India Tax Insights

Issue 15

April 2019

In this issue

EY

Building a better working world

Ernst & Young LLP

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

Ernst & Young LLP is one of the Indian client serving member firms of EYGM Limited. For more information about our organization, please visit www.ey.com/in.

Ernst & Young LLP is a Limited Liability Partnership, registered under the Limited Liability Partnership Act, 2008 in India, having its registered office at 22 Camac Street, 3rd Floor, Block C, Kolkata - 700016

EYIN1904-016
ED None

PJ

ey.com/in

@EY_India EY|LinkedIn EY India

EY India careers ey_indiacareers

Team

Publisher
Ernst & Young LLP
Golf View Corporate Tower B
Near DLF Golf Course, Sector 42
Gurgaon - 122002

Editorial Board
Geeta Jani
Jayesh Sanghvi
Rajendra Nayak
Sameer Gupta
Shalini Mathur

Program Managers
Jerin Verghese
Pushpanjali Singh

Creatives
Priyanka Jamoli

Program Support
Pranjal Bhatnagar
Vaibhavi Katiyar

Foreword

Sudhir Kapadia

Sudhir Kapadia

Partner and National Tax Leader,
EY India

We are pleased to present the 15th edition of our magazine India Tax Insights, covering a wide range of recent tax and regulatory developments.

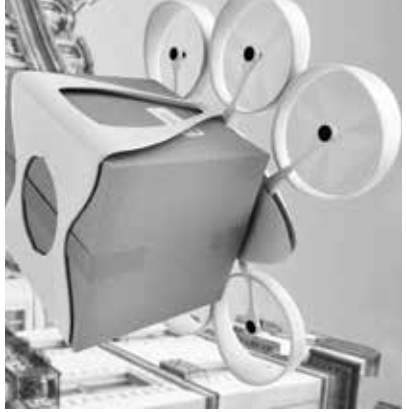
The Interim Budget for the FY 2019-20 was presented by the Finance Minister on 1 February 2019. As was widely expected, the Finance Minister did not propose any major changes to the tax laws in the Interim Budget. The amendments to the Income-tax Act, 1961 were barely a handful and this may go down in history as perhaps a budget – at least in recent times – where the Act has not been modified with a slew of amendments. A lot of the focus was therefore on the Finance Minister's budget speech, which can be said to be forward looking, economically progressive and socially relevant.

The Finance Minister's speech was a strong indicator of the speed with which the Indian tax administration is adopting technology and is going digital. As the tax administration implements new data submission and electronic auditing requirements, a whole new set of challenges will be created for taxpayers. As a first step, businesses must overcome difficulties in accessing their tax and financial data. Tax processes may not support the new submission requirements. Even where the data is accessed, the data transformation processes may be inefficient and interaction with the tax authority's submission process may not always be smooth. As a result, many companies will need a whole new way of addressing their tax compliance and tax audits as the tax administration goes digital. This is also likely to result in simplification of the tax system, improved services for the taxpayer and better tax collection. With the new Direct Tax Code in the pipeline, one can expect the next government to unveil its direct tax reform agenda shortly.

Corporate tax is at a crossroads. Disruptions abound and the tax landscape is changing as technological advances bring both taxpayers and tax administrations into contact with new ways of doing business. Trade policy is also disrupting the business landscape, with new tariffs and sanctions being announced with rapid succession. Even in this uncertain environment, however, opportunities abound and companies need to be aware of developing trends. Countries, however, want to remain competitive- with their choices constrained by the BEPS recommendations, incentives, like those for research and development, gain favour. Other developments, like the 2017 US tax reform package, are also helping to drive this growth.

Against this backdrop, this edition of our magazine covers topics such as the impact of BEPS Action 5 to nominal tax jurisdictions, effectiveness of India's patent box regime, India's trade policy, angel tax woes and rationalizing dividend taxation.

In this shifting tax environment, keeping abreast with changes is essential. We hope this publication helps you monitor the mentioned issues and understand the drivers behind key tax developments and changes happening in India and around the globe. We look forward to your feedback and suggestions.



In this issue

An end to the angel tax woes of Start-ups?

01

Pavan Sisodia, Tax Partner, EY India, *suggests that the government can follow 'exception based' approach, focus on suspicious investment and ensure that any genuine investment is not brought within the limb of angel tax.*

It's time to rationalise Dividends Taxation

02

Ganesh Raj, Tax Partner, EY India, *believes that the current dividend tax provisions merit a review to bring about a more balanced structure of taxing dividends.*

GST – the game changer has more potential

03

Uday Pimprikar, Partner & National Leader, Indirect Tax, EY India, *states that the industry and the Government need to actively collaborate, as GST law would act as a catalyst for attracting investment, driving employment and prosperity.*

India needs to re-think its trade policy formulation strategy

04

VS Krishnan, National Leader, Tax and Economic Policy Group, EY India *believes that if India wants to increase exports of goods and services, then it needs to re-think its trade policy formulation strategy.*

Impact of BEPS Action 5 to nominal tax jurisdiction

05

Rajendra Nayak, Partner, International Tax Services, EY India, *explains the application of 'substantial activities factor' to nominal tax jurisdiction.*

Effectiveness of India's patent box regime vis-à-vis global counterparts

06

Raju Kumar, Tax Partner, EY India, *highlights that India is competing with other jurisdictions like UK, Netherlands, Cyprus, and such other countries where such concessional regimes are more matured.*

Residency under the Mauritius tax laws

07

Subramaniam Krishnan, Tax Partner, EY India, *states that once the residential status of a company is determined under the domestic laws of Mauritius, it may not be reasonable for Indian tax authorities to challenge the same.*

Regulars

An end to the angel tax woes of start-ups?

Pavan Sisodia

Tax Partner, EY India

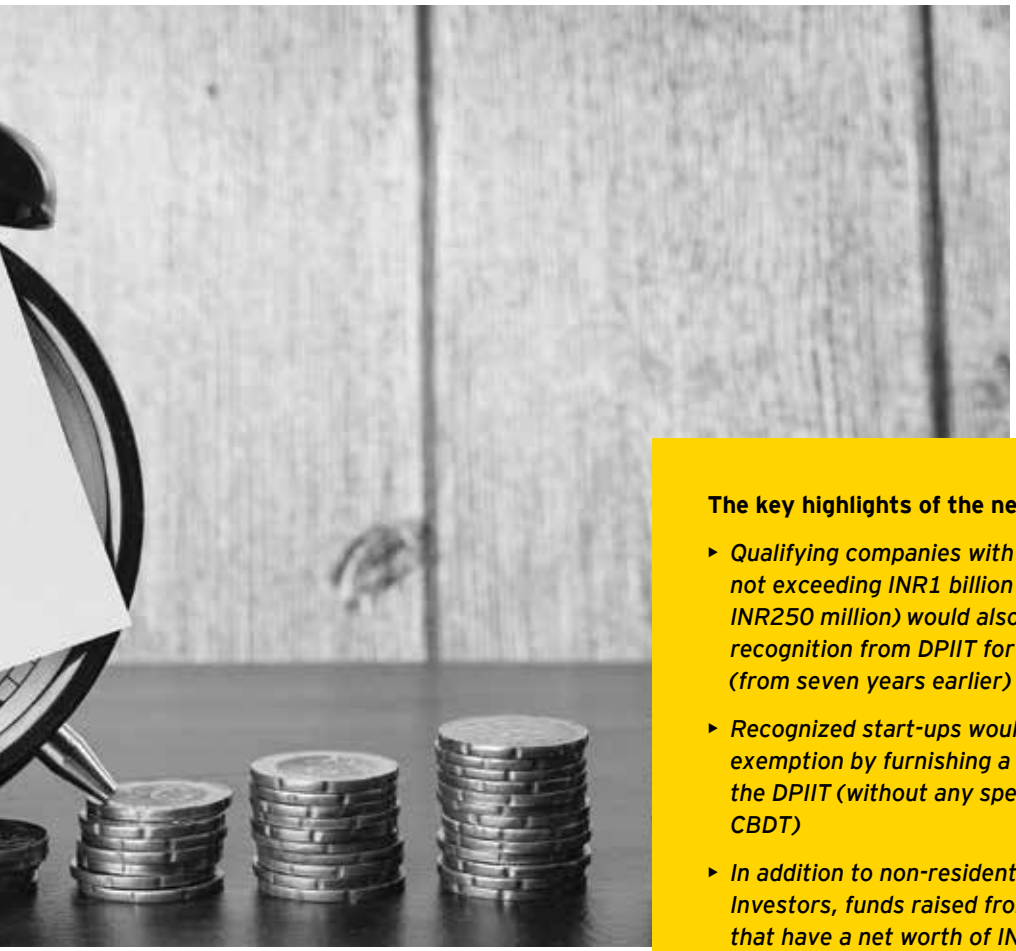
The Hon'ble Prime Minister of India, Shri Narendra Modi once said, "I see start-ups, technology and innovation as exciting and effective instruments for India's transformation". In line with his optimism, the government had launched various policies and schemes, including Startup India, to build a strong ecosystem that is conducive to the growth of start-ups. The government had also rolled out various tax incentives for start-ups including a three-year tax holiday, relaxation on the carry forward of losses, etc.

> "The new notification provides much needed relaxation and is a step in the right direction. However, there are some facets that merit closer attention.

Taxing times for start-ups

Despite the government's efforts, there have been certain tax issues that continue to cause concerns amongst the start-up and investor community- the most controversial being the angel tax that was introduced in 2012[1]. Under these provisions, any consideration received on the issue of shares by a company in excess of the Fair Market Value is taxable at 30% (plus any applicable surcharge(s) and cess(es)) in the hands of such company. While these provisions were introduced to deter the use of unaccounted money, tax officers have challenged valuations and invoked these provisions to tax even genuine investments in the past.

1 Section 56(2)(viib)



Though the intent of the government was always to exclude start-ups from the clutters of angel tax, the previous guidelines issued on this matter were perceived to be restrictive, especially around specific approval requirement from the Inter-Ministerial Board (IMB)/ Central Board of Direct Taxes (CBDT), etc.- with only a handful of start-ups actually availing the benefit. Owing to concerns raised by start-ups and strong lobbying by various bodies, the Department for Promotion of Industry and Internal Trade (DPIIT) (previously DIPP) released the new notification on 19 February 2019, aiming to significantly relax the provisions for claiming an exemption.

The key highlights of the new notification are:

- *Qualifying companies with a yearly turnover not exceeding INR1 billion (increased from INR250 million) would also be eligible for seeking recognition from DPIIT for a period of 10 years (from seven years earlier)*
- *Recognized start-ups would be eligible for this exemption by furnishing a signed declaration to the DPIIT (without any specific approval from the CBDT)*
- *In addition to non-resident and AIF Category I Investors, funds raised from listed companies that have a net worth of INR1 billion or turnover of INR2.5 billion and are frequently traded under SEBI regulations would also be exempt without any limits*
- *With respect to other resident investors, total eligible amount for exemption has been raised to INR250 million (from INR100 million)*

In fact, the exemption will be available irrespective of the date on which the shares are issued except where the assessment order is passed for the relevant financial year wherein an addition was made under these provisions. Having said this, a start-up which has invested in certain assets including land and building, loans and advances, capital contributions in other entities, shares and securities and motor vehicles will not be eligible for this exemption. Further, the start-up is restricted from investing in the mentioned assets for a period of seven years from the date of issue of shares. A declaration to this effect must be submitted and failure to comply will result in revocation of exemption with retrospective effect

What does the new notification mean for start-ups/investor community?

The new notification provides much needed relaxation and is a step in the right direction. However, there are some facets that merit closer attention. At the outset, the notification applies to start-ups registered with the DPIIT only. The total number of recognized start-ups as on date is 16,390[2] - these probably represent only a small percentage of the total number of businesses in India. Given the intent behind the introduction of angel tax provisions, an exception based approach may need to be adopted which will ensure that genuine investments do not warrant scrutiny from tax authorities.

Another important area where adequate relief has not been granted is to angel investors. Of late, there has been a spike in participation by domestic investors including angel and new-age entrepreneurs. While the provisions exclude any investment received from a foreign/ non-resident investor, any investment made by resident investors (even from legitimate/ genuine sources) continue to be scrutinized by tax authorities. It is imperative to protect the interest of such resident investors and the government could possibly look at introducing an accredit investor mechanism wherein genuine investors can get themselves registered with a government body and consequently any investment made by them will be outside the ambit of angel tax.

Also, the exemption should be extended to investments by Category II AIFs which are regulated and registered with SEBI. Further, start-ups that are currently under appeal against assessment order should be granted relief if they meet the conditions described above.

As mentioned earlier, to claim the benefit of exemption, start-ups should not have invested and are not permitted to invest in the specified assets discussed above. This puts a serious impediment on the operations of the start-ups. It is usual for companies to set-up subsidiaries or invest in shares of other companies for expansion or various other reasons. Also, loans or salary advances to employees in the ordinary course of business as well as investment of surplus funds in capital markets may not be permitted – all these restrictions seem to be onerous and need to be looked at again, keeping in mind the purpose being sought.

2 www.startupindia.gov.in

Concluding thoughts

"We will protect honest people and give the harshest punishment to the dishonest,". "The government is taking hard steps to ensure that action is taken against bad companies". These were the statements[3] made by the Interim Finance Minister, Mr. Piyush Goyal, few days before the issue of the new notification. The Interim Finance Minister also added that the stakeholders would need to wait for the final budget which will address all the concerns faced by start-ups.

The new notification is a welcome move and while the government has eased the process of availing exemption, some of the above issues are bound to restrict the applicability and many companies may not benefit from the notification. In line with the intent of these provisions, it may be useful for the government to follow the exception based approach and focus on suspicious investments and ensure that any genuine investment is not brought within the ambit of the angel tax. This will further boost the investors' faith in the government and truly enhance the ease of doing business in India.

3 Economic times – February 12, 2019

It's time to rationalize dividend taxation

Ganesh Raj
Tax Partner, EY India

The policy for taxation of dividends in India has witnessed many changes over the years, guided by varied objectives. India introduced a dividend distribution tax in 1997, to encourage companies to retain the bulk of their profits and plough them into fresh investments for future growth. However, the above system of taxing dividends was inequitable as dividend is income in the hands of the shareholders and not in the hands of the company. Therefore, in the year 2002, the incidence of tax on dividends was shifted on to the shareholders, at the rate applicable to them. In 2003, taxation of dividend again shifted to the corporate level, keeping in view the perspective of ease of collection at a single point.

Over the years, the government has introduced many changes to the dividend tax provisions to bring clarity and simplicity. However, the current provisions merit a review, to bring about a more balanced structure of taxing dividends.

Current dividend tax is burdensome

Tax on the distribution of dividends, when introduced initially, was pegged at a low rate of 10%. Over the years, however, the tax rate on distribution of dividends has increased to 20.36% (including applicable surcharge and cesses). An additional levy of the super-rich tax at 11.85% is applied in case of dividends exceeding INR10 lakh received by non-corporate investors. Such a high tax burden on capital significantly impacts the return on capital employed. With the high tax on dividends, along with the high corporate tax rate of 34.61%, the effective tax burden on capital can become almost as high as 40% to 54%.

Multiple taxation in case of non-subsidiary companies further increases the burden

To avoid double taxation, the income tax provisions were amended in 2013 to provide that the domestic holding company will not have to pay tax on dividends paid to its shareholders to the extent it receives dividends from its subsidiary company on which dividend tax is paid. However, double taxation of dividends continues in all other situations of inter-corporate receipt and distribution of dividends.

DDT significantly impacts return on investments for foreign investors

In cases where foreign investors are from countries which either have territorial taxation regime (i.e., foreign dividends are not taxed) or grant participation exemption, DDT levied in India becomes a sunk cost. Most treaties entered by India restrict the rate of tax on dividends to 10%. Hence the DDT levied in excess of the treaty rate significantly increases the cost of making an investment in India and makes India less competitive as compared to other countries. Where foreign investors are from countries which tax foreign dividend but grant foreign tax credit, such investors face

difficulty in availing credit of DDT since from a legal perspective, DDT is levied on the company distributing dividends and not on the shareholder receiving dividend.

Ambiguity around DDT refunds

Section 115O of the Income Tax Act allows the set-off of dividend income from subsidiaries against dividend payout for computing DDT liability. Since DDT is payable within 14 days of declaration of dividend there could be a timing issue in terms of the DDT computation and payout vis-à-vis dividend receipt from subsidiaries, more so in the case of companies listed on a recognized stock exchange. This could lead to a DDT refund. While the ITR forms provide for columns for appropriate disclosure of DDT liability and calculation of the refund due, the income tax authorities are unable to process DDT refunds due to an absence in procedural protocol despite the Income Tax Act (the Act) entitling a taxpayer to seek a refund of any excess tax paid under the Act. Whilst the rules do provide for the manner and the form in which such refund shall be sought, the said form deals only with the refund of taxes on income and does not provide for other refunds such as excess DDT that becomes refundable.

Litigation regarding disallowance of expenditure in respect of dividend income

In the case of dividend income, the incidence of dividend distribution tax is already borne by the beneficiary as the distributing company first deducts the dividend distribution tax and distributes the balance amount. These incomes are not exempt in the true economic sense. However, from a legal standpoint as upheld by the Supreme Court in recent judgements, DDT is levied on the company distributing dividends and consequently it is exempt in hands of the shareholders which triggers disallowance under section 14A for the shareholders. The combined rate of DDT of 20.36% and super-rich levy u/s. 115BBDA of 11.44% / 11.96% on gross amount of dividend without allowing any deduction and disallowance of corresponding expense in hands of shareholder results in very high incidence of taxation on dividend income. It also leads to litigation on quantification of disallowance under section 14A in hands of shareholders.

International experience

Globally, most countries do not levy a tax on distribution of dividends by a company. Further, dividends received by companies are also exempt to avoid the cascading effect of taxation. The dividends are taxed in the hands of non-corporate shareholders. Some countries such as Brazil, Mexico and Philippines tax dividend distribution in the hands of the company. Australia and the UK follow the franked or imputed method of taxing dividends that eliminates the double taxation of corporate income.

Q *How can dividend taxation be rationalized?*

1. Consider classical system of taxing dividends

a) There is a case for reintroduction of the classical tax system, where income tax is levied separately, both on the company income and on dividends received by shareholders. It is a simple and transparent method of taxing dividends that promotes greater equity by taxing the recipient of the income as per the applicable slab rate. It reduces the overall tax burden on the companies and even avoids the cascading impact of taxes.

Taxation of dividends at the distribution level has been favored until now on the grounds that it saves the administrative burden of handling voluminous physical TDS certificates and for the revenue department, it addresses the concern about tax revenue leakage as it means dealing with fewer taxpayers. However, today's technology has vastly improved the capacity to handle large volumes and have better monitoring and compliance capabilities. The TDS system has moved entirely online, obviating the need for the issue of physical copies of the TDS certificates. Further, the current forms (26AS) capture all incomes subject to TDS. With the information easily accessible, the tax department should have no difficulty in chasing the non-filers. Moreover, most of the shareholders have a PAN (without which they will be subject to higher TDS) and with all essential details linked to PAN, the monitoring of tax compliance becomes easier.

b) Relief to shareholders: Under the classical system, when the tax paid at the corporate level is considered, the combined tax rate on dividend income is double-taxed. Therefore, under the classical approach, lower tax rates should be applied to dividend income to partially alleviate the double taxation. In this context, a deduction upto INR25,000 may be provided. Further, where the total income of an individual / HUF shareholder is below the taxable limit, no TDS should be deducted on a declaration by the shareholder.

c) Grant deduction for inter-corporate dividend income: To avoid the cascading impact of dividend income for companies, deduction should be given for inter-corporate dividends on the lines of erstwhile section 80M of the Income Tax Act. Deduction will be w.r.t. net dividend income (after deducting expenses) distributed to shareholders. The deduction will also address the practical difficulties that arise in respect of DDT refunds.

d) Classical system of taxation of dividends will address other issues:

- Under the classical system of taxing dividends, foreign investors will get taxed at treaty rates and get foreign tax credit. This will reduce cost of investment and put India in a better competitive position vis-à-vis other jurisdictions looking for investments.
- The persistent litigation on disallowance of expenses for dividend income under section 14A will cease. The Easwar Committee had noted that around 15% of the tax litigation is attributed to the determination of expenditure relating to exempt income.
- Tax Department will have better information of flow of dividend income from TDS returns to ascertain the legal and economic owners of dividend income.

2. In case the classical system is not considered:

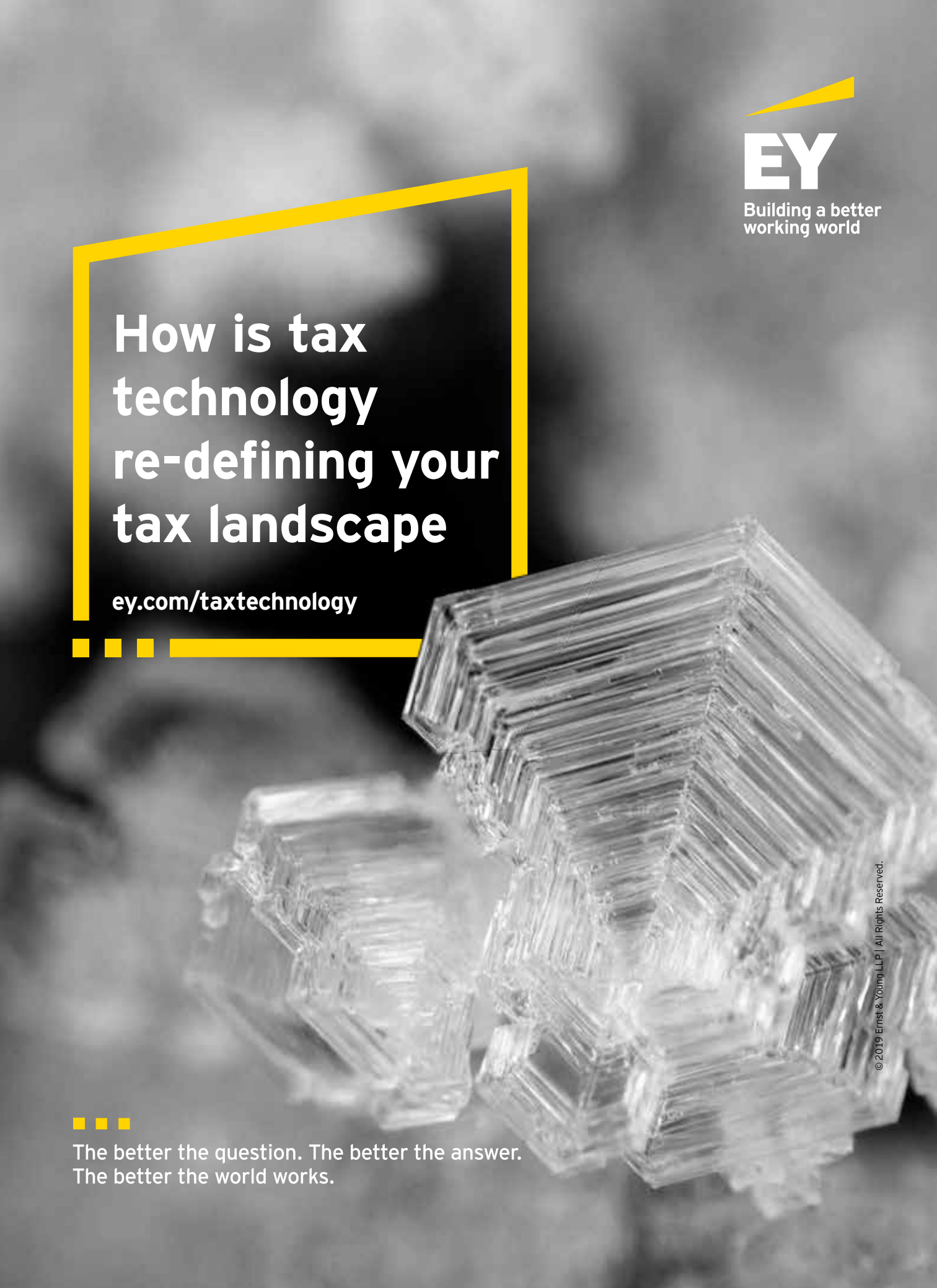
In the event that the classical system of taxing dividends is not considered, it is suggested that the following may be considered:

i) The rate of tax on dividends distributed should be lowered from the current 15% to 10% to reduce the overall burden on the corporate sector.

ii) The DDT rollover benefit should be liberalized to include dividend received from all companies, irrespective of whether they are subsidiaries or not.

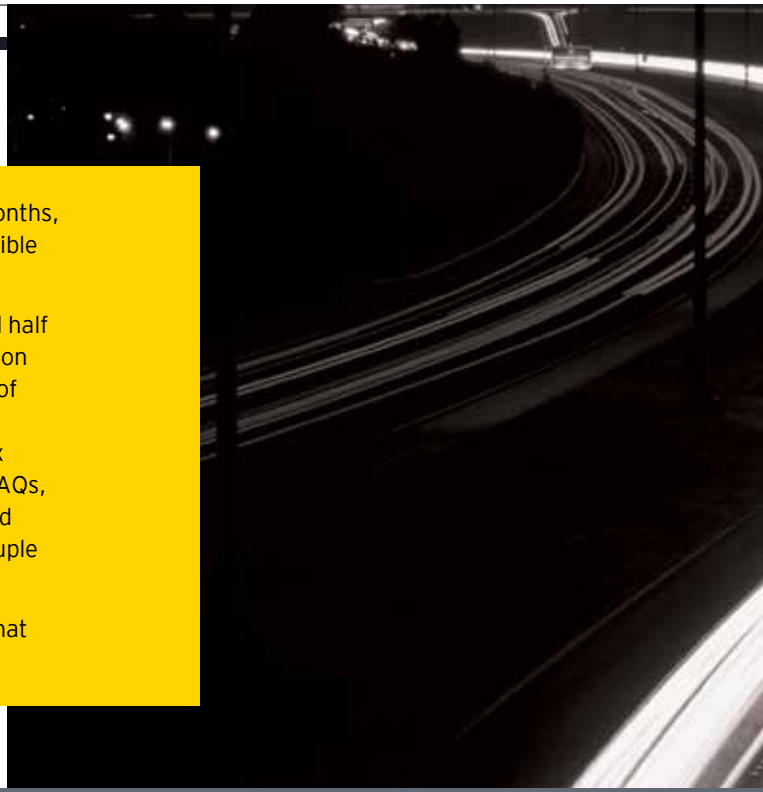
iii) In the case of dividends paid to non-resident shareholders, a final withholding tax may be applied at a lower rate of 20% (as per existing rate under s.115A) or the applicable treaty rate (subject to existing requirement of furnishing Tax Residency Certificate for availing treaty benefit) on gross basis without allowing any deduction.

iv) The income tax department should make necessary amendments to the rules and also issue operating guidelines prescribing the process for issuance of DDT refund by the tax authorities.


EY
Building a better working world
How is tax technology re-defining your tax landscape
ey.com/taxtechnology
The better the question. The better the answer.
The better the world works.
© 2019 Ernst & Young LLP | All Rights Reserved.

GST: *The game changer has more potential*

Uday Pimprikar
Partner & National Leader,
Indirect Tax, EY India



With GST approaching its second birthday in a few months, it is good time to take stock and talk about the possible course of action for the government and industry.

At the outset, as should have been expected, the last year and half witnessed hyperactivity on the tax policy and rate rationalization front. To give some perspective, the GST Council (comprised of all state finance ministers and the union finance minister) met 32 times – with each meeting driving seminal changes. The tax administration and courts have issued several clarifications, FAQs, notifications and rulings, etc. This frenetic pace of changes and improvements should be expected to continue for the next couple of years.

During the last few years several measures have been taken that have a far reaching impact on the country.

Digital compliance

The GST tax structure had to incorporate relatively high rates to achieve revenue neutrality. While higher tax rates work as a disincentive against compliance which in a normal course would have resulted in higher levels of tax evasion, the government notified a rate structure far more benevolent (as compared to the pre-GST era) assuming a much higher compliance levels (the assumption was an increase of 30% to 35%).

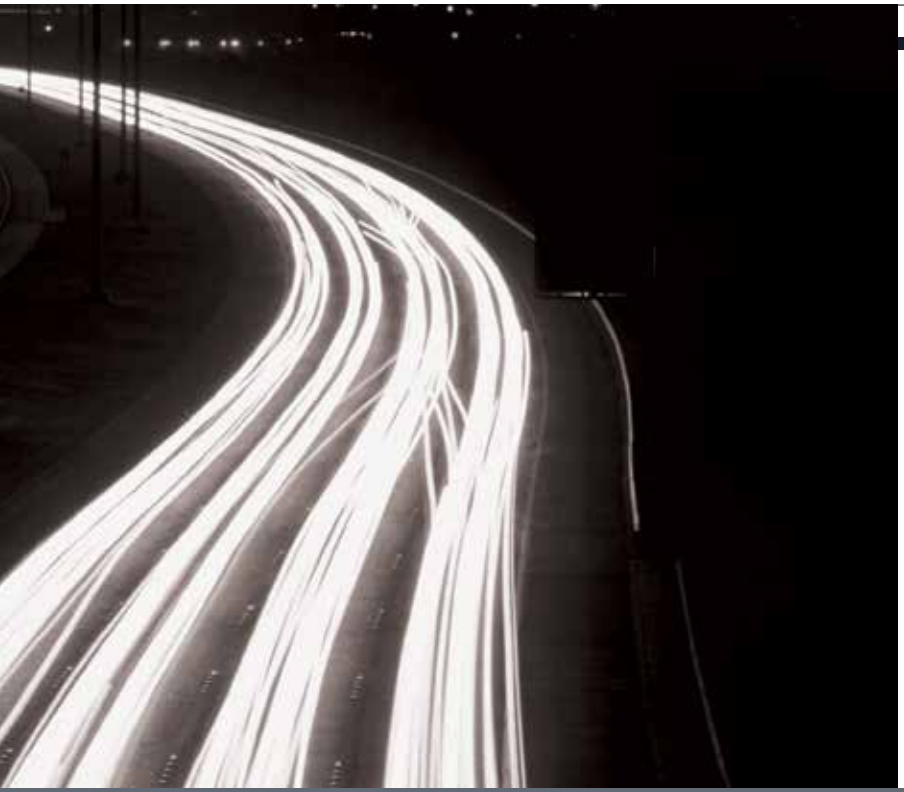
This was made possible because of the paradigm changing digital compliance regime introduced – this regime entails granular reporting of transaction level information/ data and a mandated reconciliation of the purchase details to the transactions reported by the suppliers for availing input tax credits.

This was further complemented by E-way bill compliances notified – these mandated reporting movement of every consignment of value above the prescribed threshold limits. While the regime still requires some refinement and simplification, upon stabilization, it should be expected to become a benchmark for the rest of the world.

Rate rationalization

As mentioned above, the revenue neutral rates computed by the Chief Economic Advisor were materially lower than the effective tax rates of the earlier era. Indian realities mandated a further rationalization of tax rates.

At present, it is our estimation that the actual effective rates of taxes on goods have reduced by up to 40% (either by way of reduction of rates or reduction of cascading tax costs). Despite this, the collection of GST has increased (though may not be in line with expectation). There is no doubt that this has happened on account of a significant expansion of the tax base (registrations have increased by 40% to 50%) and compliance effectiveness. This may provide a strong foundation for sustainable growth in tax collection.



Significant reduction of cascading taxes and ease of doing business

One of the major drawbacks of the erstwhile indirect tax regime was the cascading impact on the supply chain on account of non-fungibility of state taxes against central taxes. This directly impacted competitiveness of Indian products. GST has significantly reduced this negative impact. Further, GST replaced a plethora of taxes simplifying the tax regime. While some additional work needs to be done on the policy front for further simplification as also for mitigation of cascading impact, it is a great start and might have increased the country's competitiveness noticeably.

Compromises made could hurt, unless checked

A reform like GST could be achieved only through compromises that were unavoidable. Levying a dual tax simultaneously by central and state government and exclusion of certain sectors (like petroleum, real estate, alcohol, etc.) were the larger compromises. These compromises need to be acknowledged and handled sensitively.

Further, following unprecedented factors need to be appreciated:

- The GST legislation, like any other law that gets freshly minted, has its own share of complexity and ambiguity
- The dual levy has significantly increased administrative touch points – and the administration is right now a diverse body made up of a disparate group of people from the central government and state governments having uneven levels of experience and understanding of commercial and tax's technical aspects
- Granular information now available with the administrator and the stringent compliance regime imposed will drive a paradigm change in the interaction between the tax administration and a tax payer
- The digital compliance regime was materially different than the one being handled by a number of organizations and they will take time to gain control and digest the new compliances

All the above have the potential of increasing tax risk and controversies. An insensitive handling of these could have a much larger impact than earlier envisaged. How can this be done? Outlined below are some of the areas that could be looked at -

Robust and collaborative interaction between the tax administration and industry is necessary

The administration has initiated several measures to reduce ambiguity and enable uniformity in application of the law. These include issuing clarifications, FAQs and incorporating institutional framework for issuing advance rulings. The administration would need to consider avenues to improve the quality of these rulings and clarifications and make them consistent. Further it is imperative that the interaction between the government and industry is more collaborative and the dialogue more interactive. An aggressive removal of anomalies as also adherence to the international jurisprudence while issuing rulings , clarifications, etc. would also help in gaining certainty.

Penal framework needs a rejig

There is a need to reconsider the penal framework immediately. Essentially, express provisions in the law are required, restricting penalty provisions in relation to only specified evasion matters. The rest of the areas of dispute are a result of bonafide errors in reporting and gaps in compliances or differences of opinion on tax technical matters and need to be concluded in a consultative and collaborative manner and the legislation needs to enable the same.

Efforts to mitigate cascading tax cost

The primary intention behind introduction of GST has been to remove the cascading tax costs. Currently, the legislation has several provisions that are unintentionally resulting in increasing the cascading costs because of denial or blockage of credits. These need to be actively considered and resolved. A few stark examples of this are outlined below:

- Non- availability of refunds where some service providers face blockage of credit on account of inverted duty structure (i.e., where input tax rate is higher than output tax rates)
- Credit blockages emanating from recent amendment regarding realignment of credit utilization mechanism
- Credit blockages due to the fact that a person, other than a supplier, is liable to pay tax on receipt of services (for example sponsorship services, etc.)

Rationalization of certain provisions of law

Understanding of the legislation, its impact and consequences has grown since the implementation. It would help that the policy makers seek to look at and consider the best international practices and rationalize the existing law accordingly. There are several provisions that are ambiguous, making them impossible to comply with and at the same time administer. To name a few that fall within this category include the legislation related to anti-profiteering, deemed valuation of related party transactions and the taxability of intra-company transactions. These need to be revoked or rationalized. Continuing these provisions will necessarily lead to explosion of litigation without any major revenue upside. The resultant fallout would dampen the business confidence and impact ease in doing business.

Expanding the GST ambit

The exclusion of petroleum, real estate and alcohol meant for human consumption is resulting in material cascading tax cost in the economy. This impacts competitiveness of Indian products. While this was a recognized compromise, the inclusion of these sectors will have a far-reaching impact on the economy.

The country has taken a big step forward by implementing a seminal reform like GST. The industry and the government need to actively collaborate and persevere despite challenges to implement a good Law. There is no doubt that a good GST law would act as a catalyst for attracting investment, driving employment and prosperity.

> “There is no doubt that a good GST law would act as a catalyst for attracting investment, driving employment and prosperity.

(Kamal Agarwal, Senior Tax Professional, EY, also contributed to the article.)

India needs to re-think its trade policy formulation strategy

VS Krishnan
National Leader, Tax and
Economic Policy Group, EY India

1 *Promise of liberal trade policies*

Importance of international trade can hardly be overemphasized. No country after the end of Second World War in 1945 has grown at 7% per annum or more without an annual real export growth of less than 15%. Liberal trade policies help domestic firms expand their reach beyond home markets and expose them to foreign competition which induces efficiency. Further, liberal trade policies have strong linkages with poverty alleviation and economic development.

However, this wisdom is under attack from the very same developed countries which enjoyed the maximum benefits of trade liberalization. Therefore, the days of hyper-globalization may be coming to an end. Many developing countries like China and South Korea had experienced sustained GDP growth because of market access provided by the developed countries. However, this opportunity may not be available to the other developing countries going forward, and they may need to rework their international trade strategy.

2 *How should India approach trade policy formulation?*

A balanced trade policy can provide impetus to many Indian industry to achieve scalability in global markets, while at the same time affording protection, through indigenization. More specifically, India should focus on five issues as it constructs a robust trade policy:

a. Negotiating comprehensive trade agreements

Trade and investment are faces of the same coin. India should consider moving away from the traditional "shallow" tariff-reduction type agreements in favor of a dynamic and "deep" comprehensive trade agreement model. This model will permit – amongst other benefits – a dynamic, single instrument to develop trade and investment disciplines, provide a 'one-stop shop' for dispute settlement, facilitate deeper regulatory coherence, and introduce transparency in regulatory procedures.

India's most important line of trade-defense is its existing tariff levels. While India's applied tariff rates are relatively low, its bound tariff rates are quite high. Therefore, India has sufficient space for tariff-policy concessions within which it can maneuver as it enters into trade negotiations. Moreover, since trade-bargains become multi-dimensional in "comprehensive" trade agreements, India can offer reductions in its tariff rates to seek substantial concessions in services trade from its negotiating partners.

India has traditionally demanded liberal visa regimes to facilitate its services trade. However, this request has been met with caution by other countries who consider this to be a route to immigration. However, immigration does not have a direct relation with services-trade. India should devise sophisticated, sector specific demands regarding Mode 3 and Mode 4 commitments that can be accepted by partner countries.

b. Focusing on developing non-tariff barrier related disciplines

After Uruguay round, where there was massive reductions in tariffs from 40% to nearly 4%, non-tariff barriers became the next frontier for trade negotiators. These barriers are known to increase the costs associated with conformity assessment procedures and because of the lack of transparency because of implementation of opaque regulatory processes.

"Deep" comprehensive trade agreements are the best vehicles to help India achieve its negotiating objectives of eliminating non-tariff barriers for two reasons. First, the design and architecture of these agreements permit parties to streamline or harmonize regulatory processes for both goods and services.

Second, these agreements can encourage India to enhance its own domestic capacities. India can use these agreements as an impetus to develop and enhance its technical infrastructure to effectively develop conformity assessment procedures, technical regulations and standards. India can also design laboratory and accredited certification processes which are in line with international practices. Despite the costs Indian industry will gain from such an undertaking. Sectors in which India has strong export potential, such as agri-food processing and pharmaceuticals, are certain to capture greater share of global markets if India implements these changes.

Conclusion

If India wants to increase exports of goods and services, then it needs to re-think its trade policy formulation strategy, revisit its motivation to engage in trade negotiations based on insights provided through data-analysis and accordingly, recalibrate its global trade aspirations.

One practical step towards this is by achieving coherence in Indian trade and investment policy. For this, the Ministry of Commerce and Industry, currently in-charge of trade negotiations and the Ministry of Finance, currently in-charge of investment-related negotiations, should work closely to arrive at a policy position which best suits the interests of the Indian industry.

Since trade and investment don't operate in silos, trade and investment policy formulation cannot be designed independent of each other either.

c. *Identifying reasons for under-utilization of FTAs*

Utilization of FTAs by Indian industry is less than 3% of the available opportunity (Niti Aayog, 2014). This highlights the failure to educate the industry about the benefits that can be accrued through bilateral and multilateral trade agreements.

There may be lack of understanding of the implications of the FTA on industry processes, non-engagement by the private sector during stakeholder consultations which help firm the government's negotiation position, and the complicated paper-work relating to rules of origin that are required to demonstrate conformity with FTAs. On the other hand, industry in developed economies are known to utilize FTA benefits. Research undertaken by the UNCTAD shows that two-thirds of exports from the European Union have utilized FTA benefits.

Instead of taking advantage of the tariff reductions, many Indian firms actually pay non-FTA country tariffs and the benefits of negotiated FTAs remain unutilized.

d. *Engaging with China on trade discussions*

India generally trades with China at the Most Favored Nation level. However, both China and India are party to the on-going Regional Comprehensive Economic Partnership (RCEP) Agreement negotiations. This has caused Indian negotiators great discomfort; the general thinking is that providing tariff concessions to China will result in the Indian domestic market being flooded with a surge of imports from China. However, this intuitive approach need not be necessarily true. It is possible, for instance, that China is moving up the global value chain, and Indian firms can take the place that Chinese firms have vacated in this process.

e. *Designing trade policy backed by data-research*

Data-backed research can guide India in deciding the degree of tariff concessions it wants to provide to other countries in return for reciprocal concessions in either goods or services. This way, Indian negotiators have quantitative basis to mitigate risk during negotiations.

Embarking on trade policy not informed by accurate and authentic data poses several challenges. Availability of import of services-data is particularly scarce. Further, codification exercise of services has not been undertaken by India despite several revisions of the UN CPC which capture recent changes in services. It is incumbent on India to undertake the codification exercise to get better data on its services trade, so as to identify the tariff lines on which it can seek concessions.

Impact of BEPS Action 5: *Application of "Substantial Activities Factor" to nominal tax jurisdiction*

Rajendra Nayak
Partner, International Tax Services,
EY India

Recognizing the need to realign the taxation of profits with the substantial activities that generate them and to improve transparency, the Organisation for Economic Co-operation and Development (OECD) started work on addressing harmful tax competition in the late 1990s, resulting in a 1998 report, Harmful Tax Competition: An Emerging Global Issue. Under this initiative, the OECD also created the Forum on Harmful Tax Practices (FHTP) to take the work forward. Following its creation, the FHTP has been one of the key groups with the mandate to monitor and review tax practices of jurisdictions, focusing on the features of preferential tax regimes.

On 5 October 2015, the OECD released its final report on Action 5, Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance (the Action 5 Report) under its BEPS Action Plan. The Action 5 Report covers two main areas: (i) the definition of a "substantial activity" criterion to be applied when determining whether tax regimes are harmful, and (ii) improving transparency.

Given the elevation of the substantial activities requirement in the work on preferential regimes as part of the BEPS Project, the OECD believed it was appropriate to resume the application of the substantial activities requirement set out in the 1998 Report for "no or only nominal tax" jurisdictions, as well as to provide guidance on the application of the requirement. For that reason, the Inclusive Frame on BEPS (BEPS IF) has decided to apply the Substantial Activities Requirement for "no or only nominal tax" jurisdictions and on 15 November 2018 released a document with technical guidance on the application therein (the Standard).

The BEPS IF has decided to apply the Substantial Activities requirement, as set forth in chapter 4 of the final report on Action 5, for the first time to

> “The Action 5 Report covers two main areas: (i) the definition of a “substantial activity” criterion to be applied when determining whether tax regimes are harmful, and (ii) improving transparency

“no or only nominal tax” jurisdictions. Broadly, the Substantial Activities Requirement looks at whether a regime encourages purely tax-driven operations or arrangements, as many harmful preferential tax regimes are designed in a way that allows taxpayers to derive benefits from the regime while engaging in operations that are purely tax-driven and involve no substantial activities. Following Action 5, the Substantial Activities requirement is considered one of the main factors when determining whether a regime is potentially harmful. The rationale behind this approach is that as all preferential regimes for geographically mobile income must now meet the Substantial Activities requirement. It is essential, the OECD notes, to ensure that business activities do not simply relocate to a zero-tax jurisdiction to avoid the substance requirements, as this would tilt the playing field against those that have now amended their preferential regimes to comply with the Standard and in the OECD’s view, jeopardize the progress made in Action 5 to date. According to the Standard, the substantial activities requirement to no or only nominal tax jurisdictions would apply to jurisdictions which do not impose a corporate income tax. It would also apply to jurisdictions which are deemed to impose only nominal corporate income tax to avoid the requirements. Jurisdictions which have been reviewed on the basis of the preferential regimes they offer are out of the scope of the Standard, unless they subsequently significantly undertook reforms which abolished or substantially abolished their corporate income tax altogether.

In respect of the type of activities covered, the Substantial Activities requirement will apply to geographically mobile activities, such as financial and other service activities, including the provision of intangibles. The FHTP has typically identified these types of mobile activities as falling into the categories of headquarters, distribution centers, service centers, financing, leasing, fund management, banking, insurance, shipping, holding companies and the provision of intangibles.

Based on the FHTP’s guidance on substantial activities, there are two basic categories of activities: (i) activities earning non-Intangible Property (IP) income, and (ii) activities for the exploitation of IP assets (which is the nexus approach set out in the Action 5 Report).

1. For activities within scope that earn non-IP income, this would mean that the "no or only nominal" tax jurisdiction would be required to meet the same substantial activities criterion applicable for IP-regimes, meaning that it would need to introduce laws to: (i) define the core income generating activities for each relevant business sector; (ii) ensure that core income generating activities relevant to the type of activity are undertaken by the entity (or are undertaken in the jurisdiction); (iii) require the entity to have an adequate number of fulltime employees with necessary qualifications and incurring an adequate amount of operating expenditures to undertake such activities, and (iv) have a transparent mechanism to ensure compliance and provide an effective enforcement mechanism if these core income generating activities are not undertaken by the entity or do not occur within the jurisdiction.

2. Where the business activities are the exploitation of IP assets, the substance requirements used by the FHTP are the "nexus approach" which consists of two parts:

(i) a first part which sets out a formula to determine the amount of eligible income which can benefit from a lower tax rate, and (ii) a second part which is a consequence for the non-eligible income which is then taxed at the normal (i.e., higher) tax rate. For a "no or only nominal tax" jurisdiction, the challenge is that even though the formula could be applied (the result of which might be that there is zero eligible income), it is unclear how to apply the second part. In order to apply the principle underlying the nexus approach to "no or only nominal tax" jurisdictions, the Standard states that the best way forward is to apply a similar concept as applies for non-IP income, which is the core income generating activities guidance. The Standard further provides guidance on how the substantial activities requirements will apply to "no or only nominal tax" jurisdictions for more specific cases generating IP income, i.e., patents and similar assets, marketing intangibles and other exceptional cases.

The Standard also highlights the importance of ensuring compliance via a common and effective approach. In this regard, there should first be a mechanism to identify the entities conducting the relevant categories of mobile activities and to detect whether the core income generating activities were being carried out. Second, there should be a mechanism to take action in the event an entity failed to meet the Substantial Activities requirement. Thirdly, there should also be enhanced spontaneous exchange of information.

The release of the Substantial Activities requirement on "no or only nominal tax" jurisdictions will contribute the OECD says, to ensuring that substantial activities must be performed in respect of the same types of mobile business activities, regardless of whether they take place in a preferential regime or in a "no or only nominal tax" jurisdiction. Multi-national enterprises with any form of structure or transaction involving these regimes and jurisdictions should continue to monitor developments closely, as well as to assess alternative plans.

Effectiveness of India's patent box regime vis-à-vis global counterparts

Raju Kumar
Tax Partner, EY India

Introduction

Innovation and Research and Development (R&D) are considered critical to economic success of a state in this competitive global economic environment. The contribution of Intellectual Property (IP) continues to grow in the global economy, driven by effects of new pioneering technologies and ever evolving business models that extend innovation worldwide.

India has always supported R&D through various tax incentives and incentivizing innovation through a patent box regime to stimulate R&D is a step in right direction. Further, considering the innate benefits available to India, viz. low operating costs, availability of highly skilled workforce and the easing of regulatory hurdles and FDI limits, this policy initiative appears to be rightly timed.

The concessional regime introduced as part of Finance Act 2016 provides that if the total income of a person resident in India, who is a patentee, includes any income earned out of royalty with respect to worldwide commercialization of its patent which is developed and registered in India, the same shall be taxed at the rate of 10% (plus applicable surcharge and cess) on the gross amount of such royalty earned. The salient features of the Indian patent box regime are:

- Applicable to an Indian resident who is a patentee (eligible taxpayer)
- Only such patents which are granted under Patents Act, 1970 are considered
- Patentee is any person who is the true and first inventor of the invention, whose name is entered on the patent register as the Patentee as per Patents Act, 1970 (Patent Act)
- Total income of eligible taxpayer must include income by way of royalty
- At least 75% of the expenditure is incurred in India by eligible taxpayer for invention
- Royalty income has also been defined, broadly including income from use of any patent, imparting information for working/ use of it, transfer of rights in respect of the patent. Royalty however excludes income in the nature of capital gains or consideration for sale of product manufactured with the use of patented process or the patented article for commercial use (embedded IP)
- The Patent Box Regime is optional

Patent box regimes: Global experience

Incentivizing innovation through tax relief is not a new phenomenon and Patent Box regimes are quite common in the European Union countries. Ireland was amongst the first few countries to introduce the Knowledge and Development Box. Other countries having popular IP regimes in their domestic laws include, among others, UK, Netherlands, Luxembourg, France, Belgium and Cyprus.

While the 10% rate offered under the Indian regime is lower than the rates offered by a few jurisdictions (such as France, Spain, Cyprus), there are other countries that go even lower to further incentivize innovation – Netherlands (5%), Luxembourg (5.84%) and Belgium (6.8%).

Considering the type of IP assets covered under the patent box regimes of other countries, the Indian regime is a lot narrower on a comparative scale. The regime applies only to income from patents registered under the Patents Act, 1970 and does not extend the benefits to other IP assets that are functionally equivalent to patents – such as formulas, processes, designs, patterns, know-how and inventions. Few countries such as Ireland, Luxembourg, Spain and Switzerland allow income from such IP assets to be taxed at the lower Patent Box rate. China also considers income from certain types of commercial "know-how," such as process innovation, to qualify for the lower rate.

Indian Patent Box regime does not provide for beneficial rate of tax on income from embedded royalties, as compared to other jurisdictions such as UK, Netherlands, Luxembourg and Belgium which can potentially project the Indian Patent Box regime less attractive.

Another point of difference is in relation to the acquired IPs. While the Indian regime does not offer the incentive to acquired IPs, other jurisdictions such as UK, Netherlands, Luxembourg, France and Belgium have the opposite view on the matter, provided certain conditions are met (such as further development/ improvement is done post acquisition).

While on the face of it, the Indian Patent Box regime may appear less attractive as compared to some of the other countries, a level playing field on the policy front is expected to be created by the OECD through BEPS Action plan 5 recommendations which suggest a nexus approach, i.e., tax benefits must be linked with actual expenditure and location of R&D activities. Prima facie, Indian regime does not appear to violate the BEPS recommendations while some other EU jurisdictions may need to re-look at their policy framework not only to be compliant with BEPS Action Plan 5 but also EU State-Aid standpoint.

“The introduction of the Patent Box Regime under the Indian Tax Law is a welcome move and is in conjunction with the Make in India, Start-Up India and Digital India initiatives of the Government of India

Suggestions and way forward

Keeping the above in perspective, some fine tuning may be required to make India's patent box regime more competitive and contribute towards making India a Global R&D hub as intended by the Government of India while introducing this regime. Some of the areas where the government could consider bringing amendments to improve the regime are summarized below:

1. **Registration of patent in India and IP protection:** The main condition for claiming the benefit of the lower tax rate mentioned in the patent box regime is that the patent must be developed (with a leeway of 25%) and registered in India. Even though the registration takes four to eight years, but patent is effective retrospectively, the tax benefit would only be available prospectively. Accordingly, easier and faster registration should be facilitated under various laws. Further, there is also a need to spruce up our legal system to provide speedy protection from IP infringement

2. **Qualifying IP income:** As mentioned above, income from sales of goods manufactured embedding the IP is not a qualifying income. Benefits may need to be granted to such an income as well. A consistent and coherent method may be needed for separating income unrelated to IP (e.g., marketing and manufacturing returns) from income arising from IP. Expanding the coverage of qualifying IP income to IP income embedded in the sale of manufactured products would also support the government's "Make in India" initiative and would also be compliant with Action 5

3. Preferential tax rate which is only applicable to patents should be also extended to other similar intellectual property rights

India Inc. could also contribute to India's growth story as a sweet spot for global innovation by continuing to invest in R&D and emerging trends, while also reposing trust in the government's initiative to create a favorable tax environment for such innovation.

In summary, the introduction of the Patent Box Regime under the Indian Tax Law is a welcome move and is in conjunction with the Make in India, Start-Up India and Digital India initiatives of the Government of India. However, one would need to be mindful that India is competing with other jurisdictions like UK, Netherlands, Cyprus and such other countries where such concessional regimes are more matured and have been in existence for a longer period of time. The success of concessional tax regime in India would also depend on how robust the legal framework pertaining to registration and enforceability of patents is perceived by companies who presently have no presence in India. The published effective rate of tax will surely catch the eye, but it will be a combination of this and the above factors that will determine the attractiveness and effectiveness of India's new regime. Irrespective of this, such a regime is definitely pro-growth and pro-innovation and should go a long way in helping India project itself as a preferred IP destination.

Residency under the Mauritius tax laws

Subramaniam Krishnan
Tax Partner, EY India

In line with the Organisation for Economic Co-operation and Development's (OECD) initiatives to counter harmful tax practices and the commitment of the Government of Mauritius to increase and strengthen its positive reputation as an international financial center, major amendments have been made to the domestic legislations of the country by the Mauritian authorities. The abolition of the 80% Deemed Foreign Tax Credit, introduction of partial exemption and changes to the Global Business License regime and the enhanced substance requirements are some of the key amendments introduced since mid-2018.

> "On 28 November 2018, the Mauritius Revenue Authorities (MRA) issued a Statement of Practice (SOP) indicating the guidelines for determining POEM of a company under the Mauritian tax laws.

One of the other amendments which is critical for companies/ entities operating from Mauritius is the introduction of the "Place of Effective Management" (POEM) test for determining the tax residency of a company effective from 1 October 2018.

Under Mauritius' domestic tax laws, a company is considered to be a resident if it is incorporated in Mauritius or if its central management and control is exercised in Mauritius. Thus, the test of incorporation has been predominantly used to determine the residential status for companies registered in Mauritius. A Category 2 Global Business Company (GBC2) was not considered as a resident in Mauritius for the purposes of tax treaties[1].

The Mauritius Budget 2018 introduced POEM as a test for determining the residency of companies. On 28 November 2018, the Mauritius Revenue Authorities (MRA) issued a Statement of Practice (SOP) indicating the guidelines for determining POEM of a company under the Mauritian tax laws.

The SOP prescribes that any Mauritian company is deemed to be a tax resident if its strategic decisions relating to the core income generating activities are taken in or from Mauritius. Additionally, it is required that a majority of the board of directors meetings are held in Mauritius or the executive management of the company is regularly exercised in Mauritius. The SOP further states that all the relevant facts and circumstances should be examined and that consideration will be given to the impact of the use of information and communication technology.

The conditions prescribed by the SOP seem to be reasonable and are in-line with global best practices.

There seem to be conflicting views on whether the POEM test needs to be complied with by a Category 1 Global Business Company (GBC1) companies or not. Some of the Mauritian law experts are of the view that the POEM test is applicable only for the determination of residential status of Authorized Company which replaces the GBC2 entities. However, given the manner in which the new provisions under the Mauritius tax laws are worded, the POEM test could apply to all Mauritius incorporated entities. Hence, in addition to having the central management and control

1 GBC2 licence are no more being issued by Financial Services Commission after 31 December 2018. A GBC2 could apply for a change in regime by opting to continue as a GBC or as the newly introduced Authorised Company.

exercised in Mauritius, a locally incorporated company will also be required to have it's POEM in Mauritius to be resident for tax purposes.

Where a company's POEM is situated outside Mauritius, it will be treated as a non-resident in Mauritius thereby disqualifying the entity to be eligible to be issued a "Tax Residency Certificate" by the MRA . In such a scenario, the entity will not be eligible to claim the benefits of the Double Taxation Avoidance Agreement signed by the Government of India and the Government of Mauritius (India-Mauritius tax treaty).

For a fund or an investment holding company which invests in Indian companies, this would mean the following:

- Gains, if any, on securities other than shares would be taxable in India as per the domestic tax laws as against being exempt under the India-Mauritius tax treaty
- Gains, if any, on shares acquired on or prior to 31 March 2017 will become taxable in India. Currently, such gains are exempt under the India-Mauritius tax treaty by virtue of the grandfathering provisions
- Interest will be taxable under the domestic tax laws at 5%/ 20% - 40% as against 7.5% under the India-Mauritius tax treaty subject to satisfaction of the beneficial ownership test

Similarly, for an entity which acts as an investment manager entity to a fund based in Mauritius (or other jurisdiction), not being eligible to the benefits of the India-Mauritius tax treaty would mean having to evaluate a stringent condition of not having a "business connection" in India as against "permanent establishment" under the India-Mauritius tax treaty to not be taxable in India.

Another issue that could arise is the possibility of the Indian tax authorities challenging the POEM even though the MRA has determined that the company's POEM is in Mauritius.

Typically, as a part of evaluation of treaty residency, residential status of a Mauritius company will, to begin with, for the purposes of the India-Mauritius tax treaty get determined by MRA. Further, circular no. 789 of 2000 which was issued in the context of the India-Mauritius tax treaty provides that where a tax residency certificate will constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for applying the treaty benefits. This circular is effective as on date.

Accordingly, once residential status is determined under the domestic laws of Mauritius it may not be reasonable for Indian tax authorities to challenge the same, unless they have certain evidentiary proof to look at the substance of the entity or where there are circumstances to prove that Mauritius has been chosen as a destination in order to claim treaty benefits and the company is set up mere as a vehicle to invest in downstream jurisdictions.

Experts in Mauritius seems to believe that GBC1 companies are likely to satisfy the POEM requirement in Mauritius as the decision making, etc. is anyway required to be situated in Mauritius, then the Mauritius domestic law amendment on POEM more so appears to be like an "old wine in a new bottle".

Global News

OECD publishes consultation document on addressing tax challenges arising from digitalization of the economy[1]

On 13 February 2019, the Organization for Economic Co-operation and Development (OECD) issued a public consultation document (consultation document) seeking public comments on possible solutions identified to address the tax challenges arising from the digitalization of the economy.

The publication of the consultation document is preceded by the recent discussion of the Inclusive Framework on Base Erosion and Profit Shifting (BEPS IF) and agreement of the current 128 members of the BEPS IF to examine proposals involving two pillars. One pillar would focus on the allocation of taxing rights and the second pillar will address BEPS issues. Importantly, the consultation document gives more detail on the proposals within both pillars than was previously known.

The 32-page consultation document is divided into three key sections:

- **Section 1:** ***Introduction:*** Provides a detailed background, reviewing the OECD's work in this area to date
- **Section 2:** ***Revised profit allocation and nexus rules:*** Provides detailed examination of three key proposals under debate, i.e., (i) user participation proposal (ii) marketing intangibles proposal (iii) "significant economic presence" proposal
- **Section 3**: ***Global anti-base erosion proposal:*** Sets out proposals to address the continued risk of profit shifting to entities subject to no or very low taxation

The consultation document notes that the impact of these proposals is not limited to digital business models only and would impact any business models utilizing intangible assets. Further, the proposals do not represent the consensus views of the BEPS IF, the OECD's Committee on Fiscal Affairs (CFA) or their subsidiary bodies. The current proposals may continue to be revised or added to. In that regard, they represent a current snapshot of what is being discussed by the OECD member countries.

The consultation document describes the proposals discussed by the BEPS IF at a high level on which public comments on many policy issues and technical aspects were invited till 1 March 2019. The comments are intended to assist the BEPS IF in preparing a solution for its final report to the G20 leaders in 2020.

The consultation document describes the proposals discussed by the BEPS IF at a high level on which public comments on many policy issues and technical aspects were invited till 1 March 2019. The comments are intended to assist the BEPS IF in preparing a solution for its final report to the G20 leaders in 2020.

1 *Refer EY Global Alert titled 'OECD opens public consultation on addressing tax challenges arising from digitalization of the economy: time-sensitive issue impacting all multinational enterprises' dated 14 February 2019*

German tax authorities confirm that fees for online advertising should not be subject to tax withholding[2]

In a number of recent German tax audits, the tax auditors took the position that cross-border payment for online advertising should be treated as royalties or payments for the use of know-how by German companies and should thus be subject to German Withholding Tax. This proposition significantly impacted the tax position of German companies who use online advertising as well as non-resident companies, offering online advertising services in Germany.

This position was however not agreed upon by the German tax authorities, but rather an interpretation of the tax law by various tax officers, which was recently supported by a technical paper written by the head of the Munich tax audit department and published in one of the leading German tax journals. Given the potential magnitude of the issue, this matter was put on the agenda of the Federal Ministry of Finance (MoF) to agree on an official position.

Pursuant to the above, a press release was issued on 14 March 2019 by the MoF and the finance ministers of all German states, wherein it was concurred that payments of German companies to foreign service providers for online advertisement should not be subject to withholding taxes in Germany.

A press release was issued on 14 March 2019 by the MoF and the finance ministers of all German states, wherein it was concurred that payments of German companies to foreign service providers for online advertisement should not be subject to withholding taxes in Germany

2 *Refer EY Global Alert titled "German tax authorities confirm that fees for online advertising should not be subject to withholding" dated 25 march 2019*

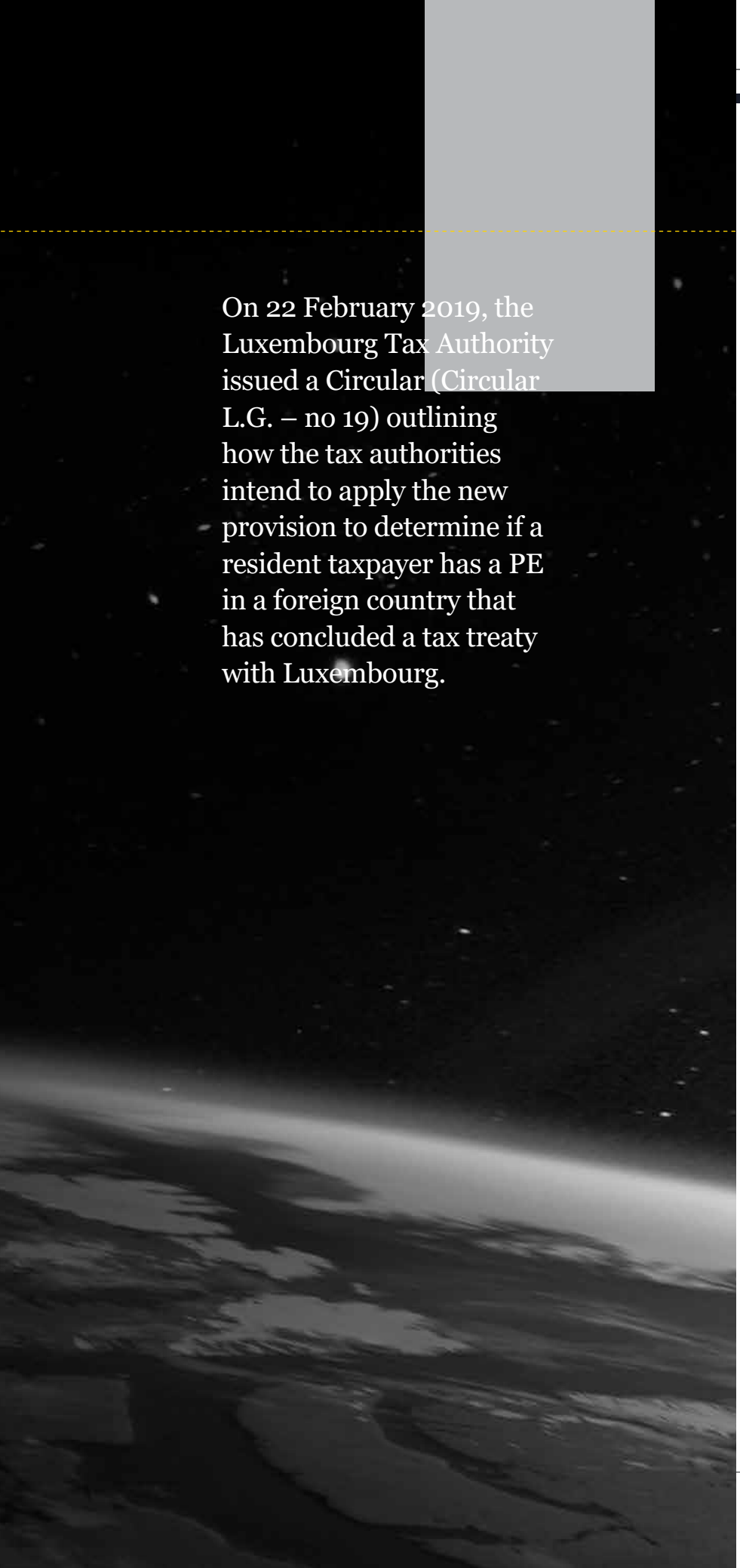
Luxembourg Tax Authority clarifies application of new definition of "foreign permanent establishment"

Luxembourg had implemented the European Union Anti-Tax Avoidance Directive[3] (ATAD) on 21 December 2018. Under implementation of the ATAD, the definition of a domestic permanent establishment (PE) was expanded by an additional paragraph relating to the recognition of foreign PEs in the domestic laws. On 22 February 2019, the Luxembourg Tax Authority issued a Circular (Circular L.G. – no 19) outlining how the tax authorities intend to apply the new provision to determine if a resident taxpayer has a PE in a foreign country that has concluded a tax treaty with Luxembourg.

The Circular sets forth that the recognition of a PE in a treaty country will be based exclusively on the criteria set forth by the tax treaty concluded with that country. Where an existing tax treaty does not define a specific term and most importantly what constitutes a "business activity," Luxembourg will apply its domestic PE definition, according to which a taxpayer will be considered as having a PE in the other contracting state if the activity that is exercised in the other country constitutes an independent activity and represents a participation in the general economic life in that other country. The Circular seems to indicate that the focus is put on the analysis of the activity that is carried out and not on the level of substance, the mere fact of not having an extensive infrastructure or a substantial and permanent presence of human resources would not seem to automatically result in Luxembourg not recognizing the existence of a PE in the other country.

The determination of whether a Luxembourg taxpayer has a PE in foreign country is factual and the Luxembourg taxpayer may be requested to provide confirmation that the other country recognizes the existence of a PE. Such confirmation must be provided where the relevant tax treaty does not contain a provision entitling Luxembourg to tax income or capital if the other country applies the provisions of the tax treaty to exempt such income or capital [i.e., a provision similar to art. 23A (4) OECD3 Model Tax Convention 2017 or art. 5 option A of the Multilateral Convention to

3 *See EY Global Tax Alert, Luxembourg: A detailed review of the EU ATAD implementation law, 28 December 2018.*



On 22 February 2019, the Luxembourg Tax Authority issued a Circular (Circular L.G. – no 19) outlining how the tax authorities intend to apply the new provision to determine if a resident taxpayer has a PE in a foreign country that has concluded a tax treaty with Luxembourg.

Implement Tax Treaty Related Measures to Prevent BEPS4 (the MLI)].

The new provision does not explicitly require the PE to be effectively taxed in the other country. However, the Circular states that the taxpayer must provide a document that proves that the competent authority of the other contracting state recognizes the existence of a PE in its territory along with some supporting evidences. Where the taxpayer does not provide the aforementioned confirmation, whether mandatory or upon request, the tax administration will consider that the taxpayer has no PE in the other contracting country.

CJEU rules on application of Danish withholding tax on dividends and interest payments and availability of benefits under EU Directives[4]

On 26 February 2019, the Court of Justice of the European Union (CJEU) decided several cases dealing with Danish withholding tax on dividends and interest paid by Danish companies to companies in other member states.

Dividend cases

With respect to withholding tax on dividend distributions, the CJEU issued decisions in two cases.

- The first case, C-116/16, deals with a dividend distribution from a Danish company to a Luxembourg parent company that was indirectly owned by private equity funds through another Luxembourg company.
- The second case, C-117/16, deals with a dividend distribution from a Danish company to a Cyprus parent company which used the proceeds to repay interest and principal to its parent company in Bermuda which repatriated the income to the United States (US) parent company in the form of a dividend.

In both cases, the main argument of the taxpayers was that Danish dividend withholding tax was not triggered by the distributions because of the participation exemption set forth in Article 5 of the European Union (EU) Parent and Subsidiary Directive 90/435 (the Directive). The CJEU held as follows:

- Exemption from withholding tax on profits distributed by a subsidiary to its parent company under EU law can be denied where there is a fraudulent or abusive practice.
- It is left for the national court to determine whether the arrangement of a particular case amounts to an abuse of the law. Proof of an abusive practice requires, first, a combination of objective circumstances in which, despite formal observance of the conditions set forth by the EU rules, the purpose of those rules has not been achieved and second, a subjective element consisting in the intention to obtain an advantage from the EU rules by artificially creating the conditions laid down for obtaining it.
- In the present cases, the CJEU observed various facts which indicate the existence of an arrangement intended to obtain improper entitlement to the exemption under the Directive, illustratively:

4 *Refer EY Global Alert titled 'OECD opens public consultation on addressing tax challenges arising from digitalization of the economy: time-sensitive issue impacting all multinational enterprises' dated 14 February 2019*

- All or almost all of the dividends are, very soon after their receipt, passed on by the company that has received them to entities which do not fulfil the conditions for the application of Directive 1
- The passing on of the dividend by the company receiving the dividends is with the consequence that it makes only an insignificant taxable profit when it acts as a conduit company in order to enable the flow of funds from the debtor company to the entity which is the beneficial owner of the sums paid
- The fact that a company acts as a conduit company may be established where its sole activity is the receipt of dividends and their transmission to the beneficial owner or to other conduit companies
- Indications of an artificial arrangement may also be established by the various contracts existing between the companies involved in the financial transactions at issue, giving rise to intragroup flows of funds, by the way in which the transactions are financed, by the valuation of the intermediary companies' equity and by the conduit companies' inability to have economic use of the dividends received
- When examining the structure of the group, it is immaterial that some of the beneficial owners of the dividends paid by the conduit company are resident for tax purposes in a third state which has concluded a double taxation convention with the source member state
- It remains possible, in a situation where the dividends would have been exempt had they been paid directly to the company having its seat in a third state, that the aim of the group's structure is unconnected with any abuse of rights

Interest cases

With respect to withholding tax on interest payments, the CJEU issued decisions in four cases. Three cases[5] deal with private equity funds that have granted loans to Danish companies through intermediary Luxemburg companies. The fourth case[6] deals with a US multinational group where a Cayman company had granted loans to a Swedish company which had granted loans to a Danish company. In all cases, the main argument of the taxpayers was that the Danish interest withholding tax was not triggered by the interest because of the exemption set forth in Article 1 of the EU Interest and Royalty Directive 2003/49 (the Directive). The CJEU held as follows:

- Where there is a fraudulent or abusive practice, the national authorities and courts are to refuse to grant entitlement to rights provided for by the Directive, even if there are no domestic or agreement-based provisions providing for such a refusal.
- It is left for the national court to determine whether the arrangement of a particular case amounts to an abuse of law. This must be determined based on the same criteria as mentioned above regarding the dividend cases. Further, the tax authority must establish, in particular, that the company to which the interest has been paid is not the beneficial owner.
- The concept of "beneficial owner of the interest," within the meaning of the Interest Directive, must be interpreted as designating an entity which actually benefits from the interest that is paid to it.
- An SCA company authorized as a "Société d'investissement en capital à risque" (SICAR) governed by Luxembourg law cannot be classified as a company of a member state, within the meaning of the Directive, capable of being entitled to the exemption provided for in the Directive if, the interest received by that SICAR, in a situation such as that at issue in the main proceedings, is exempt from corporate income tax in Luxembourg.
- In a situation where the system of the Directive of exemption from withholding tax on interest paid by a company resident in a member state to a company resident in another member state is not applicable because there is found to be fraud or abuse, application of the freedoms enshrined in the TFEU cannot be relied on in order to call into question the legislation of the first member state governing the taxation of that interest.

5 C-115/16, C-118/16 and C-299/16
6 C-119/16

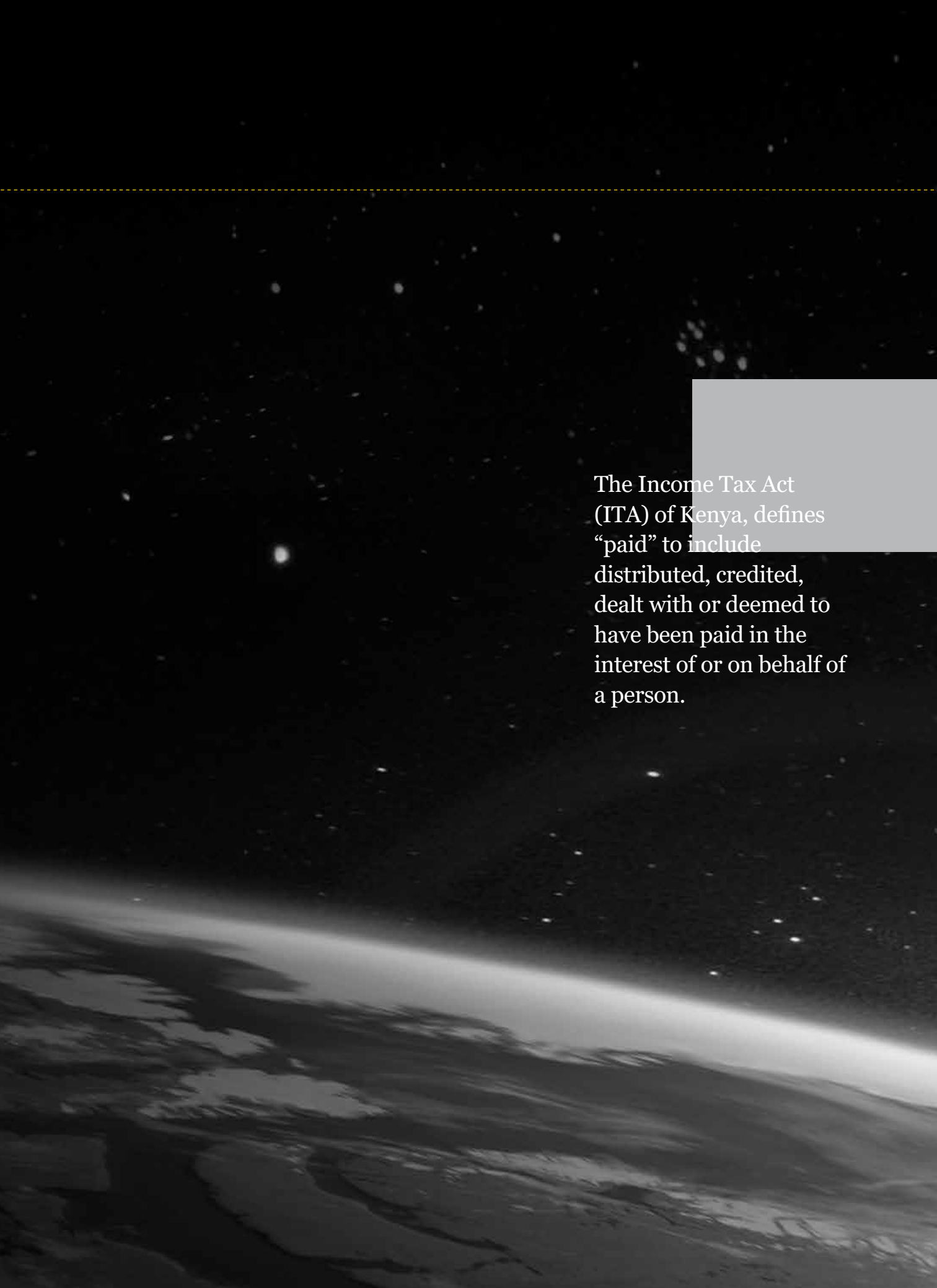
Kenya's Court of Appeal issues landmark ruling on income "paid" for withholding tax purposes[7]

The definition of the term "paid" has been subject to different interpretations. The Income Tax Act (ITA) of Kenya, defines "paid" to include distributed, credited, dealt with or deemed to have been paid in the interest of or on behalf of a person. In addition, the ITA imposes withholding tax (WHT) on payments for certain services when rendered by a resident and/or non-resident person.
The ITA uses the term "upon payment" in reference to the timing for deducting tax in advance in the form of WHT.

In an earlier case, Cimbria (EA) Ltd vs Kenya Revenue Authority (KRA), the term "upon payment" was extensively discussed and the Court concluded that it meant "paid". As a result, many taxpayers have accounted for withholding tax at the point of actual payment of the associated service.

The Court of Appeal in this case has considered the meaning of the term "paid" for purposes of the ITA. The Kenyan Court of Appeal observed that while the words "upon payment" in their colloquial and ordinary parlance suggest being given money for something in exchange, however, the ITA must be the source of the meaning to be attached to such words, by giving them context. The court highlighted that the ITA has given the word "paid" a technical as opposed to ordinary definition. The court finally observed that the income tax regime is based on the accrual system of accounting as evidenced in various sections of the ITA.

7 *Refer EY Global alert titled "Kenya's Court of Appeal issues landmark ruling on income "paid" for withholding tax purposes" Dated 20 February 2019*



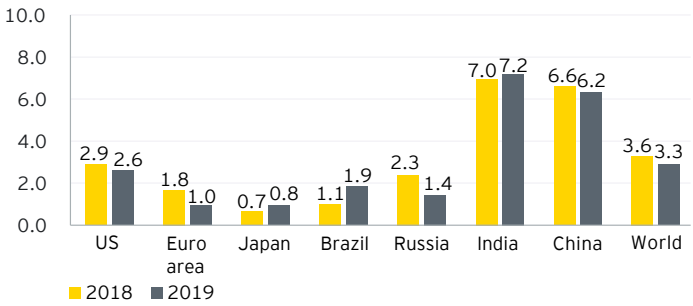
The Income Tax Act (ITA) of Kenya, defines “paid” to include distributed, credited, dealt with or deemed to have been paid in the interest of or on behalf of a person.


EconoMeter
macro-fiscal trends

1 OECD projected global growth at 3.6% in 2018, slowing to 3.3% in 2019

- The OECD projected the global growth to slow from an estimated 3.6% in 2018 to 3.3% in 2019. It has revised down the 2019 global growth forecast by 0.2% points with particularly large revisions in the Euro area
- Growth in India is estimated at 7% in 2018. It is expected to increase to 7.2% in 2019 supported by easing financial conditions, lower oil prices, accommodative fiscal policy and recent structural reforms
- Growth in China is projected to moderate from 6.6% in 2018 to 6.2% in 2019 as trade tensions have weighed increasingly on exports and industrial production

Chart 1: Real GDP growth projections (%, annual)



Source: Interim Economic Outlook, OECD March 2019

Note: estimated for 2018 and forecasted for 2019; *data pertains to fiscal year i.e., 2018 indicates 2018-19 and 2019 indicates 2019-20

2 Real GDP growth fell to a six-quarter low of 6.6% in 3QFY19

- Real GDP growth decelerated to 6.6% in 3QFY19 from 7.0% in 2QFY19, its second consecutive fall in FY19. As per the second advanced estimates of National Accounts Statistics, real GDP is estimated to grow by 7.0% in FY19, lower than 7.2% in FY18. With this, the implied 4QFY19 growth is even lower at 6.5%
- This is largely attributable to a moderation in the growth of final consumption expenditures, both private and government
- A growth in both, the PFCE and GFCE fell to 8.4% and 6.5% in 3QFY19 from 9.8% and 10.8%, respectively in 2QFY19
- However, gross fixed capital formation (GFCF) grew at 10.6% in 3QFY19, improving from 10.2% in 2QFY19
- Contribution of net exports to growth continued to be negative although the magnitude was less at (-) 0.6% points in 3QFY19 as compared to (-) 2.2% points in 2QFY19

Table 1: Real GDP growth (%)

AD component	3Q - FY17	4Q - FY17	1Q - FY18	2Q - FY18	3Q - FY18	4Q - FY18	1Q - FY19	2Q - FY19	3Q - FY19
PFCE	9.2	5.1	10.1	6.0	5.0	8.8	6.9	9.8	8.4
GCE	6.7	17.5	21.9	7.6	10.8	21.1	6.5	10.8	6.5
GFCF	7.9	5.0	3.9	9.3	12.2	11.8	11.7	10.2	10.6
EXP	7.0	6.6	4.9	5.8	5.3	2.8	11.2	13.9	14.6
IMP	10.8	7.0	23.9	15.0	15.8	16.2	10.8	21.4	14.7
GDP	7.4	6.8	6.0	6.8	7.7	8.1	8.0	7.0	6.6

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 *Real GVA growth fell to 6.3% in 3QFY19 led by lower growth in manufacturing and public administration and defense sectors*

- On the output side, GVA growth moderated for the second time in FY19 to 6.3% in 3QFY19 as compared to 6.8% in 2QFY19 due to a relatively lower growth in manufacturing and public administration and defense sectors
- Growth in manufacturing GVA was at a six-quarter low of 6.7% in 3QFY19 as compared to 6.9% (revised) in 2QFY19
- Growth in public administration and the defense sector moderated to 7.6% in 3QFY19 as compared to 8.7% in 2QFY19
- Growth in the financial, real estate and professional services sector increased marginally to 7.3% in 3QFY19 as compared to 7.2% in 2QFY19. GVA growth in construction sector also increased to 9.6% in 3QFY19, an all-time high (2011-12 series), from 8.5% in 2QFY19
- Growth in agricultural and allied sectors dipped to an 11-quarter low of 2.7% in 3QFY19 as compared to 4.2% in 2QFY19

Table 2: Sectorial real GVA growth (%)

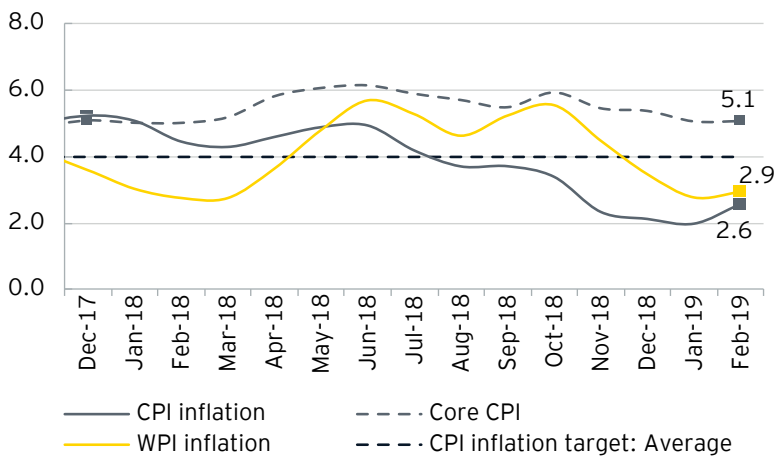
Sector	3Q - FY17	4Q - FY17	1Q - FY18	2Q - FY18	3Q - FY18	4Q - FY18	1Q - FY19	2Q-FY19
Agr.	6.8	7.5	4.2	4.5	4.6	6.5	5.1	4.2
Ming.	4.8	11.7	2.9	10.8	4.5	3.8	0.4	-2.1
Mfg.	8.6	6.4	-1.7	7.1	8.6	9.5	12.4	6.9
Elec.	10.2	8.7	8.6	9.2	7.5	9.2	6.7	8.7
Cons.	7.4	0.8	3.3	4.8	8.0	6.4	9.6	8.5
Trans.	7.8	5.9	8.3	8.3	8.3	6.4	7.8	6.9
Fin.	5.0	3.1	7.8	4.8	6.8	5.5	6.6	7.2
Publ.	9.0	14.8	14.8	8.8	9.2	15.2	7.6	8.7
GVA	7.3	6.0	5.9	6.6	7.3	8.5	7.8	6.8

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

4 The Reserve Bank of India (RBI) reduced the repo rate by 25 basis points to 6.0% in its April 2019 Monetary Policy Review

- Consumer price index (CPI) based inflation increased to 2.6% (y-o-y) in February 2019 from a 19-month low of 2.0% (y-o-y) in January 2019 (Chart 2), driven mainly by a fall in the pace of contraction in food prices
- Core CPI inflation[1] increased marginally to 5.1% in February 2019 from 5.0% in January 2019
- The RBI expects CPI inflation to average 2.4% in 4QFY19, range between 2.9-3.0% in 1HFY20 and between 3.5-3.8% in 2HFY20
- As per the April 2019 Monetary Policy Review by the RBI, outlook for headline CPI inflation is likely to be influenced by low food inflation, lower than expected core inflation, recent pick up in international crude oil prices, falling fuel inflation and further moderation in inflation expectations of households and producers

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

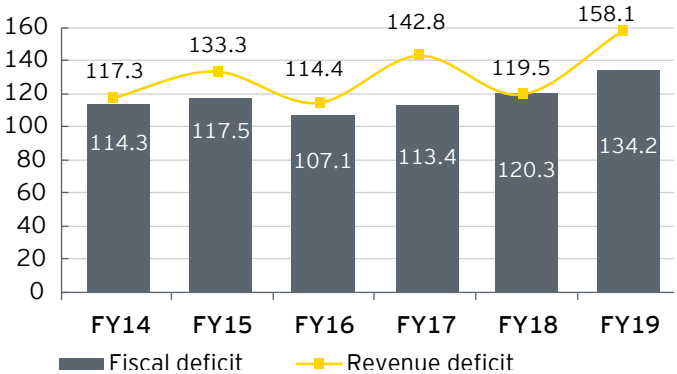


Source: MOSPI.
Note: CPI stands for Consumer Price Index

5 Center's fiscal deficit during April-February FY19 was 134.2% of its FY19 annual budgeted target

- The center's fiscal deficit during April-February FY19 stood at 134.2% of the FY19 annual budgeted target as compared to 120.3% in the corresponding period of FY18
- The center's revenue deficit during April-February FY19 was at 158.1% of the FY19 annual budgeted target, higher than 119.5% in the corresponding period of FY18
- In the Union Budget for 2019-20, the fiscal deficit target was revised to 3.4% of GDP for FY19 as compared to the budgeted target of 3.3% of GDP. The revised estimate for revenue deficit relative to GDP remained unchanged from the budget estimate at 2.2% of GDP

Chart 3: Fiscal and revenue deficit during April–February FY19 as a % of annual budgeted target



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

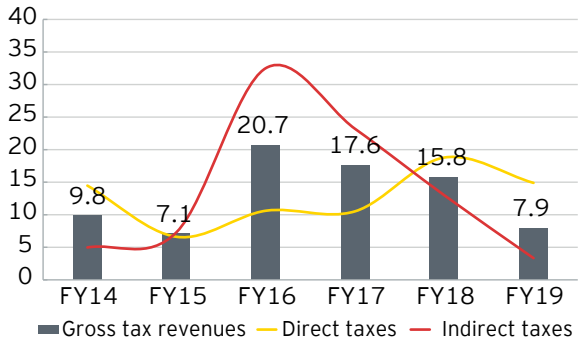
1 Core CPI inflation is measured in different ways by different organizations/agencies. Here, it has been calculated by excluding food and fuel and light from the overall index.

6 Growth in tax revenues was at 7.9% during April–February FY19

- Gross central taxes grew by 7.9% during April-February FY19, lower than 15.8% during April-February FY18
- Growth in direct tax revenues was at 14.9% during April-February FY19 as compared to 18.8% in the corresponding period of FY18
- Growth in indirect taxes (comprising union excise duties, service tax, customs duty, Central Goods and Service Tax (CGST), Union Territory Goods and Service Tax (UTGST), Integrated Goods and Services Tax (IGST)# and GST compensation cess) was low at 3.3% during April-February FY19 as compared to 13% in the corresponding period of FY18
- Center's non-tax revenues grew by 20.8% during April-February FY19 as compared to a contraction of (-) 32% in the corresponding period of FY18. Non-tax revenues during April-February FY19 stood at 70% of the FY19 revised estimate as compared to the corresponding figure of 60.2% in FY18

#IGST revenues are subject to final settlement

Chart 4: Gross tax revenues (growth rates, %)



Source(Basic Data): Monthly Accounts, Controller General of Accounts, Government of India

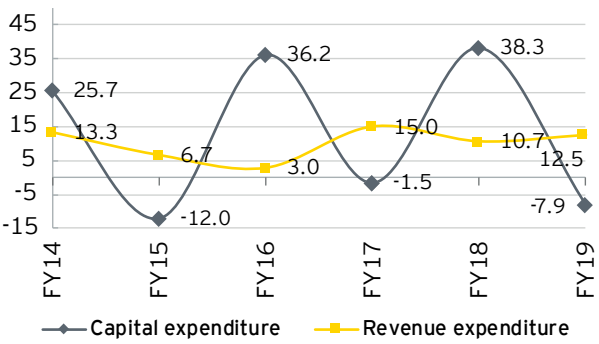
*Personal income tax and corporation tax

**Union excise duties, service tax, customs duty, and CGST, UTGST, IGST and GST compensation cess from July 2017 onward

7 Center's total expenditure grew by 9.5% up to February 2019

- Center's total expenditure during April-February FY19 grew by 9.5% as compared to 14% in the same period in FY18
- Growth in revenue expenditure was at 12.5% during April-February FY19 as compared to 10.7% in the corresponding period of FY18. Revenue expenditure up to February 2019 stood at 77.9% of the FY19 revised estimate
- Center's capital expenditure contracted by (-) 7.9% during April-February FY19 as compared to a growth of 38.3% in the corresponding period of FY18. Capital expenditure up to February 2019 stood at 86.4% of the FY19 revised estimate

Chart 5: Growth in revenue expenditure during April–February FY19 (%, y-o-y)



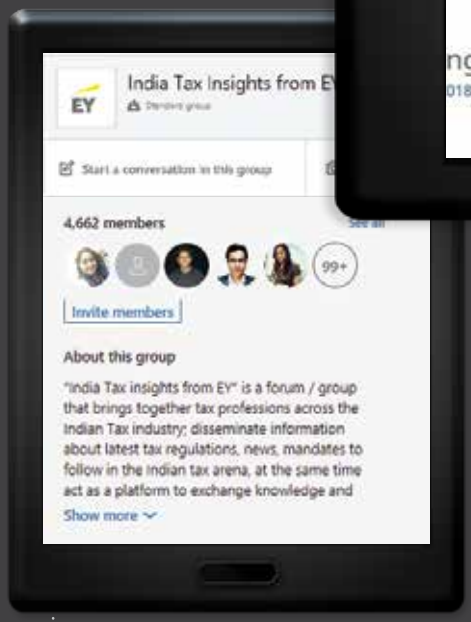
Source: Monthly Accounts, Controller General of Accounts, Government of India.


EY
Building a better working world
Should tax keep pace with transformation, or help shape it?
EY India's Tax and **Economic Policy Group** anticipates policy changes and proactively engages with the policymakers to create a better working world.
ey.com #BetterQuestions
The better the question. The better the answer. The better the world works.
© 2019 Ernst & Young LLP | All Rights Reserved.

Catch us online

EY India Tax Insights blog

Subscribe to our blog for topical reads on the Indian tax and policy landscape
Link: www.indiataxinsightsblog.ey.com



Linkedin group and page

EY India Tax Insights: Join the group and page for highlights and discussions on the latest tax and regulatory developments in India
Group: www.linkd.in/1tI6W9W
Page: www.linkd.in/1qYJ9zh

EY Twitter page

Follow us on @EY_India #EYTax for latest tax updates and insights

EY India GST webpage

Access our GST webpage for the latest updates and views
www.ey.com/in/GST

DigiGST® - an integrated GSP-ASP solution

To learn all about GST compliance visit our DigiGST® microsite.
http://www.ey.com/in/en/services/tax/ey-gsp-asp

EY India Tax Insights App

Download the EY India Tax Insights App on iPhone® and Android™ devices for deeper insights and analysis on the latest tax and regulatory developments.


EY
Building a better working world
Will the speed of the digital tax revolution leave you behind?
EY's advanced technology solutions are helping reimagine tax in limitless ways.
ey.com/taxtechnology
© 2019 Ernst & Young LLP | All Rights Reserved.
The better the question. The better the answer.
The better the world works.