

India Tax Insights

Issue 13

February 2018

**Budget 2018
Special**

In this issue

Decoding Union Budget 2018
and the way forward

US tax reform - Impact on India

The EY logo consists of the letters 'EY' in a bold, white, sans-serif font. A yellow diagonal line is positioned above the 'Y', extending from the top right towards the center.

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Foreword



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Sudhir Kapadia

Partner and National Tax Leader,
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*India Tax Insights, focusing
on the 2018 Union Budget.*

We are pleased to present the 13th edition of our magazine India Tax Insights, focusing on the 2018 Union Budget.

The 2018 Union Budget comes at a time when the past year was marked by some major reforms. The transformational Goods and Services Tax (GST) was launched in July 2017. With a policy change of such scale, scope and complexity, the transition unsurprisingly encountered challenges of policy, law and information technology systems, which especially affected the informal sector. Expedient responses followed to rationalize and reduce rates and simplify compliance burdens.

It is striking that the Center's tax-GDP ratio is no higher than it was in the 1980s despite an average economic growth of 6.5%, the most rapid in India's history. Overcoming fiscal vulnerability requires breaking the inertia of the tax-GDP ratio. The GST could help break this fiscal stasis, with positive spillovers for macro-economic stability. Also, there is evidence of a noteworthy increase in the number of tax filers in the demonetization-GST period.

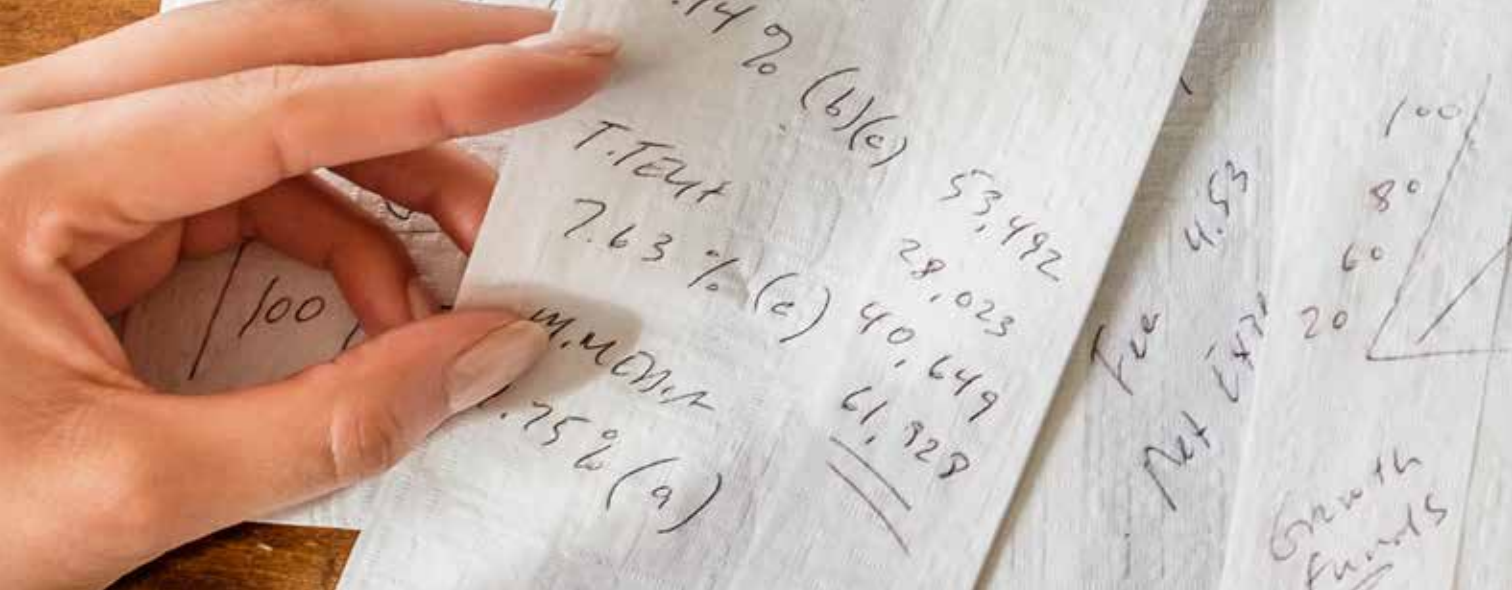
As with the Government's previous Budgets, the 2018 Union Budget continues to focus on some fundamental aspects. The Government has been steadily working toward widening the tax base, addressing the menace of the parallel economy, improving the ease of doing business and strengthening the anti-abuse provisions. At the same time, it has stepped up its spending on the infrastructure, rural and agriculture sectors and on achieving inclusive growth – all this, while maintaining fiscal discipline. The fine balancing act is truly commendable.

The Budget proposal to reduce the corporate tax rate to 25% for companies with turnover less than INR250 crore is a welcome move that will provide considerable relief for a large number of companies and enable them to make new investments. Globally, the tax rates are already moving lower toward 20%. As against this, in India, along with the dividend distribution tax, the overall tax burden on corporates can be higher than 40%. There is a clear need for the Government to consider a more comprehensive and broad-based corporate tax rate reduction plan in the near future.

The 2018 Budget also continued with the Government's focus on implementing anti-BEPS measures in India. The Budget has proposed a new nexus test by way of "significant economic presence" for taxing the digital economy. A number of issues relating to the proposal require a more detailed debate and consultation to ensure that the growth of the digital economy is not adversely impacted while at the same time protecting the Indian tax base.

The 2018 Union Budget comes at a time when the US has just introduced significant tax reforms. The legislative changes reduce the tax rates, broaden the tax base and introduce a new international tax system with a move toward participation exemption. The US tax reforms have widespread business implications, mandating a review of the financial and operational aspects of how businesses operate, invest, compete and deliver products and services.

We hope you like the articles in this edition and find this publication timely and useful. We look forward to your feedback and suggestions.



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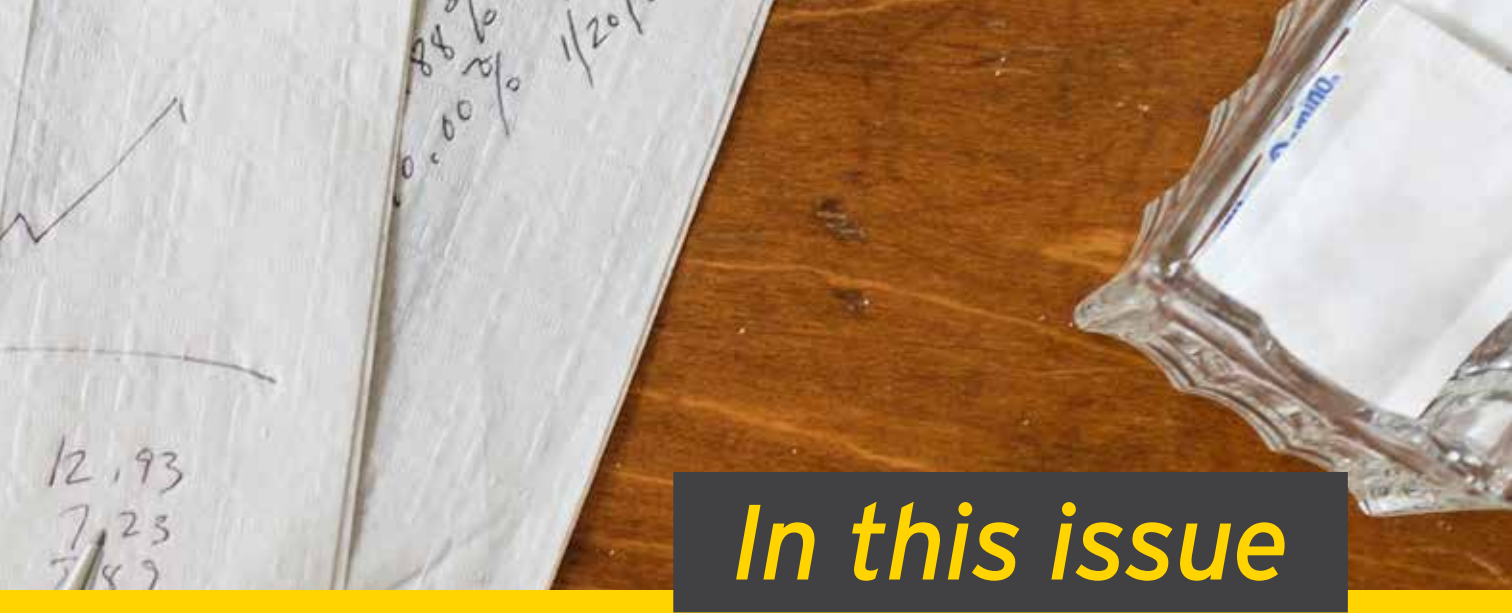
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D.K. Srivastava, Chief Policy Advisor, EY India, proclaims that macro-fiscal features may strengthen the ongoing economic recovery in India and consolidate its position as a global growth leader among major economies of the world.

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US Tax reform

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Maulik Shah, Tax Director, EY India, highlights that the proposed amendments in the Budget eminently reinforce the IBC objective and provide the desired clarity given that many bids are expected to be submitted in the near future.





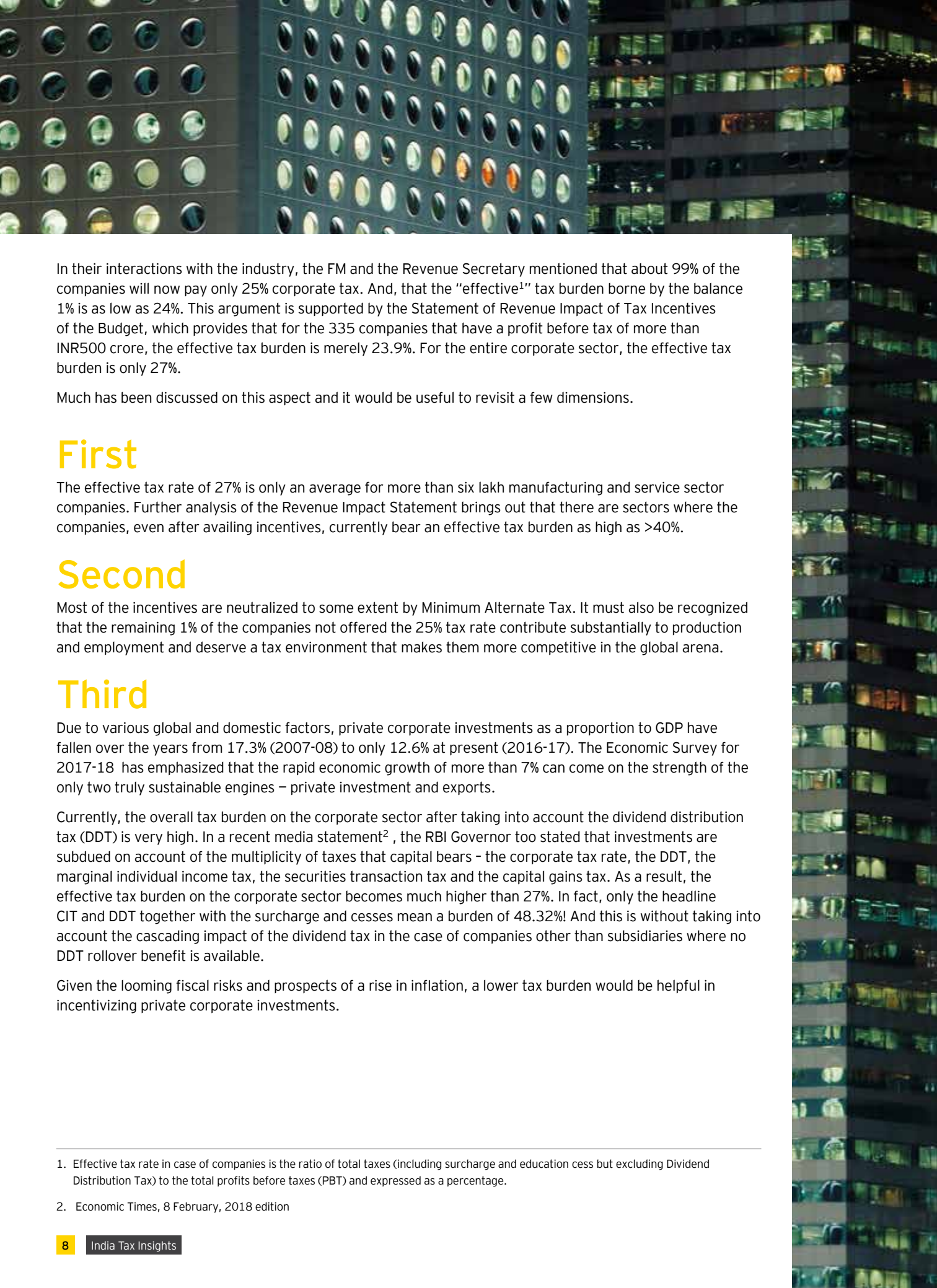
Why the 1% also deserves a low corporate tax rate



Shalini Mathur

Director, Tax & Economic
Policy Group, EY India

The Indian corporate sector was eagerly awaiting a lowering of the corporate income tax (CIT) rate in Budget 2018, in keeping with the Finance Minister's (FM) promise of reducing it to 25% by the year 2019. In a survey conducted by EY in January 2018 with a sample of 150 senior India Inc. representatives across 28 industry sectors, 67% of the respondents expected that the Government would reduce the tax rate for the corporate sector. The FM's promise, however, remains partially fulfilled as the tax rate has been lowered to 25% only for domestic companies with a turnover or gross receipts up to INR250 crore in the financial year 2016-17.



In their interactions with the industry, the FM and the Revenue Secretary mentioned that about 99% of the companies will now pay only 25% corporate tax. And, that the “effective¹” tax burden borne by the balance 1% is as low as 24%. This argument is supported by the Statement of Revenue Impact of Tax Incentives of the Budget, which provides that for the 335 companies that have a profit before tax of more than INR500 crore, the effective tax burden is merely 23.9%. For the entire corporate sector, the effective tax burden is only 27%.

Much has been discussed on this aspect and it would be useful to revisit a few dimensions.

First

The effective tax rate of 27% is only an average for more than six lakh manufacturing and service sector companies. Further analysis of the Revenue Impact Statement brings out that there are sectors where the companies, even after availing incentives, currently bear an effective tax burden as high as >40%.

Second

Most of the incentives are neutralized to some extent by Minimum Alternate Tax. It must also be recognized that the remaining 1% of the companies not offered the 25% tax rate contribute substantially to production and employment and deserve a tax environment that makes them more competitive in the global arena.

Third

Due to various global and domestic factors, private corporate investments as a proportion to GDP have fallen over the years from 17.3% (2007-08) to only 12.6% at present (2016-17). The Economic Survey for 2017-18 has emphasized that the rapid economic growth of more than 7% can come on the strength of the only two truly sustainable engines – private investment and exports.




Currently, the overall tax burden on the corporate sector after taking into account the dividend distribution tax (DDT) is very high. In a recent media statement², the RBI Governor too stated that investments are subdued on account of the multiplicity of taxes that capital bears – the corporate tax rate, the DDT, the marginal individual income tax, the securities transaction tax and the capital gains tax. As a result, the effective tax burden on the corporate sector becomes much higher than 27%. In fact, only the headline CIT and DDT together with the surcharge and cesses mean a burden of 48.32%! And this is without taking into account the cascading impact of the dividend tax in the case of companies other than subsidiaries where no DDT rollover benefit is available.

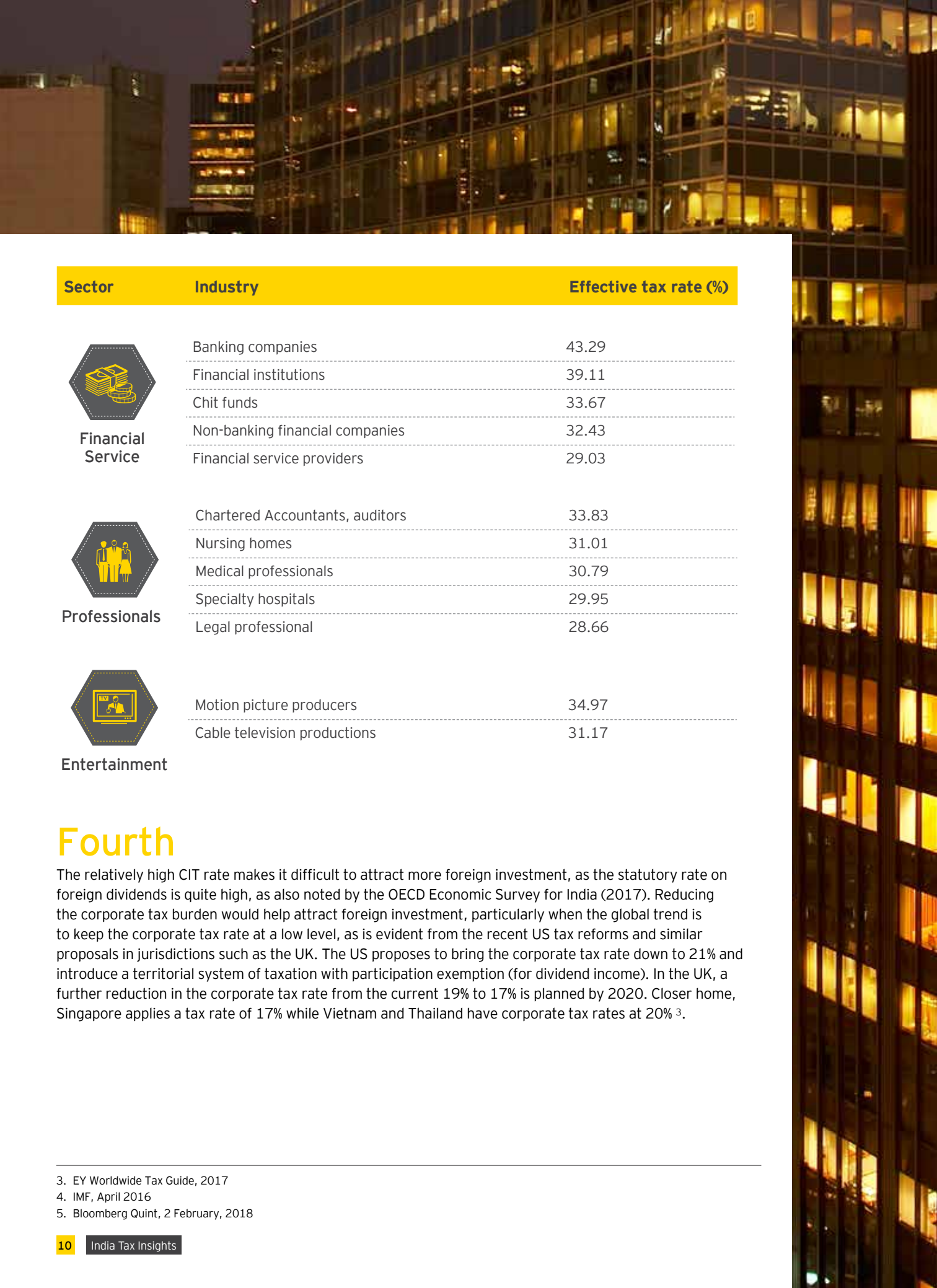
Given the looming fiscal risks and prospects of a rise in inflation, a lower tax burden would be helpful in incentivizing private corporate investments.

1. Effective tax rate in case of companies is the ratio of total taxes (including surcharge and education cess but excluding Dividend Distribution Tax) to the total profits before taxes (PBT) and expressed as a percentage.

2. Economic Times, 8 February, 2018 edition

>27% effective tax rate of sample companies across industry (2016-17)

Sector	Industry	Effective tax rate (%)
 Manufacturing	Printing and publishing	34.00
	Electronics, including computer hardware	32.23
	Marble and granite	31.24
	Food processing units	30.81
	Rubber	29.50
	Engineering goods	28.54
	Automobile and auto parts	28.15
	Fertilizers, chemicals and paints	27.97
 Trading, contractors, builders and commission agents	Mining contractors	44.00
	Chain stores	33.11
	Wholesalers	32.86
	Civil contractors	29.43
	Excise contractors	28.99
	Retailers	28.83
	General commission agents	28.11
	Builders	27.98
 Service sector	Courier agencies	41.09
	Consultancy services	37.06
	Security agencies	34.85
	Advertisement agencies	33.25
	Travel agents, tour operators	33.01
	Computer training/Educational and coaching institute	32.03
	Hospitality services	30.29
	IT-enabled services, BPO service provider	29.59
	Hotels	27.73



Sector	Industry	Effective tax rate (%)
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Financial Service

Banking companies	43.29
Financial institutions	39.11
Chit funds	33.67
Non-banking financial companies	32.43
Financial service providers	29.03



Professionals

Chartered Accountants, auditors	33.83
Nursing homes	31.01
Medical professionals	30.79
Specialty hospitals	29.95
Legal professional	28.66



Entertainment

Motion picture producers	34.97
Cable television productions	31.17

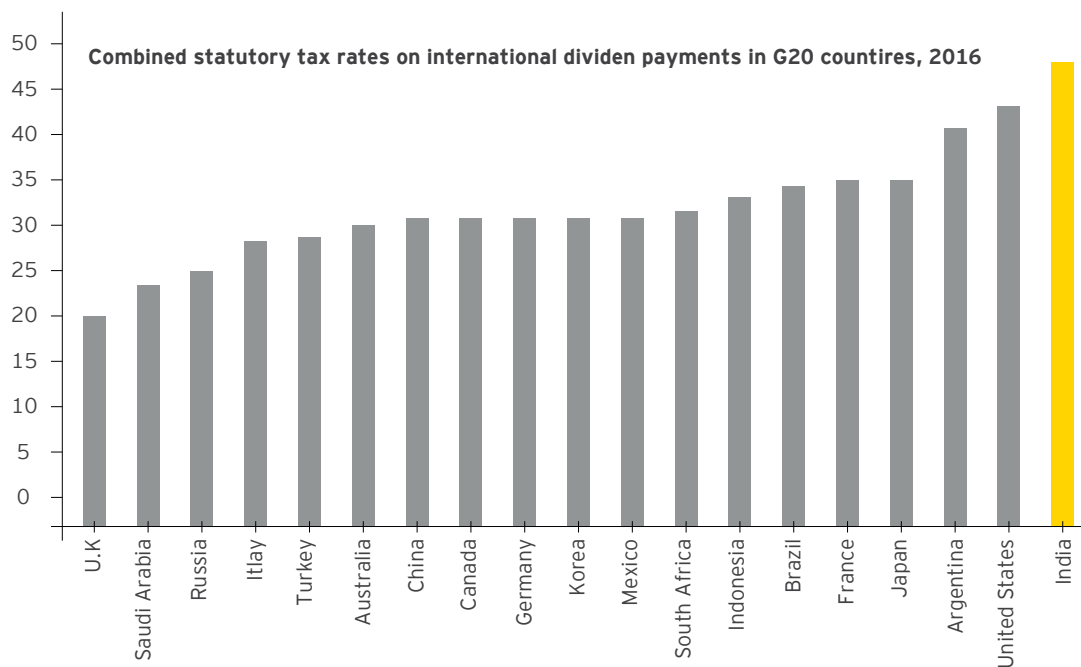
Fourth

The relatively high CIT rate makes it difficult to attract more foreign investment, as the statutory rate on foreign dividends is quite high, as also noted by the OECD Economic Survey for India (2017). Reducing the corporate tax burden would help attract foreign investment, particularly when the global trend is to keep the corporate tax rate at a low level, as is evident from the recent US tax reforms and similar proposals in jurisdictions such as the UK. The US proposes to bring the corporate tax rate down to 21% and introduce a territorial system of taxation with participation exemption (for dividend income). In the UK, a further reduction in the corporate tax rate from the current 19% to 17% is planned by 2020. Closer home, Singapore applies a tax rate of 17% while Vietnam and Thailand have corporate tax rates at 20%³.

3. EY Worldwide Tax Guide, 2017

4. IMF, April 2016

5. Bloomberg Quint, 2 February, 2018



Source: OECD Economic Survey for India (2017).

Note: Foreign source income is assumed to be exempted in the residence countries. For India, the 46% rate comprises the 30% CIT rate on corporate profits, plus 12% surcharge on CIT and 3% earmarked tax (on CIT and surcharge amount), plus the 15% DDT. The above data pertains to 2016. With the new rates of DDT and increase in cess, the overall burden is more than 48%.

Fifth

In the interest of progressivity, the logic of creating variations in tax rates based on income across individual taxpayers is well accepted. However, whether it is good tax policy to extend this logic to enterprises and create tax rate variations by size or turnover may be debatable. Size or turnover does not determine the income of the enterprise, which should actually be the true basis of taxation. Moreover, a firm's rate of growth, job creation and export activity are related more directly to the age of the business than to its size. Size-based tax preferences can create disincentives for firms to grow larger, creating a so-called "small business trap"⁴ where enterprises try to remain small to retain the tax advantage.

Finally

The Chairman, CBDT, has stated⁵ that if all the companies are put into the 25% tax net, there would be a loss of INR60,000 crore to the exchequer, a burden that the Government is unwilling to take on at this juncture where the fiscal consolidation roadmap has already shown a slippage. Interestingly, the amount of revenue foregone on account of accelerated depreciation alone is about INR65,000 crore. The Government has offered a rate of 25% to new manufacturing companies, provided they do not avail any incentives. It may be worthwhile to examine if the Government and the corporate taxpayers will be willing to opt for a lower tax rate of 25% in lieu of the acceleration depreciation benefit for a lower, simplified tax regime. The Government could also consider a phased reduction in the corporate tax rate, which would limit the immediate revenue impact.



Protecting the tax base in the digital economy

A new nexus test in the form of significant economic presence

OECD and BEPS Action 1

On 5 October 2015, the Organisation for Economic Co-operation and Development (OECD) released its final report on the tax challenges of the digital economy (Action 1) under its Action Plan on Base Erosion and Profit Shifting (BEPS). The Final Report provides the OECD's conclusions regarding the digital economy and recommended next steps to address the tax challenges presented by its evolution.

The Final Report continues to acknowledge that special rules designed exclusively for the digital economy would prove unworkable, broadly stating that the digital economy cannot be ring-fenced because it "is increasingly becoming the economy itself." The Final Report summarizes key features of evolving digital business models that the OECD considers relevant for the overall BEPS analysis; in addition, the Final Report considers the broader tax challenges raised by the digital economy and evaluates the options to address those challenges. The OECD also considered several options to address the broader tax challenges raised by the digital economy. The following additional options were considered:

- i. A new nexus test in the form of a significant economic presence (SEP) requirement
- ii. A withholding tax on certain types of digital transactions
- iii. An equalization levy

While these options were not recommended, the Final Report does state that countries could introduce any of them in their domestic laws as additional safeguards against BEPS, provided they respect existing treaty obligations, or include them in their bilateral tax treaties.

However, since the options are limited on the details required for a proper and harmonious implementation, application of the options by national governments could see significant divergence if countries choose to adopt the options.

Tax policy design considerations

The tax policy design for implementing SEP as a nexus for taxability has two related aspects: the definition of taxable presence and the principles for allocating income to the activities carried out through that presence.

In relation to the first, the OECD acknowledges in the Final Report that as a general matter, revenue that is generated on a sustained basis from a country could be considered to be one of the potential indicators of the existence of a SEP. However, in developing a revenue factor, one needs to consider transactions that would be covered. According to the Final Report, one approach that could be considered in defining a basic revenue factor is to include only revenues generated from digital transactions concluded with in-country customers through an enterprise's digital platform.

The proposed amendment seeks to define the factor so as to include all revenue generated by transactions concluded by a non-resident enterprise remotely with in-country customers (whether or not concluded through a digital platform). Total revenue, however, may not by itself suffice to evidence a non-resident enterprise's regular and sustained participation in the economic life of a country. To be an appropriate measure of participation in the economic life of a country, the revenue factor would need to be combined with other factors, such as the digital and/or user-based factors that indicate a purposeful and sustained interaction with the economy of the country concerned.

Given the importance of network effects in the digital economy, the user base and the associated data input may also be important indicators of a purposeful and sustained interaction with the economy of that another country. While a range of factors based on users could be used to reflect the level of participation in the economic life of a country, the proposed amendment seeks to cover factors based on ***“interaction with a specified number of users”*** and ***“systematic and continuous soliciting”*** of a non-resident's business activities. With regard to the user factor based on “interaction with specified number of users,” more detailed metrics would need to be developed in consultation with businesses for the purpose of using this factor, such as how to identify a unique “user” or what level of engagement is required for a user to be considered.



Budget 2018: Strategizing demand-led growth



D.K. Srivastava

Chief Policy Advisor,
EY India

The three distinguishing macro-fiscal features of the Union Budget of FY19 are:

- i. A revised fiscal consolidation roadmap
- ii. Stimulus to growth by supporting aggregate demand and
- iii. Sectoral prioritization aimed at generating high multiplier and employment-promoting effects

Together, these features may strengthen the ongoing economic recovery in India and consolidate its position as a global growth leader among major economies of the world.

Revised fiscal consolidation roadmap

According to the Fiscal Responsibility and Budget Management (FRBM) Act of 2003, as amended in 2015, FY18 should have been the year to reach the target of 3% of fiscal deficit to GDP ratio. This target was revised to 3.2% in Budget FY18.

However, the Government has provided additional flexibility to its spending programs by not only revising the entire fiscal roadmap but also amending the FRBM Act. Accordingly, the following table highlights the new fiscal consolidation roadmap as compared to the old one. Thus, the 3% target that should have been achieved in FY18 has now been postponed to FY21. This has given additional flexibility to the Central Government to adjust its borrowing program for supporting its spending program.

Furthermore, as per the amendment of the FRBM Act as detailed in the Finance Bill 2018, the Central Government will have even greater flexibility in modifying its borrowing targets in the presence of events that may adversely

shock the economy or lead to economic slowdowns. In this amendment, apart from shifting the 3% fiscal deficit-GDP ratio to end-2021, the target of achieving revenue account balance has been given up altogether. This reflects the Government's view that it is the overall expenditure that matters for aggregate demand and not its division between revenue and capital expenditures. The new statutory anchors relate to the general and Central Government debt-GDP ratios, which are to be reduced to 60% and 40% of GDP by 2024-25 based on the recommendations of the report of the FRBM Review Committee headed by N. K. Singh. Furthermore, while the 3% target is to be maintained beyond FY21, departures from it can be permitted under specified conditions as described below:

The amendment has provided that the annual fiscal deficit target may be exceeded due to the above:

- i. Ground or grounds of national security
- ii. Act of war
- iii. National calamity
- iv. Collapse of agriculture severely affecting farm output and incomes
- v. Structural reforms in the economy with unanticipated fiscal implications and
- vi. Decline in real output growth of a quarter by at least 3% points below its average of the previous four quarters. However, any deviation from the fiscal deficit target shall not exceed 0.5 % of the gross domestic product in a year.

These provisions empower the Government to expand its borrowing program under a wide range of conditions.

Table 1: Fiscal deficit as a % of GDP - Revised consolidation roadmap

Medium term plan of	FY17	FY18	FY19	FY20	FY21
2016-17	3.5	3.0	3.0		
2017-18		3.2	3.0	3.0	
2018-19			3.3	3.1	3.0
Actuals	3.5	3.5			

Source: Medium Term Fiscal Policy Statement, various Union Budgets



Expanding spending programs

The Government has proposed an ambitious spending program. As per the details given in the Budget speech of the Finance Minister, it is to be financed by both budgetary and extra-budgetary resources. The total outlays for three focus areas of the Government – namely,

- a. Agriculture and rural livelihoods
- b. Infrastructure and education and
- c. Health and social sectors – amount to 11.6% of GDP (Table 2)

The details are given in Annexures 1, 2 and 3 of the Finance Minister's speech.

Budgetary resources constitute only 19.4 % of the total outlay for agriculture and infrastructure. The balance of 80.6% is to be raised by extra-budgetary resources by the concerned public sector enterprises, special purpose vehicles and other similar institutions. Thus, the extra-budgetary resources are meant to contribute nearly 9.7% of GDP to finance the stipulated outlays.

The strategy is to leverage budgetary resources to induce much larger expenditures by supplementing these by extra-budgetary resources. If successful, this strategy might increase government-induced total demand by a very large margin, which will support growth.



However, there is a risk factor that needs to be taken care of. A substantial part of this additional spending may only be based on borrowing as the relevant bodies may have only limited surpluses. Any dependence on borrowing for these extra-budgetary resources along with the borrowing requirements of the state governments, unless steps are taken to augment the saving rate in the economy, can potentially put considerable pressure on the interest rate.

Table 2: Role of budgetary and extra-budgetary resources

S.no	Sector/Heads	GBS (INR crore)	EBR/IEBR (INR crore)	Total outlay (INR crore)	Total outlay as a % of GDP
1	Agriculture and rural livelihood program	236,127	1,198,190	1,434,317	7.7
2	% of total outlay	16.5	83.5		3.0
3	Capital outlay on infrastructure	157,208	439,935	597,143	3.2
4	% of total outlay	26.3	73.7		
5	Schematic outlays for education, health and social protection sectors	NA	NA	137,981	0.7
Total outlay				2,169,441	11.6

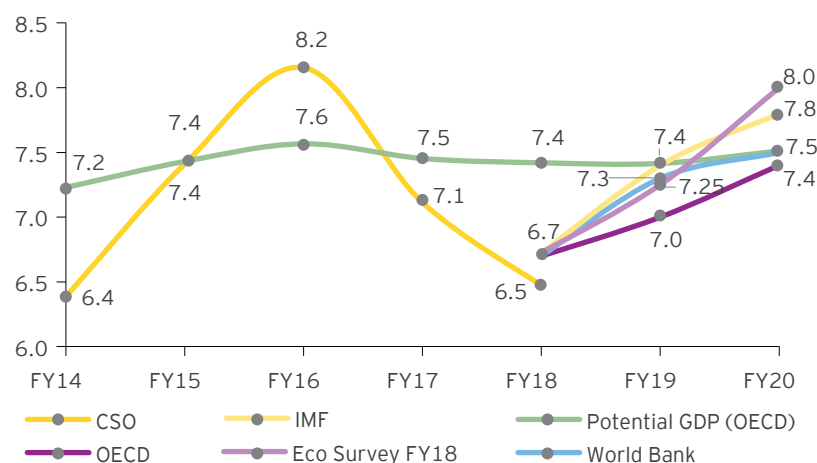
Source: Annexure I, Annexure II, Annexure III, Budget speech of Union Finance Minister 2018-19.

Note: GBS = Gross budgetary support, EBR = Extra budgetary resources, IEBR = Internal and extra budgetary resources

Supporting growth: Prioritizing agriculture, health and infrastructure

While the overall demand would be supported through the expanded expenditures as discussed in the previous section, designated sectoral allocations are aimed to strengthen the overall welfare and growth supporting impact of the budgetary expenditures. India's growth is already witnessing a strong recovery. As indicated in Chart 1, IMF projects a growth rate of 7.4% for India in FY19 and 7.8% in the medium term. This is premised on a strong positive outlook for global growth, which would support India's export demand; this has also been recognized in the Economic Survey of 2017-18. Export growth became strong in 2HFY18. Private investment demand started to improve from 1HFY18. Although private and government consumption expenditures are expected to show a slight deceleration in 2HFY18, these trends are likely to be reversed soon because of the strong demand push being introduced through the Budget.

Chart 1: India's growth – Performance and potential



The selected thrust sectors such as infrastructure, construction, agriculture and health are known to have large multiplier effects, which would support the ongoing recovery. Thus, supported by investment and export demand, which are generated primarily by the private sector and global demand, the Government's

fiscal policy thrust would further strengthen the growth momentum. However, there are two qualifying conditions. First, global oil prices should not rise much beyond the current levels. Second, the global growth recovery as forecasted by the IMF should not weaken in the forthcoming one to two years.



An overview of US tax reform

Joe Kledis

Partner,
International Tax Services, EY

On 22 December 2017, US President Donald Trump signed into law the Tax Cuts and Jobs Act of 2017 (TCJA)¹ which has been described as the most significant US tax law change in a generation.

Overall, the tax changes are a net tax cut for corporations, however, more than a few companies will end up paying more in taxes as a result of the changes. A careful review of each companies' fact patterns will be needed in order to estimate the post-law change after-tax cash flow for many companies.

The new tax law contains a number of substantial changes for companies

doing business in the US, most of which will be effective 01 January 2018 for calendar year taxpayers. The more significant changes can be separated into two different categories: (i) general corporate income tax changes; and (ii) international tax changes, both of which contain provisions to encourage investment in the US.

The more significant general corporate income tax changes include:

- ▶ Reduction of the 35% US corporate income tax rate to 21%;
- ▶ Temporary immediate expensing for qualified depreciable property;
- ▶ Limitations on the ability to deduct related and unrelated party interest expense (30% of EBITDA, changed to EBIT in 2022);
- ▶ Anti-hybrid rules that may disallow a deduction for certain related party interest and royalty payments;

- ▶ Limitation on utilization of net operating losses (NOLs) to offset only 80% of prospective taxable income, but NOLs can be carried forward indefinitely (existing NOLs are grandfathered); and
- ▶ Changes to deductibility of executive compensation for certain public US companies.

Most of these changes are intended to make the US tax system more competitive on a global basis, in particular the rate reduction and immediate expensing opportunity. The changes also had the effect of adopting certain of the OECD's Base Erosion and Profit Shifting (BEPS) proposals, including the increased limitation on interest deductions and anti-hybrid provisions.



Jillian Symes

Director,
International Tax Services, EY

1. Public Law No: 115-97 - An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018.

In addition to the changes above, the US modified its system of international taxation. The following summarizes some of the key changes to the international tax rules:

- ▶ Limited participation exemption regime
- ▶ Imposition of a one-time transition tax on US persons with untaxed offshore earnings, levied at a 15.5% rate for cash/cash equivalents and 8% rate for the balance (payable over eight years)
- ▶ Reduced income tax rates for deemed intangible income earned from exports - 13.125% until 2025 (referred to as Foreign Derived Intangible Income, or FDII)
- ▶ Limitations on the ability to benefit from tax deductions for certain payments made to foreign related parties (referred to as the Base Erosion and Anti-Abuse Tax, or BEAT), and
- ▶ New controlled foreign corporation (CFC) rule that subjects deemed intangible income of a CFC to a residual US tax to the extent the CFC income is not subject to a high enough rate of foreign tax (referred to as Global Intangible Low Taxed Income, or GILTI)

For a company considering the location of a manufacturing facility, services hub or global rights to intangible property, the incentivized tax rate of 13.125% under the FDII regime may be just enough to encourage that investment to be made in the US rather than outside of the US (when taking other considerations into account like infrastructure, education levels, the rule of law, etc.). Similarly, a

multinational corporation may think twice before housing functions, risks or intangible assets used by the US outside of the US if the US company will not benefit from a tax deduction upon making payments to foreign related parties under the BEAT (particularly if the jurisdiction of the foreign related party is going to tax the payment). The new CFC rule should also discourage US multinationals from moving intangible property offshore if the income earned from such IP is going to be subject to a residual US tax under the GILTI regime, thus reducing any tax benefits from moving the IP.

Overall, the tax law changes are good for most companies. The significant corporate income tax rate reduction, the immediate expensing for qualified property purchases, FDII and the limited participation exemption regime could make up for the adverse law changes like the interest expense limits, the BEAT and GILTI. We anticipate that the new laws will encourage investment in the US, in particular in the M&A space, and could encourage US multinationals to invest off-shore when the investments makes sense from a business perspective. Thus, while corporate taxation is still a significant consideration for any return on capital analysis, the good news is that with respect to the US, it should be less of a significant hindrance to investing in the US, or outside of the US for US multinationals.

The views expressed in this column are solely the authors' and do not necessarily reflect those of Ernst & Young LLP.







US tax reforms - Impact on India



Ravi Mahajan

Tax Partner, EY India



The Tax Cuts and Jobs Act (TCJA), signed by President Trump on 22 December 2017, has created excitement in boardrooms not only in the US but globally. As the name suggests, the TCJA is aimed at reducing the tax bill for taxpayers, attract investments and create job opportunities in the US.

The TCJA is one of the most comprehensive overhauls of the federal income tax system in the US in more than three decades and is expected to have a far-reaching impact on US-headquartered groups and non-US corporations doing business in the US.



India Inc. has significant business linkages with the US, and they have increased considerably over the years. During the calendar year 2016, the total bilateral trade between India and the US was estimated at US\$114.8 billion¹. The US tax reforms may also have a significant impact on India-US bilateral investment and trade. The key provisions of the TCJA (and comparative provisions in India) are discussed below:

Reduction in corporate tax rates:

The US Government has significantly reduced the headline corporate tax rate from 35% to 21%. This is expected to make the US an attractive investment destination and we may see an increase in India outbound investments in the US.

India's position: The reduction in tax rates in the US may also encourage the Government of India (GoI) to move toward reducing headline corporate tax rate in the country to 25% for all corporates as had been announced by the Finance Minister in his speech for India's 2015 Union Budget. A reduction in the corporate tax rate will augment India's status as an attractive investment destination and will make it competitive in an increasingly globalized world.

Base Erosion Anti-abuse Tax (BEAT) provisions:

BEAT is primarily an anti-base erosion measure intended to apply to companies that make cross-border payments to affiliates. BEAT provisions seek to disallow for

tax purposes payments (beyond a specified threshold) to non-US related parties. BEAT provisions apply to US corporations with average annual gross receipts of at least US\$500 million for three years ending with the preceding taxable year.

It is interesting to note that BEAT provisions are not applicable to goods imported from affiliates in the US for further manufacturing or trading by US corporations. Indian multinational enterprises (MNEs) that have significant US presence will have to revisit and redraw their operating and supply chain models to mitigate the impact of these amendments on their group effective tax rate.

India's position: India has no such provisions that disallow payments made to non-India related parties as long as the payments meet the arm's length criteria as laid down in the transfer pricing provisions and the business justification requirements as laid down in Section 37(1) of the Income-tax Act, 1961.

Participation exemption:

In furtherance of the US Government's agenda of boosting capital flow in the US to augment investments and consequent employment, the TCJA seeks to move toward a territorial dividend taxation rule. As per these provisions, dividend received by US corporations from non-US corporations will not be subject to taxation in the US where the US corporation holds at least 10% shareholding in the non-US corporation. This move is expected to spur US MNEs to repatriate unutilized funds in other countries back to the US.

This exemption will impact US investments in India. Indian companies

are required to pay dividend distribution tax (DDT) at 20.56%² in India on dividends distributed by them to their shareholders. Under the erstwhile US tax provisions, such DDT paid was generally available as a credit in the hands of the US parent. However, with the US exempting such income from US tax, no credit would be available in the US for DDT paid in India, which would hence become a cost for the group.

India's position: Dividends received by an Indian company from a foreign company in which the Indian company holds 26% or more are taxed in India at the beneficial rate of 15%³ and taxes withheld (if any) in the overseas jurisdiction are allowed as foreign tax credit in India, subject to foreign tax credit rules. On further distribution of such dividend by Indian companies, DDT is not payable.

Transition tax:

In lieu of the participation exemption, US corporations will need to pay a one-time transition tax on pro-rata post-1986 accumulated profits of their non-US investee companies. The applicable tax rate is 15.5% on cash/cash equivalents and 8% on other accumulated profits, which needs to be paid within eight years. Effectively, this tax deems that the entire profits of non-US corporations are repatriated to the US and subject to US tax.

This may have a double tax impact on US corporations that have invested in Indian companies. While the US parent will pay transition tax in the US on accumulated profits of Indian companies (by deeming such accumulated profits to be distributed), Indian companies will be required to pay DDT in India at 20.56% on actual dividend distribution.



Concluding thoughts

With the US taking the lead in bringing sweeping changes to its tax policies in order to attract more investments and give impetus to job creation, India needs to evaluate its tax policies vis-à-vis major world economies to ensure that it continues to provide an attractive investment framework for corporates to make further capital investments in India.

India's position: Though India does not have Controlled Foreign Company (CFC) taxation rules, profits of non-Indian entities that have their place of effective management (POEM) in India are taxable in India.

Interest limitation:

Similar to the recommendations arising from the base erosion and profit shifting (BEPS) project of the OECD, interest limitation rules have also been introduced by the TCJA prescribing the maximum interest deduction that may be claimed by US corporations. The interest limitation rule is applicable in cases where the average gross receipts for three previous tax years is more than US\$25 million. The interest expense deduction is limited to 30% of EBITDA (until 2022) and thereafter 30% of EBIT.

Indian MNEs with US subsidiaries may need to revisit the funding/capital structure of the US subsidiaries to insulate themselves from the impact of these provisions.

India's position: India also has similar interest limitation rules with the difference that the carry forward of excess interest is available only for eight years as against the indefinite period provided under the TCJA in the US.

Accelerated depreciation:

The TCJA allows 100% upfront accelerated depreciation on investment in qualified assets by US corporations till 1 January 2023. After that, till 2026, the accelerated depreciation

is reduced by 20% each year. This will induce US corporations to make additional investments in long-term assets in the US.

India's position: India had earlier introduced similar accelerated depreciation rules for specified assets. These benefits were subsequently withdrawn, and now the maximum applicable depreciation rate is 40%.



1. Source <https://ustr.gov/countries-regions/south-central-asia/india>.
2. Till 31 March 2018, the DDT rate is 20.36%. Additional surcharge and cess as applicable.
3. Additional surcharge and cess as applicable.

Thoughts



“Digitization and greater transparency is the under tone of this Budget, with FM introducing the new scheme for e-assessments across the country”

Garima Pande

National Leader, Business Tax Services,
EY India

“The custom duty proposals announced in this Budget clearly underlines the Make in India and localisation thrust”

Harishanker Subramaniam

National Leader, Indirect Tax, EY India

“Prudent and optically well packaged Budget”

Sonu Iyer

Tax Partner & People Advisory Services
Leader, EY India

“This appears to be an economy booster Budget and certainly not wanting in ambition on the expenditure side”

Sudhir Kapadia

National Tax Leader, EY India



Will the speed of digital tax revolution leave you behind?

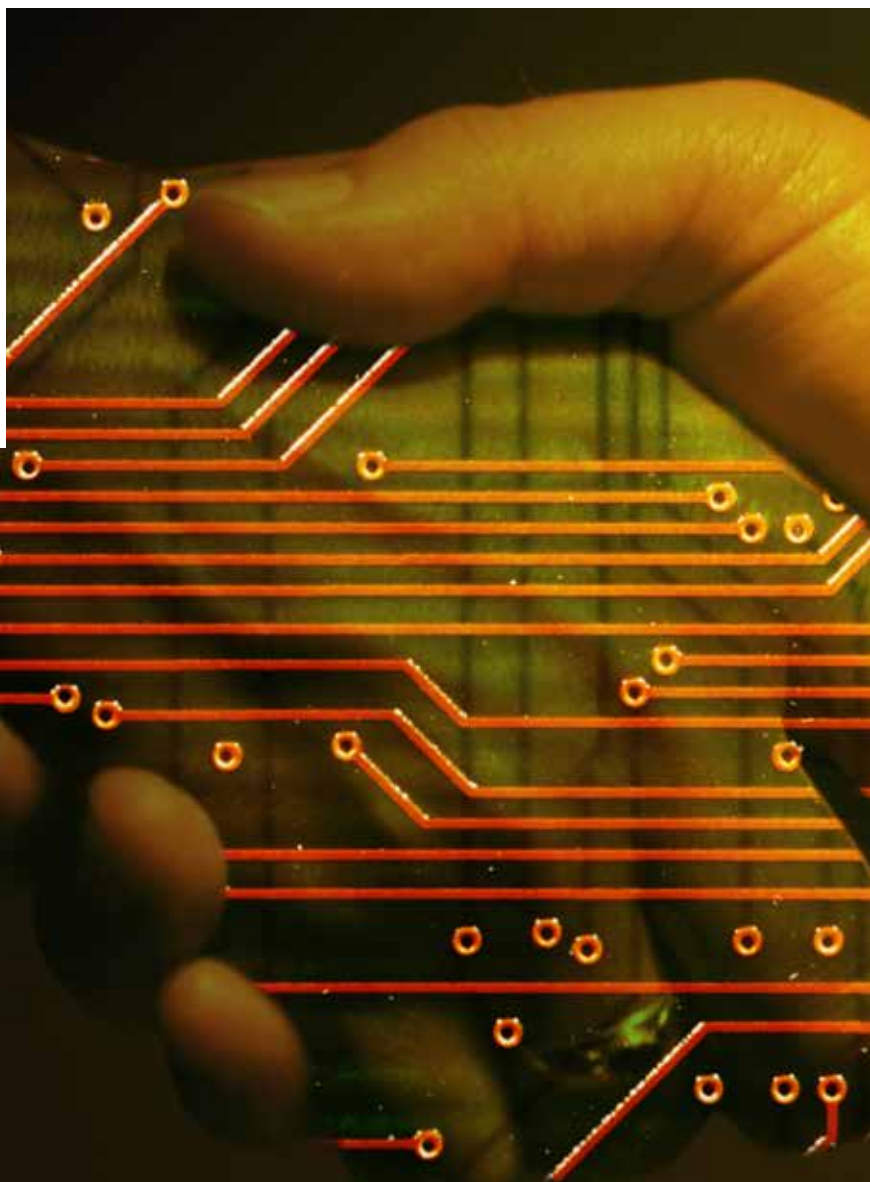
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Budget 2018 - Impact on M&As



Ajay Agashe

Associate Partner,
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Budget 2018-19 had a focus on the rural, agriculture, healthcare and education sectors along with the development of MSMEs. There was a lot of debate initially on the feasibility of some of the proposals until the point the Government, during media interactions, explained the rationale and mechanics of implementation of some of the relevant schemes. Likewise, some of the tax proposals, from an M&A perspective, have led to concerns about implementation and the expectation from the Government is to bring about clarifications to remove ambiguities/unintended consequences.

One such proposal relates to an amendment in the definition of the term “accumulated profits” The Memorandum explaining the provisions of the Finance Bill, 2018 clarifies that the intent of such an amendment is to prevent abusive arrangements, whereby companies with large accumulated profits adopt the amalgamation route to circumvent Dividend Distribution Tax (DDT) levy. The widening of the scope covers within its gamut even third-party mergers, which, at least as per the stated intent, does not seem to be the objective. If the stated intent is to be achieved, the existing General Anti Avoidance Rules can very well be invoked by tax authorities where there is any arrangement only to avoid taxes. The Government should reconsider whether the proposed insertion of Explanation in Section 2(22) is warranted.

Assuming the Explanation has to be retained with appropriate exemptions for genuine amalgamations, this amendment should be effective prospectively. Currently, the amendment is effective from assessment year 2018-19 and

hence applicable for transactions done after 1 April 2017. This results in creating a liability that was otherwise not there prior to the amendment. If the amendment is made prospective, it will also go along with the Government’s stated objective expressed in 2014 of not bringing any retrospective change that would create a fresh liability. This can be done by clarifying that the proposed change would be applicable for amalgamations undertaken and/or distributions made to the shareholders after 1 April 2018.

Another amendment relates to covering transactions involving the grant of loan by a corporate entity to its substantial shareholders within the gamut of deemed dividend and making it subject to DDT.

The tax rate proposed to be applied is 30%, which effectively increases the tax cost of the loan given to a substantial shareholder (other than a domestic company), as compared to normal dividend.

Prior to the Finance Bill 2018 being presented by the Finance Minister, there were discussions around a change in the long-term capital gains (LTCG) taxation regime. The expected amendments included a period of holding for listed shares to become long term to be increased from 12 months to 24 months and the reintroduction of LTCG. Various news/research reports indicated that the Government was losing nearly INR50,000 crore every year due to on market LTCG being exempt.

As expected, the LTCG tax exemption is proposed to be withdrawn by the introduction of section 112A. With effect from 1 April 2018, "on market" transfer of equity shares would be subjected to, first, securities transaction tax (STT) and, second, capital gains tax at 10%. When STT was introduced in Budget 2004-05, capital gains tax on shares transferred "on market" was reduced to 15% in the case of short-term gains and nil in the case of long-term gains. So, while STT continues to apply, there would be additional taxation on LTCG in the case of listed shares.

While proposing to tax LTCG, the Government duly considered its intent of not providing retrospective taxation, by specifying that the taxpayer shall be subjected to tax only on the value upside after the date of introduction of the proposed amendment. It provides that the tax liability will apply only where the consideration received on actual sale after 1 April 2018 is more than the value as on 31 January 2018. However, while applying the concessional tax rate of 10%, the benefit of indexation is denied to the taxpayer.

Effectively, after 1 April 2018, LTCG tax on listed shares transferred both "on market" and "off market" will be subjected to 10% taxation, without applying the benefit of indexation, except that "on market" transfers get the benefit of cost step-up to the extent of the value as on 31 January 2018 and will be subjected to STT (unlike "off market" transfers). Going forward, apart from the commercial considerations, the tax cost on account of the proposed amendment will be determinative whether or not to structure the transaction as "on market" vs. "off market."

The proposed amendment also requires STT to be paid both at the time of purchase and the sale of the shares so as to be subjected to the 10% tax rate in an "on market" deal. A question arises whether certain modes of acquisitions where STT was not paid at the time of purchase of the shares will be subjected to tax in the new regime. For example, in the offer for sale in IPOs, payment of STT is not feasible on the original purchase. Likewise, in cases involving gifts, bonus, preferential allotments or allotment of shares on merger/demerger, the acquisition does not involve the payment of STT.

A similar ambiguity was created when in the last year's Budget there was an amendment in section 10(38) of the Income-tax Act (stating that LTCG on the sale of listed shares will be exempt only if STT has been paid at the time of purchase of those shares as well).

However, the Government clarified the matter by issuing appropriate Notification no.43/2017 and provided LTCG tax exemption u/s 10(38) even if STT is not paid at the time of purchase of those shares, except the negative list specified.

In line with the above Circular and recognizing that similar issues may arise in relation to the new proposal taxing LTCG, among others, on the transfer of listed shares, immediately after the Budget, the Government clarified, vide FAQs, that Notification

no. 43/2017 will be reiterated appropriately for the proposed amendment. In fact, to avoid any interpretation issues, it would be better if the Government amended the law itself rather than issuing clarification/notification.

As per the proposed amendment, the cost of acquisition for shares acquired before 1 February 2018 will be higher of A) actual cost of acquisition or B) lower of (i) fair market value of the asset and (ii) full value of consideration received on transfer.

"Fair market value" is defined as the highest price of the capital asset quoted on any recognized stock exchange on 31 January 2018. The need for clarification also revolves around the mechanism for computing cost step-up in relation to unlisted shares. In cases involving an offer for sale in IPOs, assuming the transaction would qualify for the concessional tax rate of 10% without indexation (if a notification similar to Notification no. 43/2017 is issued), due to the non-existence of a method of computing fair market value for the unlisted share, a practical challenge of computing capital gains tax may arise. A specific mechanism for computing fair market value in such situation needs to be prescribed.

In addition, the Government should also clarify that the cost step-up provided in the law shall also be applicable in cases of subsequent corporate actions that are tax neutral under the existing tax provisions, e.g., gifts, merger/ demerger and inheritance.

Considering that section 48 of the Income-tax Act is the section for computation mechanism for capital gains tax, it should be clarified that the cost of acquisition for the purpose of section 48 shall be as specified in the proposed amendment (in section 112A) so as to avoid any ambiguity.

Hopefully, when the Bill is enacted, appropriate explanations/clarifications are included or the law is amended appropriately to avoid litigation.



Tax implications from the prism of the Insolvency Bankruptcy Code



Maulik Shah

Tax Director,
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The unprecedented era of stressed assets and IBC¹

Stressed assets in the Indian banking system have peaked at over INR10 lakh crore (~15% of gross advances). This makes the Insolvency and Bankruptcy Code, 2016 (IBC) one of the most important legislative reforms that the incumbent Government has undertaken, as it intends to resolve the problem of non-performing assets and channelize capital to make installed capacity productive.

Since the Code became effective in December 2016, an entire ecosystem has evolved to resolve the problem of corporate distress, with over 525 ongoing insolvency proceedings. It envisages an integration of different legislative measures into one holistic legislation for companies under IBC. For instance, SEBI had amended the Takeover Code to provide an exemption from the open offer requirement on conversion of debt into equity by lenders/subsequent acquisition of such shares by investors pursuant to an approved resolution plan.

From an income-tax perspective, the revival process entailed a considerable amount of waivers by lenders and operational creditors, leading to tax liability under both normal as well as Minimum Alternate Tax (MAT) provisions. Toward this, representations on various tax issues were made by several stakeholders to the Ministry of Finance (MoF) to suitably amend the Income-tax Act, 1961 (Act).



Amendments brought in by the 2018 Budget

The 2018 Budget has proposed two critical changes from an IBC perspective.

1 Applicability of MAT provisions on total book losses

As per extant provisions, to compute book profit under MAT provisions, a deduction is allowed in respect of the **lower** of loss brought forward or unabsorbed depreciation, as per the books of account. This has had an adverse impact on companies that have a significant amount of accumulated book loss but not necessarily an equal amount of loss available for set-off in view of the extant provisions allowing the deduction of the lower of book loss and unabsorbed depreciation.

Vide a press release dated 6 January 2018, for companies against whom an application for corporate insolvency resolution process has been admitted by the adjudicating authority (IBC companies), the MoF relaxed the above provisions to allow the **total** of loss brought forward and unabsorbed depreciation to be reduced from the book profit. This relaxation has now been formally proposed in the 2018 Budget as an amendment.



1. Source for the facts and figures in this para - Chapter 3 of Economic Survey 2017-18

However, it is interesting to note that the proposed clause uses the words, **“aggregate amount of unabsorbed depreciation and loss brought forward”** and not **“aggregate amount of unabsorbed depreciation and loss brought forward as per books of accounts.”** This nonetheless appears like an obvious oversight considering the overall scheme of things.

2 Carry forward of unabsorbed business losses (UBL)

As per extant provisions, the benefit of carry forward of UBL is lost in a scenario where the shareholding of a closely held company changes by more than 49% in a tax financial year.

In the 2018 Budget, with effect from FY2017-18, it has been proposed to relax the applicability of these provisions for IBC companies. However, the proposed amendment also provides a rider that the approval of the resolution plan should be given after affording a reasonable opportunity of being heard to the jurisdictional Principal Commissioner or Commissioner.

While it seems from this amendment that the Income Tax Department may have some sort of standing to present its view before the NCLT, it, however, does not seem to give them the ability to object or veto the resolution plan. The rationale of this pre-condition and its resultant impact is not entirely clear at this stage.

3 Procedural amendments

Further, certain procedural amendments have been proposed in the 2018 Budget to provide for the tax return to be verified by an insolvency professional (IP) during the resolution process.

In a scenario where the resolution process is completed by March, whereby the management of the IBC companies is taken over from the IP but the return of income for such year is filed in the subsequent financial year, a question arises if the IP is still required to verify the return of income for such financial year. Further, the intended objective to be achieved by such verification is still unclear.





The Government strives to strikes a balance

In the 2018 Budget, the approach of the Government appears to be to facilitate relaxations in existing restrictive provisions crucial to IBC companies. However, it has refrained from making any additional accommodations, which may be necessary considering the complex environment in which IBC companies operate. Certain key representations that were sought to be included in the 2018 Budget are as follows:

Complete relief from applicability of MAT provisions: A similar relief was earlier provided under the Act to companies falling under the erstwhile Sick Industrial Companies Act. As a consequence, any loan waivers, especially of a capital nature (which are critical to the resolution process), would not have been taxable under MAT provisions

Exemption from the applicability of deemed income provisions in the hands of the acquirer on the acquisition of the stake from defaulting promoters of IBC companies at below income-tax determined values (IT-FMV) as the real fair value may be significantly below the IT-FMV

Discharge of withholding tax liability only upon actual payment to the creditor, as withholding on accrual could be a burden for the already cash-strapped IBC companies

Exemption from the process of obtaining a no-objection certificate, as it merely acts as a deterrent in the already arduous process of reviving stressed assets

Deemed compliance of merger/demerger related conditions: If the revival plan entails a merger/demerger, it may not be possible to comply with all the prescribed conditions for a variety of reasons (such as no feasibility of achieving the required level of minimum production or the acquirer not agreeable to taking over all related assets and liabilities), which may lead to a conflict. The conditions of the revival plan should be considered as more imperative and therefore its implementation as per the agreed formula should be considered compliant with all merger/demerger related conditions

Relaxation in respect of delayed compliances: During the resolution process, the insolvency resolution process professional may not get the requisite assistance to undertake timely procedural compliance due to various reasons (such as non-cooperation from suspended management or resignation of employees). It is therefore recommended that relaxation be provided in respect of delayed compliances that may take place during the resolution process, provided such compliances are done by the IBC company subsequently

Nonetheless, the proposed amendments are certainly a welcome move and eminently reinforce the IBC objective as well as provide the desired clarity given that many bids are expected to be submitted in the near future.

(Dharini Minawala, Senior Tax Professional, EY also contributed to the article)

A stylized world map is rendered in the background using a hatched or scribbled texture. The map is centered on the Atlantic Ocean, showing the continents of North America, South America, Europe, and Africa. The overall color scheme is dark grey with yellow and white text.

Global News

01

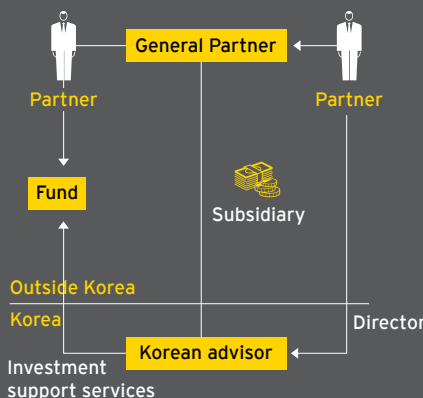
Korean Supreme Court rules on permanent establishment (PE) of foreign private equity fund¹

A non-Korean private equity fund (the Fund) had appointed a Korean advisor to obtain advice in relation to its Korean investments. The Korean advisor was a subsidiary of the general partner (GP) of the Fund. One of the directors of the Korean subsidiary was a limited partner of the GP.

The Korean advisor and its director provided investment support services to the Fund with respect to the Fund's investments in Korean companies. The Korean tax authorities argued that the Fund had a PE in Korea as the directors of the Korean advisor performed essential activities of the Fund. The authorities also argued that the directors should be treated as dependent agents who continuously and repeatedly exercised authority to conclude contracts on behalf of the Fund, giving rise to a dependent agency PE.

The Supreme Court of Korea concluded that the Fund did not have a PE in Korea for the following reasons:

- ▶ Decisions on raising funds from investors investing in Korean companies was made outside Korea by the GP of the Fund.
- ▶ Activities of the directors were performed as the directors of the Korean advisor, which was a separate legal entity.



- ▶ The activities of the directors qualified as preparatory activities as they assisted the GP in making investment decisions as well as auxiliary activities that assisted in deciding when to dispose of the assets acquired.
- ▶ Although the directors participated in the negotiation and signing of the agreements, it was in the capacity as the directors of the Korean advisor and there was no evidence that the directors exercised a continuous and repeated authority to conclude on behalf of the fund.
- ▶ This decision highlights that investment-support activities can be treated as a preparatory and auxiliary part of investment as long as the investment decisions and contracts are concluded from outside Korea.

1. Refer EY Global Tax Alert titled "Korean Supreme Court rules on Permanent Establishment of foreign private equity fund" dated 8 December 2017.

02

Italy enacts Web Tax and new PE definition²

The Italian 2018 Budget Law has introduced a new tax “tax on digital transactions” (Web Tax) and a new definition of PE in domestic laws that is partially in line with the definition provided by Organization for Economic Co-operation and Development (OECD) BEPS Action 7.

Web Tax

Web Tax is levied on services carried out through electronic means both by resident and non-resident entities rendering services to Italian entities or to PEs of non-residents in Italy.

“Services carried out through electronic means” for this purpose means services supplied through

the Internet or on an electronic network through automation with minimum human intervention and for which information technology is an essential component.

Web Tax at the rate of 3% is levied once the number of digital transactions crosses a threshold of 3,000 transactions. Further, the tax is to be settled by the receiver of services and it is not creditable against Italian income tax. Web Tax will be applicable starting from 1 January 2019.

The amended domestic definition of PE

The law replaces the domestic law definition of PE to include “a significant and continuous economic presence in the territory

of the State set up in a way that it does not result in a substantial physical presence in the same territory may constitute a PE.”

The amendment would imply the existence of a PE even in case where a company does not have a physical presence in the Italian territory to the extent other factors indicate a significant presence (for instance, revenue and number of customers).

2. Refer EY alert titled “Italy enacts Web Tax and new PE definition” dated 29 December 2017

03

Progress on the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent BEPS – Additional jurisdictions sign, ratification takes off³

The Multilateral Instrument (MLI) was developed and agreed on in November 2016 by approximately 100 jurisdictions, including the OECD member countries, G20 countries and other developed and developing countries. On 7 June 2017, 68 jurisdiction signed the MLI, followed by a few more in due course.

On 24 January 2018, six additional jurisdictions⁴ signed the Multilateral Convention to Implement Tax Treaty Related

Measures to Prevent BEPS. Four other jurisdictions⁵ expressed their intent to sign the MLI in the near future. The six new signatories of the MLI have opted to apply only a few of the non-minimum standard provisions, while all six opted to apply the Principal Purpose Test (PPT) (Article 7) and the new preamble language (Article 6).

As a result of 78 jurisdictions signing the MLI so far, 1,200 treaties will stand modified. It is a milestone in the implementation

of BEPS recommendations. The MLI will enter into force once five jurisdictions deposit instrument of ratification. So far, four jurisdictions⁶ have ratified the convention. The measures will enter into force for a specific bilateral tax treaty only on depositing the ratification of convention by both the parties of the treaty and after a specified time has passed⁷.

3. Refer EY Global Tax Alert titled "Six additional jurisdictions sign Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS" dated 26 January 2018.
4. Barbados, Côte d'Ivoire, Jamaica, Malaysia, Panama and Tunisia.
5. Algeria, Kazakhstan, Oman and Swaziland.
6. Austria, the Isle of Man, Jersey and Poland.
7. Refer EY Global Tax Alert titled "68 Jurisdiction sign the Multilateral Convention to implement Tax Treaty Related measures to Prevent BEPS" dated 7 June 2017

04

China announces and issues implementation rules on withholding taxes and deferral

On 21 December 2017, China's Ministry of Finance, State Administration of Taxation (SAT), National Development and Reform Commission and Ministry of Commerce (MOFCOM) jointly issued Circular 88 to introduce the withholding tax (WHT) deferral rules on a foreign investor's reinvestment of Chinese profit⁸.

A foreign investor will be eligible for WHT deferral treatment on dividends received from Chinese subsidiaries if they directly reinvest such dividends in China, provided the following four conditions are satisfied:

- ▶ The reinvestment should be in any of the following equity investments:
 - ▶ Increase of capital in existing Chinese subsidiary
 - ▶ Formation of a new Chinese subsidiary
 - ▶ Acquisition of equity interests in a Chinese company from a third party

- ▶ Any other form permitted by the MOF and/or SAT
- ▶ The profits reinvested should be equity investment income, i.e., declared dividends or realization of retained earnings.
- ▶ Reinvested profits should be directly paid/transferred to the Chinese subsidiary or to the third party that is disposing of its equity interest in the Chinese subsidiary.
- ▶ Reinvestment is to be made in designated encouraged industries.

The Chinese subsidiary will be required to submit the required documents to the tax authority on behalf of the foreign investor qualifying for WHT deferral treatment. On such submission, the Chinese subsidiary can suspend withholding or payment of the corresponding WHT. The tax authority retains the power to assess the eligibility, and in case of non-satisfaction of the conditions both the foreign investor and the

Chinese subsidiary will be liable to interest and penalty.

In case of future disposal of investment by a foreign investor for any reason, it shall be subject to a claw-back rule to repay the WHT within seven days of receipt of consideration. However, the claw-back will not apply in case the disposition of Chinese investment qualifies for tax deferral treatment. Circular 88 is retroactively effective as of 1 January 2017.

In addition, on 2 January 2018, SAT released a public notice (PN) to clarify the implementation rules of WHT deferral treatment on reinvestment in China⁹. The implementation rules provide for various aspects including eligible operational activities, assessment by Chinese subsidiaries on information provided by a foreign investor to apply deferral treatment, consequences of improper/ incorrect information, partial withdrawal of deferral and triggering of claw-back provisions.

8. Refer EY Global Alert titled "China announces withholding tax deferral treatment on direct reinvestment" dated 12 January 2018.

9. Refer EY Global Tax Alert titled "China issues implementation rules on withholding tax deferral treatment on direct reinvestment" dated 5 February 2018.



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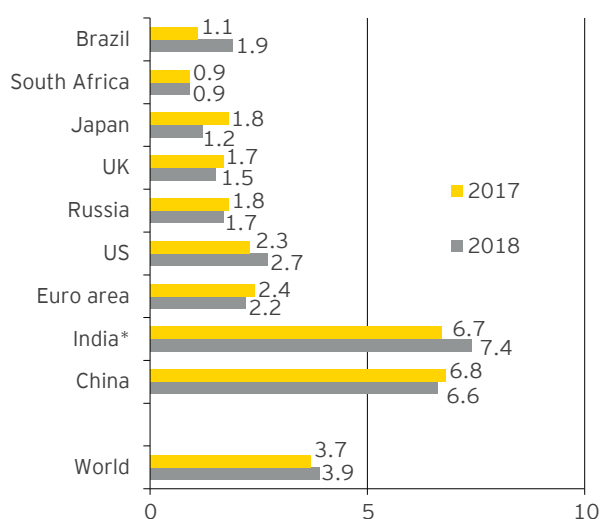
EconoMeter

macro-fiscal trends

1 India's growth prospects for FY19 improve due to expected higher growth in investment and exports

- ▶ The World Bank has assessed India's growth in FY19 at 7.3%, while the IMF has estimated it to rise to 7.4% from 6.7% in FY17. The IMF sees the medium-term growth prospect for India at 7.8%.
- ▶ The RBI, in its sixth bi-monthly monetary policy review dated 07 February 2018, has estimated India's GVA growth at 6.6% in FY17 and 7.2% in FY18, while the Economic Survey 2017-18 has estimated it at 6.75% and 7.25% respectively.
- ▶ Growth in India is likely to be supported by a benign global growth environment as per Economic Survey 2017-18.
- ▶ As per the IMF, global growth is estimated to strengthen from 3.2% in 2016 to 3.7% in 2017.

Chart 1: Real GDP growth projections (% annual)



Source: IMF World Economic Outlook Update, January 2018.
*Forecast pertains to fiscal year FY18 and FY19 accordingly.

2 The First Advance Estimates of National Income from the CSO indicate a strong recovery in GDP growth in 2HFY18

- ▶ As per First Advanced Estimates, real GDP is expected to grow by 6.5% in FY18 as compared to a growth of 7.1% in FY17.
- ▶ Although the overall growth for FY18 is likely to be lower than that in FY17, the implied growth during 2HFY18 is higher at 7.0% as compared to 6.0% in 1HFY18, clearly pointing to a recovery in growth.
- ▶ On the demand side, recovery in gross fixed capital formation and exports is likely to support growth in 2HFY18. Investment is expected to pick up from 3.1% in 1HFY18 to 5.9% in 2HFY18 and growth in exports is likely to accelerate to 7.6% in 2HFY18 as compared to 1.2% in 1HFY18.

Table 1: Real GDP growth (%)

AD component	1H - FY15	2H - FY15	1H - FY16	2H - FY16	1H - FY17	2H - FY17	1H - FY18	2H - FY18
PFCE	9.6	4.6	3.0	8.9	8.2	9.2	6.6	6.1
GCE	9.2	11.8	2.2	3.8	16.5	26.0	10.2	6.6
GFCF	2.6	3.4	4.8	5.4	5.2	-0.3	3.1	5.9
EXP	6.2	-2.3	-5.2	-5.2	1.8	7.2	1.2	7.6
IMP	2.1	-0.3	-4.7	-6.9	-2.2	7.0	10.4	9.7
GDP	7.6	6.4	8.0	8.2	7.7	6.5	6.0	7.0

Source: CSO, MOSPI, Government of India.

AD: Aggregate demand; PFCE: Private final consumption expenditure; GCE: Government final consumption expenditure; GFCF: Gross fixed capital formation; EXP: Exports; IMP: Imports; GDPMP: GDP at market prices.

3 **The estimates for FY18 point to a broad-based recovery in the growth for the majority of the sectors during 2HFY18.**

- ▶ Overall GVA growth is seen to be improving in 2HFY18 as compared to 1HFY18.
- ▶ Growth in the output of the manufacturing sector is likely to recover to 5.1% in 2HFY18 as compared to a recent low of 4.0% in 1HFY18, while growth in construction is estimated to improve to 4.9% in 2HFY18 from 2.3% in 1HFY18.
- ▶ GVA growth in 2HFY18 is to be supported by strengthening of growth in financial, real estate and professional services to 8.9% as well as that in public administration and defense services to 11.0% during 2HFY18.
- ▶ A cause for concern relates to continued slow growth in agriculture and allied activities, which is estimated at 2.2% in 2HFY18, as this may eventually lead to subdued rural demand.

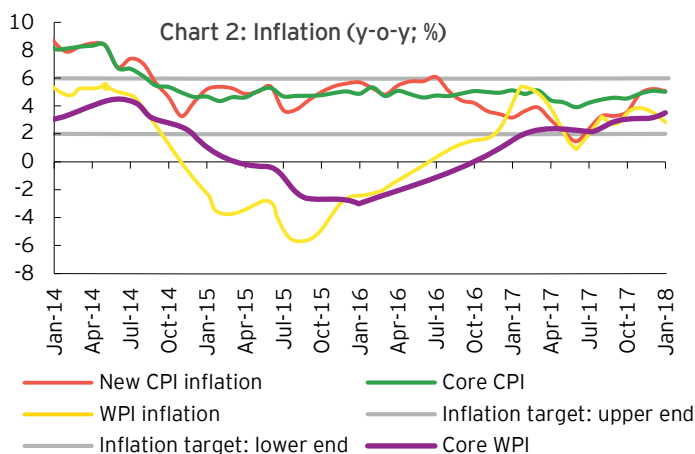
Table 2: Sectorial real GVA growth (%)

Sector	1H - FY15	2H - FY15	1H - FY16	2H - FY16	1H - FY17	2H - FY17	1H - FY18	2H-FY18
Agr.	4.2	-0.9	2.4	-0.5	3.2	6.1	2.0	2.2
Ming.	11.4	8.5	9.9	11.0	-1.1	4.3	2.0	3.6
Mfg.	8.9	5.1	8.7	12.9	9.2	6.6	4.0	5.1
Elec.	8.4	4.4	4.2	5.8	7.6	6.8	7.3	7.7
Cons.	3.2	1.7	3.9	6.0	3.7	-0.2	2.3	4.9
Trans.	7.7	8.0	9.3	11.5	8.3	7.3	10.5	7.0
Fin.	12.4	12.8	11.6	9.7	8.1	2.7	6.1	8.9
Publ.	4.6	10.9	6.7	7.1	9.1	13.5	7.6	11.0
GVA	7.8	6.3	7.9	8.0	7.2	6.1	5.8	6.4

Source (Basic Data): MOSPI., GVA: Gross value added.

4 **The Reserve Bank of India (RBI) retained the repo rate at 6% in its February monetary policy review as inflation expectations remained elevated.**

- ▶ CPI inflation remained high at 5.1% in January 2018 although slightly lower than the 17-month high of 5.2% it had reached in December 2017. Core inflation too remained high at 5.0%.
- ▶ RBI raised its CPI inflation forecast to be in the range of 5.1%-5.6% in 1HFY19 and 4.3%-4.7% in 2HFY19. Such outlook on CPI inflation implies reduced prospects of any repo rate reduction in the near future. Instead, the possibility of a rate hike may emerge.

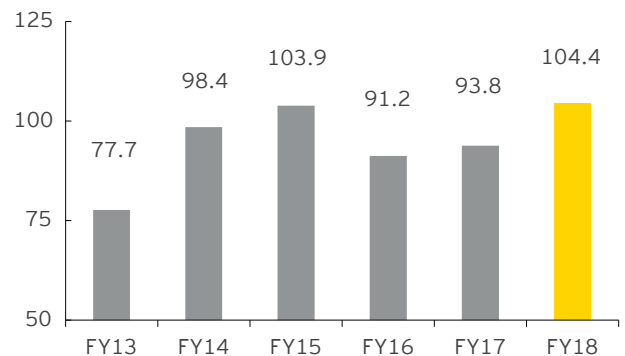


Source: MOSPI. CPI: Consumer Price Index.

5 *The Center's fiscal deficit reached 104.4% of the annual revised target up to December 2017.*

- ▶ The Center's fiscal deficit during April–December stood at 104.4% of the FY18 annual revised target.
- ▶ This is the highest share of fiscal deficit incurred in the first nine months of a fiscal year since FY01.
- ▶ The Center has revised the fiscal deficit target to 3.5% of GDP from the budgeted 3.2% of GDP.

Chart 3: Fiscal deficit during April–December FY18 as a % of annual budgeted target

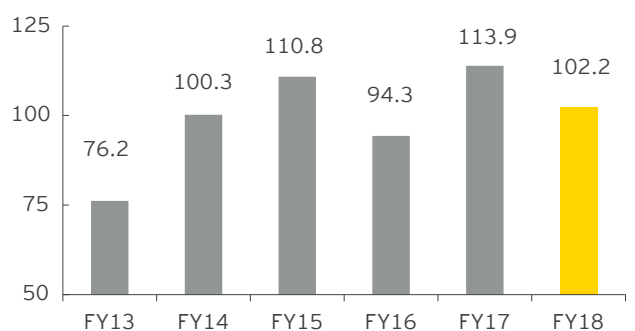


Source: Monthly Accounts, Controller General of Accounts, Government of India.

6 *The Center's revenue deficit stood at 102.2% of the annual revised target up to December 2017.*

- ▶ The Center's revenue deficit during April–December FY18 stood at 102.2% of the annual revised target.
- ▶ Budget 2018-19 has amended the Fiscal Responsibility and Budget Management Act (FRBMA) through the Finance Bill such that the revenue deficit target has been given up altogether.

Chart 4: Revenue deficit during April–December FY18 as a % of annual budgeted target

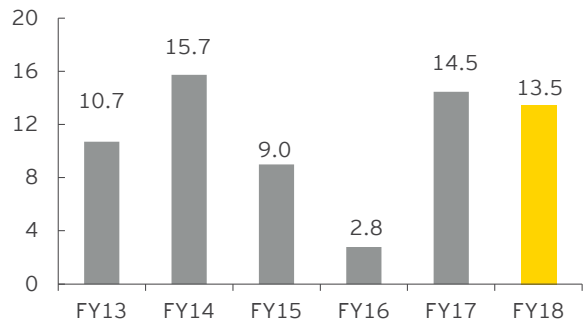


Source: Monthly Accounts, Controller General of Accounts, Government of India.

7 Growth in the Center's revenue expenditure declined to 13.5% up to December 2017.

- ▶ The total expenditures of the Central Government grew by 15.6% during April–December FY18 compared to 11.9% in FY17.
- ▶ Growth in revenue expenditure increased by 13.5% during April–December FY18 compared to 14.5% in the corresponding period of the previous fiscal year.

Chart 5: Growth in revenue expenditure during April–December FY18 (% , y-o-y)

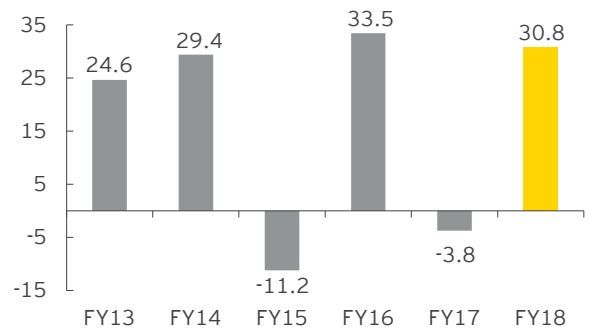


Source: Monthly Accounts, Controller General of Accounts, Government of India.

8 Growth in the Center's capital expenditure was high at 30.8% during the first nine months of FY18.

- ▶ Growth in the Center's capital expenditure was at 30.8% during April–December FY18 as compared to a contraction of (-) 3.8% in the corresponding period of FY17 (Chart 6).
- ▶ Capital expenditure up to December 2017 stood at 86.5% of the FY18 revised estimate as compared to the three-year average of 72.5% achieved up to December as a percentage of the annual actuals.

Chart 6: Growth in capital expenditure during April–December FY18 (% , y-o-y)



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

9 **Union Budget FY19: The Government relaxed the fiscal deficit target for FY18 to 3.5% from the budgeted 3.2% of GDP. The FRBMA is being amended.**

- ▶ The revised fiscal deficit estimate for FY18 in comparison to the corresponding budget estimate is higher by INR48,317 crore.
- ▶ This is on account of additional revenue expenditure that could not be offset by a reduction in capital expenditure or improved performance of net tax revenues and disinvestment receipts.
- ▶ Additional expenditure financed by budgetary and extra-budgetary resources would push aggregate demand up.
- ▶ As per the amendment in the FRBMA, the general and Central Government debt-GDP ratios are to be reduced to 60% and 40% of GDP respectively by 2024-25.

Table 3: Fiscal deficit arithmetic

Amounts in INR lakh crore; % to GDP

INR crore; % to GDP

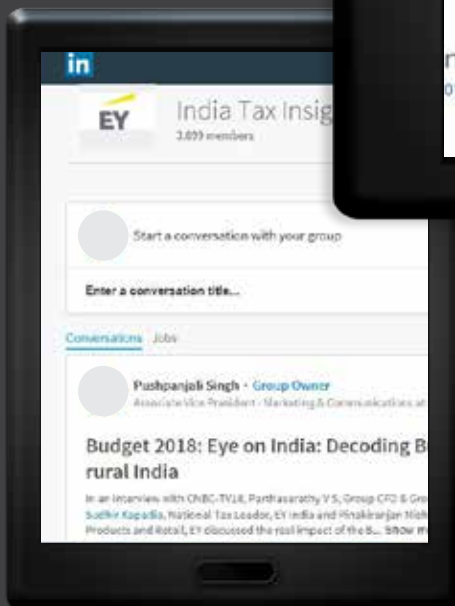
Head/Year	FY17 (Act.)	FY18 (BE)	FY18 (RE)	FY19 (BE)	Deviation FY18 (RE - BE)
Revenue expenditure	16.91	18.37	19.44	21.42	107,371
% to GDP	11.08	10.90	11.58	11.44	0.64
Capital expenditure	2.85	3.10	2.73	3.00	-36,356
% to GDP	1.87	1.84	1.63	1.60	-0.22
Net tax revenues	11.01	12.27	12.69	14.81	42,440
% to GDP	7.22	7.28	7.56	7.91	0.25
Non-tax revenues	2.73	2.89	2.36	2.45	-52,783
% to GDP	1.79	1.71	1.41	1.31	-0.31
Fiscal deficit	5.36	5.47	5.95	6.24	48,317
% to GDP	3.51	3.24	3.54	3.33	0.29
Non debt capital receipts of which:	0.65	0.84	1.17	0.92	33,040
Disinvestment	0.48	0.73	1.00	0.80	27,500
Memo					
Revenue deficit	3.16	3.21	4.39	4.16	117,714
% to GDP	2.07	1.91	2.61	2.22	0.70
GDP (nominal)	152.54	168.47	167.85	187.22	16,784,679

Source: Union Budget documents, MOSPI.

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