

A portrait of Adi Godrej, a man with glasses and a mustache, wearing a dark suit, white shirt, and patterned tie. He is seated in a brown leather chair with gold-colored studs. The background is a dark, textured wall.

India Tax Insights

Issue 3

October-December 2014

In this issue

The dawn of a new era

How business in India
will be impacted?

Measures for effective
compliance of GST

A graphic of a barcode with vertical lines of varying heights, located on the left side of the page.

Adi Godrej

*Speaks on GST's potential benefits
to the Indian economy*

Michael Keen

*Good things associated with VAT need
effective administration and coherent policy*

The EY logo, consisting of the letters 'EY' in a bold, white, sans-serif font.

EY

Building a better
working world

India Tax Insights

Issue 3
October-December 2014



Team

Publisher:

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

Editorial board:

Jayesh Sanghvi
Geeta Jani
Rajendra Nayak
Sushant Nayak
Shalini Mathur
Nilesh Vasa

Program Manager - Jerin Verghese

Creative Manager - Ashish George Kuttickal

Program Support - Pushpanjali Singh, Tripti Panda

I am delighted to share with you the third issue of our magazine, *India Tax Insights*, which presents insightful thoughts on current tax matters to business leaders.

This issue focuses on Goods & Services Tax (GST) - a "game changer" reform most awaited by the industry. The positive changes that GST would bring, compared to the current tax regime, would pave the way for higher economic growth. At the time of bringing out this magazine, the Centre and the States were still engaged in active debate on a mutually acceptable GST design. While there may be differences on certain issues in the Constitutional amendment, but the fact that India needs GST is accepted by governments at both levels.

This issue provides insights into various dimensions of GST that are currently under discussion and what the new reform would mean for the businesses.

experience of implementing VAT/GST that India could consider as it moves towards implementing the new reform. He emphasises that the good things associated with the VAT do not come automatically, but require effective administration and coherent policy.

Mr Satya Poddar, EY Partner and a noted GST *Guru*, discusses the features that are essential for making GST a 'world class' tax reform. He brings out that a comprehensive tax base, moderate and single tax rate, well thought out place of supply rules and a robust IT infrastructure are the four pillars for a successful GST.

The magazine includes other thought provoking articles by our senior indirect tax partners and directors that throw light on the emerging contours of GST and how India Inc should prepare for the smooth transition to GST.



Welcome

Sudhir Kapadia

Sudhir Kapadia
National Tax Leader
EY India

In an interview, Mr Adi Godrej, Chairman, Godrej Group shares his optimism about the government's commitment to the GST and the immense economic benefits that it will yield to India. He calls for a single rate of GST for the country and feels that even if the GST model falls short of perfection, the new reform must be brought in.

The insightful article by Mr. Michael Keen, Deputy Director - Fiscal Affairs Department, International Monetary Fund, shares valuable lessons from the international

In addition, our regular features - *Global News* and *EconoMeter* - provide a snapshot of key global tax developments and key economic indicators, respectively.

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

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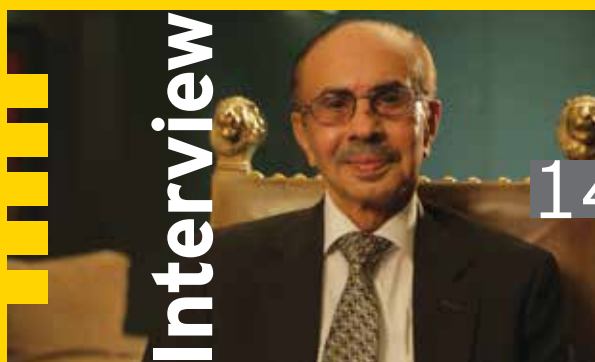
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By Satya Poddar

GST would free India from the shackles of archaic indirect tax laws



What should companies be focusing on?

By Harishanker Subramaniam

All industries need to understand the impact and opportunities offered by this reform



Getting ready for GST

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Strong national IT framework is imperative for the effective implementation of GST



To exclude or not to exclude from GST?

By Shalini Mathur

Basic objectives of GST get defeated if any sector is excluded



GST

The journey so far

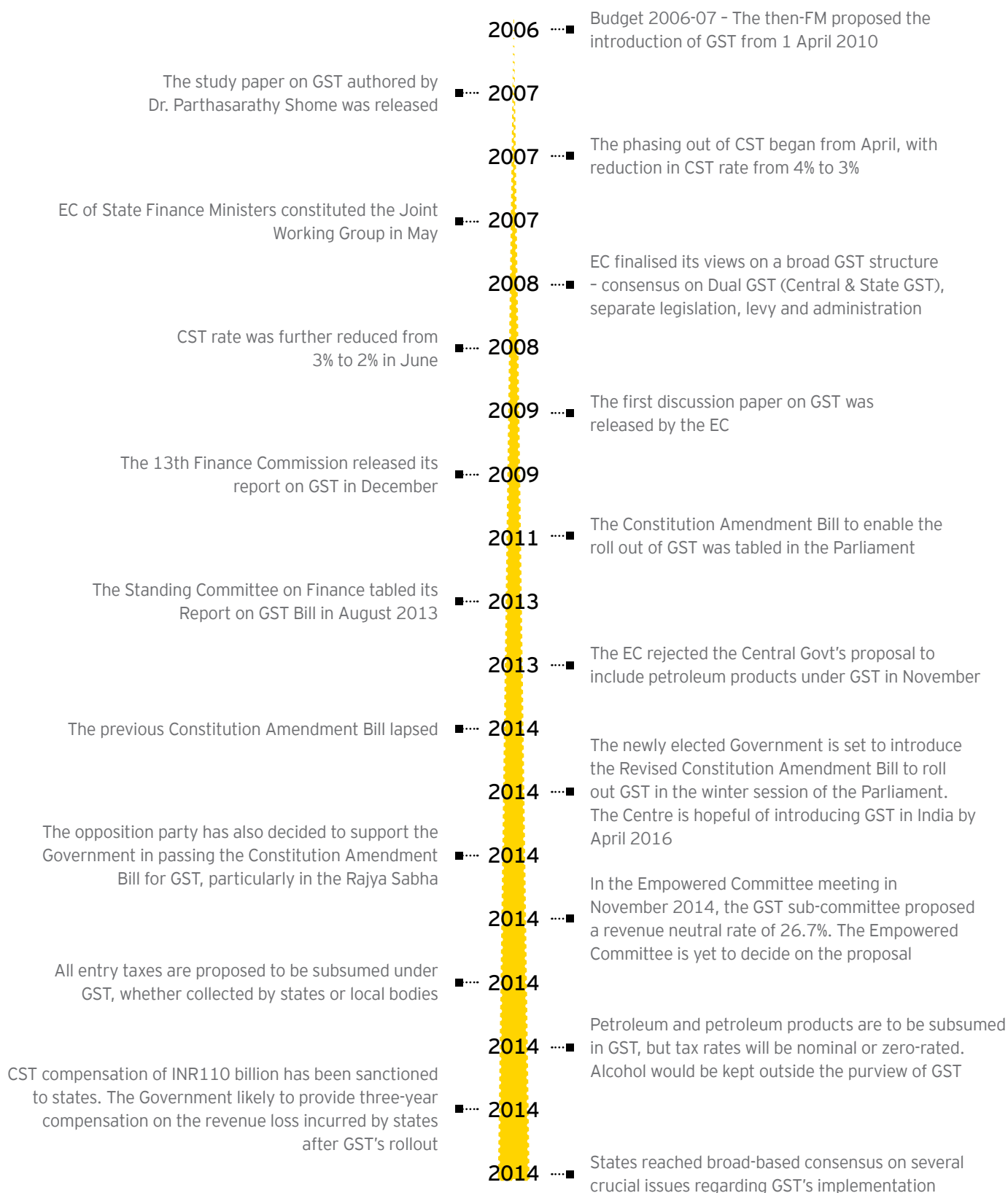
The procedure of introducing the Goods & Services Tax (GST), one of the most crucial indirect tax reforms in India, has been a long and arduous one. In 2006, the then-Finance Minister had announced in his Union Budget speech that India would introduce GST by 1 April 2010.

Since this announcement, the roll out of GST has not been easy, given the federal and state structure in the country that requires both parties to be on the same page on various contentious issues and the kind of complexities involved in subsuming the prevailing Central and State taxes and duties into the new GST regime.

The entire exercise of initiating the new reform involved a tremendous amount of ground work by the Finance Commission, the Joint Working Group constituted by the Empowered Committee (EC) of State Finance Ministers, the Standing Committee, Sub-Committees and Study Groups, IT teams and all other stakeholders including India Inc. The amendment of the Constitution for implementing GST before legislating associated provisions was a big challenge for the Government.

Lack of consensus between Centre and States and a few other practical difficulties resulted in deadlocks and delay in the implementation process.

The trade and industry has been closely following developments on the GST front, especially after the change in Central Government in May 2014.



Source: GST journey as mentioned herein has been sourced from various websites of Government departments and ministries, Press Releases made by Government and media reports.

Satya Poddar

Tax Partner - Policy Advisory Group, EY India

The dawn of a new era

How will it transform the Indian economy?

India is at the cusp of dawn of GST's introduction. Despite the continuing resistance of States, based on their fears of revenue loss, the Centre is making all-out efforts to make it a reality. It will be the most significant event in the fiscal history of the country, since it will have an impact on all the segments of the economy and will entail a fundamental shift in the way tax policies are made in the country.

GST would free India from the shackles of archaic indirect tax laws and usher in a new era of growth and prosperity. The current tax system contains many distortions that result in substantial tax cascading and inefficient production and consumption structures, which hinder economic growth. GST would remove these distortions, paving the way for a higher GDP.

GST would also bring in a modern tax system to ensure efficient and effective tax administration. The new system would facilitate compliance for parties that are willing to pay taxes and ensure strict enforcement for others that do not. It will bring in greater transparency and strengthen monitoring, thus making tax evasion difficult.

Most importantly, GST signifies the dawn of cooperative federalism, where the Centre and States will design the new tax in a harmonised and cooperative manner, rather than working on it in an isolated manner.

The benefits of GST would accrue only if tax is designed according to best practices. When the Government initially proposed a "game changer" GST in 2007, which was to be a "grand bargain", it was received by the public with enthusiasm and applause. Most tax reforms fail because of significant opposition by vested interests or a minority of tax payers who tend to lose interest in the reform. In India, surprisingly, the proposal to introduce GST received unanimous endorsement by all stakeholders including industry, business community, professionals and even consumers. However, their endorsement is not for a half-baked GST but for a truly flawless model that applies to the widest possible base at low rate.

So why have governments taken so long to usher in this tax reform despite its well acknowledged benefits?

The new tax system will be a turning point in fiscal federalism in India. Understandably, State governments are concerned about how the new GST model will unfold. Their resistance to GST is reflected in their demand for exclusions or continuation of certain taxes to compensate them for hypothetical loses. The success of GST critically depends on the trust between the Centre and State governments. This trust has definitely been a missing element in the past.

Despite all the misgivings of States, the Centre has made considerable progress in building a consensus on GST framework, as reflected in the Constitution (Amendment) Bill to be tabled in the Parliament. While the proposed framework falls short of the ideal, it retains its character of a significant turning point in the history of taxation in India. If designed properly, even within the constraints of the Constitution, it can bring about tremendous stimulus, simplify compliance and contribute to the Prime Minister's mission of "Make in India".



What will make GST world class?

The first feature that the GST design must have is a comprehensive base. Tax should apply to all goods and services. The traditional approach of exempting basic necessities and items consumed by the low-income strata (e.g., food, medicines, health care and education) have been found to be ineffective in helping those in need. Their benefits are distributed disproportionately to the rich. Moreover, they give rise to classification disputes and make

compliance more complicated, particularly for small and medium enterprises. International best practices suggest no such exemptions. New Zealand is an example where such a comprehensive model is followed.

An important element of the tax base is real property (land, buildings and structures). In modern VAT jurisdictions, no distinction is made between movable and immovable property, and tax applies seamlessly to both. Exclusion of land from the tax base gives rise to many complications.

For instance, let us consider the current work contract system under the VAT and service tax. As per current rules, works contract is divided in three parts - value of services, value of land and value of goods. The division among the three components is ad-hoc and arbitrary, which gives rise to significant complexities in applying the tax when contractors or sub contractors are involved in furnishing supplies. There is significant litigation on the definition of what constitutes a work contract. For instance, whether an agreement for sale of an apartment prior to

its construction constitutes a work contract is a disputed matter.

There is no clarity in the Constitution (A) Bill about whether real property will be subject to GST or not. Tax could apply to the entire price of the agreement as per one interpretation or to the price of supplies under such agreements. Equally, the Constitutional provision could be interpreted, such that no part of the supplies would be taxable. Such an interpretation would create a huge gap or hole in the GST base.

One unfortunate consequence of the exclusion of real estate from GST would be an increase in cascading. Builders and contractors would not be able to get input tax credit for goods, equipment, material and services that go into real estate construction. The resulting cascading burden will be substantial, which will only deter investments. It will defeat the basic purpose of GST, i.e., to reduce tax cascading.

Similar concerns hold true in the case of other sectors such as petroleum and alcohol, which states are proposing to exclude. The Centre has failed to persuade states to fully include these sectors under the GST base. Even the compromise that the Centre has proposed for zero-rate petroleum is being resisted by States.

The second important feature of GST is tax rate. The Empowered Committee announcement suggests that the rate is likely to be 12% for basic necessities and 27% for all other goods and services. Such a high rate structure is unviable for the Indian economy and will lead to massive non-compliance. There will be disputes about classification of goods and services in the low- and high-rate baskets. Most importantly, the high tax rate will be devastating for the services sector, which has been the engine of growth for the economy.

Currently, indirect taxes collected by the Centre and States in India amount to 5% of GDP. It should be possible to raise this quantum of revenue from tax rates in the range of 12%, provided the base is comprehensive. A tax at this single uniform rate will simplify tax administration, encourage voluntary compliance and minimise disputes. It can convert a vicious cycle of "narrow base - high rate - low compliance - narrow base-higher rate" to a virtuous cycle of "wider base-lower rate-better compliance-wider base-lower rate".

Another key feature in the GST design is the "place of supply" rules for dividing the tax base among States. The so-called place-of-supply rules developed until now and approved by the Empowered Committee are modelled after the rules that apply at a national level. Their application at the State level is not simple or straight forward and requires much greater thought than has gone into it.

For instance, the current version of the rules defines the place of service on the basis of the place where the supplier is located, the place where the recipient is located and the place where services are performed. In the case of many of the services, none of these indicators help in determining a unique place of supply. The supplier could be based in multiple locations within India, and could be supplying from one or more of them. Even the customer could be based at multiple locations. A case in example is advertising services, which could be offered from any of the locations of an advertising company to a customer with business establishments in multiple locations. The rules would need considerable refinement to tackle such issues at a sub-national level.

The last component of GST is the design of a single IT platform - the GST network - for the core functions of GST administration, i.e., registration, filing and processing of returns, payments

and refunds. The use of a single platform for both Centre and State GSTs will require full harmonisation of policy and procedures across India. While the details of the system are yet to be put in place, the benefits of the system are undisputable. In fact, without a harmonized system, the GST can degenerate into a tax jungle of 36 taxes rather than transforming the existing tax system.

It is the opportune time for the Government, industry and professionals to collaborate their efforts to design a world class GST. Until now, the Empowered Committee has been a fortress, with minimal opportunity for stakeholders to have a constructive dialogue on issues going into policy making. A modern tax reform of this magnitude is not possible without the active and significant participation of tax payers. A successful GST has to be one that is of the tax payers, for the tax payers and by the tax payers.



Michael Keen

*Deputy Director – Fiscal Affairs Department,
International Monetary Fund*

India's adoption of an integrated VAT, the GST, will be a major event. With more than 140 countries now adopting some form of VAT, India has long been a stand-out exception, along with (and this is no coincidence, as I will come on to) the United States. Adopting the GST will not be quite as impressive, perhaps, as putting an orbiter around Mars, but it will put India clearly ahead of the US.

The advantages of moving to the GST are well-known. Apart from cutting back a bewildering array of taxes, it will ease the problems caused by extensive "cascading", i.e., the levying of tax on things that have already been taxed. The trouble with cascading is partly non-transparency. No one really knows what the effective rate is on a good or service when some inputs have already been taxed, along with inputs to those inputs. It also wastes resources. Businesses will try to reduce the use of highly taxed inputs and more of lightly taxed ones, including perhaps by merging with suppliers. This means that firms will produce things in ways that, were it not for taxation, would not be the most efficient. Moreover, then prices will have to rise substantially to not only cover the tax itself, but the increased cost of production. Put differently, by taxing only the final consumption, as under the VAT, and not intermediate production – thereby eliminating this cascading – the Government can raise the same amount of revenue and leave consumers facing reduced prices.

Lessons for the GST from international experience: *possibilities and pitfalls*

However, the good things associated with the VAT do not come automatically. They require effective administration and coherent policy.

One possible advantage of a VAT over a cascading tax, for instance, is that a tax-compliant company will want its suppliers to be compliant too – otherwise its input prices while being increased by the tax amount that those suppliers have paid on their own inputs but, being noncompliant, cannot recover through the crediting mechanism of the VAT. Therefore, it can form “good” chains of compliance. By the same token, however, a company, which is not compliant, prefers its suppliers not to be compliant either, since otherwise its input costs will rise by the full amount of the tax. So there can be “bad” VAT chains too. Encouraging good chains and thwarting bad ones is a core administrative challenge.

Policy decisions can also undermine the inherent strength of a VAT, maybe even more fundamentally.

One danger is excessive differentiation of rates across various goods and services. This evidently adds to the costs of administering and complying with the tax - the lawyers, of course, relish it. However, it may be a very inefficient way of achieving policymakers' objectives. Pressures to set reduced rates on goods largely consumed by the poor, in particular, are well-intentioned, but consequences are often not well understood. For while the least well off may spend a large proportions of their income on some

item than the rich. The rich, being richer, may very well spend a large total amount on it. And so they get the bulk of the benefit, perhaps by a very long way. An OECD study for Mexico some time ago found, for instance, that for each US\$100 of revenue foregone only about \$4 goes to the poorest ten percent.

The real question is then, in this example, if the government has US\$100 to spend on helping the poorest, could it not find some other way that benefited them by at least US\$4? In economies with sophisticated income-related benefits the answer is almost surely yes. Even in countries with much crude instruments to pursue poverty alleviation, however, these may provide a better approach than very poorly targeted price-based measures. Reduced rates may be much less compassionate than they look.

Another set of dangers relates to treatment of goods and services that are desired to be taxed at particularly high rates, perhaps because of the harm they cause to those who use them, or to others, or maybe just because they are good revenue-raisers. Alcohol, tobacco and petroleum are the classics. These distinct considerations do not mean that these products should be subject only to special taxes outside the VAT. Policy coherences require that they be subject to special taxes and the VAT.


VAT aims to raise revenue, not to discourage the consumption of particular things by making them more expensive relative to others.

The aim of the special taxes, however, is to do both. This generally means these should be in “specific” form, charged as fixed monetary amounts, not a percentage of the price, (the local pollution that petroleum causes, for instance, depends on how much is burned, not how much it cost). Suppose then we charge specific taxes of this kind on these particular items, but not VAT. Then increasing (for instance) the VAT rate will actually make them cheaper relative to everything else, so encouraging their use. Clear policy becomes harder to make. Charging both (with VAT on top of the special tax) avoids such unintended side effects.

Perhaps the most intrinsically difficult design problem that has had to be faced in India is the treatment of interstate trade. As the EU has learnt, zero-rating “exports” between countries, or states, that have no border controls between them makes the system vulnerable to fraud. This problem is inevitable in federations that wish to operate sub-national VATs. Moreover, it is arguably the main reason why many of the last adopters of the VAT are federations in which sub-national jurisdictions have extensive powers in indirect taxation. This, of course, is where the similarity with the US comes in. In India, the IGST is an imaginative attempt to solve the problem, which no one else has yet managed to do. It has its complexities. But much of the tax world will watch with particular interest how it works – certainly in the EU, and, who knows, maybe in the US too.

(Views expressed here are his personal and should not be attributed to the IMF, its Executive Board or management)

The GST base should be as *wide* as possible



We have been talking about GST for over five years now. You have been an active speaker on the subject and have been engaging extensively with the governments on this point. At a very broad level, what is your take from these conversations and why is GST facing so many hiccups?

I think the first challenge is that governments, especially State governments, are sceptical about the change. They need to shed their anxieties and realise GST's potential benefit for the Indian economy. It will usher in stronger GDP growth and, therefore, translate into added tax revenues for governments. This is not a mechanical change; it is a fundamental reform that can really help the economy. The fear that some States have of losing revenue is totally misplaced. In my view, post GST, tax revenues of States will certainly increase; some States may gain more than others.

In addition, there is a need for better trust and confidence between the Centre and State governments. There are some issues that are important for both, and solutions or compromises need to be arrived at. Even if a perfect GST is not in place at inception, one can improve it over the next few years. If you recall, when we had switched from state sales tax to VAT, some States were not certain of its benefits and did not go along with the others on implementation (e.g., Tamil Nadu and Uttar Pradesh). Nevertheless, eventually, they realised the advantages of VAT (over threats) and, in a couple of years, they all switched to VAT.

When we talk about the design of GST, what are your thoughts in relation to the tax base being proposed. Should some sectors such as petroleum, alcohol, tobacco and real estate be excluded, as currently being discussed? Also, States want to retain certain taxing powers such as octroi/local body tax and local entertainment tax. What are your views on this?

Ideally, all products should be folded into GST. The tax base should be as wide as possible. Also, all indirect taxes, other than customs, should be subsumed. Keeping tobacco and liquor out should not be a matter of consequence, as these are consumer goods; however, alcohol for industrial use should clearly be a part of the GST framework. Similarly, petroleum should not be kept out as it is an important input into almost all industries.

I acknowledge that there will be some difference of opinion, as this is a significant change. As stated previously, it is better to have a GST that needs some improvising, rather than not have GST at all. I continue to believe that the Centre and States need to sit across the table, negotiate and close these issues quickly.



Adi Godrej *Chairman, Godrej Group*

India Tax Insights team talks to Adi Godrej, Chairman, Godrej Group on his stake on GST, reasons for the hiccups in its implementation, measures to combat the current deadlock and the benefits that the India Inc would avail of this major reform.

Some states have represented that they would like to have the flexibility of changing the SGST rate within a particular band so that they preserve their autonomy. Do you feel such autonomy is desirable?

In my view, a single rate should be applicable across the country – the principle of a simple and standardized GST levy. Multiplicity of rate would create undesired complexities and distortions. Also, narrow rate bands are not going to be beneficial for States. Thus, it is best that such concepts are not made a part of the GST design.

Do you see the likelihood of a partial GST roll-out, with some states going in at the first stage and the rest follow suite later, like it happened in VAT implementation?

No, I do not see this materialising. I strongly believe that the entire country will move in a united manner toward this reform. What is, however, possible is that we are not able to implement a perfect GST to begin with, but that we improvise on it over the years. The Constitution amendment must be very broad, so that we have the ability to improvise.

Finance Minister is paying a lot of attention to GST, and it appears to be one of his most important agenda items. Therefore, I see GST being implemented by April 2016

With regard to the median rate of tax under GST, a recent NIPFP study suggests that the revenue neutral rate works out to 27%. What is your reaction to this?

The suggested rate seems extremely high. Once GST is in force and taxes on the supply of goods and services are merged, the tax base would expand. This would make tax evasion very difficult. Therefore, on the same rate, revenues will rise. The increased tax collection of State governments when they moved from sales tax to VAT regimes is a case in point. Although rates were kept moderate under VAT, collections increased. A 27% rate of GST could potentially have a negative effect on the economy. In such a scenario, in my view, collection will decrease. So, I think it is not reasonable at all. In my view, GST should be around 18% to begin with. If tax collections dip, governments should consider increasing the rate in later years.

Now if we talk about the impact of GST on the businesses in India, what do you think will be the high points or the big positives of the GST coming in?

There will be several positives. A reasonably framed GST will lead to a GDP growth addition of 2 percentage points, other things being equal. In addition evasion will be very difficult, and reasonable rates of tax will yield more revenues leading to lower consumer prices and higher consumption, and so on. Also, GST implementation will lead to lower logistics and manufacturing costs. It will create more tax efficiency and neutrality for exports, clearly giving an impetus to both goods and services exports. It will create a virtuous cycle.

In my view, people do not attribute sufficient credit for the strong growth enjoyed by the country between 2004 and 2008 to the change from the archaic sales tax regime to a broad-based and more efficient VAT regime. VAT introduction removed several distortions and made the tax framework more consistent across States. This, in my view, clearly helped the business environment.

I also think people have not sufficiently realised that Chinese growth acceleration in the 1990s was due to them reforming their indirect tax systems.

Similarly, GST would boost growth in India. To my mind, if we move to GST, we can have several years of high GDP growth, possibly 10%+.

Do you think there are any big threats or downsides of GST?

Not at all; I do not see any downsides for any stakeholder, be it the Central or State governments, or trade, or consumers.

What would you advise the business houses, how should they approach GST and what they should be thinking of GST?

They need to plan well for its implementation. While it will help everybody, it will be most beneficial for B2C businesses. It will also help B2B businesses because the general economy will improve.

Given that it is a positive change, it will throw up opportunities, which businesses can capitalize on. Better planning would ensure greater outcomes.

Do you really think that April 2016 is realistic for the implementation of GST, as is being assured by the governments?

I think it is very doable; it is a question of how it is being handled. Our Hon'ble Finance Minister is paying a lot of attention to this, and it appears to be one of his most important agenda items. Therefore, I see GST being implemented by April 2016. There are some political matters to be addressed, but I am confident that the present Government will be able to address them proactively.

Are you happy with the Government's steps towards internal preparedness such as IT system (GSTN) and administrative structure?

I am quite happy with the progress being made. GSTN development seems to be on track and is being managed professionally. I am certain that it is working to a time frame to be ready for a roll-out much before April 2016.

Also, I do not see any significant challenges on the administrative side; the Centre and State governments should be able to chalk out a workable organisation structure for administrating GST.

Any other thought on GST that you would like to share?

I cannot think of any other reform in the country that can collectively add as much value as this reform to economic growth and market development. However some parties, including the business community, do not realise the beneficial effect of this reform. In this light, it is extremely important that all their energies are focussed on GST's implementation. I am confident that GST is going to be a reality soon and I am looking forward to it.



A profile photograph of Harishanker Subramaniam, a man with short, graying hair, wearing glasses, a dark suit jacket, a white shirt, and a red tie. He is looking towards the right of the frame.

Harishanker Subramaniam

Partner & National Leader - Indirect Tax Services, EY India

What should companies be focusing on?

The Government's efforts to build consensus with the States and table the Constitution (Amendment) Bill for introduction of the GST during the ongoing winter session of the Parliament is indicative of its commitment to put in place this most awaited indirect tax reform in April 2016.

The design and structure of GST are fundamental to understanding the potential benefits of this key reform. While it is fairly clear that we will have to live with a less than flawless GST, it is important that the tax base is comprehensive for the GST rates to be reasonable with minimum cascading effect. While the GST Revenue Neutral Rate (RNR) is still being debated, the recent proposal by the EC sub-committee of a 27% rate will be a non-starter. The rate has been computed assuming that tax base in GST would be the same as that under current indirect tax regulations. It is therefore important that the GST base is more comprehensive for RNR to be below 20%.

Our GST model, as we all know, will have CGST and SGST as two lines of taxes across the supply chain with credits across these lines of GST. In case of interstate sales or stock transfer, the proposed Integrated GST (IGST) model will apply. GST will be destination based and will see the elimination of the origin based Central Sales Tax (CST).

While the process of implementation of GST unfolds in the next 15 months, it is important for industry to understand the impact and opportunities offered by this reform. GST will affect all industries, irrespective of the sector. It will impact the entire value chain of operations, namely procurement, manufacturing, distribution, warehousing, sales, and pricing. It will also trigger the need to relook at internal organization and IT systems.

Let's talk about manufacturing. Today, state incentives as well as excise related exemptions have influenced decisions for setting up factories. What if all these tax related distortions are removed? Would companies still set up factories in remote locations? Or would they choose strategically located spots where factors are more favourable. Elimination of need to pay excise duty

on removal from factory would clearly create a positive impact on cash flow (as now taxes would be paid only when a supply is made). Further, companies that are already operating under negotiated state incentives linked to VAT and CST payouts may have to engage into a dialogue with State governments to understand the way forward.

Same would be with procurement & distribution strategies. Today, CST creates a barrier for buying from across state borders. With interstate taxes becoming creditable, companies could ring in a more efficient procurement plan. CST elimination would also pave way for an overhaul in the distribution network. India's supply chain typically has multiple warehouses in most States for a stock transfer & sell model to avoid CST. There is a clear opportunity now to evaluate whether these models need to be altered to have regional or central warehouses. Broadly speaking, supply chain design in the GST will be driven by optimum efficiency and speed to market, instead of convoluted tax-saving structures.

With a single tax for goods and service across States, it is expected that procurement costs would reduce due to minimization of non-creditable taxes or retention losses. At once, cash flows lock-up in input credits may increase with an expected increase in tax on services purchased from current 12% to the RNR rate. Supply chain productivities would result in lower costs of manufacture and distribution. All these factors would

influence pricing. A clear need to make a detailed assessment of the overall impact to ascertain the influence it will have on pricing strategies. A corollary would be dealer margins; say if the product price is reduced, would distributors and retailers be happy with a lower margin (if their margins are computed based on product price), and would this also affect pricing.

Service providers should expect different set of challenges. GST empowers states to tax services, which currently is a central levy. Most large service providers operate with a centralized registration. GST is likely to introduce the requirement of state-level registrations, wherever a supply is made. Determination of this is expected to be enshrined in place of supply rules, which are currently under preparation. These rules will be critical for sectors such as telecom, financial services, internet, media and multi-jurisdictional establishments to identify the state in which taxes are payable, along with the accompanying compliance and registrations.

Without doubt, companies would need to create a GST Steering Committees consisting of function leads to understand the potential impact and



leverage opportunities as the GST unfolds. This would typically need time and close monitoring at every stage of the implementation process. Another area that would require careful planning will be the redesign of enterprise resource planning (ERP) systems. We are all familiar with the discomfort caused by the introduction of VAT. GST will require a greater number of changes and therefore advance planning. In most companies, ERP calendars are planned in advance globally. Therefore, it is important that these calendars have a slot for



potential GST implementation in India in April 2016.

GST will affect all industries, irrespective of the sector. It will impact the entire value chain of operations, namely procurement, manufacturing, distribution, warehousing, sales, and pricing.

It is expected that all the key rules and regulations defining the GST framework would be made public in due course. Industry bodies should review these codes, and engage in an active exchange with the Government so as to made fruitful contributions to the law making process. This means that industry groups should be rallying together right now to identify potential areas which are high priority; something that they would like to definitely see in the draft regulations. This will help them once such drafts are made public.

So, as we await the presentation of the Constitution Amendment Bill in the Parliament, companies need to start examining each of the above issues, among many others, in the run up to GST.

Sectoral impact

What would GST mean to the **business**?

Ideally, within the broad structure of a consumption-type, destination-based, credit-invoice GST, tax should be levied comprehensively on all goods and services at a single rate to achieve the objectives of simplicity and economic neutrality. The extent of comprehensiveness of the GST base depends on the treatment of certain sectors, such as food, textiles, immovable property, non-profit sector and public bodies, petroleum and natural gas, electricity, alcohol etc. However, governments often deviate from this ideal structure either

because of concerns about distribution of tax burden (e.g., food, textiles), or because of administrative and conceptual difficulties in applying the tax to certain sectors of the economy (e.g., health care, education, financial services, immovable property, e-commerce etc.). These concerns are likely to be paramount at both Centre and State levels and inevitably, there will be calls to exempt, or tax at a reduced rate, items of importance to the poor or other particular groups.

Industry expects a transparent, integrated and simplified tax regime driven by objectivity. There should be optimal compliance across Centre & States for ease of business and building trust amongst all stakeholders. The primary focus of GST is to make India more competitive and business friendly where revenue distribution between Centre and State should not hinder movement of goods across 'One India.'

R Sridhar
Vice President - Taxation
Hindustan Coca Cola Beverages

"We hope GST unveils a robust tax regime subsuming all Central and State levies and creates a unified market across India. We wish States also subsumes Road Tax which ranges between 15-20%. GST will bring transparency to customers on the taxes being paid on sale of automobiles."

M S Vasan
Director Finance
General Motors India Private Limited

"Financial services sector welcomes GST, the government should allow a minimum of 12 months to align high value/ volume transactions and testing of systems for proper compliance. For ease of administration we need a single window registration, one time monthly payment, one return and single GST audit across States. Hope the Government builds consensus with States to avoid hardship for taxpayers."

Sunil Kothare
Director Finance & Tax
Citigroup South Asia



Abhishek Jain, Tax Partner, EY India

What does GST mean for the infrastructure sector?

The proposed Revenue Neutral Rate (RNR) of about 27% has sent the industry into a spin, making it imperative that the tax structure of the infrastructure supply chain is carefully thought out under GST. Given that the underlying premise of a GST is widening the tax base while minimising exemptions, the key issue for the sector is the continuity of current concessions and exemptions under GST and its plausible impact on credit chains and costing. This aspect needs to be resolved through active engagement between stakeholders and the Government.

For example, at present, there are no indirect taxes on the output of the power sector, except electricity duty levied by States. As a result, all input taxes (such as capital expenditure on setting up power plants and duties and taxes on coal) are a cost to power companies. If power is kept out of the ambit of GST and there is no concessional GST on the input side (like the 2% CST and service tax of 12.36%), the 27% GST paid on procurements will significantly increase the cost for this sector.

There are similar skews in other sub-sectors. In the mining sector, VAT is generally applicable, whereas excise duty is not leviable on most products arising out of mining. For roads, VAT is generally applicable on goods used for construction, whereas service tax is exempt on the actual construction of road. Furthermore, in the railway and port sector, construction, erection and commissioning services are exempt from service tax. On the contrary, rail travel services are partially taxable and port services are fully taxable. Thus, it would be critical as to how each of these sectors is handled under GST.

Current scenario

The Indian infrastructure sector largely encompasses power, road, port, railways and mining. Although these sub-sectors are often referred to in the same breath when speaking of infrastructure, the indirect tax landscape is varied and unique for each of them.

Goods and services for infrastructure projects enjoy a large number of concessions and exemptions under Central and State laws, since the sector is of national importance. Yet, the multiplicity of taxes and general construct of contracts give the infrastructure sector a heightened degree of complexity from the perspective of indirect taxes.

Fortunately, an end to the works contract debate is imminent, as each such transaction would be leviable to GST (comprising CGST and SGST), effectively negating the need to separately value work contracts for the purposes of service tax and VAT using various alternative mechanisms such as abatement and composition. This would avoid the current overlap of taxes in few cases. Because of the extent of civil work in infrastructure projects, it would be interesting to see the extent to which input credits are liberalised, since such credits pertaining to civil works are usually not available currently under both CENVAT and State VAT.

Overall, there are many unanswered questions about the impact of GST on the infrastructure sector, given its numerous nuances and its position in terms of structure and exemptions.

Get prepared for the big change

The scale and term of infrastructure projects make it imperative that the draft GST legislation is put in the public domain at the earliest, so that transitional challenges are minimised.

Ongoing long-term contracts at the time of introduction of GST may or may not have clauses dealing with changes in taxes and laws. Project awarders and executioners must safeguard themselves appropriately in this regard.

Furthermore, project costs and pricing would need to be reworked after taking into account amended tax rates on the input and output side, as well as input credits. This re-calibration, perhaps, would require the maximum preparedness.

The infrastructure sector is as much of a game changer as the GST from the perspective of the Indian economy. The Government should consider this fact carefully before coming out with the final legislation.



Divyesh Lapsiwala, Tax Partner, EY India

Current scenario

Financial services have been liable to service tax in India since 2001, with the scope being broadened over time. Today, all fee-based income is typically liable to tax.

In fact, in India, service tax also applies on margins made by the financial services sector on fund-based activities; for example, the sale or purchase of foreign exchange, based on a presumption that when a buy or sell rate is quoted, a service margin is inbuilt.

As a matter of fact, India is one of the few jurisdictions that substantially exploits the entire tax base of the financial services sector.



Uday Pimprakar, Tax Partner, EY India

Current scenario

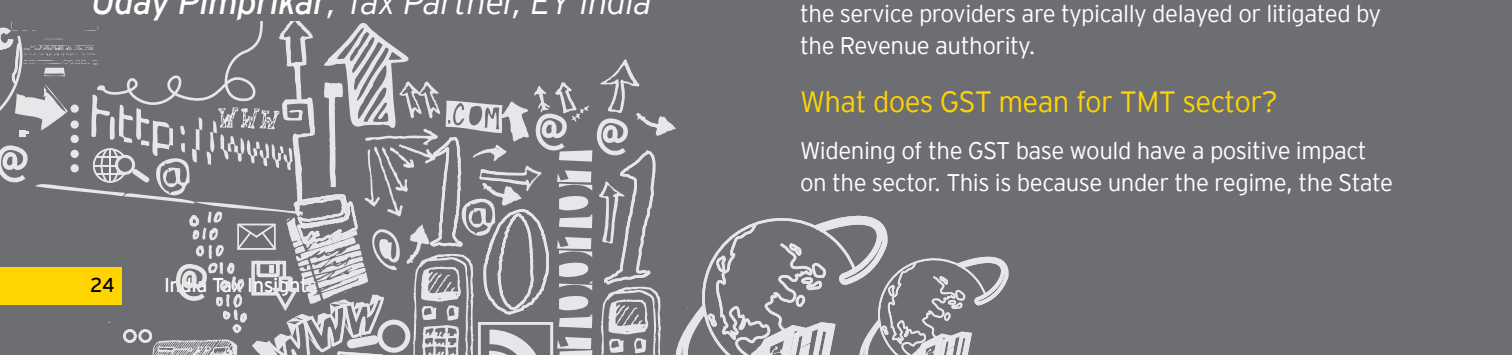
The Telecom, Media and Technology (TMT) sector provides services across geographical boundaries and deals with intangibles such as intellectual property rights and digital services.

Under the present indirect tax regime, services are liable to service tax levied by the Central Government. Meanwhile, the licensing of intangibles such as copyrights and software is liable to state VAT, in addition to service tax. Furthermore, the media sector is burdened with punitive state or local body entertainment taxes at the retail level.

Services provided by IT/ITeS to offshore clients are by and large considered as exports that are zero rated. These service providers seek refunds of the input central level taxes charged to them. These refunds claimed by the service providers are typically delayed or litigated by the Revenue authority.

What does GST mean for TMT sector?

Widening of the GST base would have a positive impact on the sector. This is because under the regime, the State



What does GST mean for financial services?

All service providers now have a centralised registration across the country, and the place of supply of services is either within India or outside. Under GST, the need to determine place of supply state-wise is a significant impact area. Financial services players have to cope with a complex set of provisions to determine the place of supply of their services within India. Clear provisions are required to handle situations where the multi-state presence of a service provider is potentially servicing the multi-state presence of the service recipient.

Conceptually, GST should usher in a clear outcome for fund based-incomes, whether they are fully exempt, fully taxable (so that the sector can take full credits), or continued to be taxed on the same basis as today. This also affects derivative transactions.

For exports, the concept of zero rating in the current law makes a distinction between supplies made to co-branches or head office and those made to independent legal entities (albeit of the same group). This distortion needs to be addressed by applying a zero rate to all export supplies.

With regard to input credits, any change in the ad hoc 50% recovery model would pose the challenges of computing exempt basket to determine reversals, especially net interest income. Similarly, clear provisions will have to be made to ascertain the exempt value of treasury transactions, which could result in profits or losses.

and Central GST charged on all supplies of goods will be available for set off against output GST liability.

However, this positive impact could be entirely annulled in case GST is levied at high rates. GST rate exceeding 20% will double tax incidence on both input and output, thus triggering pressures on pricing and materially increasing working capital needs. The impact of delayed refunds of input taxes on exports will be exacerbated. A high RNR will also impact tax compliance at the retail level, triggering a huge negative impact on revenues.

Exemption of sectors such as petroleum and the continuation of entertainment tax at the local level will worsen revenue and compliance burden on the telecom and media industry

A service provider will need to ascertain which state GST needs to be paid for each of its supply. This will be determined by rules that prescribe the place of supply. These rules are being drafted. It is imperative that these rules provide clear unambiguous parameters to determine the place of supply.

On the compliance front, effort will be increased manifold, as a large segment of the services sector, as on date, deals with taxes only imposed by the Central Government. This will

Get prepared for the big change

The first step would be to analyse high impact areas. There is a strong need to engage with the Government as a part of the formative process of the GST code. This does not necessarily mean seeking exemptions; on the contrary, it is important so that there is clarity of tax outcome on various complex transactions.

The next step would be to assess impact on business operations once the draft regulations are made public. At this time, there would be opportunities to optimise taxes, and there would also be threats due to higher taxes. Both opportunities and threats need to be understood well in advance and planned for.

The third major step would be to prepare the organisation for the change - by augmenting technology and the people organization.

Conclusion

On an overall basis, GST will usher in tax efficiencies. However, from a financial services perspective, the move will pose several types of challenges. It will be a potential opportunity to contribute to the law-making process with the aim to create a predictable and less controversial indirect tax environment.

change after GST's implementation, and compliances would be carried out at the state or local body level.

Get prepared for the big change

A GST with a very high RNR or unclear rules and procedures will wipe out all of the anticipated benefits. The industry should engage with Central and State governments to educate them on peculiar nuances and assist on adopting the new regime. The industry needs to ascertain the impact of this change on pricing, margins, cash flows and related working capital requirements, supply chains, etc. More importantly, for most parties, the impact on their software systems will be huge. All IT and ERP systems will need to be reconfigured entirely to deal with the change in taxing output and recognise input taxes at both the State and Central level. This will also be required for filing returns, along with reassessing internal tax organisations and compliance efforts.

States levying GST on services will have the ability to attract investments in the services sector. Entities looking at large investments should consider this avenue of negotiating for capital or other subsidies from State governments.

GST is a seminal change, especially for the services sector, given that it affects almost all areas for an entity.



Harishanker Subramaniam,
*Partner and National Leader –
Indirect Tax Services, EY India*

Current scenario

The indirect tax regime for the automobile sector in India is perhaps one of the most complex and multi-layered, with several Union and State levies applicable to different stages of supply chain such as Customs Duty on imports, Central Excise on manufacture, VAT and/or CST on sales, Service tax on import/provision of services, additional levies such as NCCD, Automobile cess, Entry taxes, Octroi/LBT, registration charges, road taxes etc. Furthermore, luxury vehicles are typically subjected to high tax rates of Central excise and VAT.

What does GST mean for the Automotive sector?

The changeover from a complex tax system to a simple one would, therefore, be a welcome change for the entire industry. It is likely to remove, to a large extent, the cascading impact of indirect taxes and bring down cost of doing business.

Uniform GST rates across States and subsumption of Entry taxes into GST will allow an increased level playing field to

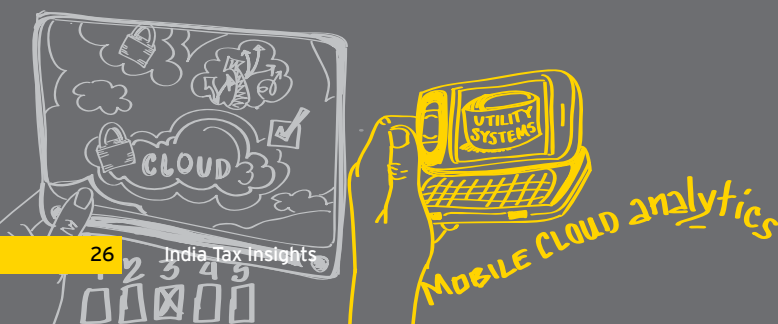


Vivek Pachisia, *Tax Partner, EY India*

Current scenario

Indirect taxation in India, which was primarily formulated around the brick-and-mortar operations of the manufacturing and trading sector, was due for an upgrade to accommodate the ever-changing business environment, influx of foreign investments and advent of unique business operations, especially the e-commerce sector. GST is a much anticipated upgrade expected to be implemented in India, in 2016.

The e-commerce sector, which operates differently from conventional businesses, has often encountered challenges in interpreting and applying existing indirect tax legislations to its business models. The online/web technology-based nature of operations cutting across State borders, absence of or limited brick-and-mortar structure, unique nature of transfer of property across borders and collection of consideration etc., has resulted in a struggle for both e-commerce companies and governments to manage e-commerce transactions under existing provisions of indirect taxation. The origin-based levy under the current VAT regime has also limited the supply-chain flexibility across State borders with need for forms in delivery States and potential jurisdictional issue with regard to taxability.



auto companies, by removing regional demand distortions and permitting uniform pricing policies across States.

With no embedded tax costs on inter-state movement of goods and a shift in the point of taxation to the ultimate consumer under GST, businesses would have enhanced flexibility to re-design their supply chains. Moreover, importer-distributors as well as domestic automobile dealers should be able to claim credit of GST paid on all business procurements of goods and services, as opposed to the current scenario, where they cannot claim a credit for the Excise duty paid on capital assets or Service tax paid on input services availed, and which, therefore, is a cost.

Similarly, current taxation rules with regard to extended warranties, insurance and maintenance contracts generally lead to double taxation of the same base value due to non-fungibility of VAT and Service tax credits. Appropriate drafting of GST legislation could bring more cost efficiency in such transactions by freeing up blocked credits.

The introduction of GST may also lead to further consolidation of operations in the Indian auto sector, with the likely neutralization of indirect tax benefits of a separate sales/distribution entity due to levy of CGST proposed to be extended up to the point of consumption.



Get prepared for the big change

While the draft law is still being prepared, GST could throw up some unique challenges for the automotive sector. For example, – taxation of used vehicles and trade-ins under GST could be complicated and lead to double taxation of the vehicle unless appropriate rules are drafted with regard to the same.

Similarly, treatment of various investment-linked or other indirect tax incentives at both Central and State levels, including the benefits under the Foreign Trade Policy for exporters, could have a significant impact on business plans. Currently, there exists a lack of clarity on the mode in which such schemes (both at the Union as well as State levels) would be continued, and whether incentives would be given against only CGST or SGST or IGST or all. It needs to be ensured that these incentives continue to remain relevant under the GST regime.

Lastly but perhaps, most importantly, businesses need to plan ahead for timely implementation of changes required in their ERP and financial reporting systems, to ensure minimal business disruptions during transition.

The introduction of GST could be a key business change driver and therefore, auto companies should do a SWOT analysis of the impact of GST proposals on their current as well as future business plans.

E-commerce business models offering market-place and delivery fulfilment services makes tax compliances challenging and entails interpretative issues with regard to jurisdiction and taxability of transactions, especially when goods are moved across borders through delivery fulfilment centres managed by e-commerce companies. Furthermore, the difficulties associated with interpretation of taxation of online sale of goods and services, availing of input tax credit, meeting the procedural and compliance requirements of various States etc. have also caused serious operational hurdles for the e-commerce sector under the current indirect tax regime.

What does GST mean to the E-commerce sector?

GST, with its proposed unsophisticated design and business-friendly approach, merger of various indirect tax legislations and convertibility of input tax credits can be used to address and resolve challenges being faced by the e-commerce sector. GST can be rightly modelled to address the needs of modern businesses, especially the highly complex and evolving e-commerce and digital businesses, with dire need for simplified procedural and compliance requirements. Furthermore, the consumption base modelled GST may also throw up opportunities to the e-commerce sector to conceptualize

and renew the existing business and transaction models to fit into the GST structure and to simplify indirect tax management. The full strength of GST could be realized and leveraged by the e-commerce sector by providing effective input and feedback to the central and state governments during the course of formation of GST legislation and implementation process.

Get prepared for the big change

GST is a game changing legislation with wide impact and ramifications across the industry sectors and especially for the e-commerce sector. It is imperative for the e-commerce sector to be informed and prepared to adapt to the changes envisaged under GST. The e-commerce companies should assess the current state of affairs and prepare for changes required to business structures and operations, changes to management information systems and other support system for management of GST on an ongoing basis.

It would be prudent for e-commerce companies to start the preparation well in advance to be able to migrate/transition from the old indirect taxation regime and operate efficiently under the new GST regime.

Getting ready for GST



T Koshy

*Partner and Leader –
Public Financial Management, EY India*



Gyanendra Tripathi

Tax Partner, EY India

Are State tax departments and India Inc ready for GST?

The implementation of GST by April 2016 appears to be a near reality now. While there is many a slip between the cup and the lip, it is hoped that the key issues will be sorted out in time for implementation. Meanwhile, taxpayers and State tax authorities need to understand the key changes requiring them to re-chart processes and procedures.

The centralisation of registration, return filing and payment electronically will enable quick and easy compliance to the provisions of the new law.

Goods and Services Tax Network (GSTN)

The State Finance Ministers have been inducted into the Empowered Committee of Finance Ministers at the Centre and have been deeply involved in all discussions on the modus operandi of GST. They have concurred to the set up of a Special Purpose Vehicle - GSTN – to enable GST implementation, facilitate centralisation of tax databases and enhance taxpayer service experience. However, State tax departments will have a number of state-specific issues that will have to be tackled while they ready themselves for GST, giving them about 16 months for such a change.

At the lowest layer of tax data management, State tax departments will have to align their databases to the omnibus database that is being created for data pooling at GSTN. They will have to put in place mechanisms that will enable them to pull data from the central database for processing and analysis or push

the data back into the central system, as and when required. Therefore, the IT design and policy of the State tax administration needs to be aligned in context.

At the administrative level, the subsuming of other taxes (such as service, excise or entry) into GST will demand the remapping of jurisdictions. Decisions will have to be taken with regard to the handling of assessments, appeals, penalty hearings and other types of taxpayer-department interactions when both the Centre and the State will have a concurrent jurisdiction over the taxpayer.

At the policy level, State tax departments may be required to re-formulate their policies, such that they do not in any way retard the creation of a single market economy in India while safeguarding the interests of the State. Most of the States are apprehensive that they may lose some revenue in the short run. Nevertheless, consumption-based tax is expected to result in overall growth of the economy and increase in the volume of consumption within States in time, resulting in higher revenue.

Impact on India Inc

Taxpayers will also benefit with GSTN, as they will no longer have to grapple with multiple State taxes or complicate their accounting practices to comply with numerous tax laws. A uniform rate across States could facilitate tax computation and discharge of legal obligations. However, a final call is yet to be taken, and States may be allowed certain flexibility within a band.

The centralisation of registration, return filing and payment electronically will enable quick and easy compliance to the provisions of the new law. Several committees on GST have pointed out in their reports that GST would:

- ▶ Negate the cascading effects of tax
- ▶ Lower the cost of compliance
- ▶ Increase the competitiveness of the industry nationally and internationally

However, compliance to GST is not plug-and-play. It cannot be achieved without transforming internal accounting processes and procedures of the business entity. India Inc will have to prepare itself for the new scenario.



Invoice level information to be filed

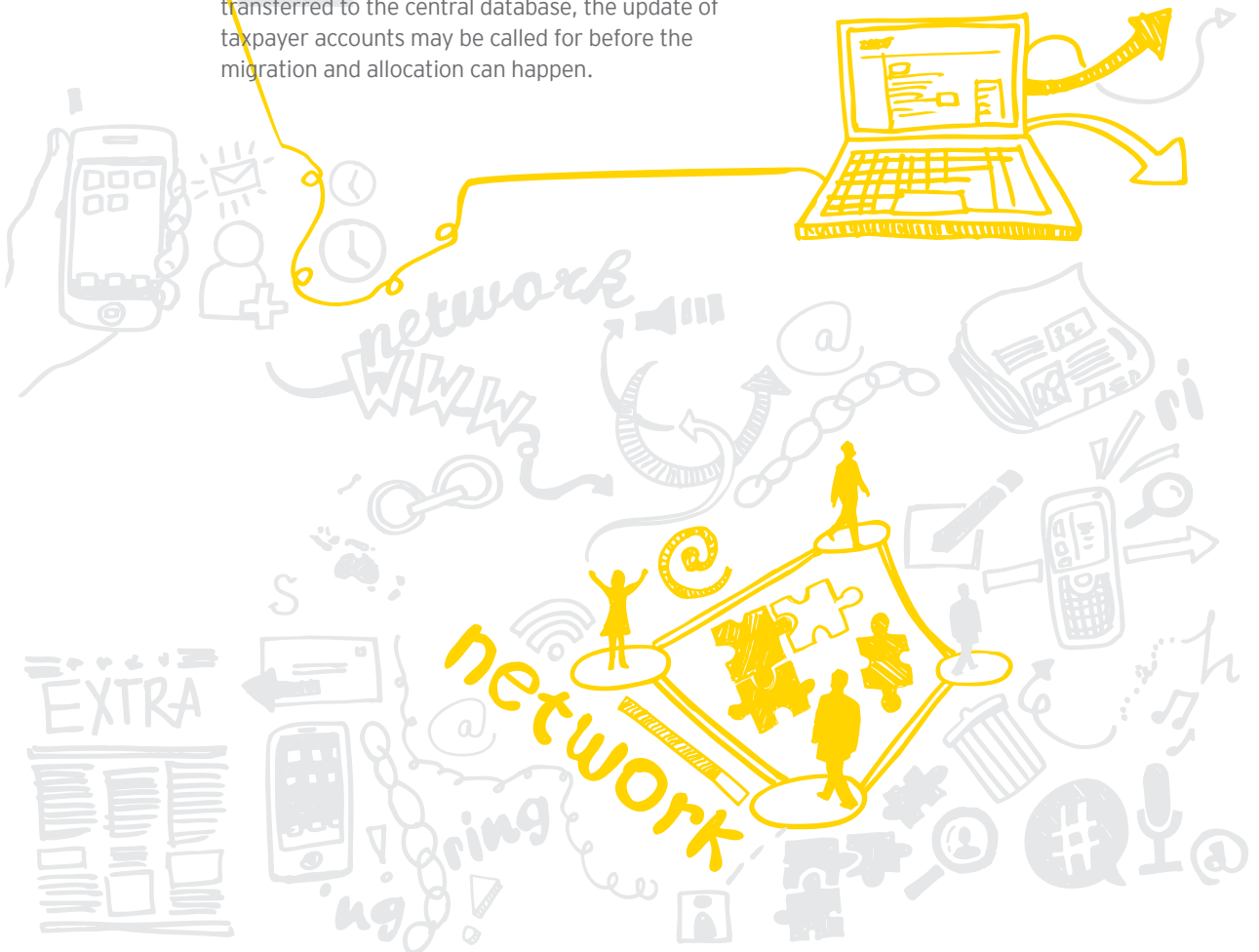
Purchase and sales information that is currently being filed at an aggregate level may change to invoice level filing of information. Invoices may have to be uploaded to the central system as a part of return filing. Processes and procedures will have to be designed to accommodate this legislative requirement.

1

2

PAN based registration number

A new 15-digit PAN based registration number will have to be obtained from GSTN. While this may be automatically allotted when state records are transferred to the central database, the update of taxpayer accounts may be called for before the migration and allocation can happen.



To revisit supply chain design and distribution network

Taxpayers may have to revisit their supply chain designs and their distribution networks to understand how the new tax regime will impact their transaction accounting practices. Since branch transfers will be treated at par with the sale of goods, the requirement of locating warehouses/branches across State borders will have no relevance from a tax point of view.

3

Common challan for all tax payments (dealing with Central and State authorities)

Taxpayers will be able to make all payments of taxes using a common challan, but they will have to identify the accounting head of the tax being paid. Taxes being paid can be State Goods and Services Tax (SGST), Central Goods and Services Tax (CGST) relating to Intra-State trade or Inter-State Goods and Services Tax (IGST), which is a total of CGST and SGST. Claims for set off against the payment of CGST and SGST can only be made against CGST and SGST, respectively, while IGST can be set off against all three. Taxpayers will have to establish a procedure for the set off to be applied accordingly.

As every transaction will have both CGST and SGST components, taxpayers may have to deal with both Central and State tax administration, unless segregation of responsibilities is agreed to and respected.

4

5

Clarity on tax treatments for certain industries/transactions

While GST is a consumption-based tax, clarity is required on the tax treatment of certain industries/ transactions such as e-commerce and in cases where a single invoice is raised on the head office of the purchasing entity for goods/services consumed by its various divisions located across States. Current accounting practices will have to be aligned to the specific requirements of GST in such cases.

Once the Constitution Amendment Bill is passed and the GST legislation is in place, India Inc will have to gear up for revised tax accounting and management dashboards. Whether they have sufficient time to make all the redesigns envisaged above is a question that will need to be answered with time. Since State governments have been involved right from the time of inception, the State Tax Department can be expected to be better prepared for the successful implementation of GST.

To exclude or not to exclude from GST ?

Overall economic interests must have precedence

A constant feature of the discord between the Centre and the States on the GST design has been the exclusion of certain goods and taxes from the GST ambit to preserve the states' fiscal autonomy and revenues. States insist that their views should be respected in the interest of cooperative federalism. However, in the larger interests of the country, the States need to reconsider their demands to allow a progressive GST that encourages investment and growth and not hinder it.

At the time of writing this article, the states were adamant that petroleum, alcohol and real estate (land) should

be excluded from the purview of the GST. They also want entry tax levied by local bodies in lieu of octroi to be out of GST. The Centre understands the significance of a comprehensive GST and has been trying hard, without success, to build consensus with the states towards this end.

The basic objectives of GST are to simplify taxation, remove the cascading of taxes that currently plagues the tax system, bring in transparency, minimise current distortions that adversely impact production and consumption, and enhance investments and economic

growth. All of these objectives get defeated if any sector is excluded from the GST.

Let's take the example of alcohol. The alcohol industry already faces substantial tax cascading resulting in increased costs. The diversity and variation in taxes across states adds to complexities and necessitate border check-posts. The exclusion of alcohol from GST will perpetuate these complexities. Even worse, it will perpetuate the illicit trade and harmful cartels that currently pervade the industry. According to media reports, Gujarat alone records an



Shalini Mathur

Director - Tax & Regulatory Services, EY India

annual turnover of INR300 billion from illicit liquor trade. Reportedly, Tamil Nadu also has a thriving illicit liquor business. The nationwide figures would be colossal. What better opportunity than GST to bring transparency to the sector?

If GST applies to alcohol, it will significantly reduce tax evasion through more efficient transactions tracking and improved enforcement and compliance.

The States need not fear the loss of revenue, since they will retain their exclusive powers to legislate on matters relating to liquor and to levy excise duties, license fees and sales and purchase taxes over and above the GST. Moreover, better enforcement itself will yield more revenues to the States.

The same arguments apply in the case of land. Real estate transactions are currently taxed under the works

contracts. Under the Constitutional amendment the real estate transactions may escape taxation under the GST. Most VAT jurisdictions explicitly apply VAT to the full value of real property transactions. Same should be the case in India. Land itself is a breeding ground for corruption and a storehouse for illegal money. A transparent and clean system can be achieved if GST applies to all goods and services.



In the larger interests of the country, the states need to reconsider their demands to allow a progressive GST that encourages investment and growth and not hinder it.

“Alcohol industry has serious misgivings about the proposed exclusion of alcohol from GST under the Constitution itself. However, industry is confident that the Parliament will take cognisance of the views of the erstwhile Standing Committee on Finance, headed by Hon’ble Shri Yashwant Sinha which strongly recommended an all-inclusive GST, with no exclusions under the Constitution.”

Sonjoy Mohanty
Secretary General, International Spirits & Wine Association of India (ISWAI)

Petroleum products account for around 30% of States' tax receipts. It is no surprise that the States want to retain this sector outside GST. As a compromise, the Centre has offered to zero-rate petroleum while keeping it within the ambit of GST. However, there are certain practical difficulties in applying zero rating, which need consideration.

First, zero rating by nature requires a timely and complete system of refunds to the producers and distributors of zero-rated products. In India, substantial delays are encountered in getting the refunds. Without a prompt and full refund of input taxes, zero rating degenerates into an exemption system, which is detrimental to businesses.

Second, for the benefits of zero rating to be realised, the current taxes (e.g., sale and purchase taxes or entry taxes) that apply to intermediate products such as crude must apply in a non-cascading manner. Currently, these taxes are not rebated against taxes applicable on the final products and result in tax cascading when crude is acquired by refineries for processing and refining.

Third, following the destination principle of GST, the burden of such supplementary taxes should be confined to the State where finished products are consumed. In the example above, taxes on crude are levied and collected in the State where the crude is refined and not where the finished products are consumed - clearly a case of misallocation of revenues between producing and consuming States.

Fourth, proper zero-rating entails that input taxes are refunded to producers and distributors at all points in the supply chain, including petrol stations and other retailers. This may encourage fraudulent claims for refunds of input



tax, particularly from suppliers in the unorganised sector. A robust system is needed to verify the validity of input tax refund claims.

The States have been demanding the exclusion of entry tax too. Entry tax imposes a major cost burden on the industry and is a deterrent for their operations and expansion plans. The problems get compounded when entry taxes are levied on industrial input and on transit sales. Such taxes go against the concept of the common market.

Entry tax has been a subject of protracted litigation. Article 301 of the Constitution precludes the States from taxing Inter-State transactions to prevent/minimise barriers to Inter-State trade. On the other hand, Article 304 allows the State legislature to impose tax on goods imported from other states or the Union Territories, in line with the tax imposed on similar goods produced in that State, to avoid discrimination between imported goods and locally manufactured goods.

In line with the recommendations of the 13th Finance Commission's Task Force on GST, entry tax at all levels should be fully subsumed in the GST.

Besides the complexities highlighted above, one must not forget that exclusions mean a narrow tax base, which in turn makes it difficult to keep tax rates at a reasonable level. The governments are discussing a revenue neutral rate of as high as 26%-27% for most goods and services. Such high rates are unpalatable and can be brought down only if the base is comprehensive.

The States must reconsider their demand for exclusions from the GST base in the overall interest of the economy. The exclusions, if at all to be made, must not be under the Constitution, a view supported by the erstwhile Parliamentary Standing Committee on Finance.

Global news



Ireland amends its residency rules; phases out “double Irish” structures

1

On 14 October 2014, while presenting the FY15 Budget, Ireland’s Minister for Finance confirmed his intention to bring forward amendments to Ireland’s corporate residence rules. These are presently based on place of management. The proposed legislation was published on 23 October 2014¹ as per the amended rules:

- ▶ All companies incorporated in Ireland will be regarded as Irish tax resident, subject to an override within a tax treaty.
- ▶ For existing companies, it is proposed that the new rule will take effect on 1 January 2021. Therefore, any impact on existing investors is deferred via a significant grandfathering period.
- ▶ The rule will apply immediately for companies newly incorporated on or after 1 January 2015.

The Minister also announced a number of immediate changes to Ireland’s corporate tax regime for multinationals. These include (i) improvements to the existing IP tax depreciation regime, (ii) expansion of the R&D tax credit system and (iii) revisions to the expatriate tax regime. The Irish Government remains committed to maintaining the 12.5% corporate tax rate.

The amendment has been brought in to phase out the so-called “Double Irish” structures², which have attracted significant negative publicity. The move is a part of Ireland’s efforts to maintain a strong international reputation with trading partners, the European Commission, OECD and other stakeholders.

Russian administrative guidance on beneficial ownership³

2

In April 2014, the Russian Ministry of Finance (MoF) issued a guidance⁴.

Accordingly, tax agents and tax authorities in Russia are required to expand the scope of their focus to include not just the country of residence of a foreign recipient of Russian-source income but also whether or not that recipient is the beneficial owner of the income while applying concessions provided in tax treaties. However, neither the above guidance nor the Russian Tax Code provides any information as to how a tax agent might demonstrate sufficient diligence in checking whether or not the recipient is the beneficial owner to avoid exposure to liability for failing to withhold appropriate taxes.

Recently, the MoF had published a letter⁵ (the Letter) to list documents required to determine the beneficial owner of dividend income. The Letter acknowledges that the Tax Code does not establish a requirement for tax agents to check whether the recipient of income is the beneficial owner, though the amendments required to introduce such a requirement in the Tax Code are likely to be enacted before the end of 2014 and have effect

from 1 January 2015. The Letter suggests that the tax agent may request the following documents besides TRC:

- ▶ Evidence as to whether or not the taxpayer enjoys discretion with regard to disposal and use of the dividends received;
- ▶ Documents (information) confirming that the income recipient that is a resident of a treaty jurisdiction "incurs tax obligations which are payable and the existence of which confirms that no saving on tax at source in Russia was made upon the subsequent transfer of funds received to third parties" (whose place of residence or registration is not a treaty jurisdiction);
- ▶ Documents (information) confirming that the income recipient carries out actual entrepreneurial activities in the jurisdiction in which it claims tax residence for treaty purposes.

It is important to note that neither of the letters issued by the MoF has any legal force; however, they provide a guidance with respect to the Government's position on what constitutes evidence and can be used by tax agents to determine the beneficial owner of income subject to withholding tax in Russia.

Global news

Anti-avoidance measures implemented by China

3

On 29 July 2014, China's State Administration of Taxation (SAT) issued an internal notification, Shuizongbanfa [2014] No.146 (Notification)⁶. The Notification requires Chinese tax authorities to investigate significant amounts of service fees and royalty payments remitted to overseas related parties from 2004 to 2013, in particular, those in low tax jurisdictions. The tax authorities are required to assess the rationale of such payments with regard to both business purpose and commercial substance. The Notification focuses on certain specific aspects while evaluating the deductibility of service fees and royalty payments. Tax authorities were required to complete their investigations and send in their reports to the SAT by 15 September 2014. If the reports contain a potential tax avoidance case, an anti-avoidance investigation procedure will be undertaken.

Furthermore, the SAT issued two administrative guidelines (Shui Zong Han [2014] No. 317 and 318) requiring Chinese tax authorities to examine the payments of dividends paid to non-residents between 2012 and 2013 and to reinforce the administration of the enterprise income tax on capital gains from share transfers⁷. The guidelines specify certain transactions that call for special attention to evaluate if there is risk of tax avoidance on dividend paid and capital gains from equity transfers and to strengthen collection/administration of enterprise income tax in China.

Japanese court holds quasi GAAR not applicable in reorganisation⁸

4

Taxpayer, a Japanese corporation, bought all the shares of IBM Japan from its 100% holding company in US using the funds borrowed from a holding company. Taxpayer is treated as a branch of its holding company as per US tax regulations. Accordingly, there was no capital gain in US when the taxpayer acquired the shares of IBM Japan. Before the acquisition, when IBM Japan paid dividends to the US holding company, it was subject to 10% withholding tax on dividend for which no credit was available in the US. After the acquisition, the taxpayer received dividends from IBM Japan and repaid the loan to the US holding company out of which only the interest portion was subject to withholding tax.

Subsequently, Taxpayer sold the shares of IBM Japan, resulting in capital losses, which were set off against its taxable income. Japanese tax authorities denied the utilisation of losses under the quasi GAAR provisions of Japanese tax law, which permits the reconstruction of an action/computation of a taxpayer when it leads to an unfair tax burden reduction.

The Japanese Court ruled against the tax authority and held that quasi GAAR was not applicable in this case due to the following reasons:

- ▶ Companies should have autonomy over their group corporate structure. Taxpayer acted as a financial intermediary in the group reorganisation. Therefore, it cannot claim that there was no business purpose in placing an intermediary holding company.
- ▶ The transaction of borrowing money cannot be discarded merely because it was not at arms' length.
- ▶ The purchase and sales prices were not unreasonable as compared to the fair value of IBM Japan.
- ▶ Such corporate restructuring was not prohibited by Japanese laws.
- ▶ The tax authority could not establish that Taxpayer intended to create and utilise losses to avoid the payment of Japanese taxes.

US Court of Appeals affirms US Tax Court's reclassification of loan as dividend⁹



The US Court of Appeals ruled that a complicated finance structure involving a series of financing transactions represented a payment of taxable dividends.

Taxpayer, a US corporation, entered a financing arrangement with its Singapore subsidiary to utilise the excess cash and borrowing capacity of the subsidiary. The Singapore subsidiary, using funds borrowed from a Singapore bank, formed subsidiaries in Bermuda, which formed another subsidiary in Delaware, which subsequently lent the funds to Taxpayer.

As per the step transaction doctrine under US tax regulations, a series of formally separate but related transactions involving the transfer of property can be regarded as a single transaction if all the steps are substantially linked. The Tax Court, applying the interdependence test for step transaction doctrine, held that the transactions represented dividend payments to Taxpayer.

The US Court of Appeals held that each of the preceding transaction in the series was completed pursuant to a prearranged plan with the purpose of granting the loan to Taxpayer. As Taxpayer failed to establish that any of the funds were repaid or represented bonafide investments, transactions without any valid business purpose represented dividends in substance.

References

- 1 Refer EY Global Tax Alerts dated 14 October 2014 and 23 October 2014
- 2 The double Irish arrangement is a tax avoidance strategy used by multinationals to shift income to a low-tax country by taking advantage of Irish residency rules. Presently, such structures are used by companies like Apple Inc., Facebook, Google, Starbucks etc. (Source - www.wikipedia.org)
- 3 EY Global Tax Alert on "Russian Government issues guidance to tax agents on beneficial ownership" dated 28 October 2014
- 4 Letter No.03-00-R3/16236 of 9 April 2014, refer EY Russian Tax Brief (May 2014 Edition)
- 5 Letter No. 03-08-05/36499 of 24 July 2014
- 6 Source - EY Tax Alert on "China begins tax anti-avoidance investigations on substantial amounts of service fee and royalty payments" dated 3 September 2014
- 7 Source - EY Global tax Alert on "China issues internal notification on tax examination of dividends paid to non residents" dated 16 October 2014, www.ibfd.org
- 8 www.ibfd.org
- 9 Barnes Group, Inc. and Subsidiaries v. Commissioner of Internal Revenue, No. 13-4298, 5 November 2014

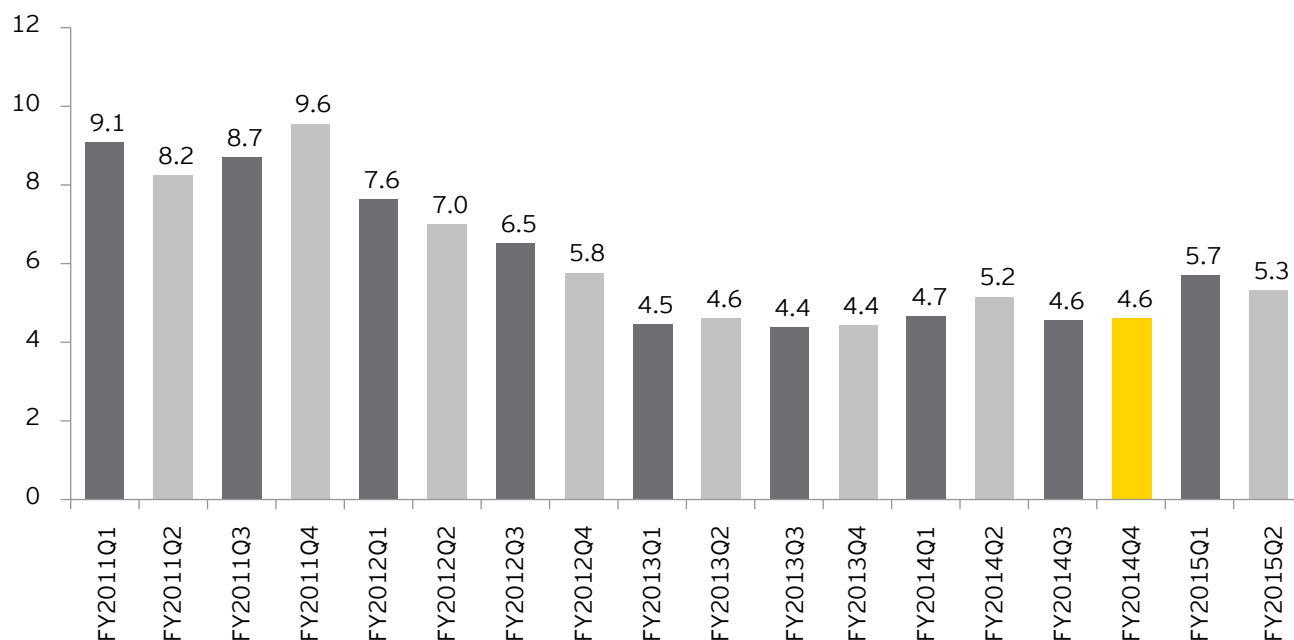


EconoMeter



Growth: Second quarter growth in FY 2015 slows down

Exhibit 1. Growth of GDP at factor cost at 2004-05 prices



Source: National Income Accounts, MOSPI, Government of India

GDP Growth fell to 5.3% year on year basis in FY2015 Q2 after improving to 5.7% in Q1.

Exhibit 2. GDP at factor cost: aggregate and sectoral growth rates

(Quarter over corresponding quarter of previous year; %)

Quarter	Agriculture and allied sectors	Mining and Quarrying	Manufacturing	Electricity, gas and water supply	Construction	Trade, hotels, transport, storage and communications	Financial, real estate and business services	Community, social and personal services	GDP at factor cost
2013Q1	1.82	-1.08	-1.08	4.22	2.77	4.01	11.67	7.62	4.46
2013Q2	1.77	-0.13	-0.03	1.33	-1.85	5.57	10.65	7.39	4.61
2013Q3	0.77	-2.04	2.50	2.61	1.00	5.87	10.18	4.04	4.38
2013Q4	1.59	-4.79	3.04	0.92	2.40	4.84	11.18	2.77	4.44
2014Q1	4.01	-3.88	-1.16	3.77	1.05	1.58	12.89	10.59	4.66
2014Q2	5.03	0.00	1.34	7.80	4.43	3.59	12.08	3.57	5.15
2014Q3	3.69	-1.19	-1.51	5.00	0.63	2.88	14.13	5.74	4.56
2014Q4	6.33	-0.45	-1.41	7.17	0.69	3.88	12.39	3.30	4.61
2015Q1	3.80	2.07	3.46	10.24	4.77	2.76	10.44	9.07	5.71
2015Q2	3.24	1.88	0.12	8.73	4.63	3.78	9.54	9.64	5.33

Source: National Income Accounts, MOSPI, Government of India

GDP growth in manufacturing has slipped to near zero in the second quarter of FY2015; social, community and public services show higher growth compared to that in the corresponding quarter of FY2014.

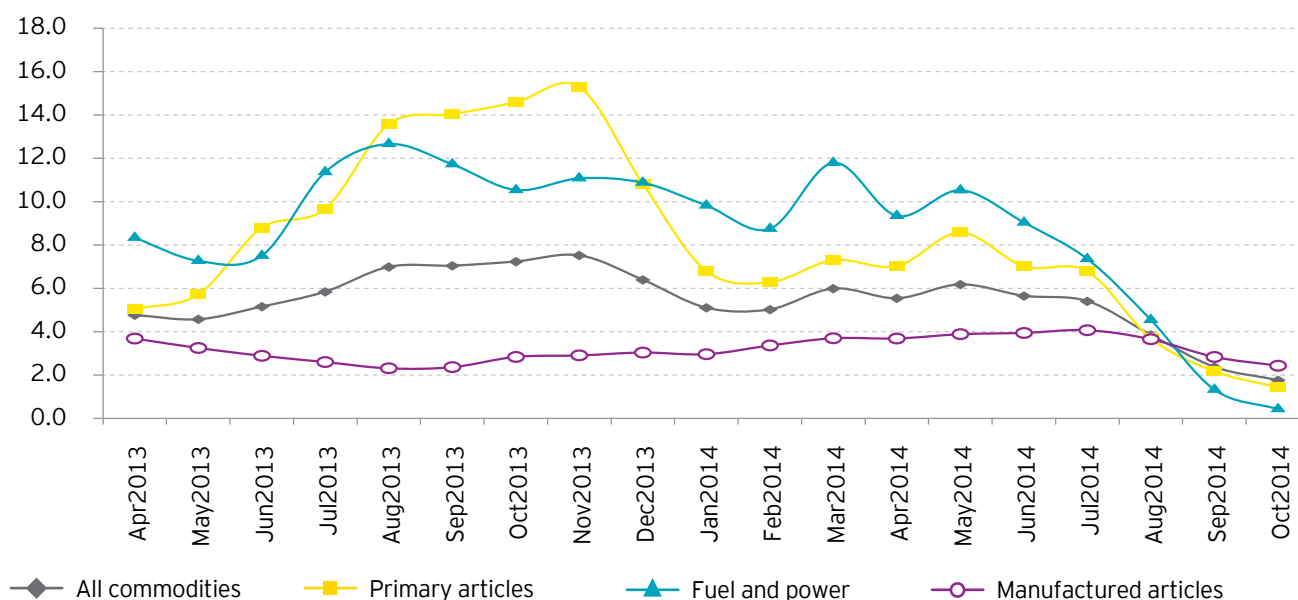
Exhibit 3. Components of aggregate demand

(Quarter over corresponding quarter of previous year; %)

Quarter	Private final consumption expenditure	Government final consumption expenditure	Gross capital formation	Exports	Imports	GDP at market prices
2013Q1	5.04	10.20	-2.27	15.08	9.96	3.97
2013Q2	4.74	9.86	0.84	10.21	11.16	4.67
2013Q3	5.07	4.53	6.60	-1.71	3.62	5.32
2013Q4	5.15	1.78	4.27	-1.38	2.30	4.90
2014Q1	5.64	12.88	-5.07	-2.85	1.66	4.21
2014Q2	2.83	-0.15	0.32	14.97	0.39	5.17
2014Q3	2.75	3.62	-3.16	11.25	-8.32	4.42
2014Q4	8.23	-0.40	-2.20	10.51	-3.69	6.14
2015Q1	5.64	8.85	3.42	11.54	-0.41	5.85
2015Q2	5.81	10.12	-1.54	-1.60	1.06	6.04

Source: National Income Accounts, MOSPI, Government of India

Demand for exports has slipped into negative territory in FY2015 Q2 after a double digit growth in four preceding quarters. Gross capital formation shows negative growth in the second quarter.

Inflation: All major inflation indicators are trending down**Exhibit 4. Inflation measured by Wholesale Price Index (Year-on-year; %)**

Source: Office of Economic Adviser, Government of India

All major components of WPI-based inflation have slid downwards, the sharpest fall being in fuel and energy prices.

Exhibit 5. Monthly Inflation Rates based on Wholesale Price Index: Key indicators

(Month over corresponding month of previous year: % change)

Month	All Commodities	Primary Articles	Fuel and Power	Manufactured Articles
Apr2013	4.8	5.06	8.33	3.69
May2013	4.6	5.72	7.27	3.25
Jun2013	5.2	8.79	7.51	2.89
Jul2013	5.9	9.68	11.36	2.60
Aug2013	7.0	13.57	12.66	2.31
Sep2013	7.0	14.03	11.72	2.36
Oct2013	7.2	14.59	10.54	2.84
Nov2013	7.5	15.29	11.08	2.91
Dec2013	6.4	10.82	10.87	3.04
Jan2014	5.1	6.80	9.82	2.96
Feb2014	5.0	6.28	8.75	3.36
Mar2014	6.0	7.31	11.80	3.70
Apr2014	5.5	7.02	9.34	3.69
May2014	6.2	8.58	10.53	3.88
Jun2014	5.7	7.01	9.04	3.95
Jul2014	5.4	6.78	7.35	4.07
Aug2014	3.9	3.69	4.54	3.65
Sep2014	2.4	2.18	1.33	2.84
Oct2014	1.8	1.43	0.43	2.43

Source: Office of Economic Adviser, Government of India



Exhibit 6. Inflation based on Consumer Price Index (new series): Combined index for rural and urban areas

(Month over corresponding month of previous year; % change)

Month	General	Food, beverage, and tobacco	Fuel and Lighting	Housing	Clothing, bedding and footwear	Miscellaneous
Oct2013	10.17	12.36	6.97	10.44	9.10	6.93
Nov2013	11.16	14.45	7.00	10.29	8.94	6.90
Dec2013	9.87	11.97	6.98	10.26	9.18	7.05
Jan2014	8.79	9.87	6.54	10.20	9.11	7.10
Feb2014	8.03	8.63	6.13	9.88	9.07	6.81
Mar2014	8.31	9.15	6.29	9.89	8.96	6.78
Apr2014	8.59	9.64	5.89	9.73	8.68	6.77
May2014	8.28	9.22	5.00	9.18	8.79	6.92
Jun2014	7.46	7.96	4.73	9.15	8.65	6.54
Jul2014	7.96	9.14	4.47	8.94	8.66	6.56
Aug2014	7.73	9.15	4.15	8.48	8.39	5.86
Sep2014	6.46	7.62	3.45	8.11	7.59	4.70
Oct2014	5.52	5.82	3.29	8.04	7.45	4.69

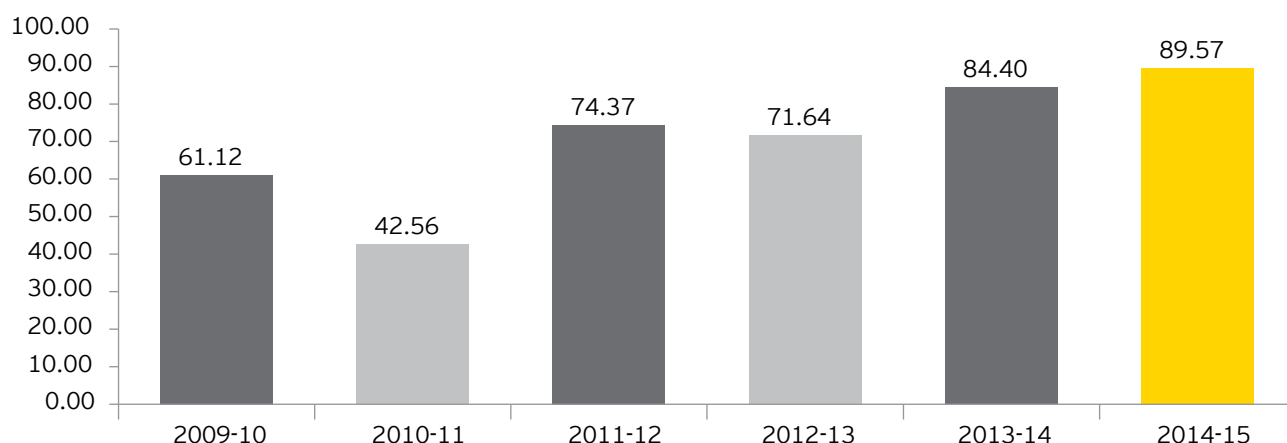
Source: Ministry of Statistics and Plan Implementation, Government of India

CPI based inflation has fallen steadily for all commodity groups over the previous twelve months. Inflation for the general group has nearly halved in this period. Inflation rates for both food and fuel and lighting groups have fallen sharply.



Fiscal performance: slippage in fiscal and revenue deficit budget targets looming large

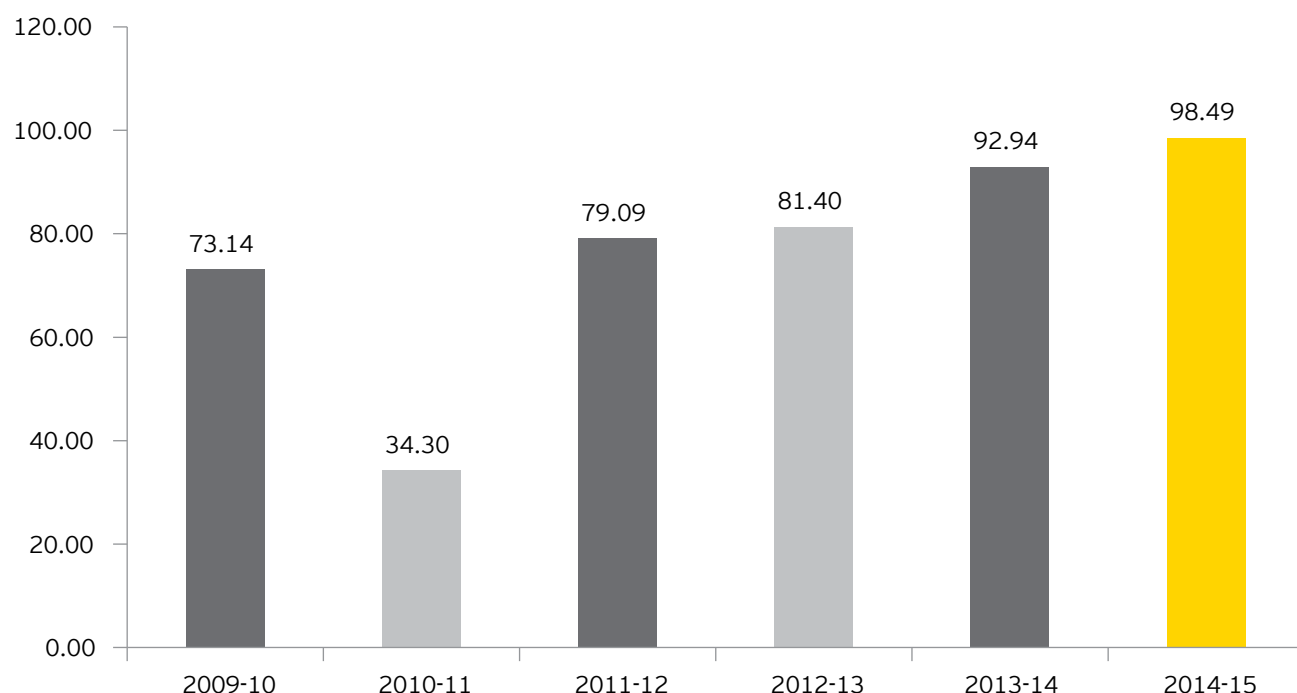
Exhibit 7. Cumulated fiscal deficit up to october (first 7 months of fy) as % budgeted target



Source: Controller General of Accounts, Government of India

Cumulated fiscal deficit up to October as % of the annual budgeted fiscal deficit shows that the FY 2015 performance at nearly 90% is the worst in recent years.

Exhibit 8. Cumulated revenue deficit up to october (first 7 months of fy) as % budgeted target



Source: Controller General of Accounts, Government of India

Cumulated revenue deficit up to October as % of the annual budgeted revenue deficit shows that the FY 2015 performance at nearly 99% is the worst in recent years, indicating that slippage from the fiscal responsibility norm of achieving balance on revenue account is almost certain.

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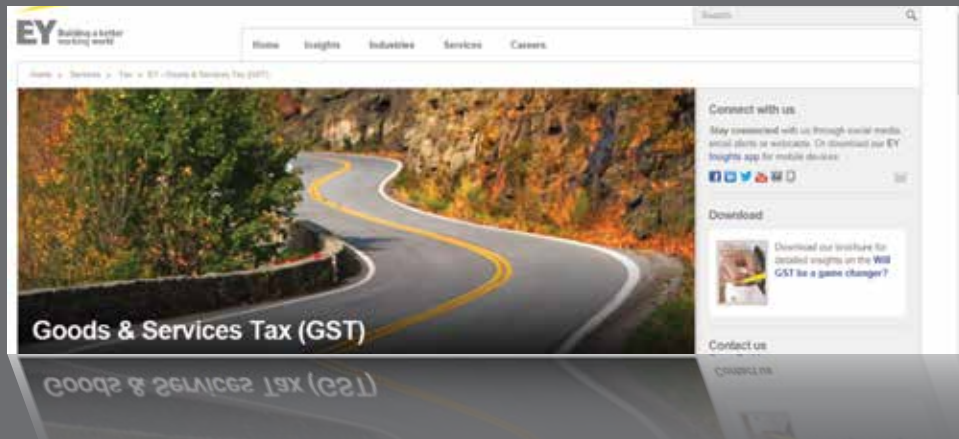
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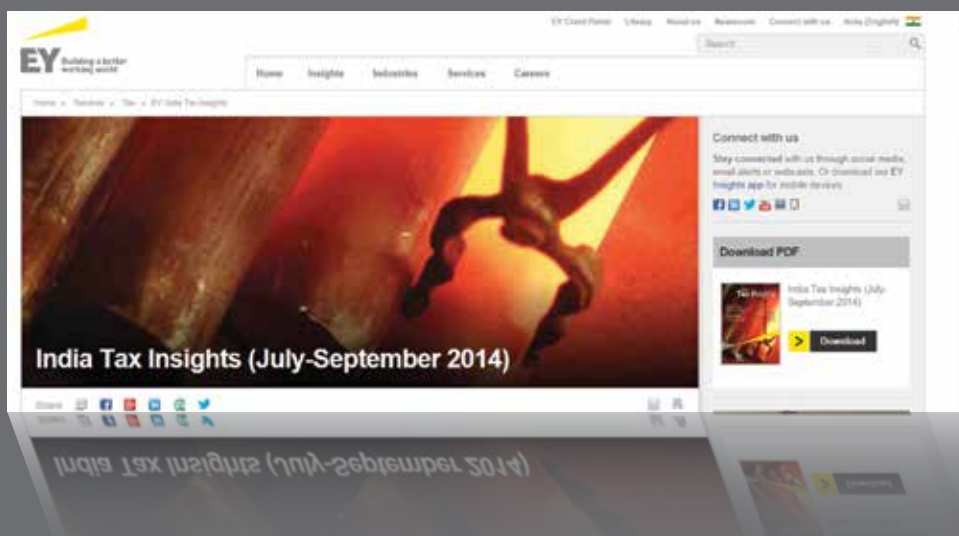
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