India

Tax Insights

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GST

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Regulatory update

Building a better working world

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Foreword

Sudhir Kapadia

Sudhir Kapadia
Partner and National Tax Leader,
EY India

"When you go in for reforms, you must never blink. If you blink you get derailed."

It is with this ambitious and upbeat sentiment that the Finance Minister and the Prime Minister will be launching the Goods and Services Tax (GST) on the midnight of 30 June.

The implementation of GST is an outcome of delicately balancing several interests, demands and expectations. Its essence lies in cooperation as against promotion of self-interests. With this sprit, the policymakers and taxpayers now await and prepare for the "one nation, one tax" vision to take shape.

The 11th issue of our magazine *India Tax Insights* focuses on the theme "life after GST" as taxpayers transition to and implement the new reform.

This issue provides insights into the complexities and challenges that different sectors will need to manage under the new tax system. The banking sector, for instance, will have to finalize the mechanism for charging internally between state registrations to fulfill the requirement of paying tax between distinct persons. The exporting community is hoping that actual disbursement of provisional refunds is done in a timely manner. The infrastructure sector will need to deal with issues surrounding rate contracts among others, and the oil and gas sector will be looking to minimize the adverse impact of being excluded from GST. The stocks lying at depots, warehouses and clearing and forwarding (C&F) locations, as well as with stockists and distributors, will be of concern to many, including the pharma sector.

A feature on Malaysia's experience with implementing GST provides the key message that it will take efforts from both the taxpayers and the authorities to turn this initiative into success. Malaysia faced the inevitable teething problems with systems and documentation, queries (and complaints) from customers and initial investigations from the revenue authorities. Businesses were also subject to anti- profiteering legislation. What was immensely helpful in managing the transition was the guidance from the Government in the form of more than 80 GST guides covering specific industries and topical issues. India too could take a cue from this.

The magazine includes a feature on the IT preparedness of the industry and GST's impact on processes and systems. It also discusses EY's own cloud-based integrated ASP-GSP solution, named DigiGST™, which provides end-to-end support in GST compliance. The integrated solution also offers the added advantages of acting as a single point of contact for all return filing and preventing data flowing through multiple organizations.

The magazine also includes other thought-provoking articles by our senior indirect tax partners and directors that throw light on GST and how India Inc. is transitioning to the new regime.

In addition to our regular features - Global News and EconoMeter, which provide a snapshot of key global tax developments and key economic indicators respectively — we are starting off with Regulatory Updates from this edition to keep you informed on key regulatory announcements.

We hope you will find this publication interesting and timely, particularly when India is on the brink of implementing its most significant indirect tax reform. We look forward to your feedback and suggestions.

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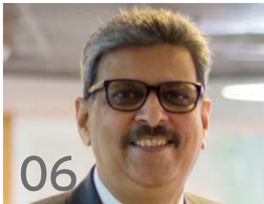

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GST rollout from 1 July

After a long wait for the implementation of this transformative tax reform, GST will be a reality on 1 July 2017. The Government and the GST Council deserve to be complimented for forging consensus on complex issues such as laws, rules and rates within a short period of time for this reform to be implemented.

While there are and there will be several issues that need redressal and clarification, as expected in a reform of this magnitude, it is important that the Government works with the industry to minimize and manage disruptions during the transition period with responsive guidance as and when issues arise.

The reform has already affected behaviors in the value chain, with inventory levels coming down significantly. However, some redressal of transition credits with the industry assuring distributors/dealers of margin protection, including offers of discounts in select sectors, will hopefully improve the throughput of goods and services in June and July and not impact sales significantly.

Stabilization of the supply chain by July/August would be critical as the festival season starts from and maximum sales happen during this period — also one of the reasons why deferment of GST to September would have been a problem.

The GST Council's decision to defer transaction-level details filing of outward and inward supplies for the month of July and August till September with an interim arrangement for aggregated return will provide some relief for the industry and compliance facilitators.

This was a serious concern for the industry and service providers with return formats undergoing a change on 3 June. It is critical for GSTN and the industry to have sufficient time to test their ERP data for GSTR filings before the process as envisaged in law gets underway.

Harishanker Subramaniam

National Leader – Indirect Tax Services,
EY India

The Council also approved several rules, the most important of which are the anti-profiteering rules. Two committees are expected to be set up to examine such representations and filter them, and the rules may be for a period of two years. These rules and mechanisms need proper understanding. The statement that anti-profiteering provisions are more a deterrent is welcome, but this view needs to be implemented in that spirit on the ground. The period of two years, if it is correct, is long and needs revisiting considering global practices.

The industry's expectation that some of its representations around rates will be heard will now have to wait for some time. The hospitality industry's concern was, however, addressed with the 18% rate now being applicable for room charges up to INR7,500 and restaurants in hotels attracting 18% on par with other AC restaurants. Another issue that was addressed was that of allowing credit on IGST paid on import of ships against GST payable on output supplies of the importer. The vehicle leasing industry's issue of getting excise credit against GST on leases at the underlying vehicle GST rate remains unaddressed and may be a huge problem for both the industry and its users. Clarity around how area-based excise incentive refunds will work, besides state incentives, is still unclear and requires immediate attention, as a large of number of sectors will be affected.

E-way bill has been an area of concern for the industry, especially in the manner in which it was being proposed, though an agenda item for GST Council consensus is still awaited. Several states have expressed reservations, so we might have to wait longer and beyond 1 July for a resolution. The statement that till then the current system may exist makes one wonder whether check posts will continue and the industry's aspiration of free movement of goods in one India will remain a dream.

This is a reform that we as a country have waited patiently for long and it is at our doorstep. Every stakeholder – the Central and state governments, the GST Council, the GST Working Committee, the industry and their advisors – has worked tireless hours for months to get ready for this milestone and it is time for all to collectively embrace this reform and manage this massive change with hopefully limited disruption.

(This article was first featured in Mint)

Malaysia GST

The story so far...

Aaron Bromley

Partner, Indirect Tax
EY Malaysia

Here in Malaysia, we have recently passed the second anniversary of the introduction of the Goods and Services Tax (GST). What a ride it has been so far, and something for India to look forward to!

The introduction of GST in Malaysia was announced during the Prime Minister's Budget speech on 25 October 2013, with an effective date of 1 April 2015. The GST replaced the previous sales and service taxes, which were single-stage consumption taxes applying on, relatively speaking, only a small number of taxpayers.

GST is levied at the rate of 6% on most domestic supplies of goods and services. The GST legislative framework provides for exported goods and services as well as some basic items to be zero

rated; certain services such as private healthcare, education and residential housing to be exempt; while there is also "GST relief" for other taxable supplies. In the main, GST- registered taxpayers making taxable supplies are entitled to recover in full the input tax incurred on their acquisitions.

From the announcement of the introduction of the tax to its commencement on 1 April 2015, most companies in Malaysia undertook comprehensive GST implementation projects. EY in Malaysia assisted some of the country's largest corporate groups, as well as multi-national entities, across most industries. Like preparations for GST in India, those projects covered the business in its entirety - supply chain, systems and processes, legal and even human resources, among others. It goes without saying that the companies who started this journey the earliest were the most prepared and the most successful with being GST- compliant from the outset. The experience during that period, while stressful at times, was also richly rewarding from a professional perspective and the bonds formed with our clients remain strong today.

GST in Malaysia is administered by the Royal Malaysian Customs Department (RMCD). From the beginning, RMCD was pro-active in assisting businesses with their preparations. From public and industry seminars, advertising campaigns, accredited GST Tax Agent courses, even direct discussions between senior officials and industry leaders, much effort was made to help taxpayers be as prepared as possible – provided they made the effort themselves (and not all did). Up to this point, RMCD has released in excess of 80 GST guides covering specific industries and topical areas of GST. These guides are a key resource for clarifying areas of the law and providing guidance on RMCD's interpretation of the same.

The start of the GST saw inevitable teething problems with systems and documentation, queries (and complaints) from customers, as well as initial investigations from RMCD on matters such as businesses not registered for GST, those that had registered voluntarily and were yet to make taxable supplies and GST refunds claimed, among others. At the same time, businesses were subject to Anti-Profiteering legislation that had been introduced earlier, with one of its main objectives being to maintain profit margins despite the introduction of GST. It was, and remains, a challenging time for business.

Two years on from implementation, we move into a new phase: comprehensive audits and investigations. While these have been carried out already to a certain degree, RMCD has been vocal that all registered taxpayers (in excess of 400,000) should expect a full GST audit in the next few years. This coincides with changes to the GST Act, particularly the penalty provisions, in a clear sign that businesses need to continue to be diligent in their GST obligations and that these did not end with just being prepared by 1 April 2015. Indeed, not too many weeks go by in Malaysia without prominent press attention given to prosecutions and fines related to serious cases of GST non-compliance. The technical discussions with Customs have grown in number and complexity. More cases advancing to the GST Tribunal stage following disputes is an indication of the change in the GST landscape.

Without question, compared to Malaysia, the implementation of GST in India will be more complex with

GST will streamline the current complex indirect tax regime and it will change the way businesses operate through the inevitable systems

29 states having multilayered tax systems. The Indian government has provided less than nine months for all businesses to undergo transformation for the implementation of GST come 1 July 2017, compared with approximately 17 months preparation time in Malaysia. It will be a challenging situation, no doubt. On the positive side, the currently complex indirect tax regime will be streamlined and it will change the way businesses operate through the inevitable systems enhancement and automation that the reporting requirements of GST bring.

Generally speaking, the implementation of GST in Malaysia was a success and that was in no small part due to the efforts put in by both the taxpayers and the authorities. It is incumbent on both sets of stakeholders in India to work together to ensure a similarly successful outcome, albeit this is just the start of the GST journey.

A big-bang approach for systems implementation

Venkatesh Narayan

Leader DigiGST™ solution

The country is set for GST implementation by 1 July 2017. Do you think that the industry is ready to accept and implement the technology change?

Unless there is a last-minute change of heart, it now seems certain that GST would be implemented on 1 July 2017. We have been working closely with the industry, which has really strived over the last few months to get its systems and processes in sync with the new legislation. Over the last two years, much of the focus has been on the GST law, rules, rates of duty and the potential impact on business. Most companies have analyzed in detail the impact of GST on their business in terms of tax, supply chain, accounting and information systems and are in a fair state of preparedness. Many of the master level data sets have been updated and some testing has been done using interim GST patches available from leading ERP providers. Over the last two months, it is compliance and the need to get the systems ready to interface with the Goods and Services Tax Network (GSTN) that have taken precedence over other issues.

The GST Council approved the final return formats in its meeting of 3 June. All the relevant rules for GST go-live have also been notified. It is heartening to observe the unanimity in the Council's deliberations, with not a single decision being put to vote. While the revised formats are designed for simplicity, it does turn the clock back for us, considering that a

lot of development has already taken place over the last few months using the formats available. Currently, the industry and its IT partner ecosystem are engaged in understanding the revised formats and developing the code as per the new rules. From the perspective of the industry, systems need to be ready on 1 July to issue invoices in new formats and with GST computation. So, one of the most important actions at their end is to ensure that the latest patches from the respective OEMs are installed and tested for at least a week. The industry will thus have to keep pace with the developments in the GSTN and put in place a faster release management process that is also flexible.

How much lead period would the industry need to test and implement the change?

First up, this is going to be a classic big-bang approach for systems implementation. All taxpayers across all sectors would transition to the new tax regime on the same date. Some other countries adopted a phased approach to VAT implementation, where industry sectors were included in the new tax regime over a period of time. Ideally, a big-bang approach should be preceded by a period of extensive testing within both the respective organizations, i.e., the Government and industry, as well as the interfaces between applications. In most other countries where GST/VAT has been implemented, the industry was given a few months after the release of the final laws to get its systems and processes ready. What we are going to attempt in India is unique, with a lead time of less than a fortnight before the finalization of all laws and rates of duty and the go-live date of GST. At the time of writing this, the next Council meeting is scheduled for 18 June to close pending issues such as anti-profiteering law and finalization of duty rates. It is hoped that there would be no more significant changes in the reporting formats between now and the go-live date. In India, we have seen that some industries, especially in the services sector, have been relatively slow in getting GST-ready, while others, especially in the manufacturing sector, have been keeping pace with the developments in GSTN in terms of the data requirements and reporting based on APIs. That may be in part because services sector taxpayers currently file only two returns in a year and that too at the aggregated level.

GST's impact in terms of process and systems change is the highest in the services sector.

All those organizations that are not ready yet have fewer than two weeks to get their systems up and start uploading their outward supply transactions into GSTN from July 2017. They still have a month longer for purchase register reconciliation. This is also the approach that GSTN has outlined, in terms of its priorities, to focus on GSTR 1, 2, 3 and 6 in that order.

What are the common challenges that the industry is facing?

Most of the perceived challenges are the outcomes of the very short lead time available for implementation. At this point, perhaps the greatest challenge is in getting the latest scripts from the software OEMs, implementing these patches on production systems and doing some limited testing before the go-live date. We are aware that GSTN is doing a commendable job against the very stiff deadlines. As the formats have undergone a significant change, GSTN has had to rework the earlier APIs, and it has started releasing them to the GSP community in small sets, starting with GSTR 1 and 2. While the specifications are helpful in coding the application, unless they are implemented on the GSTN sandbox, their working cannot be tested.

There are also a number of sectors where manual invoicing is a common practice. Companies in these sectors need to either implement an invoicing system or do manual data entry in Excel and then do an upload.

Another significant challenge is the lack of awareness about the GST provisions, particularly in the SME sector. While GSTN is getting an offline Excel utility for this sector in particular, several aspects of the law, especially those relating to valuation and transition, continue to befuddle many taxpayers. The restriction of credit on duty paid stocks to 60% of the Central GST (CGST) payable or lower, depending on the rate of duty, is a cause for concern among many sectors, with media reports of destocking of goods at the retail level to avoid double

taxation. The treatment of existing area-based exemptions has also not been clarified in detail in the GST law. On the registration front too, it can be seen that against an expected 80 lakh taxpayers, the number of GST registrations is in the region of 65 lakh. This could also be the result of the requirements under GST not percolating down to all sectors.

To sum up, I would say that the greatest challenges being faced by the industry toward a smooth transition to GST continue to be in the areas of awareness of the law and information technology.

How does the GSTN work?

An empowered group under the then Chairman of UIDAI was set up by the previous UPA Government to identify a suitable model for IT enablement of GST. The group considered issues such as a unified taxpayer portal, services on a cafeteria approach to tax administrations and analytics. In order to bring in an efficient and flexible model of implementation, GSTN was recommended to be incorporated as a Section 8 (under the new Companies Act, not-for-profit companies are governed under Section 8), non-government, private limited company, which was happened on 28 March 2013. The Government of India and state governments hold a 49% stake in the venture, while the balance 51% is with non-government financial institutions. Currently, the Center and state indirect tax administrations work under different laws, regulations, procedures and reporting formats, and consequently the IT systems work as independent sites. GSTN has addressed this problem by creating a common portal for all taxpayers and following an API-based approach for interfacing with external applications. The API formats for returns etc. have been standardized using the Java Script Object Notation (JSON) format. GSTN has also created an ecosystem of GST Suvidha Providers (GSPs) for facilitating taxpayer compliance by consuming these APIs. It has also encouraged start-ups and other software OEMs, called Application Service Providers (ASPs), to create applications for GST compliance. ASPs will interact with GSTN through the GSPs. This has achieved the twin objective of farming out capacity while maintain a tight control over security through smaller numbers of trusted partners. GSTN is also creating an Excel-based utility for small and medium businesses that can be directly uploaded on the portal. GSTN will also provide workflow applications to a large number of state tax administrations, enabling assessments, audits, refunds etc. online. It would also provide a mechanism for Integrated GST (IGST) settlement and tax collection reconciliation by connecting to accounting authorities, banks and the Reserve Bank of India.

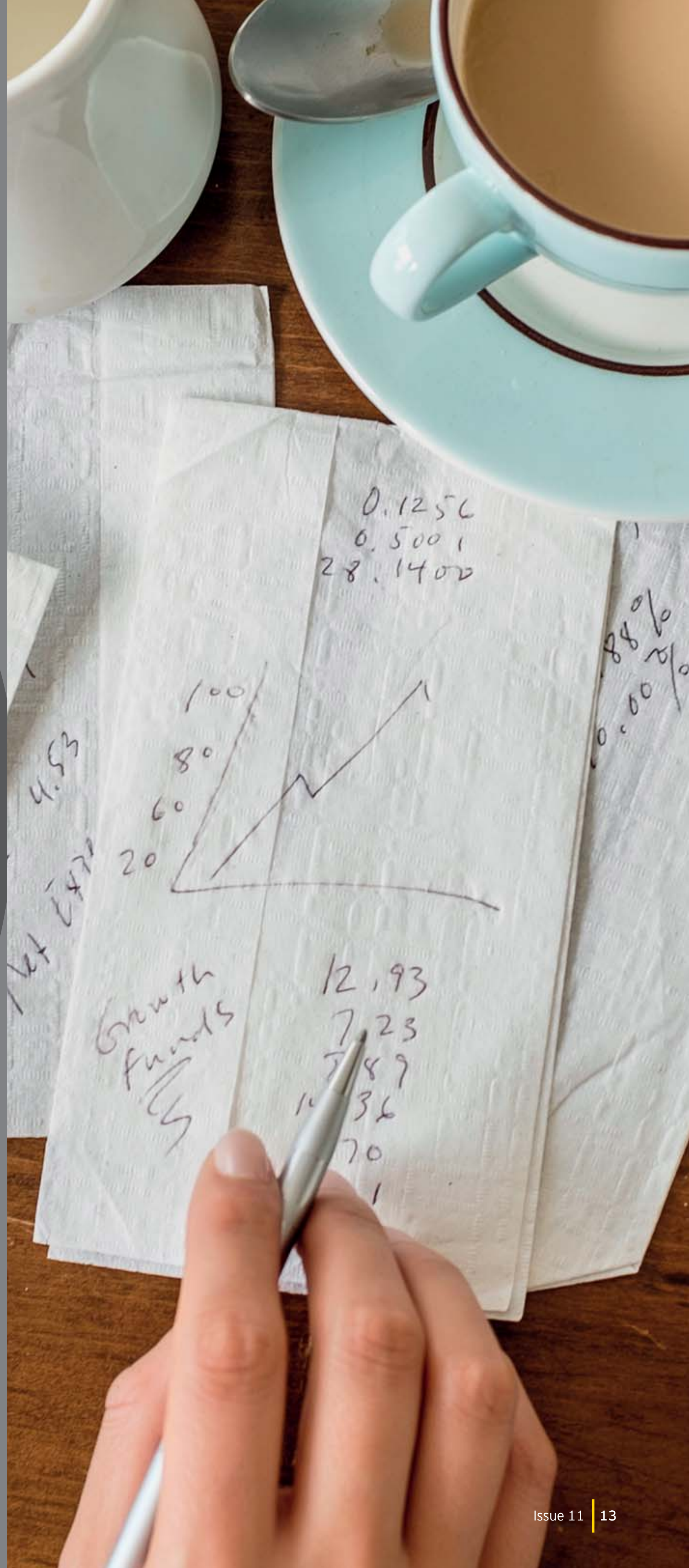
What are the roles of GSPs and ASPs?

GSPs are service providers who connect to GSTN over secure links and are able to submit and query GST returns data from GSTN using APIs published by GSTN. Essentially, they serve as a secure communication channel between the ASPs and GSTN. All the tax functionalities – including upload of transaction data, validation, reconciliation, dashboards and creation of returns for digital signing – are handled by the ASPs. At present, there are 34 authorized GSPs but many more companies and firms that are ASPs.

On what criteria should a company select a GSP?

I believe that the solution should be evaluated for ensuring taxpayer compliance because corporate governance and reputation are non-negotiable. Across the company, the requirements for different classes of users are likely to be different. From a CFO's perspective, having robust compliance with strong dashboards is important, while a CTO may be concerned with issues around integration and data security. Tax heads would typically be concerned around correct reporting of taxes and availment of input tax credits. The solution should meet each of these requirements and yet be scalable and flexible to meet new requirements, as both GST laws and user requirements are subject to change. EY's own cloud-based integrated ASP-GSP solution, named DigiGST™, has been built from the ground up using these principles. DigiGST™ provides end-to-end support in GST compliance and enables smart enterprises with deep insights through intuitive dashboards for critical business decision making.

> The integrated solution also offers the added advantages of acting as a single point of contact for all return filing and preventing data flowing through multiple organizations.



Banking:
A transformational change to bind technology and process

Divyesh Lapsiwala

Tax Partner, Indirect Tax Services
EY India

Banking is a sector with a national footprint and presence in almost all cities and towns. It has a complex delivery model, with services provided locally at the branch level, at select few branches, at the regional offices and at the corporate office. Application of GST in the form that it is proposed might be a significant challenge for such business models in being able to identify the right "state." The interdependence between officers coupled with centralization of functions such as credit risk analysis, treasury and lending adds to the complexity.

Banks have another task at hand from a systems perspective. Banks use several systems in addition to the core banking software. Each of these systems will have some aspects related to tax, and a change in the manner in which tax applies will mean that every such system needs to be configured to the new environment.

We have been involved in this journey with some banks for the past eight months. We started with mapping all product processes. Thankfully, as taxability principles were always expected to be the same as for service tax, our effort was more about dissecting functions related to delivery of services, to determine where the services are provided "from". The law requires the determination of the "establishment most directly concerned with the provision of supply." For this, banks have to examine every product process and make an election of which state operation is the most directly concerned with the supply. This may be easier where service provision is largely linear and one of the offices always plays a more dominant role than the others. In banking, though,

there are several instances where multiple offices and multiple states are involved in providing a solution to the client and therefore this has become a judgement call, with a very fine line in the interpretation of the "from" state.

Another interesting aspect we worked upon was the location of the customer. While it is a very simple proposition in the law, it is challenging for banks as even retail customers have multiple addresses with the bank and these addresses may be in different states. Based on interpretation of the guidelines and consensus among industry players, a position has evolved to consider the communication address available on records.

These are just simple examples of how complex this journey has been for banks thus far. Once these technical calls are made, systems will have to be reconfigured to be able to deliver taxation in this manner. Also, given that the regulation requires reconciliation to be prepared at the state level, internal records of mapping revenue to states are being looked at to make sure that the revenue mapping ideology is close to the tax positions been taken in GST. While this mapping is not mandatory, it is likely to ease out the need for preparing complex reconciliations if internal revenue capture is similar to the manner in which tax positions are arrived at in GST.

On the procurement front, banks with a widespread network end up buying significantly from various vendors. Therefore, the risk of loss of credit if vendors do not comply with GSTN requirements is reasonably high. This will impact working capitals of banks. Also, the requirement to pay reverse charge on transactions with unregistered dealers may have a P&L impact for banks given that recovery is limited to 50%.

The top five aspects that banks are dealing with today are

1. Building consensus across the industry so that all players take common technical positions

2. Getting systems ready to be able to issue invoices statements, and purchase and sales register effective go live date

3. Closely looking at vendors

4. Finalizing the mechanism for charging internally between state registrations to fulfil the requirement of paying tax between distinct persons

5. Preparing to manage the exception reports and mismatch reports that will be thrown up from the first month onward once GST and goes live

Life for banks after GST is expected to be very dynamic in the initial period, and they have to brace themselves up not only to deal with the technical challenges of interpretation but also to operationalize position and process changes, be ready to meet customer expectations and deliver compliance in a timely and accurate manner.

Industry view

Rajendra Khandelwal

Head Taxation and Planning,
ICICI Bank Ltd.

GST is clearly a transformational change, and at ICICI Bank we welcome this change. It introduces the concept of dual levy, with the power to tax services also being shared with states. We appreciate this, and understand that the sharing of powers is not to the detriment of the taxpayer. However, given that the business model that banks operate is very complex, fairly early in the journey of GST, we, through the Indian Banks Association, took the lead in routing for a centralized registration for banks.

The objective of this was to balance the need for ensuring that states get revenue out of our services to customers across the country, and us not having to deal with the challenge of dissecting our operations at a state level. This challenge was not merely about the fact that we had to split our business but had more to do with the fact that the integrated manner of our operations made it almost impossible to determine the "state" from where services are being provided.

With the Government expressing their inability to grant such a registration, we immediately embarked on the journey to identify the aspects that required change management, and created a steering committee and a project management office to drive this change. We also immediately started drives to sensitize various teams about the nuances of GST so that the organization started to understand the law, ask the right questions and determine its individual way forward.

A fine-tooth comb review of all products and operations helped us decide on our tax positions. Once this was done, we triggered the process of review of systems and processes. We also started reviewing our documentation with regard to each product.

In parallel, we started a customer outreach program, to determine their expectations. This also helped us customize our approach so that we are proactively prepared for dealing with their "asks" once GST goes live.

Our procurement teams have also commenced vendor education drives and a detailed process of evaluating their capabilities to deliver compliance under GST.

At ICICI Bank, we are focused on driving efficiencies and ensuring that we are able to pass on the benefits of these to our customers. I believe we are ready to meet this change. For me, personally, this has been one of the most interesting and challenging journeys in my professional life. I think it is a very bold decision by the Governments to roll out this regulatory change, and I congratulate them for making it a reality.

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Exports:

Exemptions or ease of compliances and expeditious refunds?

Sarika Goel

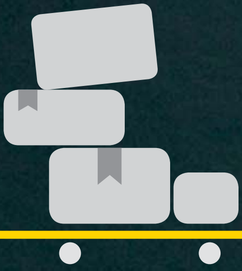
Tax Partner, Indirect Tax Services
EY India

Global merchandise trade is expected to rebound this year as per the World Trade Organization forecast, but developments on the India GST front are keeping Indian exporters a worried lot. Since the release of the first Model GST Law in June 2016, the provisions relating to exports of goods and services have seen multiple and drastic changes.

Of the lot, exporters operating from SEZs have reasons to cheer, as the final IGST Bill passed by the Parliament on 12 April 2017 allows supplies of goods or services or both to SEZ developers or units to be considered as zero rated, which means that they have the option to claim upfront exemption or a refund on their procurements.

However, unfortunately, similar benefits have not been provided to exporters operating as Software Technology Parks (STPs), Export Oriented Units (EOUs) or Electronic Hardware Technology Parks (EHTPs), which also have an almost similar contribution to India's exports as SEZs. This could lead to the exit of many companies from the EOU/STP/EHTP schemes, to operate as domestic tariff area (DTA) exporters.

While the Central GST Bills were passed by the Parliament on 12 April 2017 and the GST Council has also released the Rules, there are various fundamental issues that the exporter segment is still grappling with.



Fate of Foreign Trade Policy (FTP) schemes

It is still not clear whether the export promotion schemes under FTP, such as the Advance Authorization and Export Promotion Capital Goods (EPCG) Scheme, would continue to allow for upfront exemption from import duties, including IGST. Further, if the schemes are not going to be continued, clarity is required on the fate of importers that have already been issued authorizations but would import/procure under the GST regime.

Likewise, exporters are awaiting information on continuation of boutique schemes such as MEIS/ SEIS in their present form, as well as clarity on what would happen to current scrips in hand, as the GST Bills or the Rules do not contain any provision allowing payment of GST through the usage of these scrips.

Procedures and compliances for SEZs under GST

The GST Bills and recommended Rules prescribe a separate registration for SEZs. However, the rules are not clear on whether multiple registrations, and hence multiple sets of compliances, would be required where a company has multiple SEZ units within the same state.

Also, for SEZs, an exemption mechanism based on self-declaration should be explored by the Government instead of the current multi-level approval and documentation system involving various forms.

Claiming refund of Input Tax Credit (ITC) by exporters

In addition to apprehensions around actual disbursement of provisional refunds in a timely manner, as is envisaged under the law, it is generally being feared by the industry that discretionary powers with refund officers could bring in ambiguities in the process of timely sanctioning of the refund claims.

Further, the GST Law provides that no refund of ITC be allowed if the supplier of goods or services or both avails drawback of central tax. A clarification (or possible realignment of statutory provisions) is required to ensure that the drawback given against basic customs duty is allowed to be continued without adversely impacting the exporters' right to claim refund of ITC, as basic customs duty is in any case not available as a credit under the GST regime.

Under GST, with most exemptions for exporters having been withdrawn, the most crucial aspects that exporters are looking for are ease of compliances and expeditious refunds. Thus, a special focus by the Government on the needs of Indian exporters on a timely basis would go a long way in making Indian exports competitive.

Reliance on unorganized sector could prevent the industry from taking advantage of GST

Sidhartha Jain

Tax Partner, Indirect Tax Services
EY India

With the introduction of GST being imminent, trade and industry are gearing up to meet the challenge, and the infrastructure sector is no exception.

One of the biggest challenges of the sector at this point is the lack of clarity on the continuity of exemptions that are currently in place, such as service tax exemption on road projects, duty exemptions on machinery used for specified projects, and deemed export benefits. It is likely that the GST regime will see most of these exemptions getting converted into a refund route, and it is imperative for the industry to evaluate and understand the net impact in the changed scenario.

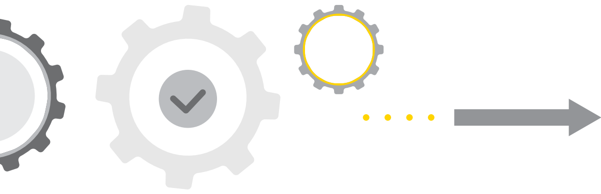
The sector might see an increased ability to take credits in the GST regime; however, the overall impact would need to be evaluated considering the fact that

the rate on works contracts has now been fixed at 18% whereas the general rate of tax currently applicable on the output side for the sector hovers around 12%.

On the procurement front as well, a large segment of the sub-contractors or vendors engaged by the industry is unorganized. This is an additional challenge for the sector because in order to avail the full benefit of GST, the entire ecosystem needs to be compliant for credits to flow seamlessly. It is unlikely that the smaller players will be fully prepared to cope with the challenges of being GST ready, specifically on the IT front.

Additionally, the requirement to pay tax on advances received and provisions relating to withholding of taxes would add to the cash flow pressures in an already cash-strapped sector.

Given the above, it becomes imperative for any player in this sector to plan its transition into the GST regime specifically keeping in mind the portfolio of projects serviced by the sector. Some of the critical aspects of this transition process involve revisiting the tax cost envisaged for a project at the bid stage, the tax position of the contract (i.e., whether inclusive or exclusive) and,



most importantly, the ability to recover the increased taxes from the project owners as laid out in the change in law clause of the contract agreed. There may be further complexities, such as treatment of delayed projects or cases of price variation, which require a specific and pointed approach to be developed.

From a transition planning perspective also, the industry needs to gear up to plan for inventory and stock on the transition date, evaluating the status of WIP lying in books and planning for transition credits (which continue to lack clarity in respect of ongoing projects), vendor management and payment terms, given that the operations for most companies in this sector are spread across the length and breadth of the country. It is also important to formulate a strategy for bidding of new projects to adequately take into account the proposed changes under the GST regime.

The sector has historically witnessed extensive litigation on aspects of exemptions, taxability, valuation etc. While the introduction of GST should put to rest the debate on multiplicity of taxes on works contracts, the interplay of tax rates on goods and services would still need to be watched out for.

Most infrastructure projects cater to public utilities where project owners do not have the ability of taking credits, and thus the increase in tax cost would only lead to a cascading effect, which defeats the efficiency that GST proposes to bring about. The Government has a steep task of balancing the core principles of GST with the requirements of this sector, which forms the backbone of the Indian economy.

Industry view

Anil Khandelwal

CFO
Tata Projects Ltd.

Introduction of GST is one of the most significant post-Independence reforms that India is going to witness. It is going to change the way business is done in terms of efficiency and transparency.

For the infrastructure sector, tax planning and structuring has historically played a very critical role in the pricing methodology adopted for bids. GST seeks to change many of these fundamentals; however, the lack of clarity on critical aspects such as continuity of exemptions and concessions just short of the implementation date is adding to the challenges of transition.

Most of the projects/contracts undertaken are with public sector undertakings and any change in pricing/tax recoveries entails extensive negotiations, which are time consuming. Delays in concluding these discussions would result in an adverse working capital impact on an already pressured sector that, if not adequately addressed, could hurt the execution of critical infrastructure projects.

The lack of clarity has affected the level of preparedness of the industry, especially of the smaller players, which would have a spiral effect on the industry at large. Another big challenge for the sector is the reality of the unorganized sector – the additional compliance responsibility in this regard would add to the administrative burden of the sector.

On the procedure front as well, the continuity of waybills is a setback to the expectations of the industry of simplification of procedures and administrative compliances for interstate movement.

The Government should look at an early redressal of these critical concerns of the industry for a successful transition into GST by providing clarity at the earliest and providing enablers for the smaller players to be GST ready.

Life sciences:

Would GST be the balm for the sector?

The pharma industry is gearing up to face the challenges of this transformational change, which would impact all facets of its operations.

Suresh Nair

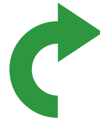
Tax Partner, Indirect Tax Services
EY India

Considerations for the pharma industry

Rate of tax and pricing

The rate of GST for pharma formulations has been finalized at 12% and for identified lifesaving drugs at 5%. There is an increase in the GST rate for medicines, attracting 12%, as compared to the current effective indirect tax rate on formulations, which translates into a hit of around 3% for the industry. Since the prices for some of the formulations have been set by the Government under the National List of Essential Medicines (NLEM), the industry would look forward to support from the Government in passing on this additional tax cost by revising the MRP of such medicines.

Continuity of area-based indirect tax benefits under the GST regime (albeit by way of the refund route) is another area that the GST Council should consider, as companies have made significant capital investments in it.



Inverted duty structure

The GST Act provides for refund of accumulated credit resulting from a higher tax rate for inputs than outputs. Another positive is that the transitional provisions provide for transfer of accumulated credit under the current indirect tax law into the GST regime. The industry would look forward to beneficial rules that enable refund of such transitioned credit.

Loan licensee model

Special provisions for GST-free movement of inputs goods/ material for job work find mention in the GST Act. However, there does not appear to be any provision that enables movement of goods for job work on payment of GST, enabling the job worker to pay GST on supplies of processed goods. The GST Council is expected to clarify this aspect in the coming days.

Transitional provisions

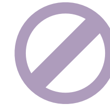
For the pharma industry, stocks lying at depots, warehouses and clearing and forwarding (C&F) locations, as well as with stockists, distributors and chemists, are quite high. Some of the transitional provisions in the current draft rules do not appear to be beneficial for the industry. The GST Council should provide for beneficial clarification to ensure that the industry is not worse off during the transition phase.

Physician samples

Supplies of physician samples to the medical fraternity are unique to the industry. The current approach followed for such supplies would need to be revisited given that movement of said goods to own hubs located in other states could attract GST and also that credit related to supply of physician samples to the doctors would be subject to reversal.

Patient assist programs

Taxability of free supplies by way of such programs would need to be examined based on their specific facts. Whether or not such supplies are subject to corresponding credit reversal is a position that the industry would need to take based on the related facts.



Expired goods

Goods that are near their expiry period and those beyond the declared shelf life period are returned by the distributors/ chemists to the principal for eventual destruction. This would result in the supplier issuing credit notes to address the commercial aspects of the said supplies. The input tax credit rules mandate reversal of credit related to goods that are destroyed. The industry would need to map such transactions and the different scenarios thereof, study the tax positions, understand the financial implications of such returns during the transition period etc.

Key action steps

Companies should have a detailed week-wise plan mapping the respective consideration areas (some have been referred to above) with corresponding timelines for addressing them. This will help the project management team track the progress in real time and flag off functions that require intervention and special focus.

Given the impact of transitional provisions, companies would need to have a detailed study of the likely impact to business, take an informed strategic decision on the transitional stock and engage proactively with the association bodies/trade to arrive at a win-win proposition.

Pricing of pharma goods during the transitional phase and in the GST regime would be critical, and hence companies should have the pricing simulations ready factoring in all possible scenarios (including benefits, if any, from the area-based exemption scheme, refunds etc.)

Credit harvesting should also be on top of the agenda for pharma companies. As compared to the credit blockages in the current regime, the industry should identify all such credit that can be optimized in the GST regime.

Creating awareness and training key stakeholders such as suppliers, distributors and employees across functions would be a key part of GST change management.

Another work stream that should be given due importance relates to GST compliances and the need of technology intervention to smoothly transition into the GST regime. The pharma industry would have unique requirements such as refund of inverted duty structure, credit reversals on physician samples and valuation-related aspects, and companies should accordingly evaluate the requirement of a customized application service provider (ASP) solution apart from getting their enterprise resource planning (ERP) system GST compliant before the GST go live date.

Sodium
Heparin

Industry view

Head, Indirect Tax
Lupin Limited

India is the largest producer of generic drugs globally, with the pharmaceutical industry in India estimated at US$40 billion. Its eminence cannot be over-emphasized, testimony to which is the Government of India identifying it as one of the key sectors under the ambitious "Make in India" initiative.

Traditionally, indirect tax considerations have played a significant role in determining where to set up manufacturing facilities and establishing depots in various states. Under the GST regime, the expectation is that business decisions would be independent of indirect tax considerations.

The overall tax burden is likely to reduce owing to the elimination of cascading of taxes and availability of credits across the supply chain. An optimized distribution network can be strategized, resulting in reduced distribution and logistics cost. Business efficiencies should ideally result in bringing down prices of medicines and providing a competitive edge in international markets.

The issue of inverted duty structure that currently plagues the industry, resulting in accumulation of credits, has been addressed by providing for a refund mechanism. However, the benefits of such a measure would bear fruit only if the process is simple, transparent and quick.

The tax treatment of unsold stocks lying with stockists and retailers during transition and the treatment of loan licensee arrangements remain a concern. The credit matching concept in GST making it incumbent on the receiver to ensure GST compliances of supplier is stringent. Working capital requirements would have to be reassessed considering that GST would apply even on stock transfers. Valuation of stock transfers could also be a sticky issue.

GST, being a tax-triggered business transformation, would require dedicated participation of various business functions in transitioning to GST. Dependency on technology for adhering to GST compliances would be sine qua non.

While GST in its present form may not be ideal, it is bound to throw up several opportunities for bringing in efficiencies and discipline across any business.

Oil and gas: Restructure the business to maximize the credits and ease the compliance

Abhishek Jain

Tax Partner, Indirect Tax Services
EY India

One of the sectors that will be negatively affected by GST is the oil and gas sector, as its major products – i.e., crude oil, natural gas, petrol, diesel and aviation turbine fuel (excluded products) – are outside the ambit of GST initially whereas other petroleum products (e.g., kerosene, naphtha and LPG) are covered.

Under GST, the companies in this sector would not be eligible to avail GST credits on goods and services used for the manufacture and sale of excluded products. The fate of continuity of exemptions and concessional rate of tax available under the current regime on procurement of goods and services for use in the oil and gas sector is not clear. Removal of such concessional rate/exemptions would increase the kitty of ineligible credits in the sector.

This may increase the price of the excluded products, which may reduce their demand by forcing customers to look for alternatives. Further, the VAT/excise duty charged on these excluded products (specifically for natural gas) would not be available as credits to the companies in the sector that are under the GST regime. This would be another reason for increase in cost for customers.

It might get challenging for the sector to comply with both the current tax regime as well as the GST regime, which would include filing tax returns under the current VAT/excise legislations and under the GST regime, bifurcating and apportioning eligible and ineligible credits, dealing with multiple tax authorities, completing multiple assessments and possibly also facing increased indirect tax–related litigations.

Further, since the entire credits on self-supply of most goods/services would not be available to companies in this sector, GST on such supplies would be payable at the open market value. This would adversely affect the industry and might be an area of litigation in the future.

The companies in the sector are exploring the possibility of restructuring their businesses to maximize the credits and ease the compliance burden. Restructuring would involve separating, to the extent possible, the businesses that are under the GST regime from the businesses that are outside the ambit of GST.

Another solution that the sector is exploring is the outsourcing of the compliance activity and electronic reconciliation of the data recorded in their system with the data uploaded on GSTN by their vendors and customers.

Way forward

Considering the situation the oil and gas industry would be in under the GST regime, companies should consider:

Looking at their organization structure and manpower requirement for carrying out the compliances

Revisiting their processes to plug any loopholes that may result in tax costs

Developing robust IT implementation to reduce the dependence on manual work and automating compliances

Engaging with the Government for inclusion/ zero rating of petroleum products

Industry view

“

A three-fourth production in a refinery is typically of goods which are outside the ambit of GST. This would mean that there would be credit reversal of three-fourth GST paid on goods and services used in a refinery. Since there will be huge credit reversals, there will always be disputes with regard to availability of credits and would require us to take decisions as regards to availability of credits in case of disputed positions. We would be required to comply with the current tax laws of Excise and respective state VAT as well as the GST regime. Managing dual compliances, electronic reconciliation and filing timely return would be a challenging task.

”

- Sanjeev Madan
DGM, HMEL

“

Exclusion of natural gas from GST means that we will be under the GST regime as well as existing tax regime. This would result in increase in tax costs due to loss of input tax credits. We would be required to undertake compliances under both the tax regimes, which would be cumbersome. Our cross-country pipeline (for transportation of natural gas), having a fixed establishment in each state, would qualify as a service provider in respective state. The units located in each of such state would be required to raise an invoice on account of self-supply of service, leading to manyfold increase in invoices without any real business requirement. We feel that natural gas is predominantly an industrial input and is more environment friendly than other fossil fuels. We are, therefore, of the view that natural gas deserves to be included under GST regime since beginning. We hope that considering the positive aspects associated with natural gas, it will be included under GST regime at an early date.

”

- Ashish Purwar
DGM, GAIL

Date with GST: Are you prepared to take the plunge?

The countdown has begun and the stage seems to be all set for the rollout of a new tax reform that aims to replace the current complex structure of multiple indirect taxes with a dual GST. Its expected implementation from 1 July 2017 signals a new era in indirect tax administration as it infuses a fundamental change in the basic concepts and practices of indirect tax. With just a few days away, GST has created a lot of sensation and anxiety among every single stakeholder.

GST machinery

Most of the work required for making GST a reality has been completed. The GST Council, consisting of representatives from the Central as well as state governments, has met on 17 occasions in the past seven months and cleared:

- GST Acts
- GST Rules
- Forms
- Tax rate structure, including Compensation Cess
- Classification of goods and services
- Exemptions
- Thresholds
- Tax administration

Are you ready for GST?

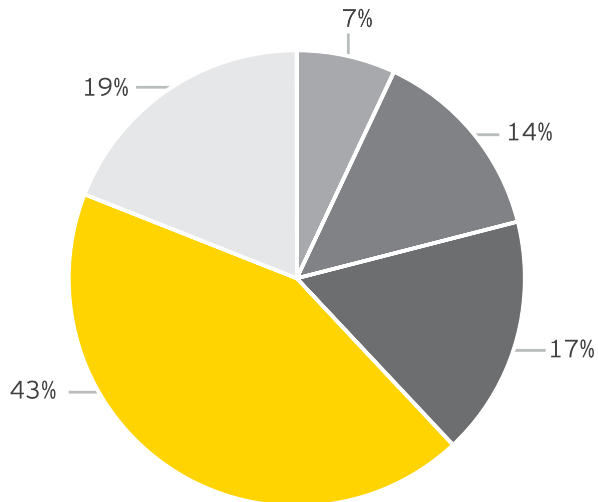
Q-1 Have you completed the migration process, taking a provisional ID under GST?

Q-2 Is your IT system more than 75% ready for GST compliance?

Q-3 Are your vendors and distributors in the supply chain more than 75% ready?

If your answer to all these questions is in the affirmative, be rest assured that your business gains an edge over competition on day one of the GST implementation.

GST rates



Rate classification for goods

Exempt
Food grains, Cereals, Milk, Jaggery, Common salt

5%
Coal, Sugar, Tea and coffee, Drugs and medicine, Edible oil, Indian sweets

12%
Fruit juices, Vegetable juices, Beverages containing milk, Bio-gas fuel, Fertilizers

18%
Capital goods, Industrial intermediaries, Hair oil, Soap, Toothpaste

28%
Air conditioner, Refrigerators

28% + CESS
Small cars (1%/3% cess), Luxury cars (15% cess)

Rate classification for services

Exempt
Education, Healthcare, Residential accommodation, Hotels/Lodges with tariff below INR1,000

5%
Goods transport, Rail tickets (other than sleeper class), Economy class air tickets, Cab aggregators, Selling space for advertisement in print media

12%-18%
Works contract, Business class air travel, Telecom/Financial services, Restaurant services, Cinema tickets (ticket price up to INR100), Hotels/Lodges with tariff between INR1,000 and INR7,500

28%
Cinema tickets (ticket price exceeding INR100), Betting, Gambling, Hotels/Lodges with tariff above INR7500

Important dates

Enrolment: The window for migration will re-open for the third time on **25 June 2017** and will be kept open for three months.

GST returns: Relaxation has been provided for the first two months of GST implementation:

Return month	GSTR - 1		GSTR - 2 (auto populated from GSTR-1)		GSTR - 3B
	Due date	Extended date	Due date	Extended date	
July 2017	10 August	1 - 5 September *	11 - 15 August	6 - 10 September	20 August
August 2017	10 September	16 - 20 September	11 - 15 September	21- 25 September	20 September

*The facility for uploading outward supplies for July 2017 will be available from 15 July 2017.

Checklist for being GST ready

- Re-wire your enterprise resource planning (ERP) systems to capture relevant data fields in accordance with the new reporting requirement under GST
- Align your invoicing and debit/credit note formats and the vendor and customer masters updated with their respective state-wise GST identification number
- Develop rate masters with a Harmonized System of Nomenclature (HSN) and service accounting codes with the applicable rates
- Realign your business with the supply chain – on the procurement and the distribution fronts – to adapt to the new tax regime
- Initiate the process of negotiating the tax-triggered product re-pricing with vendors
- Revisit your purchase orders, logistics and warehousing strategies
- Ensure that there is requisite awareness, training and capacity building, and fix the roles and responsibilities of people across levels
- To mitigate the risk of loss of tax credit, assess the details of stock in hand and unutilized tax and duty credits vis-a-vis expected state-wise taxable supplies under GST and appropriate strategy framed for transitioning such credits
- Plan to engage with Application Software Providers/GST Suvidha Providers or GST practitioners who combine tax domain expertise with technology

Global News

01

BEPS Multilateral Instrument (MLI) signed by 68 countries[1]

In October 2015, the Organisation for Economic Co-operation and Development (OECD) released the final reports on the 15 action items of the BEPS Action Plan. The final reports contain recommendations that target domestic rules as well as tax treaty provisions – namely, recommendations in relation to treaty abuse, hybrid mismatches, permanent establishment and dispute resolution. To enable jurisdictions to swiftly and consistently implement the treaty-based recommendations, the final report on Action 15 analyzed whether an MLI was feasible. Accordingly, MLI was developed by approximately 100 jurisdictions, including OECD member countries, G20 countries and other developed and developing countries. However, it is open for signature to any interested jurisdictions.

On 7 June 2017, 68 jurisdictions signed the MLI during a signing ceremony hosted by the OECD in Paris. Eight other jurisdictions expressed their intent to sign the MLI in the near future.

At the time of signature, the signatories submitted a list of their tax treaties in force that they would like to designate as Covered Tax Agreements (CTAs), i.e., to be amended through the MLI. Together with the list of CTAs, signatories also submitted a preliminary list of their reservations and notifications (MLI positions) in respect of the various provisions of the MLI. The definitive MLI positions for each jurisdiction will be provided upon the deposit of its instrument of ratification, acceptance or approval of the MLI.

The MLI will enter into force after five jurisdictions have deposited their instruments of ratification, acceptance or approval of the MLI. With respect to a specific bilateral tax treaty, the measures will only enter into effect after both parties to the treaty have deposited their instruments of ratification, acceptance or approval of the MLI and a specified time has passed.

At this stage, it is expected that over 1,100 tax treaties will be modified based on matching the specific provisions that jurisdictions wish to add or change within the CTAs nominated by the signatories. Signing the MLI constitutes an unprecedented moment in international taxation. It is also a key milestone in the implementation of the treaty-based BEPS recommendations.

1 Refer EY global alert titled, "68 jurisdictions sign the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS," dated 7 June 2017

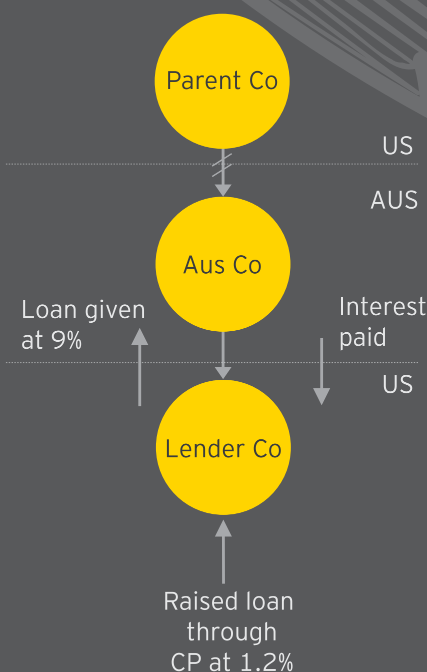
02

Australian ruling on interest paid on cross-border loan between related parties

An Australian holding company Chevron Australia Holdings Pty. Ltd. (Aus Co)[2] entered into a credit facility agreement with CFC (Lender Co), a subsidiary of Aus Co and tax resident in the US. Lender Co was formed to raise debt funds through commercial papers (CP) in the US market at lower interest rates with the help of guarantee from the ultimate parent company in the US (Parent Co). The inter-company interest rate was set at 9%.

The debt borrowed by Aus Co was not backed by any guarantee or any security. Aus Co claimed that the interest paid was at arm's length price (ALP) as the third-party lender would have provided unsecured non-guaranteed debt to Aus Co on such comparable terms.

Lender Co was not taxable in the US on the interest received from Aus Co. As a result of the interest differential, Lender Co generated profits, which it distributed as dividend to Aus Co, which were exempt from tax in Australia. The pictorial representation of the facts is as under:



The Australian Tax office (ATO) alleged that the 9% interest paid by Aus Co was in excess of an arm's length rate under the transfer pricing (TP) law of Australia. The Australian Court agreed with the ATO's position and held that:

1. Under the Australian TP law, the consideration to the transaction relates to not just the interest paid but potentially also the giving of security, financial covenants or a parental guarantee. In the present case, it was reasonable to assume that in an arm's length scenario, Parent Co would have provided additional security/guarantee and/or required covenants to be included in an unsecured loan agreement.

2. While applying the independent assumptions in TP laws, relevant attributes of the broader corporate group to which the taxpayer is a member should be considered.

   Accordingly, Aus Co should not be treated as a standalone/ orphan company that is wholly independent of the corporate group to which it belongs.

3. In effect, a significant reduction in interest rate should apply to this loan.

2 Refer EY global alert titled, "Australian Court rejects Chevron's appeal relating to borrowing from related party," dated 1 May 2017

03

Germany issues draft guidance for withholding tax on cross-border payment for use of software and databases[3]

The German Federal Ministry of Finance issued a draft guidance that contains 13 examples and covers situations where a domestic (German) customer obtains the temporary use right for software or database applications from a foreign vendor/licensor and uses this right in its (domestic) business.

Under current German law, a cross-border "payment in consideration for the temporary use of a right"/"payment for a transfer of know-how" should give rise to withholding tax (WHT) in a business-to-business (B2B) situation. Business to consumer (B2C) transactions should not give rise to WHT.

According to the draft guidance, the overriding principle that determines whether a software/database transaction leads to a German WHT obligation for the payer is whether the user is being granted rights to exploit the software/database that go beyond those rights that are typically granted for the intended use of the software/database. The draft guidance provides the following examples:

1 Cross-border payment for the use of word processing software with a right to create 5,000 copies to be used by employees of the German customer: *No WHT obligation, as no rights are granted beyond the intended use.*

2 German IT-sourcing company purchases license to use word processing software in the group to which the sourcing company belongs (via sub-licenses): *No WHT obligation, as no rights are granted beyond the intended use*

3 Foreign parent allows German subsidiary to further develop, copy and distribute the parent's software products against royalty payments: *WHT obligation, as rights are granted that go beyond those needed for the intended use of the software*

4 German subsidiary of foreign software developer is a reseller of downloadable software: *No WHT obligation, as this is only a sales transaction.*

3 EY global alert titled, "Germany issues draft guidance on classification of cross-border software and database use payments for withholding tax purposes," dated 18 May 2017

5 Foreign company provides "infrastructure as a service" (IaaS) offering through a German subsidiary and, together with the right to use the IaaS, grants the German subsidiary the right to use and modify (for customer use) archiving software: *The IaaS-related payment would not be subject to WHT (service, no grant of right), while the right to use and modify the software should be subject to WHT*.

6 Cloud-based "software as a service" (SaaS)/"application service provision" (ASP) transactions where software remains installed on the service provider's server, and beyond the use of software, additional services are agreed (software maintenance and updates, data storage and hotline service): *No WHT, as no rights are granted beyond the intended use*.

7 The foreign cloud service company interposes a German ASP distributor, who contracts with German customers: *Payments by the German ASP distributor become subject to WHT, as rights are granted that go beyond those needed for the intended use of the software (distribution rights).*

8 Foreign SaaS company distributes in Germany through a subsidiary, which is being granted copy, modification, distribution and publication rights to the software: *Payments by the German SaaS distributor become subject to WHT*.

9 Payments for access to online scientific journal (only reading and printing rights): *No WHT obligation*.

10 Foreign rating agency allows German bank through end user license to use financial market data online (access, reading and printing rights): *No WHT obligation*.

11 If the German bank also has the right to grant its customers access to the database: *WHT obligation, as rights are granted that go beyond those needed for the intended use of the database*.

12 The bank also has the right to grant its customers access to data generated from the database (although not access to the database itself): *No WHT obligation, as no rights are granted beyond the intended use*.

04

China guidance on TP and mutual agreement procedure[4]

China's State Administration of Taxation (SAT) issued SAT Bulletin Gonggao [2017] No. 6, effective from 1 May 2017 (Bulletin 6) providing new TP guidance and strengthening the Mutual Agreement Procedure (MAP) process.

1 **MAP process:** Bulletin 6 contains detailed provisions governing the MAP process for TP cases. Taxpayers should apply directly to the SAT if they wish to invoke the MAP for their TP cases. Taxpayers with ongoing special tax investigations or those who have not paid taxes assessed in an investigation may be denied access to MAP.

2 **Intangible property transactions:** In addition to the DEMPE functions (development, enhancement, maintenance, protection and exploitation), Bulletin 6 adds promotion as a sixth function (i.e., DEMPEP functions), demonstrating the importance China places on value created through marketing activities undertaken by Chinese companies.

3 **Review of intercompany royalty:** Tax inspectors are advised to pay particular attention to whether: (i) the value of the licensed intangibles has declined since the royalty was initially established, (ii) price adjustment clauses are commonly found in third-party contracts in the industry, (iii) functions as well as assets and risks have changed and (iv) the licensee has performed DEMPEP functions for which it has not been reasonably compensated

4 **Base Erosion and Profit Shifting guidance:** (1) An entity that merely funds intangible development activities but does not perform any DEMPEP functions should only be entitled to earn a reasonable financing return, and (2) an entity that has mere legal ownership but does not control financing functions or risks should not be entitled to any intangible related profits.

5 **Intercompany services transactions:** Bulletin 6 follows the internationally accepted and OECD-sanctioned benefit test. It incorporates a provision that empowers tax authorities to disallow a deduction for service fees paid to a related party that does not have significant substance.

6 **Location-specific advantages (LSA):** LSA adjustments are only required if the comparables operate in different economic conditions. Existence of LSAs is a comparability factor for TP analysis and LSAs are not themselves intangible property.

7 **TP methods:** The transactional net margin method (TNMM) is generally not appropriate in transactions where the tested party has significant intangible assets. In addition, where the Chinese taxpayer undertakes significant DEMPEP functions, including promotion activities, tax authorities may argue that a PSM should be applied

4 EY global alert titled, "China issues updated transfer pricing and Mutual Agreement Procedure rules," dated 7 April 2017

05

Danish employee's home office constitutes PE of the German employer[5]

A German corporation (Taxpayer) engaged in delivering software and hardware solutions had hired a Danish resident sales manager to carry out sales activities and customer service in Denmark and the other Scandinavian countries.

The sales manager received a laptop and a mobile phone from the Taxpayer, and his travel expenses were also reimbursed by the Taxpayer. The sale manager was not provided with any office/ premise in Denmark and his employment contract required him to work from home. However, he was not to be reimbursed for furnishing or in other ways for setting up a home office. He also carried out his work at the premises of the clients, partners and suppliers.

The issue under consideration was whether the home of the employee was to be considered as a fixed place PE of the Taxpayer in Denmark.

Based on OECD Model Convention, the Tax Board ruled that the sales manager's occasional use of a home office for administrative work would constitute a PE of his employer, the Taxpayer. In coming to its conclusion, the Tax Board observed the following:

1 It is irrelevant whether the premises are owned, rented or in other ways made available for the taxpayer, as long as core business activities of the foreign corporation are effectively and habitually carried out at the premises.

2 The home office is at the disposal of the taxpayer if the core business activities of the taxpayer are effectively carried out at the premises by the employee(s) of the taxpayer.

3 The administrative work carried out at the sales manager's home was carried out in connection with his work for his employer and qualified as core business of the German corporation.

4 Work carried out at the home office must be regarded as occurring on a regular basis, and thus not be sporadic and occasional, simply due to the fact that the work at home can be planned as part of the regular course of carrying out his work as sales manager.

5 Refer EY global alert titled, "Danish Tax Board rules that Scandinavian sales manager's work from home creates PE for German company," dated 19 April 2017

06

Russian ministry denies lower WHT rate under a look through approach[6]

The Russian Finance Ministry (the Ministry) recently (7 December 2016) published a letter clarifying the application of the "look through approach" in relation to dividend payments. The Ministry considers a situation in which the actual recipient of dividends is a foreign company whose participation in the capital of the Russian company paying the dividends is not direct but indirect (structured via a series of intermediate holding companies).

As per the Russian domestic laws, the recipient of income has to fulfil a set of criteria in order to qualify for benefits under Russian tax treaties. In many cases, this position would prevent a lower WHT rate from being applied under the "look-through approach" by virtue of the fact that a foreign shareholder made its investment in a Russian company not directly but through intermediate foreign companies, which are not the actual recipients of the dividends.

In order for the look-through approach to be applied to dividends, the following conditions must be met:

1. The entity to which the payment is made must acknowledge that it does not have an actual right to the income.
2. The entity that has an actual right to the income must hold a direct and/or indirect interest in the Russian company paying the dividends.
3. The entity that has an actual right to the income must provide the following documents to the tax agent before the date on which the income is paid:

- *Confirmation of residence of a state with which Russia has an international tax treaty, certified by a competent authority of the relevant foreign state (tax residence certificate)*
- *Confirmation that the company has an actual right to receive the income in question*

In the letter, the Ministry examines a situation in which the actual recipient of the dividend income paid by a Russian company is a Spanish tax-resident company.

The Ministry asserts that in order to qualify for the 5% rate, a Spanish tax resident, which is the actual recipient of dividends, must have invested at least EUR100,000 directly in the capital of the Russian company paying the dividends. Therefore, under the look-though approach the Russian tax agent would have to withhold tax at the higher rate of 10%.

However, there is support for the taxpayer's position that the lowest tax rate is applicable, since the look-though approach as such is an expression of the substance-over-form principle, and using it as a basis for applying a selectively formal approach to individual criteria is questionable.

6 EY global alert titled, "Russian Finance Ministry issues clarification on use of look-through approach regarding dividend payments," dated 30 March 2017

Regulatory *Update*

What after FIPB?

India has become a favored investment destination in light of its large domestic consumption based economy, favorable demographics, skilled workforce and the continuing global focus on emerging markets. In recent times, the Government of India has been constantly aiming toward creating a non-adversarial, business-friendly and more governance-oriented financial and economic environment. It has adopted various measures to attract foreign investment in the country, one of which is the relaxation in the FDI policy for the investors and abolition of the Foreign Investment Promotion Board (FIPB).

FDI investments in India are governed by a comprehensive FDI policy[1]. It embodies the general and sector-specific conditions on FDI for prospective and existing foreign investors in India. Every year, the Department of Industrial Policy & Promotion (DIPP), a Government body under the aegis of the Ministry of Commerce & Industry, releases a circular updating the policy. The annual circular consolidates all the FDI-related policy announcements through

press notes/press releases issued during the year. The Reserve Bank of India (RBI) is the nodal agency for administration of foreign investments and foreign exchange. The procedural instructions for administration of the FDI policy are issued by the RBI by making necessary amendments to the regulations/directions announced under Foreign Exchange Management Act, 1999 (FEMA). This policy framework is operationalized by rules, regulations and circulars issued from time to time.

FDI can be made in India under the automatic route or the government route. Over a period of time, the Government has liberalized its FDI policy and brought majority of the sectors (over 90%) under the automatic route.

Under the automatic route, procedurally, investors are required to comply with the dual reporting requirement with the RBI, at the time of receipt of funds for capital injection and also at the time of issuance of capital instruments.

Under the government route, proposals are considered and approved by the Government after considering the credentials of the investor, amount of foreign investment, trade benefits, employment generation, infrastructure creation etc. Once a company has been granted an approval, the dual reporting requirement as prescribed under the automatic route needs to be complied with.

In addition, there are certain sensitive sectors where FDI is prohibited, e.g., lottery business, gambling and betting, chit funds, Nidhi companies, and real estate business or construction of farmhouses.

Until now, proposals falling under the government route were approved by the FIPB with total foreign equity inflow up to INR5,000 crore and additionally by the Cabinet Committee on Economic Affairs (CCEA) with total foreign equity inflow beyond INR5,000 crore[2].

It is pertinent to note that the Hon'ble Finance Minister in his 2017 Budget speech had announced the abolishment of the FIPB. In line with the Budget announcement, on 24 May 2017, the Union Cabinet formally approved the proposal of scrapping the FIPB in line with the ultimate objective of "ease of doing business" and the principle of "maximum governance and minimum government."

After this decision, proposals for foreign investments mandating government approval, which were earlier considered by the FIPB, will now be considered and approved by the respective line ministries/departments in consultation with the DIPP. Further, proposals involving security concerns will additionally mandate the approval of the Ministry of Home Affairs. Proposals with total foreign equity inflow beyond INR5,000 crore would continue to be additionally cleared by the CCEA.

The SOP for granting approvals for foreign investments would be announced by the DIPP shortly. It is expected that the said SOP may provide for transit provisions, timelines for granting the approvals, review mechanism, filing mechanism and other matters in connection with granting approvals. The step of dismantling the FIPB and shifting the approval mechanism to the respective ministries might streamline the approval process and cut the timelines in granting approvals.

Based on publicly available information, it is expected that the DIPP is in the process of further liberalizing the FDI policy, by enhancing FDI limits, bringing more sectors under the automatic route and simplifying other conditions in the government/automatic route sectors to attract more foreign investment. In order to attract more global players in the single brand retail trading (SBRT) sector, the automatic route limit in the sector is likely to be enhanced from the existing 49% to 100%. Further, the demands made by foreign retailers for allowing non-food items such as homecare products may also be considered in the ensuing FDI policy. It is also likely that the Government may further relax its policy for sectors such as construction development and print media.

The further liberalization in the FDI policy and approval mechanism announced by the Government recently is aimed at removing the procedural impediments by avoiding duplication and making the process simpler for the foreign investors. This is expected to improve the business environment and attract more FDI into the country.

1 http://dipp.nic.in/English/Policies/FDI_Circular_2016.pdf
2 http://dipp.nic.in/English/Policies/FDI_Circular_2016.pdf

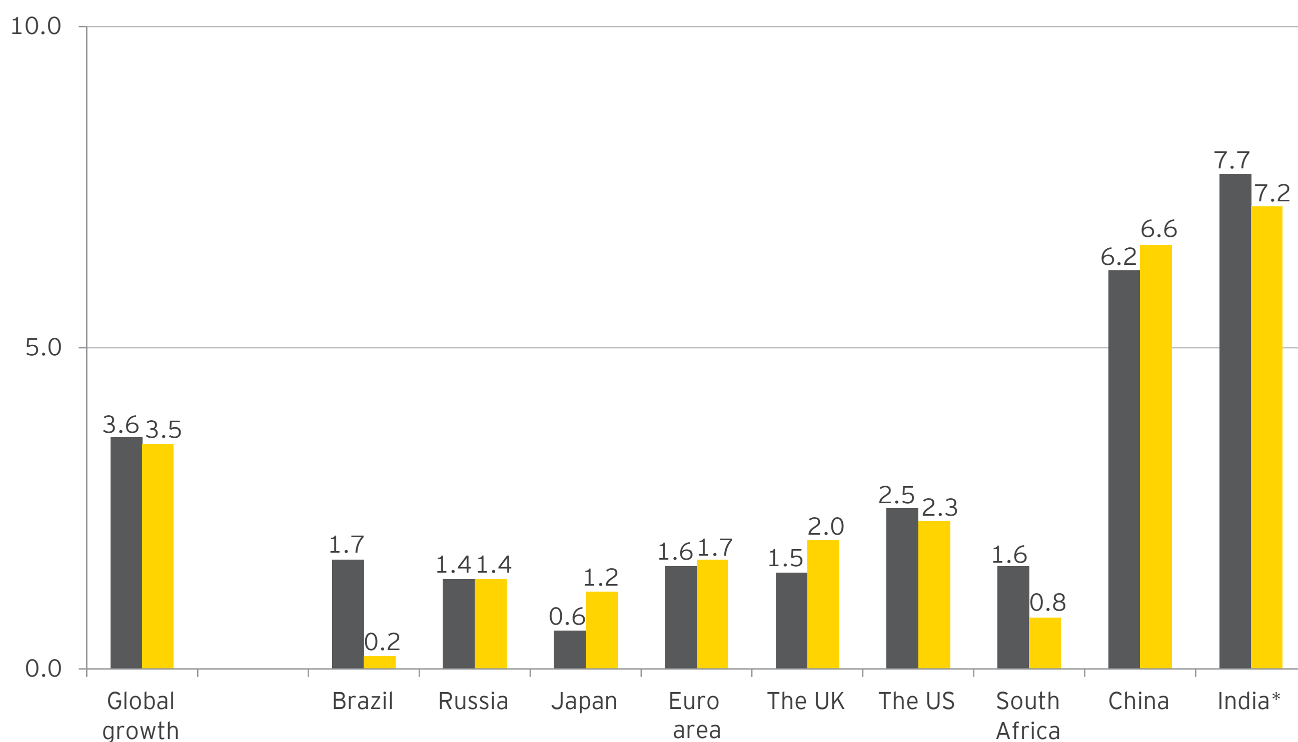
EconoMeter

macro-fiscal trends

India remains a global growth leader in FY18 and beyond in spite of the adverse effect of demonetization on FY17 growth

- The IMF and the World Bank lowered India's FY17 GDP forecast to 6.8% on account of demonetization. The IMF projects India to grow by 7.2% in FY18 and 7.7% in FY19.
- The RBI, in its June 2017 Monetary Policy Review, projected a strengthening of GVA growth at 7.3% in FY18 from 6.6% in FY17.
- The IMF projects global growth to rise from 3.1% in 2016 to 3.5% in 2017 and 3.6% in 2018.

Chart 1: IMF World Economic Outlook, April 2017



Source: IMF World Economic Outlook, April 2017
*forecast pertains to fiscal year

After demonetization, output growth in 4QFY17 fell to 5.6%

- After demonetization, GVA growth in 4QFY17 fell sharply to 5.6%.
- Growth in financial services and manufacturing significantly slowed down while that in construction contracted as well in 4QFY17.
- But for public administration and defense services and agriculture, output growth would have fallen further.

Table 1: GVA: annual and quarterly growth rates (%, y-o-y)

Sector	1Q FY17	2Q FY17	3Q FY17	4Q FY17	FY14	FY15	FY16	FY17
Agr.	2.5	4.1	6.9	5.2	5.6	-0.2	0.7	4.9
Ming.	-0.9	-1.3	1.9	6.4	3.1	9.8	10.5	1.8
Mfg.	10.7	7.7	8.2	5.3	5.1	7.7	10.8	7.9
Elec.	10.3	5.1	7.4	6.1	4.0	7.3	5.0	7.2
Cons.	3.1	4.3	3.4	-3.7	3.0	4.1	5.0	1.7
Trans.	8.9	7.7	8.3	6.5	6.8	8.9	10.5	7.8
Fin.	9.4	7.0	3.3	2.2	11.0	11.3	10.8	5.7
Publ.	8.6	9.5	10.3	17.0	3.8	8.1	6.9	11.3
GVA	7.6	6.8	6.7	5.6	6.2	7.0	7.9	6.6

Source (Basic Data): MOSPI GVA: gross value added

Demand conditions signal continued weakness in investment

- Growth in gross fixed capital formation, reflecting investment demand in the economy, declined from 7.4% in 1QFY17 to (-) 2.1% in 4QFY17 registering its third consecutive quarterly decline.
- Growth in export and import demand picked up in 4QFY17.

Table 2: Annual and quarterly growth in components of aggregate demand with 2011–12 as base (% y-o-y) at constant prices

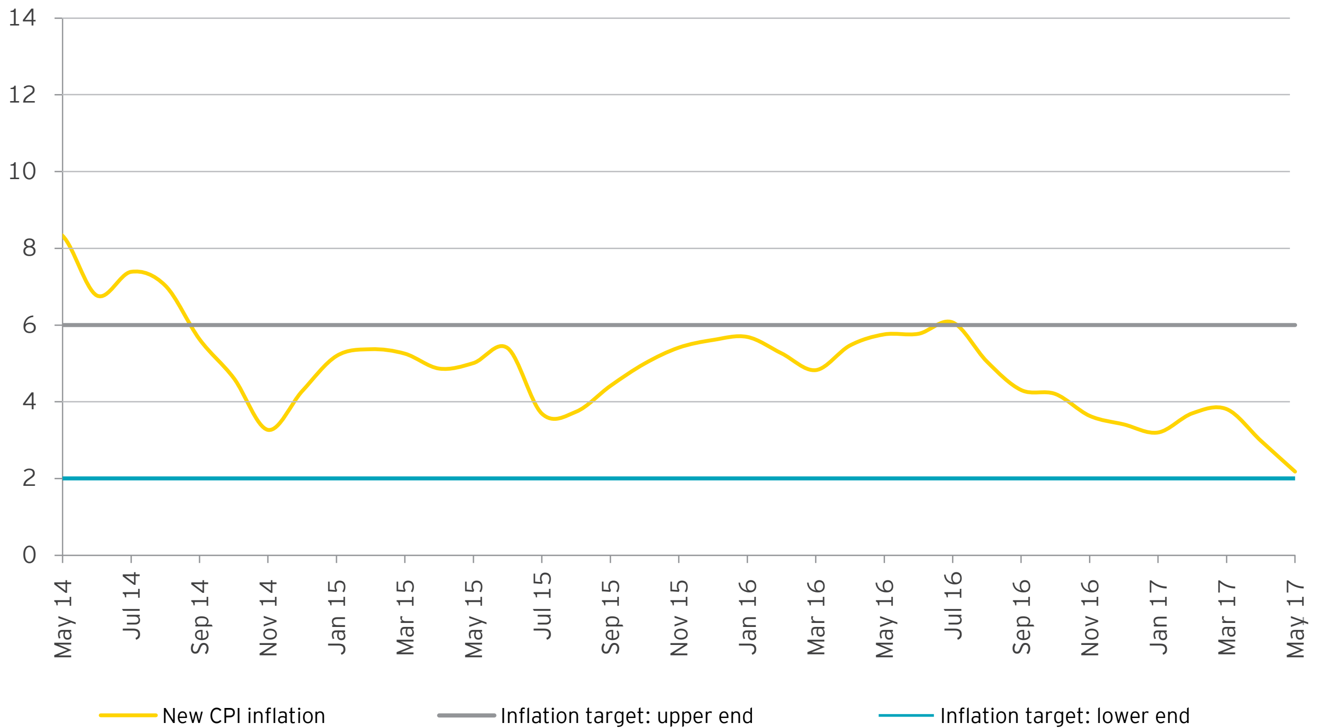
AD component	1Q FY17	2Q FY17	3Q FY17	4Q FY17	FY14	FY15	FY16	FY17
PFCE	8.4	7.9	11.1	7.3	7.4	6.2	6.1	8.7
GCE	16.6	16.5	21.0	31.9	0.6	9.6	3.3	20.8
GFCF	7.4	3.0	1.7	-2.1	1.8	3.2	6.5	2.4
EXP	2.0	1.5	4.0	10.3	7.8	1.8	-5.3	4.5
IMP	-0.5	-3.8	2.1	11.9	-8.1	0.9	-5.9	2.3
GDP	7.9	7.5	7.0	6.1	6.5	7.3	8.0	7.1

Source: CSO, MOSPI, Government of India
PFCE: private final consumption expenditure; GCE: government final consumption expenditure; GFCF: gross fixed capital formation; EXP: exports; IMP: imports; GDPMP: GDP at market prices

RBI left the repo rate undisturbed, maintaining its neutral stance in June 2017

- The RBI left the repo rate unchanged at 6.25% in its June 2017 Review.
- Consumer Price Index-based inflation decreased to a historic low of 2.2% in May 2017 due to a sharp fall in food price inflation, particularly in vegetables and pulses.

Chart 2: Inflation (y-o-y; %)

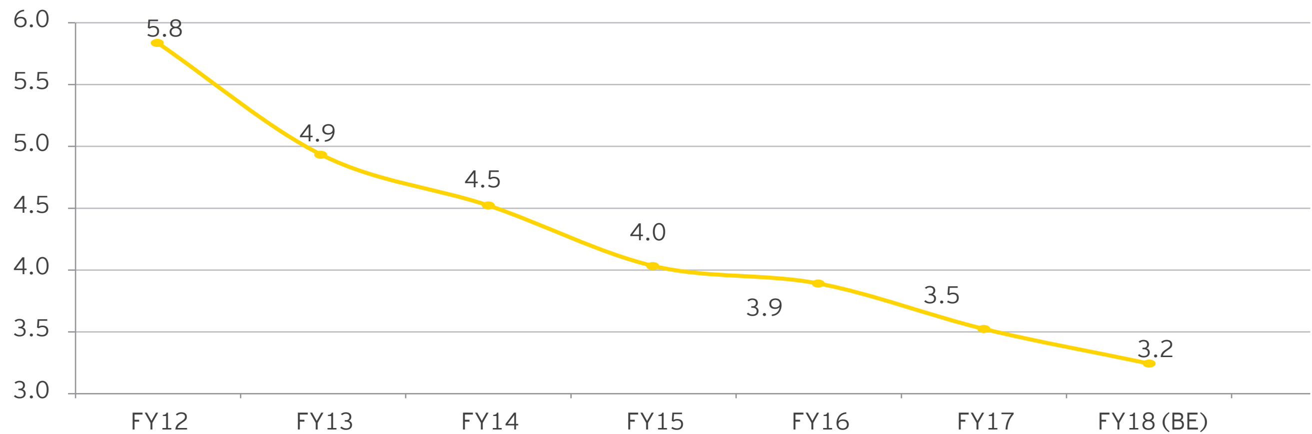


Source: MOSPI

The Center met its fiscal deficit target of 3.5% of GDP in FY17, driven by buoyant tax revenues

- The Center's fiscal deficit stood at 3.52% of GDP in FY17.
- Disinvestment receipts stood at INR46,246.5 crore for FY17, meeting the FY17 revised estimate of INR45,500 crore.
- Fiscal deficit in the first month of FY18 was 25.7% of the annual budgeted target.

Chart 3: Fiscal deficit as a % of GDP

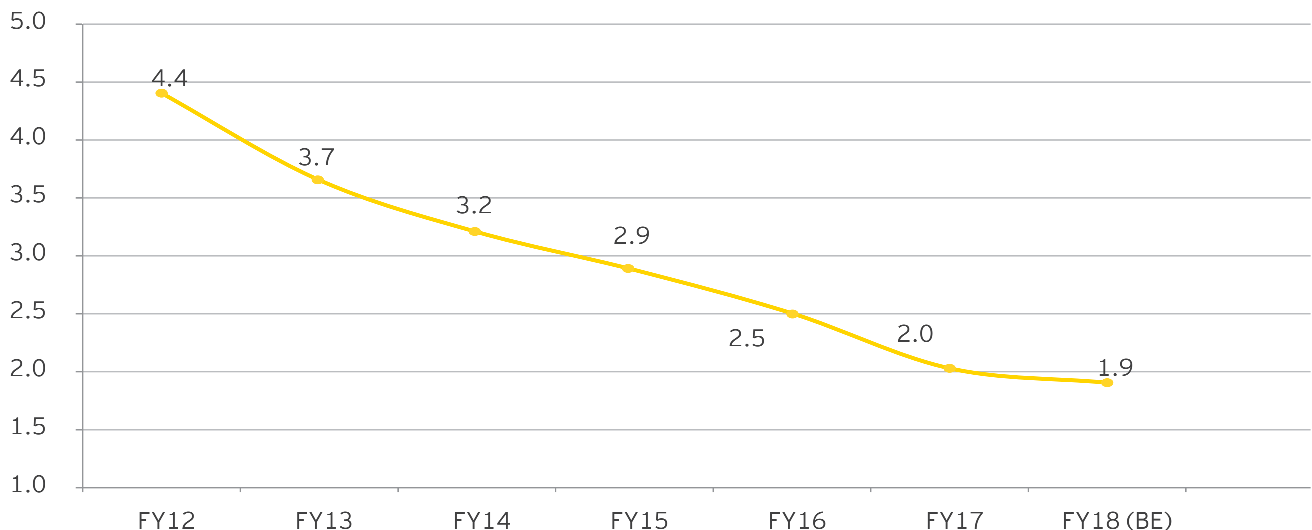


Source: Union Budget FY18, Monthly Accounts, Controller General of Accounts, Government of India

The Center also managed to achieve its revenue deficit target for FY17

- The Center's revenue deficit stood at 2.03% of GDP in FY17, slightly lower than the revised estimate of 2.1% of GDP.
- Revenue deficit in April FY18 was at 33.6% of the annual budgeted target.

Chart 4: Revenue deficit as a % of GDP



Source: Monthly Accounts, Controller General of Accounts, Government of India

Tax revenues grew by 18% in FY17 but growth in non-tax revenue remained sluggish

- Gross tax revenue grew by 17.9% in FY17 compared to 17.0% in FY16.
- Direct taxes grew by 12.3% and indirect taxes by 22.9% in FY17.
- Growth in non-tax revenues was low at 9.3% in FY17 due to a contraction in the Center's interest receipts and a slowdown in the growth of dividends and profits.

Table 3: Gross tax and non-tax revenue (annual growth rate, y-o-y)

Tax/Non-tax revenue	FY14	FY15	FY16	FY17	FY18 (BE)
Gross tax revenue	9.8	9.3	17.0	17.9	11.3
Non-tax revenue	44.6	-1.1	27.3	9.3	5.3

Source: Union Budget FY18 and Monthly Accounts, Controller General of Accounts, Government of India
RE: revised estimates; BE: budget estimates;

Major central taxes have performed satisfactorily

- High growth in income tax revenue in FY17 (21.5%) was largely due to two income disclosure schemes after demonetization.
- Growth in excise duties in FY17 (32.7%) was lower than in FY16, reflecting movement in petroleum prices and consequent adjustment in specific excise duty.
- Growth in corporation tax (6.7%) and customs duty (7.4%) remained low in FY17, reflecting weakness in investment and imports.

Table 4: Tax revenues (annual growth rates, y-o-y)

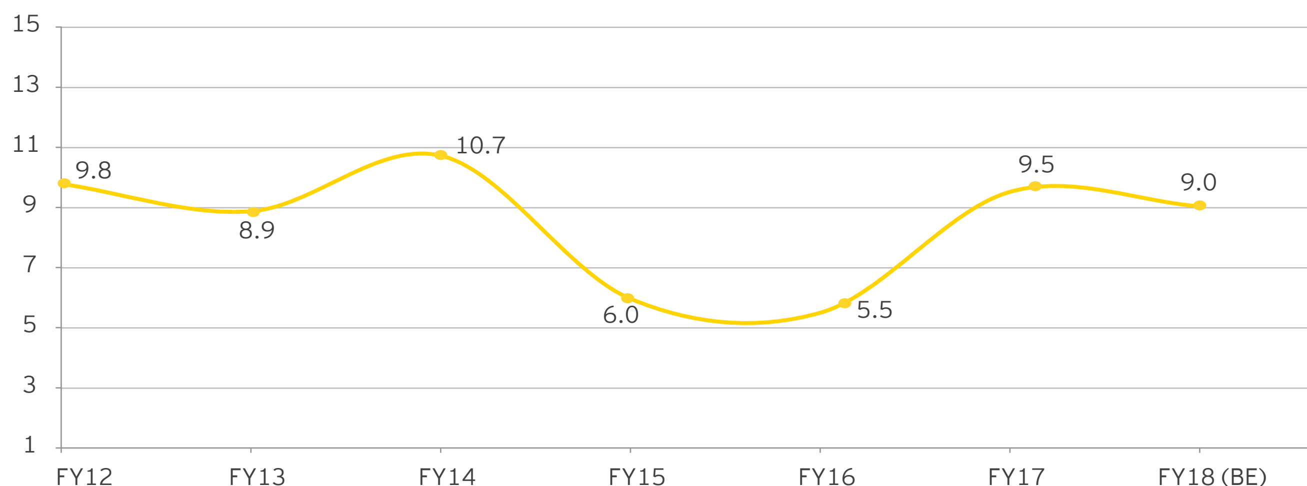
Tax revenues	FY14	FY15	FY16	FY17	FY18 (BE)
Corporation tax	10.8	8.7	6.0	6.7	11.1
Income tax	20.8	8.7	8.5	21.5	29.6
Custom duty	3.8	9.2	11.9	7.4	8.4
Excise duty	-3.6	11.6	51.9	32.7	6.8
Service tax	16.7	8.6	25.8	20.4	8.0

Source: Union Budget FY18 and Monthly Accounts, Controller General of Accounts, Government of India

Growth in the Center's revenue expenditure increased sharply in FY17 due to revision of salaries and pensions

- Total expenditures of the Central Government grew by 11.4% in FY17 from 7.8% in FY16.
- Growth in revenue expenditure increased sharply to 9.5% in FY17 due to the implementation of the 7th Central Pay Commission's recommendations.
- In April FY18, revenue expenditure grew by 51.2% from 9.9% in April FY17.

Chart 5: Growth in revenue expenditure (%, y-o-y)

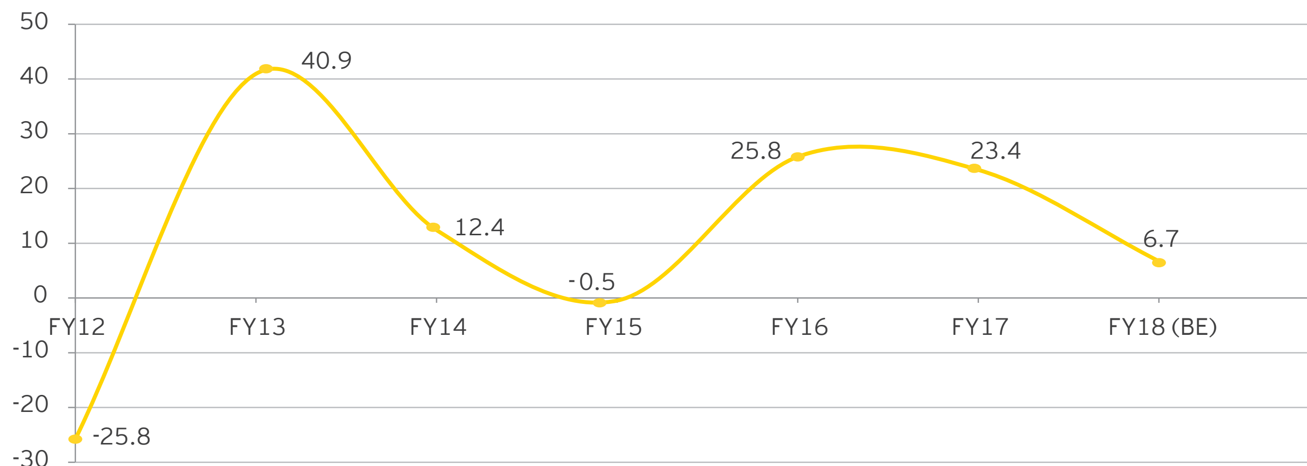


Source: Union Budget FY18, Monthly Accounts, Controller General of Accounts, Government of India

Growth in the Center's capital expenditure fell in FY17. It is budgeted to fall further in FY18

- Growth in the Center's capital expenditure marginally fell to 23.4% in FY17 from 25.8% in FY16.
- Budgeted capital expenditure growth in FY18 is only 6.7% over the actual achieved in FY17.
- In April FY17, capital expenditure grew by 37.7% as against a contraction of (-) 20.5% in April FY17.

Chart 6: Growth in capital expenditure (%, y-o-y)



Source: Union Budget FY18, Monthly Accounts, Controller General of Accounts, Government of India

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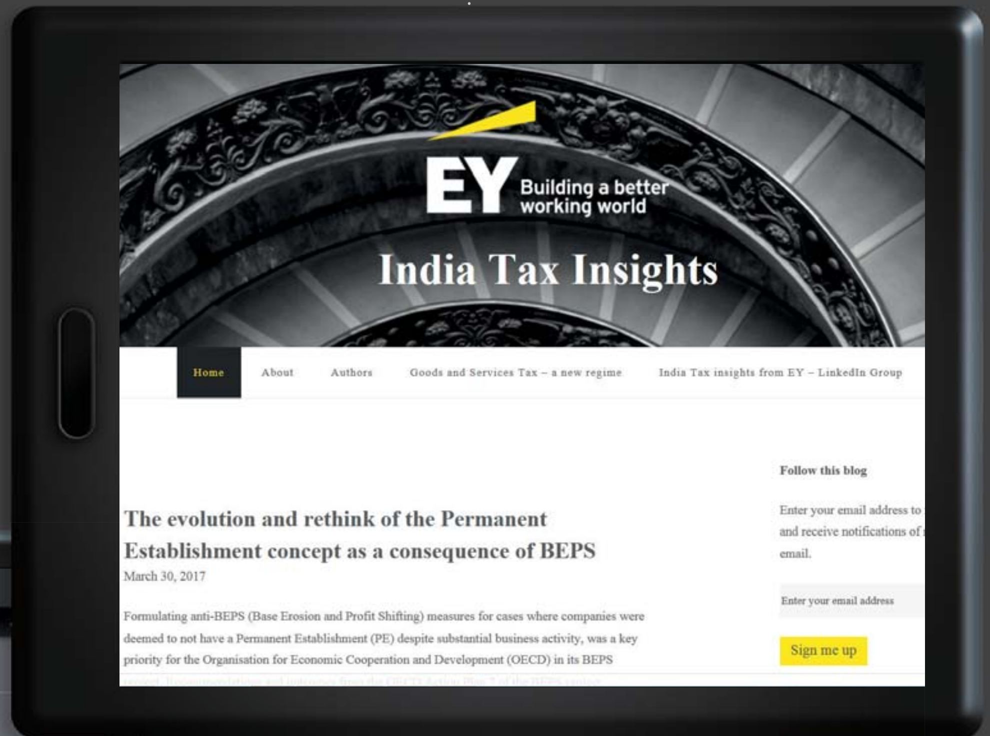

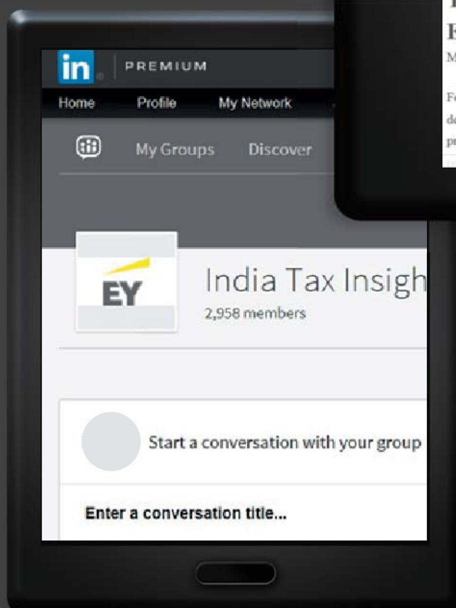

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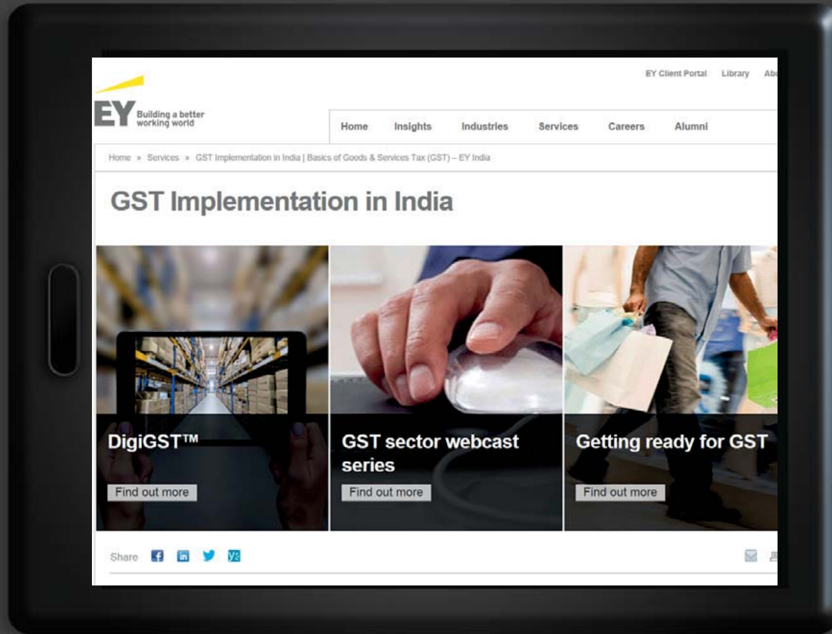

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