financial transactions. TP controversy in India has grown manifold since the initial year of TP audits in 2004. As per government of India reports, in the eight rounds of TP audits so far, the cumulative value of TP adjustments till FY11-12 is INR 933 billion (approx. US\$15.5 billion). To compound things, the domestic appeal and dispute resolution process has proved to be slow and time consuming.

As TP continues to evolve, advance means of agreement on TP issues is a critical element. This process is plainly illustrated by the willingness of even the most recalcitrant countries to embrace the adoption of APA-style programs. Interestingly, the United Nations had suggested that developing countries not adapt APA programs as they begin to implement transfer pricing regimes. This is largely due to the perception that their tax authorities lack the experience to deal with such issues.

The legal framework that has evolved to deal with TP matters is essentially the same throughout the world and strives to attain an arm's length or market charge. The OECD Guidelines are demonstrative of the experience of its members over many years. The parameters of the applicable law in most countries and procedures are essentially consistent with the Guidelines. Throughout the world, TP disputes have nonetheless become a principal subject of international tax controversies. A newcomer involved in an international TP matter would inevitably ask why a contentious dispute should arise if the underlying law is essentially the same in all countries. The simple answer is that TP issues are factual in nature and often applied differently in each country. The appropriate resolution of an issue in one situation may be entirely different from the same issue's resolution for another taxpayer in the same business, because of these differences.

The concept of the APA is to provide a means by which taxpayers and tax administrations can voluntarily and mutually agree on TP issues. This process may be bilateral in nature and include the tax administration of other countries in which the taxpayer and its associated enterprises have transactions (provided a treaty relationship exists between the countries). In this way, a wide range of issues can be resolved. The advance dispute-resolution mechanism is beneficial to both taxpayers and tax administrations, because complex factual issues can be resolved, forestalling the time-consuming and expensive process of a comprehensive tax examination that can involve controversy, litigation, appeals, or competent authority. In theory, the time and expense on both sides over many years should be significantly reduced through such procedures.

Over **10,000**

cases referred to the transfer pricing officers in last 9 years

Almost **40%**

have faced an adjustment

Over **50%** Increase

in the recent rounds of audits.

Adjustments totalling to over

INR1 trillion

Approx. US\$16.7 billion, FY11-12 and FY12-13 newspaper reports

The Indian APA program, which was launched in 2012, is expected to provide an opportunity to resolve TP issues in advance. Ever since the launch of the APA program, there has been an enthusiastic response from taxpayers. The uncertain and unpredictable domestic tax law litigation process makes the APA program an attractive option for managing TP controversy in advance.

An alternative dispute resolution mechanism such as the APA program provides a welcome opportunity for taxpayers to prevent future controversies and thus eliminate uncertainty and cost and effort expected to be expended on future litigation.

An APA is a controversy management mechanism wherein a taxpayer and the tax authority enter into an arrangement to determine, in advance, either the price itself or a set of criteria that would govern the determination of arm's length prices, for covered intercompany transactions over an agreed period of time.

The APA provisions were introduced in India with effect from 1 July 2012 vide the Finance Act, 2012. The detailed rules (APA Rules) for the implementation of the APAs were introduced by the Central Board of Direct Taxes (CBDT) by way of a notification in the official gazette on 31 August 2012. The APA Rules provide detailed guidelines on the process along with information, data, fee details and forms that need to be filed.

The APA regime in India is widely seen as a step towards eliminating dispute and uncertainty on transfer pricing matters by creating a conducive environment for negotiation to arrive at a unanimous approach. The ground level implementation of the program is critical to its success and so far the Indian tax authorities have approached the program with a positive attitude.

International experience

As per the EY 2013 Global Transfer Pricing Survey, 66% of the Multi National Enterprises (MNEs) identified "risk management" as their highest priority for transfer pricing, a 32% increase over surveys conducted in 2007 and 2010.

The APA is largely looked upon as a mechanism to deliver certainty for both the taxpayer and the tax authorities. As per the above Survey, 26% of parent respondents use APAs as a controversy management tool. The level of satisfaction of users with the APA process is high, with 79% indicating that they will implement an APA in the future.

However, as with transfer pricing documentation, the length of the process was the primary source of dissatisfaction. Of those dissatisfied with the APA process, 89% cited the length of time required to complete as the primary source of dissatisfaction.

Despite the now global reach of documentation requirements and the current availability of APAs in more jurisdictions, including developing markets, APAs in practice remain largely a province of the earliest waves of countries that adopted documentation requirements following the arm's length principle. Respondents reported that nearly half of their APAs were with the United States, up from just 30% in 2007. Canada and the United Kingdom experienced sharp increases as well

at 21% each, up from 9% and 17% in 2007, respectively.

Some industries favour the use of APAs more than others. The use of APAs was highest in industries that, as a result of high profit levels, complex value chains or dependence on intellectual property, are subject to frequent tax authority challenge. The pharmaceutical industry reported the highest level of APA use: 56% of parent respondents reported having entered into an APA. Pharmaceutical companies also appear to seek comprehensive risk reduction through their APAs; relatively high proportions (50%) of their APAs were bilateral or multilateral.



Experience with the APAs

While the Indian APA rules do provide for bilateral APAs, the trend has largely been towards seeking unilateral APAs. One of the reasons for this has been due to India's position on correlative adjustment clause in a tax treaty. India is of the view that in the absence of a correlative adjustment clause in a tax treaty [equivalent of Article 9(2) of the OECD Model Convention], it would not entertain a bilateral APA with that treaty partner. This approach has denied bilateral APA access to taxpayers in

Generally speaking, an incentive for some taxpayers seeking APAs is the prospect of a rollback of the result developed in an APA to resolve past open tax years, which may be provided under an APA program. A rollback may provide a cost-effective way to resolve an ongoing TP dispute. The absence of roll back provisions in the Indian APA rules has often been stated as a concern by many taxpayers. Permitting roll back of APAs - even to a limited extent of say, 1-2 prior years which may not have been audited at the timing of APA filing - may go a long way in further enhancing the benefits of the Indian APA program.

be made optional - especially for certain standard transactions. Alternatively, the pre-filing consultation may need to be used by the APA authorities to establish a case for entry into the APA program. This approach may also help avoid the backlog of unresolved APA cases.

Despite some of the above issues with the APA program, the overall experience with the APA Authorities has been very reassuring for taxpayers and the response has been equally enthusiastic.



some of India's larger trading partners such as France, Germany, Singapore and Korea. As regards bilateral APAs with the United States, there have been reports about a stalemate with the United States Competent Authority. The United States Competent Authority's disengagement with their Indian counterparts has discouraged a number of U.S. taxpayers from applying for U.S.-India bilateral APAs despite a broad interest. As a bilateral U.S.-India APA is likely to benefit the US business community, one would hope for a restoration of normalcy in competent Authority relationship as well as a moderation in India's position on some of these issues, sooner rather than later. It has also been reported that the Indian Tax Administration may re-look at its position on not entering into bilateral APAs in the absence of a correlative relief clause in the relevant tax treaty.

Roll back may also avoid the rush by applicants - which puts a lot of strain on tax administration resources - to file by the last date of the previous financial years.

The Indian APA program provides for a mandatory pre-filing consultation before a formal APA application may be filed. The objective of the pre-filing consultation is to enable the applicant to understand the scope of the APA, identify transfer pricing issues, determine the suitability of international transaction for the APA and discuss broad terms of the APA. Given the nascent stage of the Indian APA program, current experience suggests that the pre-filing consultation is largely a formality to qualify a taxpayer for filing the main application. However, with the maturing of the APA program, one would expect the pre-filing consultation

- ▶ The APA team has been cooperative, responsive, and importantly non-intrusive or non-investigative in their approach.
- ▶ The overall attitude is non-adversarial and solution/resolution oriented. There is a clear distinction between the APA process and a routine TP audit.
- ▶ Discussions and meetings (including site visits) with taxpayers have been performed with an open mind with no prejudices.
- ▶ There is an sincere attempt by APA officials to understand the business of the taxpayer through site visit process.
- ▶ It is a collaborative approach of economic analyses and comparability criteria and willingness to undertake appropriate economic adjustments.



Conclusion

An APA program may initially put a strain on resources, because tax administrations generally must divert resources earmarked for other purposes. Demands may be made on a tax administration's resources by taxpayers seeking the earliest possible conclusion to an APA request, keeping in mind their business objectives and time frames. In addition, the APA program as a whole will tend to be led by the demands of the business community. These demands may not coincide with the tax administration's resource planning, thereby making it difficult to process both the APAs and other equally important work efficiently. The Indian tax administration should therefore consider adequately resourcing the APA program to address these issues.

Another potential disadvantage could occur as there may be a tendency to harmonize the basis for concluding later APAs similarly to previously concluded APAs without sufficiently regarding taxpayer specific facts and circumstances. Care should therefore be taken when the results of previously concluded APAs are interpreted as being representative across all taxpayers.

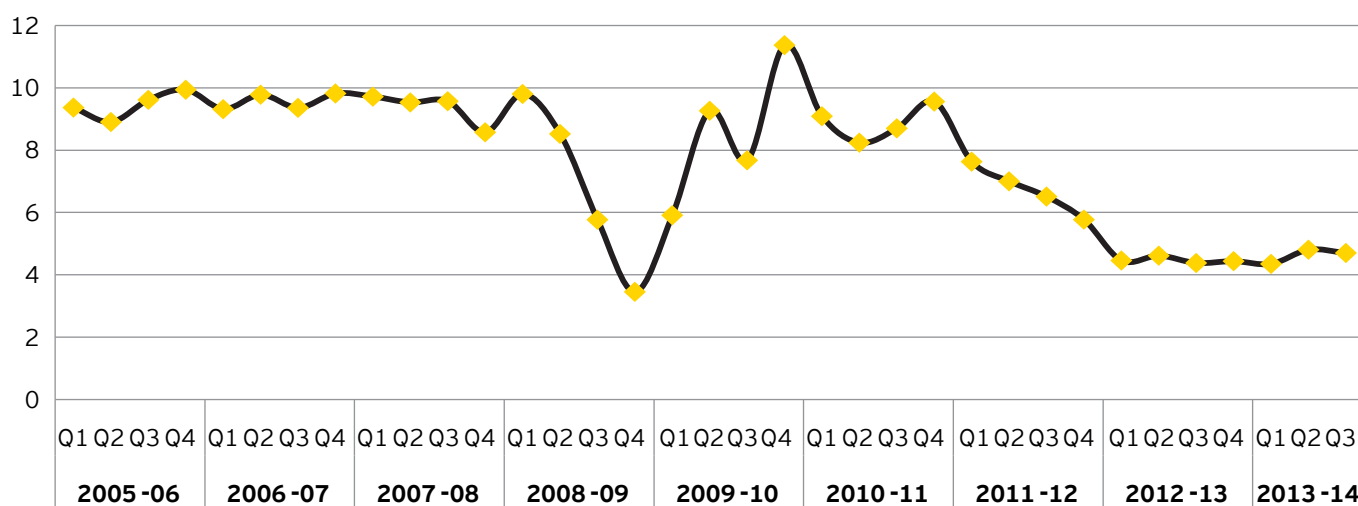
To be successful, an APA program needs to provide an atmosphere in which all parties come to the table intending to find a mutually satisfactory arrangement. The Indian APA office is looking at creating an atmosphere that encourages taxpayers to come to the table to find a mutually satisfactory resolution to difficult TP issues.

Challenges

With a high level of interest in the APA program, a question that is often raised is whether the Indian APA office has adequate resources and staff to deal with the applications expeditiously. The tax administration may need to consider ramping up its resources to ensure that the APAs are concluded within a reasonable time frame. Further, an adequate succession plan for officers should be put in place so that taxpayers are not adversely affected by any change caused due to movement of specialist officers appointed for the APA program.

Also, the APA mechanism as it stands today has no firewall provision. Hence, any information submitted with the APA authorities can be used by the Revenue Authorities subsequently for their purposes during audit processes.

Exhibit 2. Real GDP growth rate (%) at factor cost from Q1 2005-06

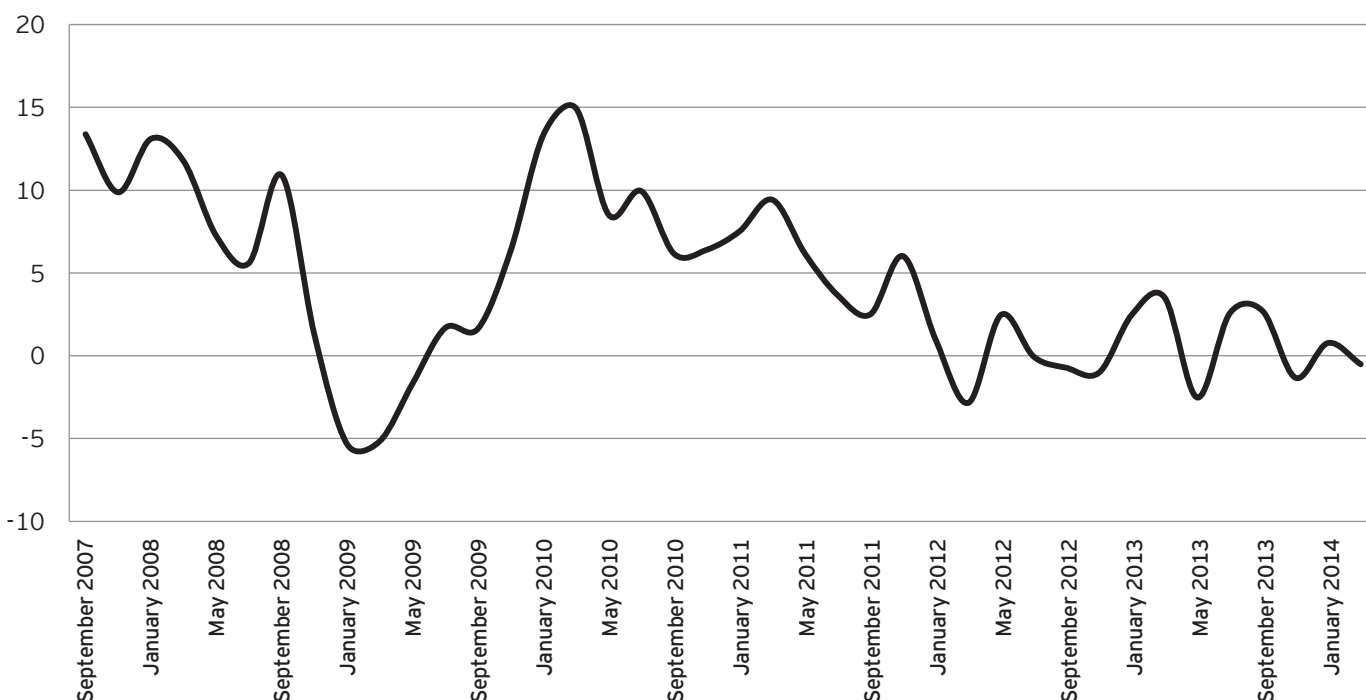


Source: Monthly economic report, April 2014, Ministry of Finance

Exhibit 3. Percentage change in index of industrial production

Industry group	April - March 2012-13	April - March 2013-14	March 13	March 14
General index	1.1	-0.1	3.5	-0.5
Mining	-2.3	-0.8	-2.1	-0.4
Manufacturing	1.3	-0.8	4.3	-1.2
Electricity	4.0	6.1	3.5	5.4
Basic goods	2.4	2.0	3.2	4.0
Capital goods	-6.0	-3.7	9.6	-12.5
Intermediate goods	1.6	3.0	2.1	0.6
Consumer goods	2.4	-2.6	1.8	-0.9
Durables	2.0	-12.2	-4.9	-11.8
Non-durables	2.8	5.2	7.3	7.2

Source: Monthly economic report, April 2014, Ministry of Finance

Exhibit 4. Year-on-Year growth (%) of IIP

Source: Monthly economic report, April 2014, Ministry of Finance

Exhibit 5. Policy Rates/Interest Rates (percent per annum)

Item / Week ended	2013	2014
	26 April	18 April
Cash Reserve Ratio (per cent) (1)	4.00	4.00
Bank Rate	8.50	9.00
Repo Rate	7.50	8.00
Reverse Repo Rate	6.50	7.00
Prime Lending Rate (2)	9.70 / 10.25	10.00 / 10.25
Deposit Rate (3)	7.50 / 9.00	8.00 / 9.25
Call Money Rate (Weighted Average) (4)	7.57	8.07

(1) Cash Reserve Ratio relates to Scheduled Commercial Banks (excluding Regional Rural Banks).

(2) Prime Lending Rate relates to five major Banks.

(3) Deposit Rate relates to major Banks for term deposits of more than one year maturity.

(4) Data cover 90-95 per cent of total transactions reported by participants.

Source: RBI

Exhibit 6. Exports and imports (in US\$ million)

Item	2011-12 (April-March)	2012-13 (April-March)	2013-14 (April-March)	April 2013	April 2014	% Change in April 2014
Exports	305964	300401	312610	24354	25634	5.30
Imports	489320	490737	450068	42026	35720	-15.00
Oil imports	154968	164041	165148	13054	12978	-0.60
Non-Oil imports	334352	326696	284920	28972	22742	-21.50
Trade balance	-183356	-190336	-137458	-17672	-10086	-42.90

Source: Provisional data as per the press note of the Ministry of Commerce and Industry

Exhibit 7. Foreign currency assets

	Amount		Variation	
	INR Crore	US\$ million	INR Crore	US\$ million
At the end of (over last year)				
March 08	1196023	299230	359426	107306
March 09	1231340	241676	35317	-57554
March 10	1150778	254935	-80562	13259
March 11	1225999	274580	75221	19645
March 12	1333954	260742	107955	-13838
March 13	1418339	260775	84385	33
March 14	1672942	278361	254603	17586
2014-15 (over last month)				
April 14	1723905	285710	50963	7349

Source: RBI

Exhibit 8. Year-on-Year inflation based on WPI and CPIs (percent)

	WPI	CPI-IW
	2004-05	2001
April 13	4.77	10.24
May 13	4.58	10.68
June 13	5.16	11.06
July 13	5.85	10.85
August 13	6.99	10.75
September 13	7.05	10.7
October 13	7.24	11.06
November 13	7.52	11.47
December 13	6.4	9.13
January 14	5.11	7.24
February 14	5.03	6.73
March 14	5.7	6.7
April 14	5.2	-

Note: WPI inflation for March and April 14 and CPI (New series) inflation for April 14 is provisional

Source: Monthly economic report, April 2014, Ministry of Finance

Exhibit 9. Trends in Central Government Finances: April-February 2014 (INR Crore)

	Revised estimates	April-February	Col.3 as percent of	Col.4 as percent of	Percent change over preceding year		
	2013-14	2012-13	2013-14	2012-13 RE	2013-14 RE	2012-13	2013-14 (4/3)
1. Revenue Receipts	1029252	678828	783595	77.9	76.1	14.5	15.4
Gross tax revenue*	1158905	812616	892007	78.3	77	15.5	9.8
Tax (net to Centre)	836026	571932	627134	77.1	75	15.9	9.7
Non Tax Revenue	193226	106896	156461	82.4	81	7.6	46.4
2. Capital Receipts	561182	540711	616162	96.7	109.8	5.2	14
<i>of which</i>							
Recovery of loans	10802	10555	10576	75	97.9	-40.4	0.2
Other Receipts	25841	22797	6287	95	24.3	731.1	-72.4
Borrowings and other liabilities	524539	507359	599299	97.4	114.3	2.8	18.1
3. Total Receipts (1+2)	1590434	1219539	1399757	85.2	88	10.2	14.8
4. Non-Plan Expenditure (a)+(b)	1114903	866518	990823	86.5	88.9	11.3	14.3
(a) Revenue Account	1027689	787149	899602	85.6	87.5	12.9	14.3
<i>of which</i>							
Interest payments	380066	263852	321844	83.3	84.7	11.8	22
Major Subsidies	245451	207781	218347	83.8	89	64.9	5.1
Pensions	74076	59396	67072	93	90.5	14.6	12.9
(b) Capital Account	87214	79369	91221	96.9	104.6	-2.9	14.9
5. Plan Expenditure (i)+(ii)	475532	353021	408934	82.3	86	7.5	15.8
(i) Revenue Account	371851	287791	318371	83.8	85.6	3.7	10.6
(ii) Capital Account	103681	65230	90563	76	87.3	28.3	38.8
6. Total Expenditure (4)+(5)=(a)+(b)	1590435	1219539	1399757	85.2	88	10.2	14.8
(a) Revenue Expenditure	1399540	1074940	1217973	85.1	87	10.3	13.3
(b) Of which Grants for creation of Capital Assets	121283	92498	116412	74.4	96	-10.8	25.9
(c) Capital Expenditure	190895	144599	181784	86.2	95.2	9.1	25.7
7. Revenue Deficit	370288	396112	434378	101.2	117.3	3.8	9.7
8. Effective Revenue Deficit (7-6(b))	249005	303614	317966	113.7	127.7	9.3	4.7
9. Fiscal Deficit	524540	507359	599299	97.4	114.3	2.8	18.1
10. Primary Deficit	144474	243507	277455	119.2	192	-5.5	13.9

Source: CGA, *Gross Tax Revenue is prior to devolution to the States.



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