

India Tax Insights

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In this issue



Building a better
working world



Foreword

We are pleased to present the 21st edition of our magazine India Tax Insights.

The rapid pace of digital innovation, the significant demographic shifts and the increasing demand for a more sustainable world create megatrends influencing and transforming economies, the business environment and wider society. The COVID-19 pandemic has further amplified these developments. Governments are shoring up their economies impacted by the pandemic through record stimulus packages and introducing new policies and legislation to drive a sustainable recovery. Businesses are re-evaluating their supply chains and reimagining how their workforce operates. As we have seen during the pandemic, digital means were at the heart of many businesses' ability to shift from physical engagement among employees and with customers, to virtual engagement. Without digital means, the economy would not have been able to respond with such agility to the pandemic.

The digitalisation of the economy is creating disruptions and opportunities in many areas. One of these areas relates to tax. The international tax rules were originally conceived in the early 20th century when profit generating activities were still "bricks and mortar". In the current environment, businesses can have significant economic engagements with consumers and users in a jurisdiction, without having any physical presence in such market jurisdiction. As taxation rights in the existing bilateral tax treaties are linked to having a physical presence in a jurisdiction, this prevents market jurisdictions from implementing domestic rules to tax profits from these remote activities. This has led to a strong push for taxing the profits from such activities based on a global consensus on a new division of taxing rights. At the same time, number of countries have expressed concerns over what they term as the "race to the bottom" regarding taxation of multinational groups. This has led to a call for global rules that would ensure that all large international operating businesses pay at least a minimum level of tax.

This edition of our magazine contains insightful articles on recent tax and fiscal policy developments. The articles cover topics ranging from implications for India from the OECD Inclusive Framework's Pillar One and Pillar Two blueprint on global taxation, impact of India's production-linked Incentive regime in making India a global manufacturing hub, analysis of the recent Supreme Court decision on taxation of computer software transactions and key tax and regulatory considerations relating to use of special purpose acquisition companies for capital raising. Of specific interest would be a conversation with Mr. Rasmi Ranjan Das, Joint Secretary, Foreign Tax & Tax Research in the Ministry of Finance, where he shares his candid thoughts on the direction of India's tax policy for dealing with tax challenges arising from digitalisation of the economy.

In this shifting tax environment, keeping abreast of changes is essential. We hope this publication helps you monitor the issues and understand the drivers behind key tax and regulatory developments and changes happening in India and around the globe.

We look forward to your feedback and suggestions.



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Taxing the digital economy - new taxing right under Organisation for Economic Co-operation and Development (OECD) Pillar One

The rapid spread of digitalization has driven considerable changes in the way businesses operate. This has led to the emergence of new business models and to the substantial transformation of old ones. These changes have placed pressures on the basic concepts underlying existing international tax rules, which were created almost a century ago.

On 12 October 2020, the OECD/G20 Inclusive Framework on BEPS released a series of documents in connection with the BEPS 2.0 project, including a detailed report on the Blueprint on Pillar One (the Blueprint). The aim of Pillar One is to reach a global agreement on adapting the allocation of taxing rights on business profits in a way that expands the taxing rights of market jurisdictions. In order to achieve this, Pillar One contains three elements:

Pillar One contains three elements:

1

New taxing rights for market jurisdictions over a share of the (deemed) residual profits of a multinational enterprises group (MNE) or segment of such a group (Amount A)

2

A fixed return for certain baseline marketing and distribution activities taking place physically in a market jurisdiction (Amount B)

3

Processes to improve tax certainty through effective dispute prevention and resolution mechanisms



As the OECD documents make clear, the Blueprint does not reflect agreement by the member jurisdictions of the Inclusive Framework on BEPS because there are political and technical issues that still need to be resolved. However, the cover statement of the Inclusive Framework refers to the Blueprint as a “solid basis for future agreement” and states that the member jurisdictions have agreed to keep working “to swiftly address the remaining issues with a view to bringing the process to a successful conclusion by mid-2021.”

The Blueprint indicates that the follow up work on Pillar One will focus on resolving the remaining political and technical issues, which include essential elements of Pillar One, such as issues around scope, quantum, the choice between mandatory and safe harbor implementation, and aspects of the new tax certainty procedures connected to Pillar One. There are a number of aspects relating to design and implementation elements of the Blueprint that would require a consideration.

Scope

The new taxing rights under Amount A apply to multi-national enterprises that fall within the defined scope. Two categories of activities are proposed to be included in the scope: (a) Automated Digital Services (ADS); and (b) Consumer Facing Businesses (CFB). Given that the concern of most countries around base erosion arises from digital businesses, the OECD could consider a phased implementation with ADS coming first and CFB following later.

Amount of profit to be reallocated

Agreement on how much residual profit would be reallocated under the new taxing right is conditioned on agreement on scope. The quantum would depend on the determination of different threshold amounts and percentages for the purpose of scope, nexus and profit allocation (the formula). Much work has been completed on the impact of different thresholds and percentages of profit to be allocated. The current approach seeks to allocate only a portion of the residual profit to market jurisdictions. There may be merit in considering whether market jurisdictions should be allocated, beyond residual profit, a portion of routine profit as well in the case of remote marketing and distribution activities facilitated by digitalization. In addition, the OECD should also consider “differentiation mechanisms” in order to increase the quantum of profit reallocated to market jurisdictions for certain business activities (for example, ADS), or a scalable reallocation depending on the profitability of the business (profit escalator). These variations to the Amount A profit allocation rules would need serious consideration if a consensus is to be reached.





Extent of tax certainty

While all members have agreed on the need for an innovative solution to deliver early certainty and effective dispute prevention and resolution for Amount A, there continue to be differences of view on the scope of mandatory binding dispute resolution beyond Amount A. The Blueprint contains proposals to bridge these divergent views. A decision on this issue will need to be part of a comprehensive agreement also covering the other two open political issues on quantum and scope. While India has historically not been in favor of resolving tax disputes through binding arbitration, considering the overarching objective of providing tax certainty, it may consider revisiting its historical position.

Scope and application of Amount B

While the Blueprint contains an outline of a solution that assumes that in-scope distributors are to be identified based on a narrow scope of baseline activities, there may be merit to explore the feasibility of broadening the scope of Amount B. There may also be a need to further refine the design of Amount B such that the intended simplification benefits are achieved, and further consider that implementation through a pilot program at first may allow for some evaluation of the benefits in practice.

Taxation of the digital economy raises complex technical questions, and there are also differing views among countries on the extent of changes to the international tax rules. Concerns about the inadequacy of the current rules to deal with the broader tax challenges is evidenced by the increasing number of uncoordinated, unilateral actions. Hence, it is important to find a multi-lateral solution to the issues. The proposals under Pillar One represent a substantial change to the tax architecture and go well beyond digital businesses. These proposals could lead to significant changes to international tax rules under which businesses operate. If no agreement can be reached by mid-2021, it is expected that many countries will introduce digital services taxes. Moreover, countries could introduce other elements of the Pillar One architecture through their domestic legislation, such as for example a variation of Amount B. If there is no coordinated global agreement, this could lead to a rise in double taxation and controversy.



Concluding thoughts



India perspective on Pillar Two of BEPS 2.0



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On 12 October 2020, the Organisation for Economic Co-operation and Development (OECD) released a series of major documents in connection with the ongoing G20/OECD project (the BEPS 2.0 project). These documents include the long-awaited report on the Pillar Two Blueprint (the Blueprint). Pillar Two of the BEPS 2.0 project addresses the development of global minimum tax rules with the objective of ensuring that global business income is subject to at least an agreed minimum rate of tax regardless of where they are headquartered or the jurisdictions, they operate in.

The Blueprint

The Blueprint provides technical details on the design of the Pillar Two system of global minimum tax rules. The global anti-base erosion (GloBE) rules comprise of income inclusion rule (IIR) and the undertaxed payments rule (UTPR) acting as a backstop to the IIR. IIR triggers an inclusion at the level of the shareholder where the income of a controlled foreign entity is taxed at below the effective minimum tax rate. It is complemented by switch-over rules (SOR) which would permit a residence jurisdiction to switch from an exemption to a credit method where the profits attributable to a permanent establishment (PE) or derived from

immovable property (which is attributable to a PE) are subject to an effective rate below the minimum rate. It is further supported by UTPR which acts a backstop to deal with circumstances where the IIR is unable, by itself, to bring low tax jurisdictions in line with the minimum rate.

Further, subject to tax rule (STTR) complements the GloBE rules by subjecting a payment to withholding or other taxes at source and adjusting eligibility for treaty. Unlike IIR or UTPR, the STTR is not concerned with effective tax rate (ETR); instead it looks to the nominal tax rate that applies to certain covered payments between connected persons.

In terms of the order of application, STTR takes on a primary role and is applied in priority to GloBE rules. Under GloBE rules, application of IIR will take precedence over the UTPR. UTPR will apply only in the absence of IIR and in relation to the intra-group payments to low tax jurisdictions. Thus, the top-up tax imposed under the STTR in the source jurisdiction is taken into account while determining the ETR for purposes of the IIR and the UTPR.

Notably, Pillar Two leaves jurisdictions free to determine their own tax system, including whether they have a corporate income tax (CIT) and where they set their tax rates, but also considers the right of other jurisdictions to apply the above rules as proposed where income is taxed at an effective rate below a minimum rate.

The determination of in-scope groups and entities is based largely on the definitions and mechanisms that are used in connection with country-by-country reporting (CbCR). MNEs with total consolidated group revenue below €750 million in the immediately preceding fiscal year generally are excluded from the GloBE rules.

India perspective

India has a worldwide system of taxation, under which persons resident in India [which includes foreign companies having place of effective management (POEM) in India] are subject to a comprehensive tax liability on their worldwide





income, regardless of source of the income. India's current rate of corporate income rate is 25% and 17% for new manufacturing companies. India has extensive taxing rights under the source rule in the form of withholding tax which target passive income streams as well as certain active business incomes, generally perceived as base eroding payments like royalty, fee for technical services (FTS), dividend and interest, irrespective of whether the same is undertaxed or not. In addition, the Indian income-tax law has transfer pricing and other anti-abuse provisions which are designed to counter cross-border shifting of profit. Overall, it can be said that even with the corporate tax rate reduction and phasing out of tax incentives, India is not indulging in "race to the bottom". Given that the primary objective of Pillar Two is to target allocation of significant intangible and risk (and related returns) to group entities in low tax jurisdictions, the proposed rules for top-up tax/ minimum tax is a positive factor for countries like India which is largely a capital and technology importing country.



Implications

Implementation of GloBE rules requires changes to the domestic tax legislation as well as the tax treaties which may be done through bilateral negotiations or amendment to MLI. Therefore, any imbalance or non-coordination with the existing domestic tax rules (particularly those relating to residency, POEM, withholding and credit of taxes) would lead to double taxation which is not the intended objective of the GloBE rules. Because dispute prevention provides far more certainty and cost efficiency to businesses and tax administrations than dispute resolution after the fact, the Blueprint requires mandatory dispute prevention mechanisms to be implemented. Businesses should have access to an effective mechanism to get an advance determination on all of the determinations that would be required in applying the new rules. Hence, unless India is able to adopt an effective mechanism for preventing and resolving disputes under current tax rules - particularly those involving cross-border tax matters - implementing GloBE rules would be a challenge. Businesses also should evaluate the potential impact of these changes on their business models.





In Conversation with

Rasmi Ranjan Das

Joint Secretary, Foreign Tax & Tax Research and
Competent Authority for India

OECD's Pillar One and Pillar Two

Impact and way forward



*The views expressed here are personal.
This interview was conducted in February 2021.*



EY

Multinational companies (MNCs) and stakeholders find Pillar One and Pillar Two Blueprints to be complex and have expressed concern in the public consultation process around double taxation arising from unilateral measures. In this context, what are your views on the overall framework of Pillar One and Pillar Two and the approach in which these issues will be discussed at the Organisation for Economic Co-operation and Development (OECD) level?

Rasmi Ranjan Das

Thank you and EY very much for giving me this opportunity to discuss the ongoing debate on Pillar One and Pillar two. I must clarify that the views expressed herein are my own and do not necessarily represent the views of the Government of India.

Now coming to your question, I have no hesitation in admitting that both blueprints on Pillar One and Pillar Two which seek to provide solutions to the challenges primarily posed by digitalization are not simple documents. However, I must say that any solution that is transformational may look, at least at the first instance, more complex than it is.

As Albert Einstein once said,

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if at first an idea is not absurd, then there is no hope for it.

The fundamental problem that is sought to be addressed by the blueprints is that the existing international tax rules which were framed almost 100 years ago rely on a nexus rule based on physical presence and a profit allocation rule based on arm's length principle. The all-pervasive digitalization of economy has created business models that can operate in a jurisdiction without physical presence. These models have scale without mass and heavily rely on intangible assets which have no observable location. These developments have rendered existing rules ineffective, if not completely obsolete. When you have such fundamental problems, the solution will always challenge the existing paradigm and cannot be an incremental one.

Even before Pillar One's Unified Approach, the solutions that were initially proposed, i.e., marketing intangible approach, user participation approach, the significant economic

presence approach; all rejected the separate entity approach and considered multinational enterprise (MNE) group as one. These solutions, in fact, attempt to align the taxation principles with the reality because an MNE group operates as one entity. But once we consider an MNE group as one taxable unit and seek to adhere to the fundamental principle of corporate taxation, that is, taxation of net income and elimination of double taxation, we are in unfamiliar territory. Therefore, at first instance, Pillar One looks complex. The same applies to Pillar Two as well. Having said that, without sacrificing the integrity of the rules, the Inclusive Framework is committed to making the rules as simple and predictable as possible. Particularly, India, along with other developing countries has always emphasized that the proposed solution to the digitalized economy must be simple so that it is easy to administer and easy to comply with.



This quest for simplicity and the desire to lower the compliance burden informs the design features of Pillar One. The simplicity is sought to be achieved by refining the scope, laying down the positive list and negative list, having a revenue threshold based nexus, a profit allocation rule based on formulaic approach, reliance on consolidated financial results so that the MNE group does not have to rewrite its accounts, providing a segmentation safe harbor, and considering a marketing and distribution safe harbor, to name a few. Equally important is the emphasis to provide a robust mechanism for dispute prevention and resolution mechanism.

Similarly, under Pillar Two, simplification is attempted through consolidated financial accounts, effective tax rates based on Country by Country (CbC) reports, the safe harbor

wherein the effective tax rate for one year will be accepted for subsequent multiple years without fresh calculation, a de-minimis profit threshold, concept of low risk jurisdictions, etc.

Still, given the overriding concern over the complexity of the proposal, as is evident from the public consultation inputs that have been received, the Inclusive Framework will be very mindful of those concerns and related suggestions. EY should also provide inputs on how the design can be simplified. We deeply value the inputs provided by EY in response to our request for comments as it is only through such collaborative approach that we can have a solution which shall be easy to administer and comply with.

EY

The economic impact assessment done by the OECD states that Pillar One would involve a significant change to the way taxing rights are allocated among jurisdictions, as taxing rights on about US\$ 100 billion of profit could be reallocated to market jurisdictions under the Pillar One rules. Further, the combined revenue gains from both pillars are estimated to be broadly similar. Furthermore, the Pillar One Blueprint notes that 80% of the residual profit of an MNE group (or segment where relevant) calculated for the purpose of Amount A would continue to be taxed in accordance with the existing arm's length principle based profit allocation system, and the other 20% would constitute the allocable tax base for Amount A purposes. So, 80% of the residual profit will be left out of the scope of Base Erosion and Profit Shifting (BEPS) 2.0. Given this data which the OECD has come up with, do you believe that this entire exercise will deliver the desired results?

Rasmi Ranjan Das

There are two aspects to your question. First is the revenue. Pillar One is not about getting additional revenue, but more about reallocating taxing rights. Revenue will shift from one country to another. For example, something getting taxed in the United States may be taxed in India or something getting taxed in India, may be taxed in the Netherlands. So, the net increase may not be substantial. The other aspect is that the proposal moves from a single entity approach to a group approach, looks at the group revenue and group profit, and then allocates part of group profit among various jurisdictions. Thus, any revenue forecasting exercise in relation to such a proposal is a complex one.



We also need to note that the OECD's economic impact assessment is ex-ante. is based on data of 2016, and thus does not capture impact of the United States' tax reforms. Further, currently, we do not know the impact of COVID, particularly when there are so many moving parts of the proposal which are still to be agreed upon. On share of only 20% of residual profit assumed in EIA, it must be noted that the same is an assumption only. No agreement has been reached on how much of residual profits would be shared. We also should note that finally it will be a compromise between various countries and that impacts the scope and correspondingly the revenue to be shared. Apart from revenue, equally important for most countries involved in the discussions is the goal of modernizing the international tax system to bring tax rules in line with realities of 21 century. I think at the end of the day it is better that we have a solution, otherwise there will be increased unilateral or national tax measures. So, I think the balance of convenience lies in favor of having a solution rather than not having one.

EY

In the quest for simplicity, do you think the OECD will be more open to considering the United States' option of safe harbor or is it completely out of the picture?

Rasmi Ranjan Das

Safe harbour is a United States' proposal,

but many of the Inclusive Framework members are not very sure how safe harbor will work. Safe harbor works when a country has taxing rights. For instance, we have taxing rights in transfer pricing and so we can have a safe harbor in transfer pricing. But, when the country does not have a taxing right, how will safe harbor work? Let us say, we are

looking at having taxing rights in respect of a company which operates remotely in my country, it has a certain revenue threshold and thus develops a taxable nexus as per the proposed solution. Unless we rewrite Article 5 or we have another article which over rides Article 5 of the double taxation avoidance agreement then safe harbor may not help. So, we need fundamental changes and those changes must be in the legal framework governing the international tax rules. Preferably, we should have a multilateral instrument which will

override the existing limitations or the existing definition of the nexus rules or profit allocation rules in Article 5 and Article 7 and, to some extent, may be Article 9. Therefore, I am not very sure, how the safe harbor will work in the absence of legal changes in international tax rules. However, the discussion on safe harbor at the OECD is still on the table and the countries are engaged with USA to understand its position and concerns.



EY

Pillar One Blueprint provides for various thresholds and classification of profits into routine and non-routine before arriving at the share of profits to market jurisdictions. In your view, are some of these proposals likely to be more beneficial or they are likely to create more issues than status quo? What are India's expectations from BEPS 2.0 and more specifically from Pillar One?

Rasmi Ranjan Das

Let me answer the second part of the question first. If the Inclusive Framework fails to agree on a consensus solution, the counterfactual is not encouraging, i.e., there may be unilateral tax measures and negative impact on global growth. So, what I want to emphasize is that, there is no possibility of "status quo" continuing. If we do not have a multilateral solution, we will have more of what people call as unilateral tax measure, I prefer to call them as national tax measures. As Lampedusa said in his work, *The Leopard*, "***If we want things to stay as they are, everything will have to change.***" So, things will change, and we have no option but to work towards a solution.

Now, coming to the first part of the question, I think providing thresholds does not complicate the issue but simplifies the issue. Thresholds restrict the number of companies which are required to comply. These are, revenue wise, big MNE group, who have the necessary capacity and resources to comply with the new rules. Similarly,

various other thresholds like de-minimis profit threshold and even quantification of routine or non-routine profits which are based on formulaic apportionment, are only going to help in implementation of the law so that we are not talking of a qualitative analysis of the residual profit or the fact and circumstances of the case.

Regarding our expectations from BEPS 2.0, the Unified Approach as on date is not our preferred solution. It is, after all a compromise. We would have been happier if the G24 proposal, where India played a part in its formulation and in piloting it, which is based on significant economic presence and fractional apportionment, would have found a wider acceptance. Anyway, we stay engaged in this compromise solution of Unified Approach because it accepts that the two fundamental problems afflicting the international tax rules i.e., nexus and profit allocation need to be addressed. We hope that a consensus-based solution on the Unified Approach framework shall be fair, equitable, simple and administrable

for the 137-member network of Inclusive Framework.

More specifically, we favor a taxable nexus based on a revenue threshold. We are not very excited about the plus factors because in our view it makes things complex. On profit allocation we want a high percentage share, preferably, an escalated approach where the share of profit to be given to the market jurisdiction goes up as the profit margin goes up. There is adequate academic research to suggest that profits beyond a margin are more due to market failures and mostly represent monopoly or near monopoly rents and not because of any intrinsic worth of the goods and services provided by a business. We also want a share in deemed routine return, in respect of the remote presence where there is no physical nexus. Overall, we are interested to have a reallocation of taxing rights under Pillar One that brings meaningful and sustainable revenue for source and market countries. It must also address the concern that several



companies perceived to be not paying their fair share of taxes in the source or market jurisdiction, shall pay their share of taxes. I must reemphasize that the aspects of quantum of revenue to be distributed and the new regime being perceived as fair and equitable by major stakeholders are very important. Otherwise, the new regime will not be stable in the medium term and we will soon be back to table discussing BEPS 3.0 and the national tax measures in some form or the other to capture that revenue perceived to belong to market jurisdictions will continue in the meantime.

Thus, a suboptimal multilateral consensus solution, with both multilateral and individual country measures coexisting, will make things more chaotic. So, we need to have a solution which is perceived as fair and equitable by at least a majority of stakeholders.

EY

Are the objectives sought to be achieved by OECD aligned with India's policy considerations? In terms of India's economic assessment, how beneficial is Pillar One from expected revenue target, compliance, certainty and administrative standpoint?

Rasmi Ranjan Das

I have already indicated how the new proposals are aligned with India's policy considerations. This is the proposal which accepts that there is a problem with the existing nexus and the profit allocation rules. This is in accordance with India's position, which we have articulated for years, for instance in our reservation to the OECD model on Article 5 and 7. Further, the reason why it is aligned with our policy objective is that we strongly believe that markets do contribute to profit of an enterprise. And therefore, the jurisdictions that host markets do have a taxing right on part of those profits along with other jurisdictions that host production factors. In fact, as four economists wrote in their famous report in 1923, to the League of Nations,

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The oranges upon the trees in California are not acquired wealth until they are picked, not even at that stage until they are packed, and not even at that stage until they are transported to the place where demand exists and until they are put where the consumer can use them. These stages, up to the point where wealth reached fruition, may be shared in by different territorial authorities.

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So, countries where oranges are harvested, where they were packed and processed and where they were sold all should have taxing rights. The Unified Approach accepts those principles when it recognizes a taxable nexus based on remote sales and a profit distribution formula linked to sales in a jurisdiction. So yes, the Unified Approach is aligned with our policy objective and the direction is in line with our policy goal. Now the question is, it accepts the principle but how far does it go in giving those rights. This is something we will know only when we have the final solution.

Regarding economic assessment, it is always difficult to make a revenue forecast ex ante, particularly when we still have so many moving parts. We do not yet know the exact



scope, nor the thresholds nor even the profit allocation percentage. Having said that, intuitively one can say that given the policy rationale and the direction of the proposal, there will be revenue gain for market jurisdictions like us. In addition, we are a fast-growing market and the ratio of sales in India to global sales for an MNE can only increase in coming years. That will be beneficial for us, as the distribution of profit is linked to sales in jurisdiction. But, beyond revenue, we must look at the broader picture, i.e., the benefit of having a modern international tax framework that provides certainty and predictability to all. This is most important to both tax administration and to the taxpayer. So, we hope that the solution will bring sustainable revenue, is fair and equitable and promotes innovation, investment and growth.

EY

Do you think India will continue with unilateral measures like the equalization levy if the expectations on share of market related returns under BEPS Pillar One are not met?

Rasmi Ranjan Das

That is a hypothetical question. For the time being, we in the Inclusive Framework are engaged in finding a consensus-based solution which on implementation should eliminate the rationale to have any national tax measures, whether it is equalization levy, digital service tax, or base erosion and anti-abuse tax or various other forms of national tax measures that have been taken including diverted profits tax, multinational anti avoidance law, etc. We hope that the solution will be such that it will eliminate the reasoning to have those measures. Finally, however, it is the governments which will take the appropriate policy call in this regard, at the appropriate time, looking at the solution that we finally agree. Hence, at this stage, it is a hypothetical question.

EY

Any insights on the United States' view on equalization levy?

Rasmi Ranjan Das

The United States Trade Representative has a published report wherein they have given their views on equalization levy. We are engaged with them in a discussion. We feel that the equalization levy is not targeted at any country or any business per se given our scope and our threshold and we also feel these are consistent with our international obligations.



EY

Do you believe the inclusion of consumer facing business as in scope for Pillar One would diverge from India's tax policy objective to address complexities notably arising out of digitalization?

Rasmi Ranjan Das

When the debate started, the focus was on those businesses, which due to digitalization can participate in the economic life of a country without an in-country physical presence. So, we had a remote nexus problem which needed to be addressed. And naturally, these businesses normally deal with digital goods or provide digital services. However, some countries felt that the scope should be much wider to cover certain other businesses which supply tangible products or provide on-ground

services to consumers. It was felt that under the existing profit allocation system based on arm's length principle, a part of the residual profit which should be getting taxed in the market jurisdiction does not get captured in those jurisdictions. Therefore, there is a case to distribute such profits to those market jurisdictions. That is how the consumer business came as "in-scope".

I agree that consumer facing business will add to the complexity of the proposal, but many countries feel

that the policy goal should be to comprehensively address the problems in digitalization including the limitation of ALP. This is in line with our own view. We have not accepted new Article 7 to 2010 OECD model and made known our reservation. Most of the countries including many in the Inclusive Framework, do not accept that arm's length principle always results in a fair and equitable distribution. That way the UA is also in line with our thinking about limitation of arm's length principle and I do not see it as a departure from the policy objectives.





EY

One of the arguments in Pillar One is that they do not distinguish between digital companies and consumer facing businesses. Do you believe the Blueprints do bring equality considering that there are certain exclusions for consumer facing businesses that do not apply to a digital business? Is the parity really achieved?

Rasmi Ranjan Das

Most of the documents brought out by the Inclusive Framework highlighted two problems. First, there is a possibility for a business to be involved in the economic life of a country without having a physical presence, i.e., there is a nexus issue. Second, on which all the Inclusive Framework members equally agree is that the arm's length principle is good, when used to allocate profit or to find out the transaction value in respect of routine transactions i.e., for which comparables are available. But it fails to allocate appropriately the profit, which is the residual profit as they call it, the profit beyond what is allocated for routine functions. These are the two fundamental things on which Inclusive Framework members agree.

The second part which says that residual profit cannot be allocated properly under the arm's length principle is being addressed in respect of consumer facing goods where, even though they already have a physical presence, some additional profit will flow to the market, because it is believed that under the arm's length principle, the allocation of profit to the market jurisdiction is less than equitable

The businesses which have been taken out of consumer facing even though apparently they look as consumer facing are those, for instance banking industry, where there is an understanding or acknowledgement that all the residual profit gets generated and captured because of the regulatory framework

that govern banking industry, in the country in which they undertake the business. Hence there is no need for allocating any residual profits, because all the profits that get generated gets captured in those market jurisdictions. However, I accept your point that there may be a case to include all businesses and it may not be fair to target a limited number of consumer-facing businesses. But since this is a 137-member group, it is a compromise solution where most countries agree that digitalized businesses and consumer facing businesses should be covered. Beyond that, for business to business (B2B) model under CFB and other businesses, which are not covered in the scope, there is no agreement yet.



EY

Tax certainty is an essential element of Pillar One and this Blueprint has taken an approach which is based on the number of steps whether it is dispute prevention and the existing Mutual Agreement Procedure (MAP) to new and innovative mandatory binding dispute resolution mechanisms. OECD peer review reports on India MAP process, have acknowledged that the experiences of the peers in handling and resolving MAP cases with India have been generally positive. In this backdrop, is India adequately equipped with controversy management options for dealing with future controversy that may arise on these counts?

Rasmi Ranjan Das

Dispute prevention and dispute resolution in any case is a priority goal for the Indian tax administration. India's efforts in resolution under MAP have received international appreciation. India, along with Japan, has been awarded the first prize in 2020 by the OECD MAP Forum for resolution of transfer pricing MAP cases.

We need to look at dispute prevention and resolution regarding Amount A differently because it is a multilateral profit distribution mechanism, based on an MNE group as a taxable unit and therefore the bilateral MAP process will not work there. It is by nature multilateral, and therefore we require a multilateral dispute settlement system. The Blueprint provides the basic architecture for such a multilateral mechanism - an early certainty process, followed by a review panel and determination panel. I personally feel that the most important thing is to design the rules and to provide early certainty. In the first year, there may be issues about whether some businesses are in scope and how they are computing their consolidated profit or what will be their revenue sourcing rules. But, once that is agreed upon and looked into by the lead tax administration, in the following years it would be much easier to decide on these issues. If we have simplified rules, a review panel and a determination panel, we should be able to resolve the controversies that may arise because of the implementation of Amount A. So, I am hopeful that the system that we are trying to design will answer all questions that may arise in the spectrum of Amount A under Pillar One.

EY

India has had some concerns on certain dispute resolution mechanisms like arbitration. How do you foresee an innovative mandatory binding dispute resolution mechanism?

Rasmi Ranjan Das

India has an in-principle opposition to arbitration as a mechanism to resolve tax disputes. It is based on the principle that taxation is a sovereign function and tax disputes can only be resolved either by statutorily empowered tax officials or by a competent tribunal and court. Now the new innovative binding dispute resolution mechanism under Amount A does not embrace arbitration. It is built around a panel of tax officials and hence is not something which is against our policy position.



EY

India has not implemented controlled foreign corporation (CFC) rules in the past or due to various tax policy considerations. Do you believe similar considerations could have an impact while introducing income inclusion rule (IIR) as per Pillar Two? What are your thoughts on the interplay between the IIR and India's existing place of effective management rule (POEM)?

Rasmi Ranjan Das

The first part of your question is hypothetical. Introduction of a tax measure is a sovereign policy choice of the government and such decisions are made after a careful consideration of all aspects of the matter. Pillar Two is not going to be a minimum standard i.e., every country is not obliged to impose IIR. It is a policy choice made available to all jurisdictions so that by virtue of an agreement on Pillar Two (as and when reached), any country that wishes to have an IIR can have it in the manner agreed, without any constraints. Therefore, at this stage, what India, or for that matter any country will do is a hypothetical question. Further, the primary purpose of Pillar Two is not to garner revenue, but to ensure that the large profit making MNEs pay certain amount of minimum tax. I would like to believe that once Pillar Two is agreed, tax rates in most low or no tax jurisdictions will come up to at least the minimum rate level. If that happens, imposition of an IIR type of tax may not be very relevant.

On interaction between IIR and PoEM, IIR helps to tax profits of the subsidiary at the parent level. And, rules like POEM are designed to decide the residence of a company. As they operate on completely different levels I do not see any conflict between the two.

EY

Which element of Pillar Two Blueprint do you think will have a greater relevance for India and why?

Rasmi Ranjan Das

In Pillar Two, as India has always said and which has been echoed by most developing countries, including by G24 of which we are a part, the "subject to tax rule" (STTR) is of critical importance to fight base erosion. The STTR is based on the rationale that a source jurisdiction that has ceded taxing rights in a tax treaty should be able to apply a top up tax, where the income in the hands of the resident is not taxed or taxed at below the minimum rate by the treaty partner. In a sense, it complements the IIR and undertaxed payments rule and is in line with overall policy of Pillar Two. So, yes, more than IIR, we are interested in STTR from a developing country perspective. Where base eroding payments if not taxed at the level of other treaty partner will be taxed by the source country in exercise of its secondary taxing rights and that is important for us.



EY

If the consensus is not achieved, do you expect India to explore the United Nations (UN) proposal of Article 12B or similar extended sourcing rights?

Rasmi Ranjan Das

Let me start by saying that India is a G20 country and it is a G20 mandate to achieve consensus by mid-2021. We are committed to try for that consensus. I am hopeful that we will have some consensus, because so much has been invested by countries over the last three years and the counter-factual of not reaching a solution is not pretty.

On the UN proposed Article 12B, I feel that the problem that we are dealing with is multilateral which requires a multilateral solution. It is very difficult to implement a multilateral solution through bilateral negotiation of tax treaties as United Nations or for that matter OECD models

are meant for. Therefore, multilateral inter-governmental forum like Inclusive Framework is the best place where this can be done.

The other part is, Article 12B appears to be simple and it is simple if you implement it on a gross basis. Some businesses in fact say that they may prefer a small gross basis taxation rather than what they perceive to be extremely complex Pillar One. 12B will be helpful if we have such a tax. But once you move to a net-basis taxation which majority of the businesses and countries want, 12B has to address all the related problems like group financials, segmentation of in scope business, interaction of consolidated financial accounts

with taxable profits, elimination of double taxation, dispute prevention and resolution which the Inclusive Framework is currently grappling with. Having said that the UN proposal is now effectively part of the UN model and hence it has got a huge persuasive value for all countries. Whatever be the solution, it will be inevitably compared with the UN proposal and Inclusive Framework solution will be sustainable if it is perceived to be better and more comprehensive solution by most of the countries and stakeholders as compared to UN proposal of Article 12B. So, I see the value in UN proposal of Article 12B as setting a benchmark and providing guidance to countries on how the solution can possibly look like.





EY

How is India gearing up for this change? And in case the BEPS 2.0 proposals get implemented on an as is basis, what are the organizational changes you anticipate including the structural changes, administrative team, strengthening the team and the skills, etc.

Rasmi Ranjan Das

The good thing is that India is part of the rule making process, so we know and will know the nuts and bolts of the solution well in advance. There will be no surprises or lack of clarity for the Indian tax administration. I, therefore, see no problem in implementing the new rules as and when they are finalized. The exact administrative response in terms of structural changes or capacity building will depend on the finer details of the solution which are yet to be agreed upon.

EY

Any final thoughts for our readers on this subject?

Rasmi Ranjan Das

We live in momentous times so far as international taxation is concerned. Pillar One and Pillar Two, whatever be their final shape, are likely to govern the policy space for at least next couple of decades. It is therefore necessary that all stakeholders, including governments, businesses, academia, civil society and professionals should participate and provide their inputs. In that context, the role of professional bodies like yours (EY) is quite important in shaping these discussions. So, I urge all your readers to stay engaged in this discussion and provide us and the Inclusive Framework, with their inputs and suggestions. We must also note that change is inevitable in international tax rules. It cannot simply be wished away. Therefore, we should prepare ourselves for those changes and look at our processes closely so that when changes do come, we are not found wanting to cope with it. So, to all of us, stay informed.



Production-linked incentive scheme – *A key step towards self-reliant India*



Bhavesh Thakkar

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The Government of India announced Production Linked Incentives (PLI) schemes across ten key sectors in November 2020. Similar schemes were announced earlier last year for mobile phones, pharmaceuticals and medical devices, which were appreciated by the industry. Subsequently, key sectors were identified for the grant of similar incentives, i.e., as a percentage of their turnover, upon meeting the specified investment, capacity, turnover criteria and so on.

The announcement has piqued curiosity among domestic and foreign investors alike, owing to the significant budget outlay and incentives.

The National Manufacturing Policy of 2011 paved the way for the Make in India initiative of 2014. While investors continued availing the existing Central and State government incentives, the industrial ecosystem necessitated a focused sector specific approach to incentives, which would catalyze rapid growth and holistic development.

With this backdrop, the PLI schemes are formulated on the following key pillars;

A

Creation of large-scale manufacturing capacities

Here, the grant of incentives is directly to production capacity/ incremental turnover, compelling investors to create large scale manufacturing facilities. This should lead to improvements in industrial infrastructure, benefiting the industry at large. Thus, its ripples are expected to be felt by manufacturers of all sizes, even if they are not direct recipients of the incentives.

B

Import substitution and increase in exports

Currently, there is heavy reliance on imports for raw material and finished goods. To illustrate, the electronics industry comprises of several assembly units over manufacturing units.

PLI schemes intend to plug this gap by enabling domestic manufacture of goods. This would trigger a two-fold impact – an immediate reduction in reliance on imports and in the long term, a higher quantum of exports from India.





C

Employment generation

It is evident that envisaged large-scale require abundant manpower. Hence, this initiative should also enable utilization of the country's ample human capital.

Therefore, the PLI framework envisages definitive steps toward India becoming self-reliant over the next few years. These hold potential to add US\$520 billion worth of manufacturing value to the economy, according to Mr. Amitabh Kant, CEO, NITI Aayog.

Sector	Budget outlay US\$ billion (approximate)	Quantum of incentives (as a percentage of incremental turnover, unless otherwise specified)	Current status of cabinet approval (as on 9 April 2021)
Advance chemistry cell battery	2.4	Awaited	●
Electronics and technology project (including IT hardware, laptops)	1.0	1%-4%	●
Automobiles and auto components	7.6	Awaited	●
Telecom and networking equipment	1.6	4% - 7%	●
Textile sector	1.4	Awaited	●
Food products	1.5	4% - 10% (depending on category)	●
Pharmaceutical drugs	2.0	Category I and Category II: 6% - 10%, Category III: 3% - 5%	●
High efficiency solar photovoltaic modules	0.6	Awaited	●
White goods	0.8	4% - 6%	●
Steel products	0.8	Awaited	●

● Cabinet approval awaited ● Approved by cabinet

*For all approved schemes, the detailed guidelines are awaited (Data source: www.pib.gov.in)

In the ensuing paragraphs, we explore the nuances of the sectors covered under the PLI schemes.

Automobiles and auto components


This sector accounts for over

7.1% of the nation's GDP.

Particularly reeling under the impact of the economic slowdown, this announcement is being welcomed, especially since it has been granted the largest budget outlay for incentives. The scheme will comprise of further sub-schemes aimed at encouraging growth across the ecosystem, i.e., for the component makers as well as the OEMs.

Advanced chemical cell batteries

With electric vehicles (EVs) slated to gradually become mainstream, it was only natural that incentives be formulated for battery manufacturers. So far, investors desirous of venturing into this space were hesitant owing to the lack of fiscal support and the slow rate of EV adoption in India. With this announcement,



investors have begun firming up their plans. These investments should go hand in hand with EV adoption over the next ten years, while also reducing the dependence on imports. The scheme is largely targeted at large players.

Pharmaceuticals

This is the second scheme for the sector. The first round focused on the manufacture of critical drugs, while the coverage has been extended to various categories of pharmaceutical products now. Previously, applicants were chosen on the basis of their proposed manufacturing capacity and selling price. The base for eligibility has now been changed to global manufacturing revenue. A special sub-group will also be created for MSME units.

Food processing

Despite being the world's largest producer of some agricultural commodities, the food processing sector in India is still in nascent stages. The benefits accruing from the PLI scheme are expected to cascade to the farmers and help harness the massive employment generation potential in the sector.

Specialty steel

This is a niche sector, which was hitherto not given large incentives. The scheme should help the nation build manufacturing capacities in certain grades of steel which are currently imported. Overall, it is also expected to lead to an increase in total exports.

Solar photovoltaic modules

Despite its tremendous potential, the lack of financial and policy incentives in this sector has long impacted its growth, creating a greater reliance on imports. While this scheme may benefit only a handful of players, it is certainly expected to amplify the manufacturing capacity.

White goods (air conditioners and LED lights)

Largely centered around encouraging full-fledged manufacture in India, as opposed to assembly units, these schemes should contribute to the establishment of a global supply chain footprint in India

Telecom

The scheme aims to offset the huge import of telecom equipment. The incentives are likely to go up to 20 times the minimum investment threshold. Recognizing the need for additional support to MSME units, it allows them additional incentives in the initial years. This scheme would aid the ongoing focus towards digital transformation.

Textiles

This scheme aims to shift the production from natural fibers to man-made fibers and technical textiles. This would aid alignment of the sector to global consumption patterns.



As indicated in our [previous article](#) on PLI, investors are chosen for PLI based on a detailed evaluation of their proposals submitted online. Once approved, they are granted incentives on fulfilling the commitments. The schemes have an inbuilt evaluation and monitoring mechanism to ensure performance standards are met. Their simplistic structure and transparent design should lead to swift processing and appraisals.

With the launch of PLI, investors are likely to take a keen view of the incentives across other nations and factor them into the investment decision.

In China, incentives are provided through reduced corporate tax rates, tax deductions and tax holidays. Additionally, local governments offer cash grants, concessional buildings, tax credits and loan subsidies on a discretionary basis. Other South East Asian nations such as Vietnam, Indonesia and Philippines offer long term tax holidays and reduced corporate tax rates.

Unlike this approach, the India PLI schemes are designed on a direct correlation between the incentives and upscaling of manufacturing capacities, which is at the core of this initiative. Through PLI, the policymakers have adopted a sharp, structured approach to incentives, thus making it attractive to investors. This is expected to continue and yield clear results in the foreseeable future. The coverage may also be extended to additional sectors soon.

Additionally, several other pro-manufacturing initiatives have been taken such as:

Announcement of competitive
17%
corporate tax rate for new manufacturing investments

Re-evaluation of
400
customs duty exemptions and concessions

Announcement of Manufacturing and Other Operations in Warehouse Regulations (MOOWR), which enables considerable duty savings

Rapid transformative changes to the state level incentives policies across India

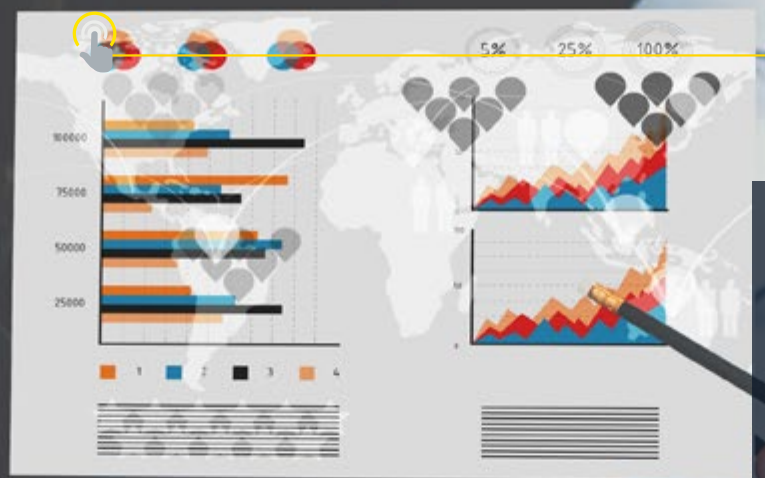
Therefore, several avenues for increased savings are offered to investors. An extensive evaluation would be critical in ensuring all available benefits are pursued.

The momentum generated by these initiatives should trigger the creation of a dynamic business ecosystem. Consequently, it is expected to yield long term economic benefits. Such measures should pave the way for India to become a preferred investment destination and emerge as a viable alternative ahead of its competitors.

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Special purpose acquisition company (SPAC) likely to boost inflow of foreign investment in India



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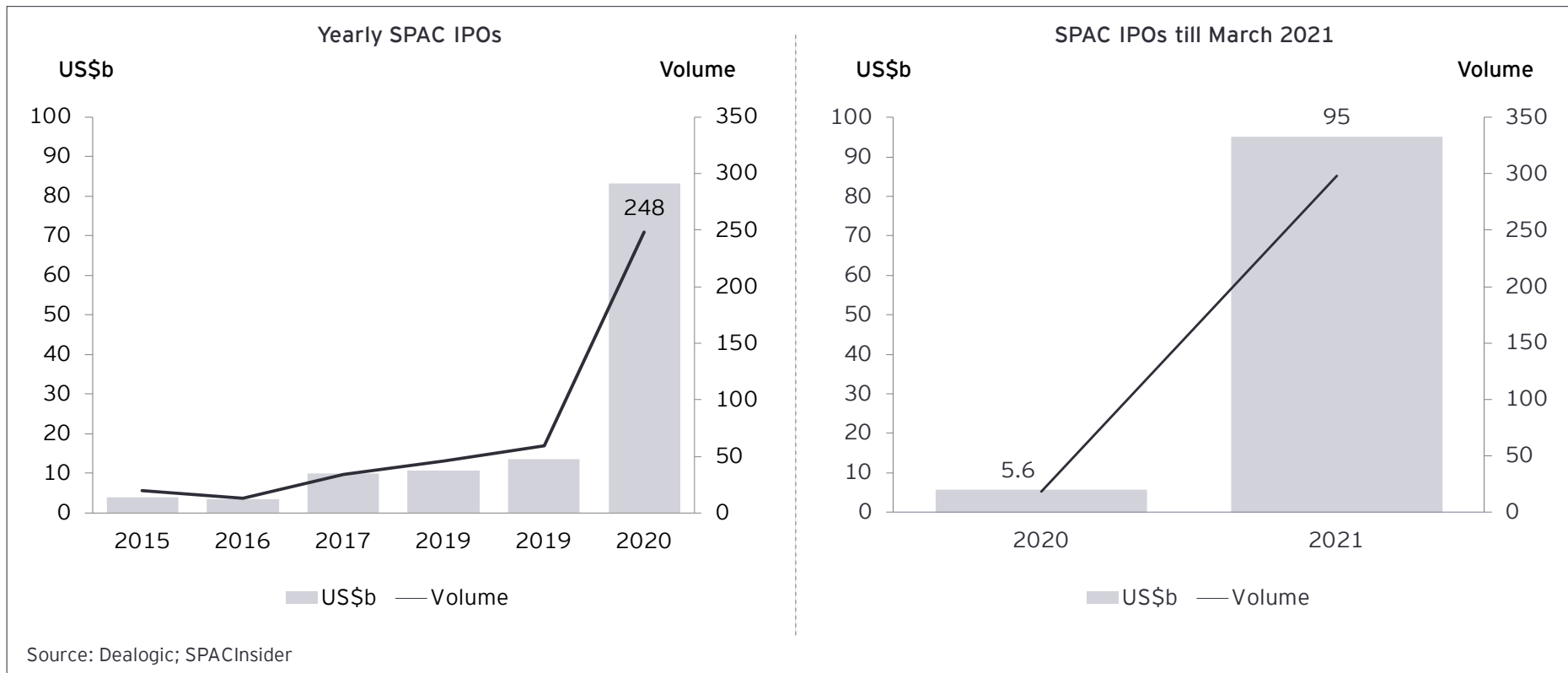
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In September 2020, the Indian government amended the corporate law to permit direct listing of shares of Indian companies in overseas stock exchanges. Although detailed guidelines on how to achieve the same, along with other amendments and clarifications from tax and regulatory perspective are still awaited. As an alternate to this, special purpose acquisition companies (SPACs) have generated and attracted attention for many Indian companies looking to go public outside India.

As you would note from the charts below, SPACs have raised a record US\$83 billion in previous calendar year 2020, and an additional US\$95 billion has been raised in the first three months of this year itself (as compared to just over US\$5 billion in the first three months of the last year). Based on news reports, it is understood that there are 400+ active SPACs as on date, with a total cash capital of US\$140+ billion waiting to be deployed in potential targets around the globe in the next 12 to 18 months.

SPACs are companies that raise capital from investors and public - with no operations as on the IPO date, but with the objective to acquire an attractive target in the future. Accordingly, SPACs are typically founded and backed by seasoned professionals with well-established track records (known as sponsors). Sponsors typically have 18 to 24 months to identify the target and deploy the funds, failing which they must refund the listing proceeds to the investors.





As far as targets are concerned, consolidating or merging with a SPAC is an efficient way to achieve listed company status. Most importantly, SPACs help private companies to go public relatively quickly without being subject to multiple investor/underwriter negotiations, valuation uncertainty, and overwhelming documentations and filings.

In India, while historic SPAC deals are few and far between (most notable names being the Silver Eagle - Videocon d2h deal and the Terrapin - Yatra Online deal), there has been a recent spike in interest - with renewable energy major ReNew Power going down the SPAC route with RMG Acquisition Corporation.

Considering the wide-spread anxiety and interest around this new vehicle, International Financial Services Centre Authority (IFSCA) is also now looking to facilitate the listing of SPACs in the GIFT City of India. A new consultation paper has been issued by IFSCA for this purpose - the key features of the SPAC in the GIFT City seems to be a minimum public offer size of US\$50 million, compulsory sponsor holding of at least 20% (of post issue paid-up capital), minimum application size of US\$250,000 and a minimum subscription of at least 75% of the offer size. Companies will have to wait and watch how these regulations evolve further.

Currently, the biggest apprehension for Indian companies (with Indian resident promoters and shareholders) contemplating the SPAC route is the tax and regulatory considerations governing transitioning into a SPAC. Typical structures to transition into a SPAC include a share-swap or a merger of the target into the SPAC. Under both the options, resident shareholders would eventually give up their current holdings in the Indian target in exchange for shares of the overseas SPAC/listed company - this would result, inter alia, in following two challenges for the shareholders:

1

A specific RBI approval may be required by Indian resident shareholders for transitioning into a SPAC which may involve considerable uncertainty. Amongst other considerations, either of the options discussed above is likely to result in a round-trip structure, whereby Indian resident shareholders may hold shares in an overseas company owning significant majority in an Indian target. Seeking RBI approval is likely to be a rigorous process and would depend on merits of each case and is likely to be subjected to scrutiny by the regulators. Additionally, uncertainty around timelines may also create concerns for the SPAC - which needs to deploy its funds within 18 to 24 months

2

Also, there would be capital gains tax for the shareholders under both the options, despite the fact that they may not have monetized their investment, and merely got shares in the SPAC. This would be a clear impediment for the shareholders to transition into a SPAC, and one may need to evaluate the potential tax consequences, and consider/explore alternate structures and possibilities depending on the facts of each case to ensure smooth transition into the SPAC structure



On a related note, following critical future considerations of a SPAC (deriving substantial value from Indian companies) needs to be kept in mind while firming up the decision to transition into a SPAC:

1 Different India tax considerations applies on sale of shares in an overseas SPAC compared to shares sold in a company listed in India, for both Indian resident and non-resident shareholders - refer table below

Particulars	SPAC Tax rate	India IPO Tax rate
India Resident Shareholders ▶ LTCG ¹ ▶ STCG	up to 28.5% up to 42.8%	up to 11.9% up to 17.9%
≥ 5% Non Resident Shareholders ▶ LTCG ¹ ▶ STCG	up to 14.3% ² up to 43.7% ²	up to 11.9% up to 17.9%
< 5% Non Resident Shareholders ▶ LTCG ¹ ▶ STCG	Nil Nil	

1. Shares listed on Indian stock market are treated as 'long-term' if they are held for 1 year (as against 2 years for shares listed overseas)
2. Treaty benefits may be available for Non Resident Shareholders
3. The above table assumes highest rates of Surcharge and Cess

2 Under the current RBI regime, investment into a SPAC would primarily be permitted under portfolio route by: a) an individual Indian resident shareholder (up to US\$2,50,000 per financial year); and b) listed companies only. In addition, there may be further conditions that may need to be met by them - this may restrict participation of various Indian resident shareholders in such SPAC.

All in all, the Indian government may consider putting in place a detailed policy framework to provide a clear path to access the large pool of SPAC capital that is eagerly waiting to be deployed in companies across various sectors in fast growing economies like India. In particular, it would be very encouraging if the government considers to permit 'share-swap' or merger under the automatic route (with appropriate conditions based on the sector in which they are operating), and defer the taxes in the hands of the continuing shareholders upon exit from the SPAC. Also, aligning the capital gains taxability of Indian resident shareholders in a SPAC with the capital gains tax in a shares listed in the Indian stock exchange, and permitting access to resident shareholders in such SPACs, would go a long way to make this vehicle attractive for Indian companies.

With the abundant liquidity and general positivity currently present in Indian capital markets, there may not be a better time for India to embrace the SPAC trend which may lead to significant inflow of foreign investment into India. A right step in this direction could also provide an impetus to the entire start-up ecosystem, which has significant further potential to generate employment, spur innovation, stimulate spending among the public and drive significant growth in the economy.



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Supreme Court's software verdict: *Impact and way forward*



At a time when G-20 and the OECD¹ are attempting to build regulations to cope with evolving technologies and virtual business models, the Indian Supreme Court has finally put an end to one of the most litigated cross border disputes. The landmark ruling pronounced in favor of taxpayers on 2 March 2021, covered over hundred appeals and provided some much awaited certainty on the taxability of software revenues earned by non-residents to Indian end-users or resellers.

Over the last two decades, the Indian Revenue Authorities (IRA) have asserted that payments for software supplies, imported in whatever form (off the shelf, licensed or embedded in hardware), qualify as 'royalty' irrespective of the nature of rights acquired by the Indian end users and re-sellers.

Following the internationally accepted principles and interpretation of the double tax treaties, the Supreme Court has now ruled that purchase/license of a copy of a software does not confer any rights in the underlying IPR or copyright to the user and hence, payment for purchase/license of such copyrighted article/product shall not fall within the definition of "royalty". The apex court has also observed that unilateral measures by India by amending the domestic tax laws, do not influence the beneficial interpretation under the double tax treaties. Thus, while cross border software transactions will fall in the net of "royalties" under the domestic law, the apex court ruling will unequivocally apply to cases involving double tax treaties.

Some key fall outs from the ruling which require careful evaluation both by foreign sellers as well as importers of software are:

The appeals pending before various forums where IRA have made similar assertions should be decided in favor of the tax payors. Non-residents will have to ensure that they meet the eligibility criteria for treaty entitlement, i.e., fulfilment of the beneficial ownership test with a valid evidence of a tax domicile. For open years including going forward, the IRA may now carefully evaluate potential permanent establishment (PE) of the non-residents in India, particularly where related parties are appointed as distributors or re-sellers in India.

Non-resident sellers who have claimed refunds in their tax returns, should now be able to get the said refunds processed. Given that the verdict of the Supreme Court is now the law of the land, besides, for matters in litigation, one of the possible options that can be explored is to also file a rectification application before the IRA seeking rectification of the initial assessment order. What will also be relevant is to revisit the credit for claimed in domicile jurisdiction for tax withheld in India.

In cases where a non-resident seller did not claim refund of taxes deducted by the Indian importer (under net-off tax contracts) and consequently, did not file any tax return, the option of approaching the CBDT² can be explored for filing belated tax returns to lodge such claim.

Where withholding taxes have been borne by the Indian importer on grossed up basis, law provides for a mechanism to claim such taxes as refund by the Indian party. Alternatively, non-residents may also be able to claim a refund which they may contractually need to pass on to the Indian importers.

Though the ruling is in favor of the taxpayers, cross border transactions of similar nature (where software is supplied through a digital platform by the non-resident) may now fall within the ambit of the new Equalisation Levy (EL) regime which intends to levy two percent charge on India revenues earned on online supply of goods or services. Considering that EL is part of the Finance Act and not the Income Tax Act, foreign tax credit against EL paid in India may not be straightforward.

1 Organisation for Economic Co-operation and Development

2 Central Board of Direct Taxes



Way forward

The landscape of disputes on cross border transactions broadly revolves around three key areas, viz. existence of PE, taxability of payments as “royalties” and “fee for technical services”. In the past few years, the Supreme Court has laid down few important international tax principles on existence of a PE³. With the principles laid down in the software ruling, some of which have a wide implication such as those relating to treaty override and retrospective application of withholding provisions, there would be a much greater certainty even in relation to other disputes concerning international tax matters which still need resolution.

Rapid technological developments over the years have evolved new business models for software delivery including digitally delivered software or as a part of a cloud solution, software-as-a-service and platform-as-a-service. The applicability of the apex court ruling on such new models will be analyzed in greater detail both by taxpayers as well as the IRA, in light of the nature and extent of rights being granted to the end-users. The present ruling would go a long way to assist in determining taxation of these models.

Contributor

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³ ADIT v. E - Funds IT Solution Inc (2017) 399 ITR 34 (SC); Formula One World Championship Limited vs. CIT, International Taxation - 3 Delhi (2017) 394 ITR 80 (SC)



EconoMeter

macro-fiscal trends

1

Organization for Economic Co-operation and Development (OECD) projected global growth to recover to 5.6% in 2021 following a contraction of (-)3.4% in 2020.

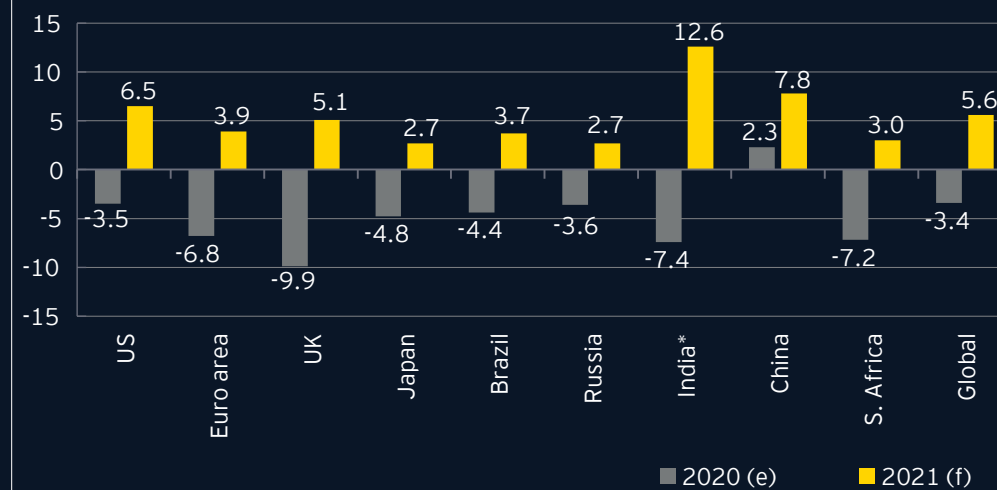
The OECD estimated a global contraction of (-)3.4% in 2020, lower than (-)4.2% estimated in December 2020.

Global growth is projected at 5.6% in 2021, 1.4% points higher than OECD's December 2020 forecast reflecting stronger economic activity in the latter half of 2020, increasing efficacy of Covid-19 vaccines, and the announcement of a large stimulus in the US.

Helped by a significant fiscal stimulus and faster vaccination, the US is forecasted to emerge from a contraction of (-)3.5% in 2020 to 6.5% in 2021.

India's GDP is estimated to contract by (-)7.4% in 2020 (FY21). This is an improvement upon the estimate by the IMF and the NSO at (-)8.0%. While the OECD projects a recovery at 12.6% in 2021 (FY22), the IMF's estimate was relatively lower at 11.5%. India's Economic Survey for FY21 projected the real GDP growth at 11.0% in FY22 and the RBI in its April 2021 monetary policy report retained its forecast at 10.5%. Further the RBI projected a growth of 6.8% for FY23.

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



Source: OECD Interim Economic Outlook, March 2021
*data for India pertains to fiscal year

Real GDP grew by 0.4% in 3QFY21 after a contraction in previous two quarters

2

Real GDP grew by 0.4% in 3QFY21 as compared to (-)7.3% (revised) in 2QFY21.

On an annual basis, real GDP is estimated to contract by (-)8.0% in FY21, marginally higher than (-)7.8% as per the first advance estimates.

Only one demand component namely, gross fixed capital formation (GFCF), a measure of investment demand, showed a positive growth of 2.6% in 3QFY21 after contracting sharply in 1Q and 2QFY21.

The other components of domestic demand namely, private final consumption expenditure (PFCE) and government final consumption expenditure (GFCE) continued to contract although at a slower pace of (-)2.4% and (-)1.1% respectively in 3QFY21.

In 3QFY21, both exports and imports contracted by (-)4.6% each.

Table 1: real GDP growth (in %)

Aggregate demand	1Q FY20	2Q FY20	3Q FY20	4Q FY20	1Q FY21	2Q FY21	3Q FY21	FY20	FY21 (2 nd AE)
PFCE	7.6	6.5	6.4	2.0	-26.3	-11.3	-2.4	5.5	-9.0
GFCE	1.8	9.6	8.9	12.1	12.8	-24.0	-1.1	7.9	2.9
GFCF	13.3	3.9	2.4	2.5	-46.4	-6.8	2.6	5.4	12.4
EXP	3.0	-1.3	-5.4	-8.8	-22.0	-2.1	-4.6	-3.3	8.1
IMP	9.4	-1.7	-7.5	-2.7	-41.1	-18.2	-4.6	-0.8	-17.6
GDP	5.4	4.6	3.3	3.0	-24.4	-7.3	0.4	4.0	-8.0

Source: Central Statistical Organization (CSO) MoSPI, Government of India
 AD: Aggregate demand; PFCE: Private final consumption expenditure; GFCE: Government final consumption expenditure; GFCF: Gross fixed capital formation; EXP: Exports; IMP: Imports; GDPMP: GDP at market prices; AE: Advance estimate

Real gross value added (GVA) showed a positive growth of 1.0% in 3QFY21.

Real GVA grew by 1.0% in 3QFY21 as compared to a contraction of (-)7.3% in 2QFY21. On an annual basis, real GVA is expected to contract by (-)6.5% in FY21.

Five out of eight broad GVA sectors showed a positive growth in 3QFY21 as compared to only two sectors in 2QFY21.

The highest growth at 7.3% was seen in electricity sector followed by financial and real estate and construction sectors at 6.6% and 6.2% respectively in 3QFY21.

In FY21, only two sectors namely agriculture and electricity et. al. are expected to show a positive growth of 3.0% and 1.8% respectively. The sharpest contraction is estimated for the trade, transport et. al sector at (-)18.0%, followed by Construction at (-)10.3%.

Table 2: sectoral real GVA growth (in %)

Aggregate Output	1Q FY20	2Q FY20	3Q FY20	4Q FY20	1Q FY21	2Q FY21	3Q FY21	FY20	FY21 (2 nd AE)
Agr.	3.3	3.5	3.4	6.8	3.3	3.0	3.9	4.3	3.0
Ming.	-1.3	-5.2	-3.6	-0.9	-18.0	-7.6	-5.9	-2.5	-9.2
Mfg.	0.6	-3.0	-2.9	-4.2	-35.9	-1.5	1.6	-2.4	-8.4
Elec.	6.9	1.7	-3.1	2.6	-9.9	2.3	7.3	2.1	1.8
Cons.	3.7	1.0	-1.3	0.7	-49.4	-7.2	6.2	1.0	-10.3
Trans.	6.2	6.8	7.0	5.7	-47.6	-15.3	-7.7	6.4	-18.0
Fin.	8.8	8.9	5.5	4.9	-5.4	-9.5	6.6	7.3	-1.4
Publ.	5.6	8.8	8.9	9.6	-9.7	-9.3	-1.5	8.3	-4.1
GVA	5.0	4.6	3.4	3.7	-22.4	-7.3	1.0	4.1	-6.5

Source (Basic data): MoSPI

GVA: Gross value added; Agr: Agriculture and allied activities; Ming: Mining and quarrying; Mfg: Manufacturing; Elec: Electricity, gas, water supply and other utility services; Cons: Construction; Trans: Trade, hotels, transport, communication and services relating to broadcasting; Fin: Financial, real estate & professional services; Publ: Public Administration, defence and other services

The RBI retained its policy repo rate at 4.0% while maintaining an accommodative policy stance in its April 2021 monetary policy review.

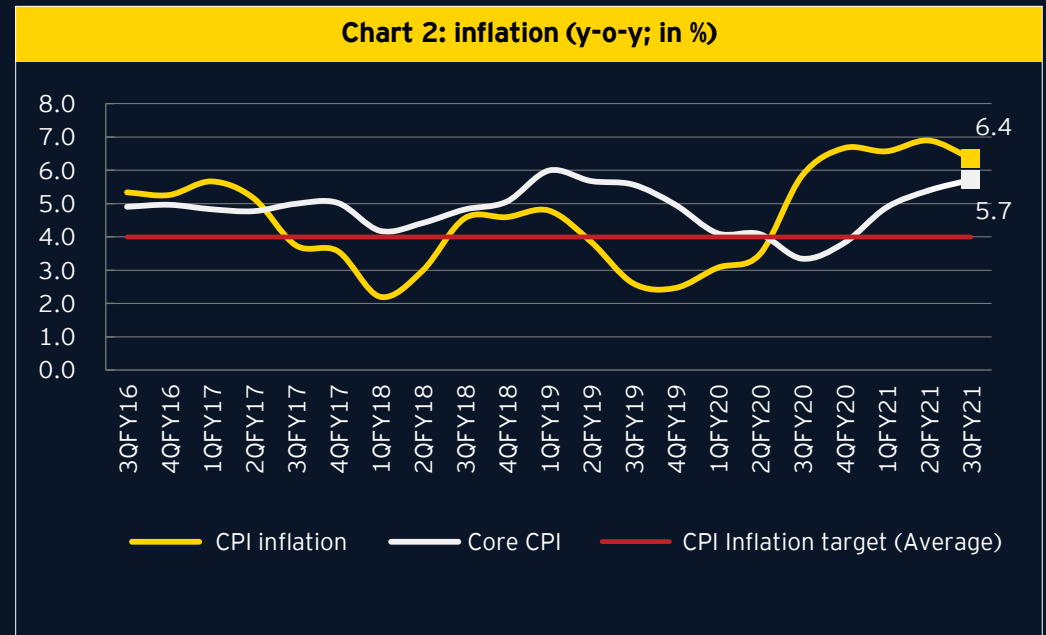
Consumer Price Index (CPI) inflation remained high at 6.4% in 3QFY21 as compared to 6.9% in 2QFY21¹ led by high food and fuel prices.

Core CPI inflation², increased to a nine-quarter high of 5.7% in 2QFY21 reflecting pass-through from higher crude oil and non-oil commodity prices, high fuel and other taxes post-COVID and increased operating costs.

On a monthly basis, CPI inflation increased to 5% in February 2021 from a 16-month low of 4.1% in January 2021. Core CPI inflation also increased to 6.1% in February 2021.

The RBI retained the repo rate at 4.0% in its monetary policy review held on 7 April 2021 due to continued high levels of core CPI inflation.

1 Headline CPI inflation for the month of April 2020 and May 2020 have been imputed by the MoSPI; http://www.mospi.gov.in/sites/default/files/press_release/CPI%20Technical%20Note%20on%20imputation.pdf
 2 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.



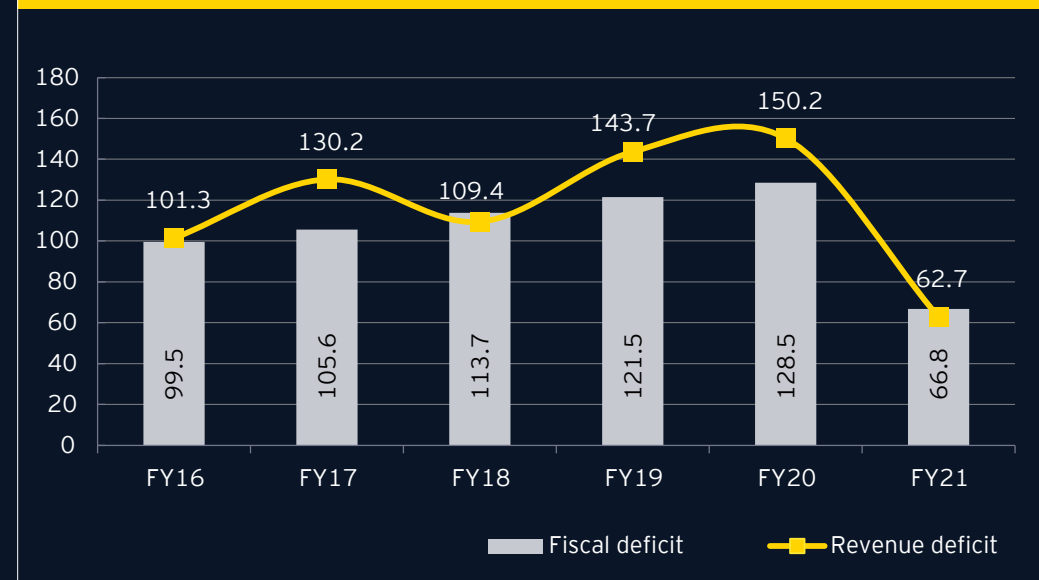
Source: MoSPI; Note: CPI stands for Consumer Price Index

Center's fiscal deficit during April-January FY21 stood at 66.8% of the revised target

Center's fiscal deficit during April-January FY21 stood at 66.8% of the annual revised target as compared to 128.5% during the corresponding period of FY20. As per the Union Budget for FY22, center's fiscal deficit has been estimated at 9.5% of GDP for FY21 (RE).

Center's revenue deficit during April-January FY21 stood at 62.7% of the annual revised target as compared to 150.2% in the corresponding period of FY20. Center's revenue deficit has been estimated at 5.9% of GDP for FY21 (RE).

Chart 3: fiscal and revenue deficit as a % of revised target



Source: Monthly Accounts, Controller General of Accounts, Government of India; Union Budget documents, various years

Gross central taxes witnessed a contraction of (-) 1.0% during April-January FY21

The Union Budget FY22 has estimated center's gross tax revenues (GTR) to contract by (-)5.5% in FY21 (RE) over the actuals of FY20.

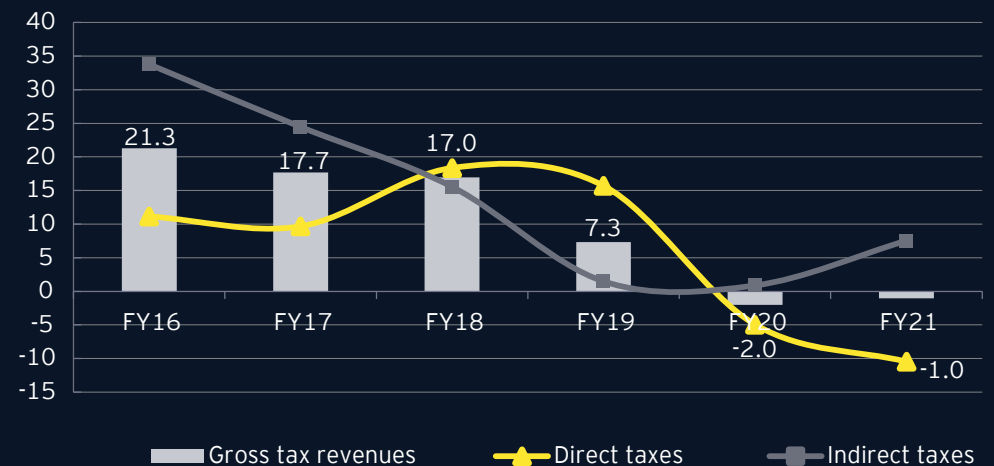
As per the CGA, Center's GTR during April-January FY21 contracted only by (-)1.0% indicating the possibility of a lower than estimated contraction in central taxes in FY21.

Direct tax revenues contracted by (-)10.5% during April-January FY21 as compared to (-)4.9% in the corresponding period of FY20.

Indirect taxes (comprising CGST, UTGST, IGST and GST compensation cess, union excise duties, service tax and customs duty) showed a growth of 7.5% during April-January FY21 as compared to 0.9% during April-January FY20.

While center's GST revenues contracted by (-)8.6%, there was a positive growth of 57.8% in revenues from union excise duties and of 1.8% in customs duty revenues during April-January FY21.

Chart 4: growth in central tax revenues during April-January (in %, y-o-y)



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

Notes: (1) Direct taxes include personal income tax and corporation tax, and indirect taxes include union excise duties, service tax, customs duty, CGST, UTGST, IGST and GST compensation cess from July 2017 onwards; (2) IGST revenues are subject to final settlement; (3) other taxes (securities transaction tax, wealth tax, fringe benefit tax, banking cash transaction tax, etc.) are included in center's gross tax revenues along with direct and indirect taxes.

7

During April-January FY21, center's capital expenditure posted a strong growth of 35.2% while revenue expenditure grew by 7.7%.

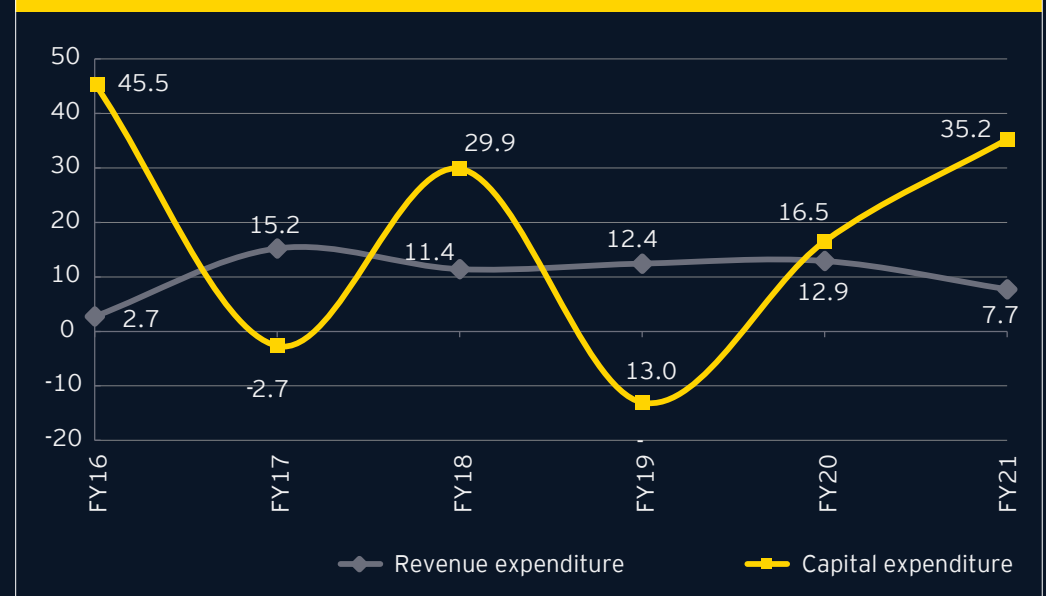
Center's total expenditure during April-January FY21 grew by 11.0% as compared to 13.3% during the corresponding period of FY20.

Revenue expenditure grew by 7.7% during April-January FY21 as compared to 12.9% during the corresponding period of FY20.

For achieving the FY21 (RE), an extraordinary growth of 145.2% would be required in the last two months of FY21. This partly reflects the impact of transferring on to the budget, the accumulated food subsidies to the tune of INR2.54 lakh crores given to the Food Corporation of India (FCI) through National Small Savings Fund loans.

Center's capital expenditure showed a buoyant growth of 35.2% during April-January FY21 as compared to 20.6% in the corresponding period of the previous year. A growth of 11.7% would be required in the last two months of FY21 to achieve the FY21 (RE).

Chart 5: growth in central expenditures during April-January (in %, y-o-y)



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



Global News

- ▶ OECD Secretariat issues updated guidance on tax treaties and the impact of COVID-19 pandemic
- ▶ OECD releases guidance on transfer pricing implications of COVID-19 pandemic
- ▶ European Commission launches consultation on EU digital levy separate from OECD's Pillar One
- ▶ The Netherlands starts consultation to better align legal entity and partnership classification rules with international tax standards
- ▶ Belgian Court of Appeal issues decisions on tax abuse – applied CJEU Danish cases



01

OECD Secretariat issues updated guidance on tax treaties and the impact of COVID-19 pandemic¹

On 21 January 2021, the Organisation for Economic Co-operation and Development (OECD) published on its website an updated guidance on tax treaties and the impact of the COVID-19 pandemic (the guidance). This guidance revisits the guidance published on 3 April 2020² by the OECD Secretariat.

The updated guidance provides an analysis of some of the treaty-related issues that may arise due to the COVID-19 pandemic and intends to provide more tax certainty to taxpayers. The guidance represents the OECD Secretariat's views on the interpretation of the provisions of tax treaties (i.e., each jurisdiction may adopt its own guidance to provide tax certainty to taxpayers). However, the document indicates that the guidance reflects the general approach of jurisdictions and illustrates how some jurisdictions have addressed the impact of COVID-19 on the tax situations of individuals and employers.

This updated version of the guidance considers some additional fact patterns not addressed in detail in the April 2020 guidance, examines whether the analysis and the conclusions outlined in the April 2020 guidance continue to apply where the circumstances persist for a significant period and contains references to country practice and guidance during the COVID-19 pandemic.

It must be noted that the guidance is informational only and does not represent the official views of the OECD member countries. Further, provisions in bilateral double tax treaties may differ from the OECD Model and such differences would need to be considered in analyzing the result in any particular situation. It also should be noted that the analysis reflected in the guidance only covers the OECD Model and only certain PE scenarios (e.g., service PE issues are not specifically addressed).

The guidance addresses the following issues:

Concerns related to the creation of permanent establishments (i.e., home office PE, agency PE, construction site PE)

Residence status of companies (based on place of effective management) and individuals

Treatment of employment income

¹ Refer EY Global Alerts dated 27 January 2021 titled "OECD Secretariat issues updated guidance on tax treaties and the impact of COVID-19 pandemic"

² Refer EY Global Tax Alert, OECD Secretariat issues guidance on impact of the COVID-19 crisis on treaty-related issues, dated 10 April 2020.



02

OECD releases guidance on transfer pricing implications of COVID-19 pandemic³

On 18 December 2020, the OECD released a report containing guidance on the transfer pricing implications of the COVID-19 pandemic (the Report). The Report notes that the unique economic conditions arising from COVID-19 and government responses to the pandemic have led to practical challenges for the application of the arm's-length principle. According to the Report, the arm's-length principle and the OECD Transfer Pricing Guidelines for Multinational Enterprises (MNEs) and Tax Administrations 2017 (OECD TP Guidelines 2017) should continue to be relied upon by tax administrations and MNEs when performing a transfer pricing analysis, including under the possibly unique circumstances introduced by the pandemic.

The Report focuses on how the arm's-length principle and the OECD TP Guidelines apply to issues that may arise or be exacerbated in the context of the COVID-19 pandemic, rather than on developing specialized guidance beyond what is currently addressed in

the OECD TP Guidelines. The Report addresses four priority issues where it is recognized that the additional practical challenges posed by COVID-19 are most significant and these are described in separate chapters in the Report:

Comparability analysis

Losses and the allocation of COVID-19 specific costs

Government assistance programs

Advance pricing agreements (APAs)

These issues have been presented as discrete topics in the Report, but it is emphasized that in performing a transfer pricing analysis, these topics may be interrelated and therefore should be considered together and within the analytical framework of the OECD TP Guidelines.

The Report has been developed and approved by the Inclusive Framework on Base Erosion and Profit Shifting (Inclusive Framework) and represents

a consensus-based document. While it is recognized that some developing country Inclusive Framework members may also follow the United Nations (UN) Practical Manual on Transfer Pricing for Developing Countries (2017), the press release states that the guidance should be helpful in circumstances where the UN Manual follows a similar analytical framework and allows for similar conclusions as the OECD TP Guidelines.

As a response to the unique challenges posed by the pandemic, MNEs should review the impact of the pandemic on their transfer pricing policies and APAs, and contemporaneously document how and to what extent they have been impacted. Collection of clear evidence on how independent parties in comparable circumstances would have amended their commercial and financial relations plays an important role. The guidance contained in this Report provides a framework for analyzing some of the key transfer pricing implications related to the pandemic.

³ Refer EY Global Alerts dated 23 December 2020 titled "OECD releases guidance on transfer pricing implications of COVID-19 pandemic"



03

European Commission launches consultation on EU digital levy separate from OECD's Pillar One⁴

On 21 July 2020, the European Council (EC) has agreed for the introduction of EU wide taxes which included the digital levy. On 14 January 2021, the European Commission (the Commission) published a roadmap including a public consultation for the introduction of a digital levy. A public consultation on the design of such digital levy is open until 12 April 2021. The Commission is expected to table a proposal on a digital levy in the first half of 2021. This levy would be a separate tax which should not be linked with the digital tax rules that are being negotiated in the G20/OECD level. The main objective of the digital levy is to come forward with a measure that allows for a fairer contribution from companies that operate in the digital sphere for the purposes of the recovery and to support a more stable medium-term outlook.

According to the roadmap, the initiative will be designed in a way that is compatible with the international agreement to be reached in the OECD

as well as broader international obligations. To supplement the analysis being undertaken at the OECD/G20 level, the Commission wants to explore additional policy options, such as:

01

A corporate income tax top-up to be applied to all companies conducting certain digital activities in the EU

02

A tax on revenues created by certain digital activities conducted in the EU

03

A tax on digital transactions conducted business-to-business in the EU

Further, on 16 March 2021, the EC held an informal videoconference wherein the Ministers discussed the way forward on the challenges stemming from the digitalization of the economy and issues related to economic recovery. During the meeting, ministers also underlined their continued support for

the ongoing negotiations at the OECD level and confirmed their commitment to achieve a global and consensus-based solution by mid-2021.

While EU Finance Ministers reiterated their support for a global agreement in the OECD/G20 format, the launch of the public consultation on a digital levy shows that the Commission is already working on its own plan to address the challenges arising from digitalization of the economy. The Commission's statement that such levy may be designed as a measure separate from the Pillar One framework raises concerns over the levels of taxation for digital services in the EU. Policymakers in the EU will have to assess how this would affect the EU digital agenda including their strategy to enable a digital empowered Europe by 2030. Moreover, if there is no coordinated global agreement, either at OECD or EU level, it is expected that many countries will introduce digital services taxes leading to a rise in double taxation and controversy.

⁴ Refer EY Global Alerts dated 15 January 2021 titled "Singapore updates guidance on tax residence status and determination of a permanent establishment due to COVID-19"; and refer EY Global Alerts dated 17 March 2021 titled "EU Finance Ministers exchange views on digital taxation while the Commission announces it may introduce a digital levy separate from OECD's Pillar One"



04

The Netherlands starts consultation to better align legal entity and partnership classification rules with international tax standards⁵

On 29 March 2021, the Dutch Government released for public consultation, a draft proposal to revise the Dutch classification rules for entities incorporated under foreign law and partnerships formed under Dutch as well as foreign law.

Under the current rules, a foreign entity is compared to the Dutch legal entity which it most closely resembles based on its legal characteristics (legal form comparison). In addition, the Dutch limited partnership (CV) may qualify as either transparent or non-transparent for Dutch tax purposes depending on the free transferability of the partnership interests (also referred to as the prior consent requirement). As a result, comparable foreign limited partnerships are often treated as non-transparent from a Dutch perspective, potentially resulting in a hybrid entity mismatch.

It is proposed that the prior consent-requirement for CVs will be abolished. As a result, CVs will always be transparent for Dutch tax purposes. Further, the legal form comparison analysis will remain applicable. If no comparable Dutch legal equivalent can be found, foreign entities are to be classified based on the tax treatment of the jurisdiction under the laws of which that entity has been established.

The proposed new entity classification rules are intended to be better aligned with international tax standards. It is expected that this will result in less potential hybrid situations due to mismatches in entity classifications between the Netherlands and foreign jurisdictions.

The consultation closes for comments by the public on 26 April 2021. Subsequently, the Dutch Government will issue a legislative proposal that will be subject to review and the regular parliamentary proceedings. If enacted, the proposed changes may take effect as of 1 January 2022.

⁵ Refer EY Global Alerts dated 31 March 2021 titled "The Netherlands starts consultation to better align legal entity and partnership classification rules with international tax standards"



05

Belgian Court of Appeal issues decisions on tax abuse – applied CJEU Danish cases⁶

In two recent decisions, the Belgian Court of Appeal of Ghent ruled on the tax treatment of a dividend distribution by a Belgian company to its Luxembourg holding vehicle. In both cases, the tax exemptions applied at source were denied on the basis of general anti-abuse principles (GAAR).

The cases are landmark cases as they provide a first insight on how the GAAR may be applied to a series of transactions considering the findings of the Court of Justice of the European Union (CJEU) in Danish Cases⁷. The Court applies the principles that European Union (EU) law cannot be relied on for abusive or fraudulent ends.

In both cases, making explicit references to CJEU cases, the Court reviewed the facts to assess whether there is tax abuse based on “objective” and “subjective” criteria. The objective criteria reviews whether, even if all conditions have been formally observed, the purpose of the rules was not achieved. The subjective criteria reviews whether the intention of the taxpayer was to obtain a tax advantage by artificially creating the conditions set forth for achieving this objective.

In both cases, the taxpayers had executed a series of steps between 2006 and 2012. These steps were all taken into account by the Court when it assessed the tax treatment of the final steps which occurred in 2012, i.e., the repatriation of the cash proceeds in a tax exempt manner to a Luxembourg holding company (and to a Belgian resident individual co-investing manager). The cash proceeds that were distributed were the result of a series of steps executed whereby, among others, a new double-tier holding structure was set-up, companies were capitalized through contributions of shares and thereafter merged. Pursuant to merger, shares were funded with external debt and transferred within the group at non arm’s-length terms, debt was reallocated, and cash could be distributed to the shareholders in a tax-exempt manner.

The Court considered that all steps taken since 2006 constitute “tax abuse” as their ultimate purpose was to ensure repatriation of proceeds in a tax-exempt manner.

Continued

⁶ Refer EY Global Alerts dated 29 March 2021 titled “Belgian Court of Appeal issues decisions on tax abuse - application of the CJEU Danish cases”

⁷ Refer EY Global Tax Alert, dated 26 February 2019 titled “CJEU rules on application of Danish withholding tax on dividends and interest payments”



Multiple business motives were presented by the taxpayers to justify the transaction steps and the tax treatment applied. However, the Court ruled that those were not convincing and could not outweigh the apparent and predominant tax motives.

The Court's decision confirms that setting up a joint venture holding company at the occasion of the investment by a new third-party investor can constitute an economic justification for its incorporation and can be a valid legal structure. However, the Court considers that absent any substance and activity of the company (other than the repatriation of proceeds in a tax-exempt manner), such justification cannot be upheld to counter the application of the GAAR. Also, the absence of any specific justification for the incorporation of the holding company in Luxembourg (i.e., a location without any nexus to any of the investors or the underlying business operations) is also considered by the Court as problematic.

These court cases highlight the critical importance of the presence of sound business rationale to achieve an effective withholding exemption on dividend repatriations. Generic justifications that can apply to all restructuring are considered to be insufficient. In addition, the substance of any holding company and economic justification for both its existence, involvement and location as well as the at arm's-length nature of all events are essential.

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