

India Tax Insights

Issue 4

January - March 2015

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Building a better
working world



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January - March 2015

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W e l c o m e

This issue marks the fourth edition of our magazine – *India Tax Insights*. It includes insightful articles, interviews and reports that will provide business leaders with the most relevant information to take informed decisions.

A momentous opportunity awaits India, which has reached a spot that is rare in the history of countries. It seems finally set on the path of achieving a double-digit growth in the medium term. This was the focus of the 2015 Budget proposals made by the new Government.

The Prime Minister has made the revival of the Indian manufacturing industry a top priority. This is reflected in his “Make in India” campaign and slogan. The objective is as laudable as the challenges it faces are daunting because this sector has been stagnating, especially when compared with the success achieved by East Asian countries.

The question arises – what policy interventions can help our country realize the “Make in India” goal? In this issue, we focus on how India should choose the right strategy to achieve this objective. Improving the business environment by formulating and implementing regulations and making taxes less onerous, building infrastructure, reforming labor laws and enabling enhanced connectivity – all of this will reduce the cost of doing business in India, increase profitability and encourage the private sector, both domestic and foreign, to increase investments in the industry. These measures will not only benefit manufacturing, but all the sectors.

After the 2012 Budget caused consternation in the international business community

because of a retrospective amendment made to tax indirect transfers of Indian assets, the 2015 Budget proposes amendments to provide clarity with regard to taxation of such transactions. Our article on this matter provides an overview of the comparative approaches of India and China to taxation of indirect transfers, which both the countries realize has an adverse effect and erodes the tax base.

The current definition of a resident company in tax law is one that is incorporated in India or one whose control and management is wholly located in the country. The main criticism of this definition is that it is subject to relatively simple and formalistic manipulation. The 2015 Budget seeks to expand the scope of the residence principle of taxation by regarding a company incorporated outside India as resident in India if its territorial connection with India is established by virtue of its place of effective management being in the country. In this issue, we discuss challenges facing this concept and how other countries have dealt with the same issues.

We also discuss in depth the new taxation regime proposed in Budget 2015 for taxation of Real Estate Investment Trusts (REITs) and Alternate Investment Funds (AIFs). These vehicles are expected to provide the much needed capital for India’s economy.

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

We hope you find this publication timely and useful. We look forward for your feedback and suggestions.

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Make in India

We are living in an environment that is extremely complex and fraught with volatility, be it in commodities, currencies, energy prices or technology.

With nations competing fiercely on growth, India has launched an ambitious program, Make in India, to drive its economy to the next level of growth. The campaign is expected to transform the country into a manufacturing leader.

The task is tough and therefore it is important to map some of the countries with whom we may need to compete.



China's model has been "export at any cost." Plentiful subsidies for power, access to cheap capital from the Government, a large and cheap workforce, a business-friendly labor regime and easy availability of basic commodities have fuelled China's dominance in world trade. Massive capital investments made by the Government in infrastructure such as high-speed rail, road networks, ports and industrial parks have contributed significantly to making operations efficient and building scale in the country. Businesses were incentivized by offering tax incentives for setting up manufacturing units in special export oriented zones.

However, in recent times, with the world economy struggling, China is finding it difficult to sell its products. Labor costs have doubled over the past decade and so has the price of natural gas, and consequently, electricity. With what started as a "cost" lead war for growth in earlier years, today, China is more expensive than countries such as Mexico. The appreciation of the yuan by more than 10% in the last few years has added to the country's woes. However, it still remains a dominant exporter that can cater to the world market.



With its proximity to USA and easy access through trade agreements, Mexico is poised to serve the North American market. Its productivity-adjusted labor costs are reported to be around 13% lower than China's. With Mexico's gas prices tied up with the US', total costs are reported to be lower than in China by 5%.

A friendly tax regime, which among other benefits provides exemption from import duties for toll manufacturers that use the country for exports, has facilitated the growth of Mexico as a manufacturing base. Furthermore, under the domestic tax regime, non-resident principal entities that use toll manufacturers in Mexico are granted general exemption from tax in the form of "Permanent Establishment," which provides certainty to non-resident principals and avoids unnecessary litigation.



The US is re-emerging as a preferred manufacturing destination due to the following reasons:

- ▶ Weakening of its currency vis-à-vis countries such as China
- ▶ A drastic fall in energy prices due to the Shale gas boom
- ▶ Its high focus on innovation and technology
- ▶ Stable labor costs and flexible workforce due to financial slowdown
- ▶ Easy availability of credit and at low costs



Choosing the right strategy for India

It is imperative for India to formulate an appropriate strategy, considering the strengths of some of the countries with whom we may need to compete for attracting manufacturing and also learn from their experience. Ideally, the following three-pronged approach may be most suitable in the current situation:

- ▶ Manufacturing lead by import substitution
- ▶ Manufacturing with a thrust on export
- ▶ Manufacturing focused on catering to domestic demand

Import substitution through tariff barriers may not be the right approach, since artificial barriers could hamper our competitiveness. A better alternative could be to encourage value-added manufacturing in India, which could ultimately bring about cost efficiency and make our manufactured products more competitive for exports as well as for the domestic market.

An illustration of the success of the model mentioned above is manufacturing of metro coaches in India. The nodal agency for awarding contracts for the Delhi Metro set a condition in the tender that import content would be capped at 25% of the total cost. This led to large manufacturers, along with their captive vendors, building manufacturing capabilities in India. With limited imported content, the Indian manufacturing units gained access to technology from their global affiliates. Over the last few years, the coaches manufactured in India have been meeting global standards at costs that are 60% of those of coaches manufactured in developed countries. Coaches made in India are now being exported to countries such as Brazil and Australia.

The Chinese model with a significant thrust on exports has worked well for a couple of years. However, the Chinese export lead model is facing challenges due to the



Nikhil R Meswani

Executive Director
Reliance Industries Limited

'Make in India' is a pioneering initiative that will help India to relook at manufacturing with renewed vigour. In the normal course, the economies move from agriculture base to industry and then graduate to services. India directly moved from agriculture to services. Currently manufacturing share of Indian GDP is stagnant at 16% while other major competing economies' manufacturing share is more than 25%. The current initiative of 'Make in India' will help to traverse the path of growth in manufacturing successfully. Let me quote Gita Gopinath, Professor of Economics at Harvard University, "With the new government coming in, there is an expectation that decisions will be made, there is a positive enthusiasm. Manufacturing is the new star candidate. Make in India looks great." Realising the change, Global investors are showing new interest in India for major investments.

With global turmoil impacting major European countries, Chinese manufacturing becoming costlier and Middle East and African countries impacted by political issues we are in the tight time to refocus on manufacturing to prop up our growth. Reflecting this trend, Reliance Industries is investing more than USD 25 billion as a part of 'Make in India' initiative. I am optimistic on further downstream investment of more than USD 25 billion.

I would go to the extent of saying that India is at the threshold of manufacturing revolution. The fruits of these efforts will start to benefit the economy in the next five years to fulfil national priorities like employment generation for youth.

slowdown in Europe and the US leading to a glut in demand, unemployment of workers, etc.

In view of the above, a comprehensive manufacturing strategy that focuses equally on import substitution, exports as well as on meeting domestic consumption may be the need of the hour.

The Government of India has announced several measures to facilitate manufacturing in the country. Some of the important ones include:

- ▶ Rationalizing the inverted duty structure in certain industries to eliminate blockage of tax credit
- ▶ Offering tax and fiscal incentives to manufacturing units set up in specified regions/areas
- ▶ Announcing its intent to reduce the Corporate Tax rate to 25% over the next few years to increase the country's competitiveness vis-à-vis its neighbors
- ▶ Granting additional tax benefits on investments made in newly acquired plants and machinery
- ▶ Expanding and simplifying processes to be followed to avail fiscal incentives for exports and introducing a unified scheme to cover export of goods and services
- ▶ Making a firm commitment to introducing a centralized Goods and Services Tax (GST) regime to substitute levy of Sales, Excise and Service Tax and certain other entry taxes with the GST to reduce the cascading effect of taxes by providing seamless credit for input taxes
- ▶ Lessening tax costs associated with payments for transfer of technology by non-residents to Indian manufacturers by reducing withholding tax on remittances for royalty and technical fees
- ▶ Investing in dedicated freight corridors that will run across India (This is expected to significantly reduce freight costs, since the dedicated freight corridor will have increased load-carrying capacity and will carry cargo at a faster speed. Furthermore, reduced travel time will lead to lower investment in stock and a resultant reduction in working capital.)
- ▶ Using waterways for hinterland transport to reduce costs and carbon emissions as well as congestion on roads and rail networks
- ▶ Speeding up the clearance process to build infrastructure facilities; using the EPC route instead of BOT

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for infrastructure projects in the road sector for faster execution and reduction in capital costs, since entrepreneurial risks will be partly borne by the Government; monetizing road assets that are already operational with visible revenue streams to attract long-term funds looking for steady returns, and providing liquidity to fund the cost of building new assets

- ▶ Increasing ease of doing business in India by announcing measures that will reduce time and paperwork required to obtain multiple approvals
- ▶ Increasing Foreign Direct Investment (FDI) limits in the defence sector and prioritizing transfer of technology

and domestic manufacturing over imports (With large orders expected from the Government, global players may now find it viable to set up manufacturing facilities in India.)

- ▶ Setting up of inland container terminals with custom-clearance facilities to facilitate import and export across the country
- ▶ Making a commitment to implementation of an investor-friendly tax policy with no retrospective surprises
- ▶ Launching of the National Skills Mission, primarily to conduct formal skill-training for rural youth to increase availability of a skilled workforce for manufacturing units

While the intent is admirable, success can only be achieved if execution is tightly monitored. Due importance also needs to be given to the role of the private sector, since capital generally is most efficiently deployed by it, as compared to government funding. Fostering entrepreneurship and backing investment in technology and innovation with a business friendly regime could be the pillars for sustained long-term success. We hope the Government keeps its ears on the ground and remains extremely agile to gauge and meet the changing business needs to make the program a resounding success.



Nalin Jain

Director Finance
Volkswagen Group Sales India Pvt. Ltd.

'Make in India' is a great initiative by the Hon. Prime Minister. This is definitely an area where globally, India lags behind significantly and has tremendous potential. India has huge local demand and has the potential to be a global player in many product segments. It is also very important initiative to boost the economy, generate employment and build more self-reliance for India in some of the key areas.

The various measures outlined by the government will help boost the confidence of both local and global manufacturers. We are seeing implementation of some of these already. The key for 'Make in India' to be successful is ensuring transparency and certainty in all the policies and laws especially tax laws. The GST announcement by the Hon. Finance Minister will be very important change for us in the automotive industry and we look forward to its implementation.

Partners in progress

Significant increase in the share of states in resource transfers from the Centre¹

The 14th Finance Commission (FCXIV) has recommended a significant increase in the share of states in resource transfers from the centre. This has both a quantitative and a qualitative dimension: quantitatively in FY16 there is a 55% increase in the share in taxes as compared to 6% in FY14; qualitatively, higher transfers through taxes rather than grants make these independent of centre's discretion. States whose share in the resource transfer has increased will have greater flexibility for infrastructure development. Focus on infrastructure will enhance demand and create new opportunities for private sector investment.

Resources transferred to states (excluding loans)						
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
INR Crores	Actuals	Actuals	Actuals	Actuals	RE	BE
States' share of Taxes and Duties	219303	250522	291547	318230	337808	523958
Total Grants	159585	177821	180457	198904	343171	315698
Resources transferred to states (excluding loans)	378888	428343	472004	517134	680979	839656
		% change				
States' share of Taxes and Duties		14.2	16.4	9.2	6.2	55.1
Total Grants		11.4	1.5	10.2	72.5	-8.0
Resources transferred to states (excluding loans)		13.1	10.2	9.6	31.7	23.3

¹ Fourteenth Finance Commission's own projections will need revision in light of the fact that the base year of projections for Central taxes contains over-estimated Central revenue tax figures by approximately Rs one lakh crores.



Recommendations of 14th Finance Commission

Will States offer new opportunities for investment?

Changes in horizontal share of the States

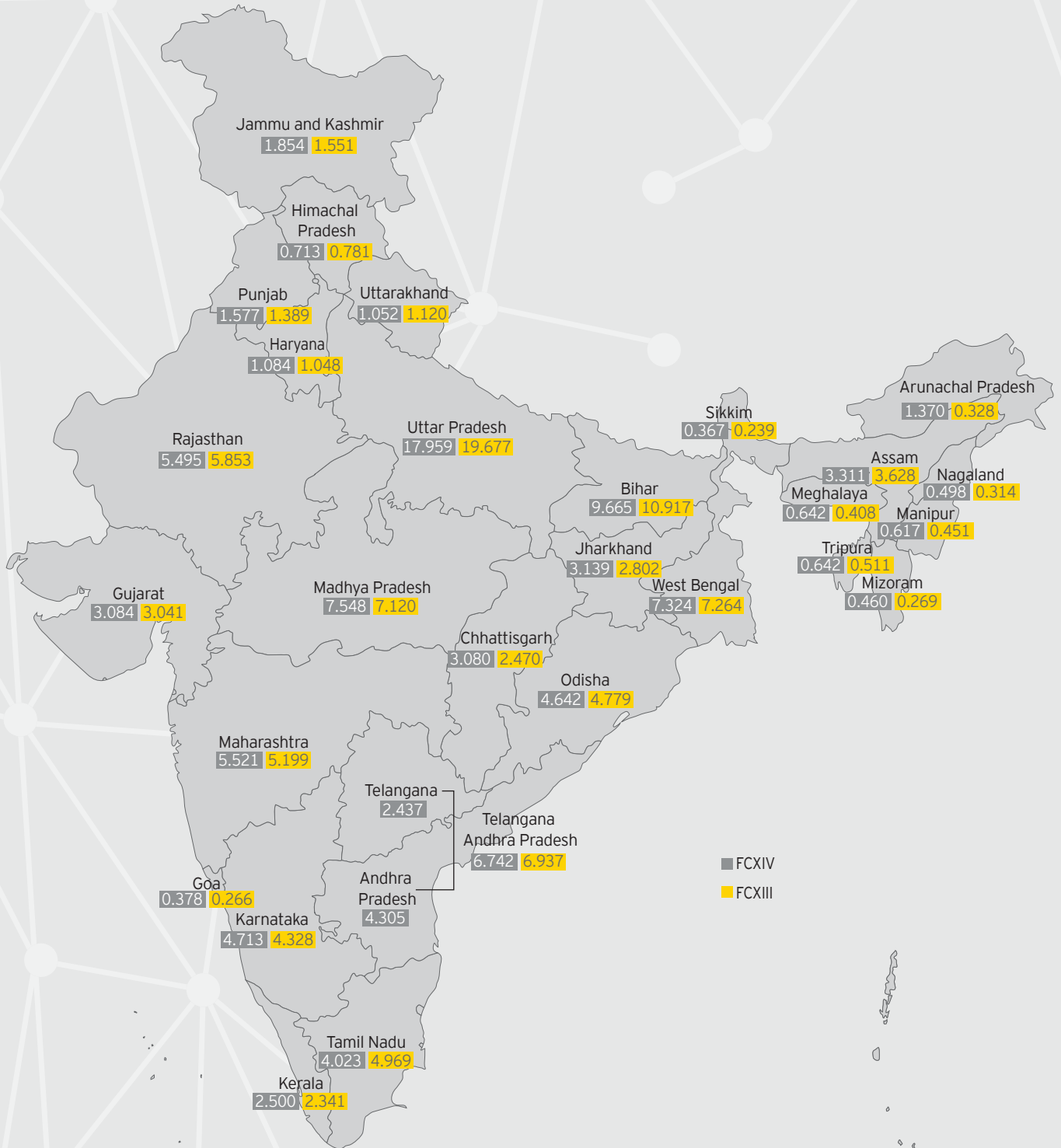
Compared to the FCXIII, the FCXIV has changed the criteria and weights in determining the inter-se shares of States in the divisible pool of central taxes. As a result, States rich in forest area and mineral resources have gained. These States will have additional resources to spend on infrastructure and in sectors which utilise mineral resources intensively such as cement, iron & steel and power, thus offering opportunities for private sector investments.

Criteria and weights for tax devolution		
Criteria	FCXIV	FCXIII
Population (1971)	17.5	25
Population (2011)*	10	0
Income/Fiscal capacity distance	50	47.5
Fiscal discipline	0	17.5
Area	15	10
Forest cover	7.5	0

**Reflecting demographic change*

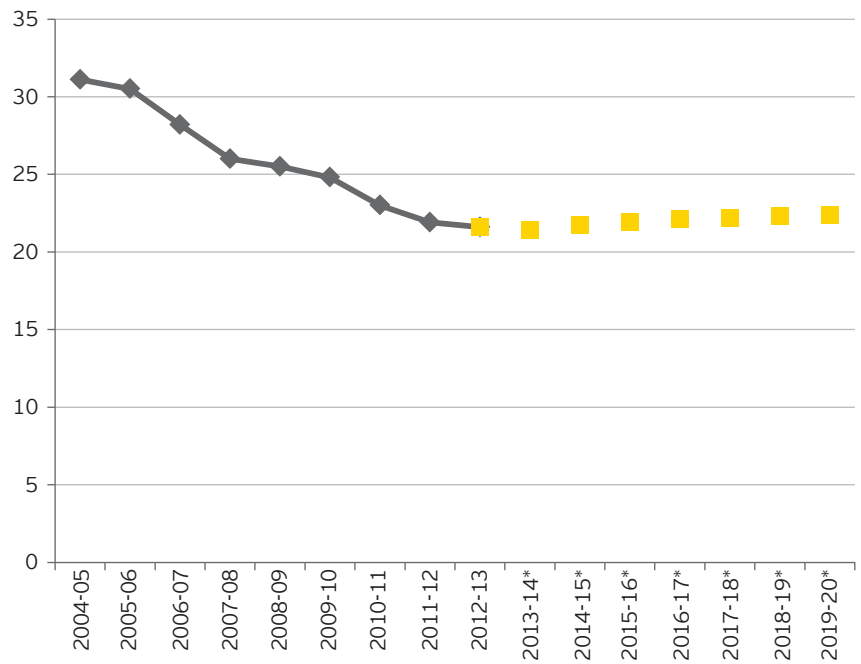
Share of States in Central Taxes

Comparison of recommendations of 13th and 14th Finance commission



Fiscal responsibility roadmap of the States

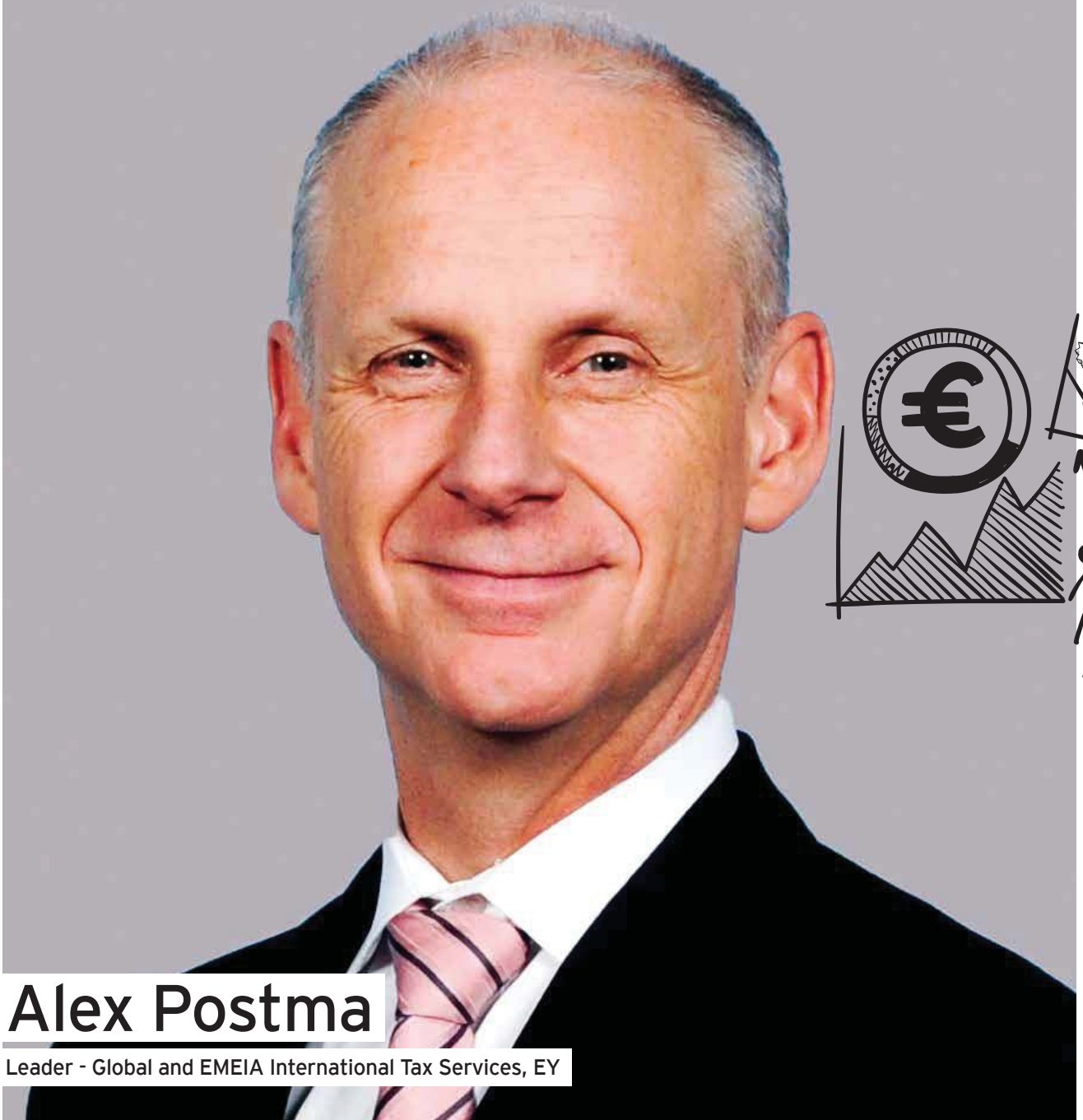
The States which maintain better fiscal discipline have been provided more room for borrowing from 3% of GSDP to 3.5% of GSDP, provided they meet conditions relating to the debt-GSDP ratio, ratio of interest payments to revenue receipts and maintaining revenue account balance. According to the FCXIV projections, the debt GSDP ratio of the states will stabilize at around 22% of GDP reflecting a marginal increase from the current levels. States with a relatively better debt and fiscal deficit position will be able to attract and absorb more investment.



◆ Outstanding Debt (all states combined as % of GDP)

*FCXIV projections

Source: 14th Finance Commission Report



Alex Postma

Leader - Global and EMEA International Tax Services, EY

Place of effective management

A new litmus test for the tax residency of foreign companies with an India presence

criteria seem to run counter to generally the accepted principle of an overall central management as in, for instance, China⁶, where the POEM is considered to be the establishment that exercises, in substance, overall management and control over production and business, personnel, accounting, properties, etc., in an enterprise. Therefore, the emphasis is on the entire management and control over the resources of the enterprise. And the price is high! Companies that are tax resident in India under these proposed rules are taxable in the India on their global income, irrespective of whether the income has been subjected to tax in the country where it arose/ accrued.

6 Article 2 of China's Enterprise Income Tax Regulations and SAT Circular no. 82

In the absence of any objective tests, the new provisions in Indian tax law go beyond the "head and brain" principle of "place of central control and management" laid down by the decision of De Beers⁷. This is because the proposed provisions may even cover cases wherein certain key management or commercial decisions are taken in India while the vast majority of decision-making and the actual management and control takes place outside of India. For example, consider a scenario where a foreign enterprise engaged in information technology (IT) business is conducting a successful global IT brainstorming session in India where ideas are generated and some key

7 5 TC 198 (1905)

decisions taken. Such decisions may go to the root of the company's prime business. In this scenario, would it need to be analysed, whether the decisions would fall under the purview of key management and commercial decisions for the whole company, and consequently, whether there is a risk that, it may be alleged that the foreign entity is a tax resident in India.

For enterprises with their ultimate holding company in India, the new rules (much like the "deoffshorization"⁸ rules in Russia) would require that the effective decision-making powers of Indian group's subsidiary companies are reviewed and shored up, and residence articles in the many treaties

8 Refer EY Global Alert Russia's State Duma passes De-offshorization draft law (<http://www.ey.com/GL/en/Services/Tax/International-Tax/Alert-Russia-s-State-Duma-passes-De-offshorization-draft-law>). The draft law was then signed by Russian President on 24 November 2014.



that India has concluded need to be dusted off lest such subsidiaries would all end up being Indian tax residents.

In the case of non-Indian enterprises on the other hand, the proposed provisions will create new levels of uncertainty in India and may trigger off unwanted tax disputes. It needs to be borne in mind that the personnel of multinational enterprises have become increasingly mobile and technology and connectivity are as important as never before in their global competence. This poses risks that a traveling executive may create significant unforeseen tax burdens in India. For instance, consider a situation where a board meeting is held on the day when one

of the directors is present in India and he attends this meeting by means of a video conference. In this case, it needs to be analyzed whether the active participation of the director in decision-making would “in substance” amount to decisions made in India. These uncertainties may not just be obstacles for foreign enterprises conducting business in India, but may ultimately be a roadblock for India in meeting her economic growth targets, attracting new investments and achieving success in her “Make in India” campaign.



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Taxation of indirect transfers

One step forward



In recent years, an aspect of taxation that has attracted global attention is the mechanism for looking through holding companies' structures to tax their indirect transfer of assets. In India, this trend came into prominence with the position taken by Indian revenue authorities in the Vodafone case¹. Rejection of this position by the highest Indian court prompted introduction of the indirect transfer provisions in the Indian Tax Laws (ITL) in 2012, with retrospective effect from 1962. Not to be left behind, China² also introduced its indirect transfer rules as part of its General Anti-Avoidance Rule (GAAR) regime in 2009.

Given the changing economic landscape in which countries vie for foreign capital due to their need to attract investors, China released its revised rules early this year, providing additional guidelines to

facilitate increased investment in the country³. India has been grappling with the uncertainties encompassing its ITL provisions. The attempt made in Budget 2015 to clarify and relax restrictions is a step forward in the right direction. However, these amendments need to be coherent and there is scope for further relaxation of rules to regain the confidence of foreign investors.

China

China first issued its reporting guidelines on indirect share transfer – Cir (2009) No. 698 (hereinafter referred to as Cir 698) – in 2009. The circular has set the stage for China's first efforts to impose tax on overseas share transfer transactions that indirectly transfer investments made in China. Over the past five years, the State Administration of Taxation (SAT)

and taxpayers have gained experience in proceeding with and/or handling indirect share transfer cases. The SAT has finally rolled out its revised indirect transfer rule, the SAT Announcement (2015) No. 7 (hereinafter referred to as Notice 7), which aims to reflect the efforts made by China's tax administration, taxpayers' feedback and in addressing or responding to relevant concerns and needs. Notice 7 introduces several new concepts, which should improve administration of indirect transfer in China.

Unlike other jurisdictions that have built specific provisions in their Income Tax regime, defining the taxability of indirect transfer for underlying investment, China's Corporate Income Tax (CIT) Law does not have a specific provision to define how offshore indirect transfer should be taxed. In order to tax related transactions, Chinese tax authorities have to refer back to GAAR according to the CIT Law as the valid technical basis to tax

1 (2012) 340 ITR 1 (SC)

2 Refer Circular (2009) No. 698

3 Refer SAT Announcement (2015) No. 7

“While efforts are being made by various countries to bring in more certainty and clarity, India needs to make its indirect transfer provisions more taxpayer-friendly along the lines of China.”



offshore indirect transfer transactions. The limitation in this regard is that GAAR is general in nature, and given the lack of detailed guidelines, administration on indirect transfer income is difficult and lacks consistent interpretation. Notice 7 aims to close the gap (mentioned above) by introducing additional guidelines and definitions.

Given that the fundamental technical ground to tax indirect transfer is GAAR, and a large part of GAAR is the definition of “business purpose,” Article 3 of Notice 7 has provided seven suggesting factors tax administrations can use to assess the business purpose of indirect transfer transactions. These suggesting factors should help to increase

consistency during examination of indirect transfer transactions. More importantly, some of these factors have been correspondingly adopted in Article 4 of Notice 7 (i.e., the deeming provision), which defines “automatic no business purpose” indirect transfer transactions, and is therefore likely to be treated as taxable. Technically, the indirect transfer law in China is still under GAAR when it comes to establishing taxing rights for indirect transfer transactions. However, introduction of these two articles under Notice 7 has significantly improved administration of indirect transfer by providing detailed guidelines and interpretations, e.g., how taxability can be examined and determined and what transactions are automatically deemed as taxable. In addition to the

above, Notice 7 has expanded the scope of exemption (i.e., Article 5) and the safe harbor provision (i.e., Article 6) on internal indirect transfer transactions. Introduction of these new concepts aims to provide more specific guidelines to the tax administration and taxpayers so that uncertainty about the taxability of indirect transfer transactions is reduced and possibilities of inconsistent tax treatment are reduced.

Another eye-catching and landscape-changing clause under Notice 7 indicates that reporting on indirect transfer of Chinese taxable assets has now become voluntary. Although this may seem to be good news to many readers, the author urges you to read on. Although a voluntary reporting mechanism, Notice 7 specifically cited penalties imposed on both sellers and buyers (or withholding agents if applicable) if disclosure and reporting obligations are not fulfilled with respect to taxable indirect transfer transactions. In addition, the party responsible for settlement of the relevant consideration over a taxable indirect transfer is, under Notice 7, now obligated to withhold tax on behalf of the seller and also be responsible for any unsettled tax liabilities from the same taxable indirect transfer.

Generally, Notice 7 is considered to have brought about significant improvements as compared to Cir 698 and has taken the administration to the next level on indirect transfer transactions. On one hand, Notice 7 provides a greater degree of certainty on related parties or internal indirect transfer, on the other, it stipulates more stringent reporting obligations and higher penalties on indirect disposal of Chinese investments conducted with third parties. The changes (mentioned above) introduced under Notice 7 on indirect transfers have ultimately redefined the deal considerations of buyers when negotiating for protections or indemnities from Chinese tax liabilities



that may arise from indirect transfer of Chinese investments. It is therefore more important than before for foreign investors to examine their indirect transfer (external and internal) transactions against Notice 7 in order to avoid unexpected levy of Chinese tax on offshore transactions.

India

As a sequel to the Indian Supreme Court's judgment in the case of Vodafone International BV⁴, indirect transfer provisions were introduced in 2012, with retrospective effect from 1 April 1962, in the ITL, to impose tax on gains arising from transfer of shares/interest in foreign companies/entities (FCs/FEs) that substantially derive, either directly or indirectly, their value from assets in India. The factor of retrospectivity has been criticized by foreign investors and tax deductors. The impact of retroactivity persists in some situations.

Acknowledging the concerns of various stakeholders, the 2015 Budget's proposals clarify, although prospectively, that the Fair Market Value (FMV) of assets located in India should represent $\geq 50\%$ of the FMV of all the assets of an FC/FE to constitute substantial value derived from India. Under a complex mechanism, FMV

is reckoned with in reference to a "defined" specified date by including the tangible and intangible assets of entities, but ignoring their liabilities. Some rules pertaining to this are still to be notified. Once a transfer is taxable, taxation is contemplated on a proportionate basis⁵, unless a charge is relieved on the basis of an applicable tax treaty.

Certain exemptions have also been included, e.g., for small shareholders (holding directly or indirectly, along with its associated enterprises, 5% or lower than the stake in FC/FE that directly holds assets located in India, when the FMV of the assets located in India in the transferred FC/FE is \leq INR 100 million (irrespective of the transaction value) or in limited cases of overseas amalgamation or demergers on satisfaction of certain conditions, while the proposal has unintentionally missed exempting the shareholders of such amalgamating or demerged companies.

The ITL requires buyers, including non-residents, to withhold applicable Indian taxes in all cases. Failure to do this attracts interest and penalty. Additionally, unlike in China, there is a mandatory reporting obligation on Indian concerns in which or through which an FC/FE holds substantial

assets. Failure to report this has penal consequences⁶

In India, regulation operates as SAAR, forms an integral part of the statute (ITL) and can apply even where a transaction is not *per se* "abusive" or even if the seller pays fair tax in its country.

While efforts are being made by various countries to bring in more certainty and clarity, India needs to make its indirect transfer provisions more taxpayer-friendly along the lines of China. Based on the Shome Committee's recommendations⁷, there is a need for exemptions to be made in the case of listed companies and groups, and PE and foreign institutional investors. The value-comparison mechanism should be simplified and the provision should be considered applicable only in the case of an anti-avoidance exercise. Onerous reporting obligations also need to be relaxed.

All in all, there is a need for rationalization of the Government's provisions to improve investments and establish a more favorable tax regime for foreign investors in the competitive tax environment.

⁶ Of upto 2% of the transaction value or INR 0.5 mn, depending on the nature of default

⁷ Refer EY Alert on "Draft Report of the Expert Committee on retrospective amendments relating to indirect transfer" dated 10 October 2012.

⁴ (2012) 340 ITR 1 (SC)

⁵ As is reasonably attributable to assets located in India

Alternative Investment Funds

Reasons for cheer



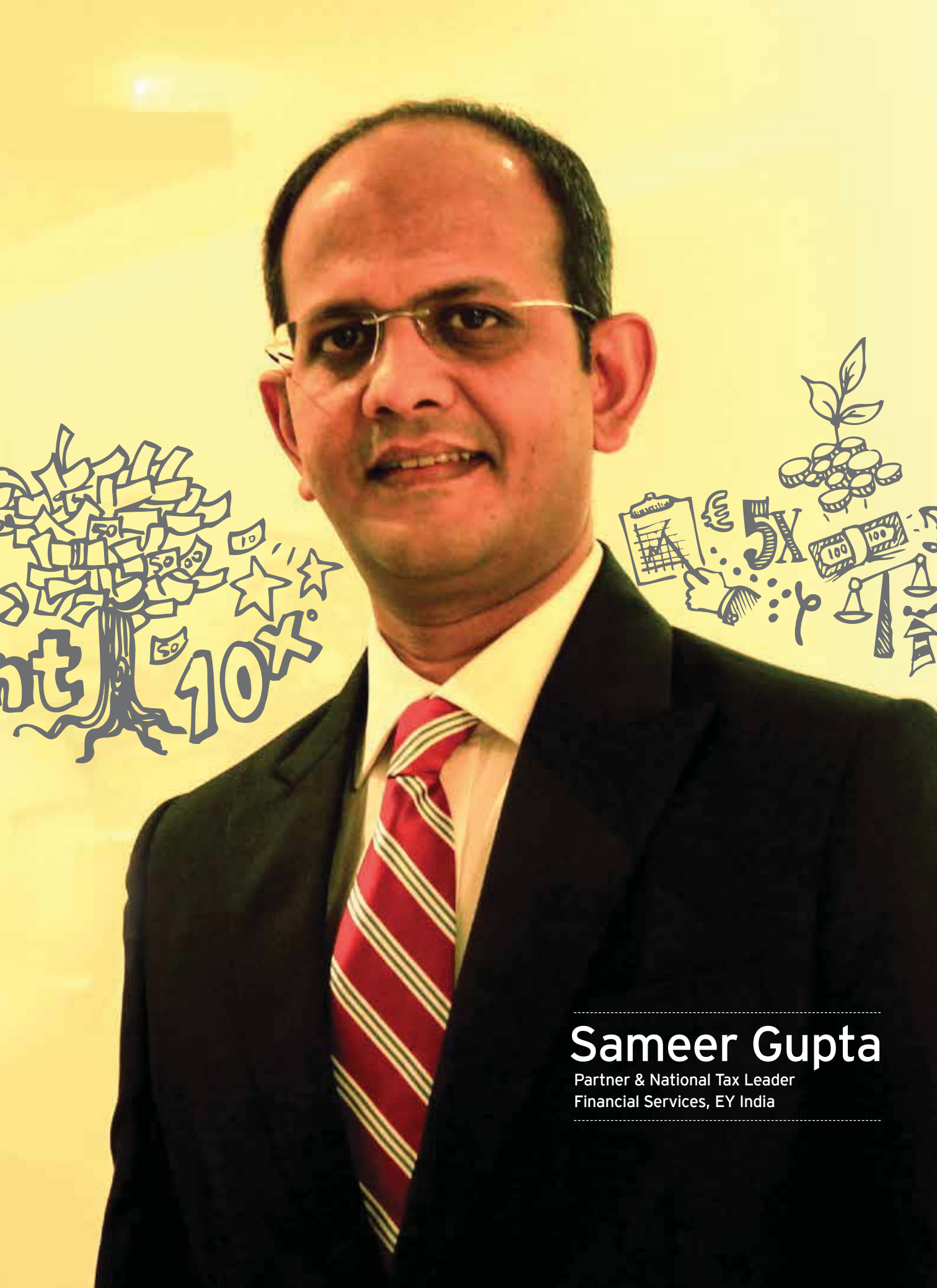
The Securities and Exchange Board of India (SEBI), recognizing the need for a long-term and cost-effective funding source for start-ups, small and medium businesses, and infrastructure, notified the Alternative Investment Funds (AIF) regulations in May 2012 after extensive consultations with stakeholders. Within a span of two years up to November 2014, SEBI had granted registration to over 120 AIFs, and until December 2014, had raised commitments totalling INR204.6 billion (around US\$3.2 billion). AIF regulations significantly broadened the asset classes for fundraising and liberalized investment conditions in the country, which were hitherto restricted by Venture Capital Fund (VCF) regulations.

On the tax front, after multiple flip flops in India's tax policy, there is now a provision that provides a pass-through tax status on the specified incomes of AIFs that are registered under VCF sub-category of category 1 AIFs (sub-category only representing 4.5% of the total commitments raised by AIFs¹). Funds registered under category 1 (other than VCF), category 2 and category 3 AIFs, which include small and medium enterprises, infrastructure, private equity, debt and hedge funds (the majority of which have been formed as trust) have to face the ambiguities and uncertainties of trust taxation provisions in the tax law, which were not designed from the perspective of investment funds.

1 As on 31 December 2014, as per SEBI website.

After several rounds of representation by the industry, seeking a special tax regime for AIFs, the Central Board of Direct Taxes issued a circular² on 28 July 2014 to clarify certain tax aspects for AIFs. However, the circular, instead of clarifying AIFs' tax issues, compounded uncertainties relating to the tax by bringing to the fore several issues that directly conflicted with the technical position adopted by AIFs. These were supported by judicial precedents and historical administrative guidance in the context of trusts. Briefly, the circular could impact the net investment returns of AIF investors, i.e., domestic investors (such as insurance companies, pension funds and charitable trusts, which may

2 Circular No. 13 dated 28 July 2014.



Sameer Gupta

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be taxed at a lower rate or be made exempt from tax) and foreign investors that may be eligible for exemption under a tax treaty, since their income is exposed to tax at the maximum marginal rate. However, the circular does not obliterate the legal position to the disadvantage of taxpayers since it is only binding on tax authorities.

In the backdrop of this rather challenging background, the announcement made by the Finance Minister in his Budget speech that “pass-through is proposed to be allowed to both Category-I and Category-II Alternative Investment Funds, so that tax is levied on the investors in these Funds and not on the Funds per se” was the breakthrough the sector wished for. The key features of the special tax regime³ are as follows:

- ▶ The AIF will be exempt from tax on any income (other than business

profits). Business profits will be taxable at applicable tax rates if an AIF is a company or firm and at the maximum marginal rate (30%) in other cases.

- ▶ The unit-holders of AIFs will be taxable on the latter’s income from investments on a pass-through basis on accrual of income. An AIF will pay taxes to the extent it derives business profits, and accordingly, the unit-holders will be exempt from it.
- ▶ Net losses, computed in accordance with the provisions of the Act, incurred by the AIF in any financial year is to be carried forward to be set off by the investment fund (in accordance with the Act) and will not be distributed to the investors.
- ▶ Taxes will be withheld at the rate of 10% on income (other than business profits) payable by an AIF to a unit-holder.
- ▶ Income payable to an AIF will not be subject to tax withholding requirements.

The special tax regime addresses most of the key concerns in the context of the prevailing uncertainty about taxation of AIFs. The income of an AIF is considered the key factor to determine its compliance and that of its investors under the regime. Most venture capital / private equity funds have historically taken a position that their investments are made with a medium to long-term capital appreciation perspective, and therefore, have shown gains to tax as their capital gains. While there continues to be some controversy on this aspect, based on judicial precedents, AIFs expect to succeed in this matter. The level of clarity and certainty ought to enhance if the tax administration implements objective rules for classification of investments made by AIF before the special tax regime are enacted into law in order to mitigate controversy.

Another feature, which conceptually departs from a classical pass-through regime, is treatment of net losses. The special regime contemplates the

³ Finance Bill 2015 proposes to insert a new chapter, Chapter XII-FB in the Income-tax Act, 1961.



AIF carrying forward and setting off net losses incurred by it in any year. While this may not materially impact an AIF/ its investors where it is able to absorb its losses against its subsequent gains, in the absence of a carry back rule in the Indian tax law, its inability to pass-through net losses could, in certain scenarios, result in loss of tax benefits that would have otherwise been available to investors. A provision to allow losses to the investor at least at the end of the term of an AIF would be beneficial.

Lastly, the proposed tax withholding at 10% on income payable to AIF investors (resident and non- resident) perhaps unintentionally imposes tax withholding on income that is otherwise exempt from tax under the

tax law (e.g., long-term gains on listed share investments, dividends, etc.). While taxes withheld will be refundable to investors without a tax liability, it would postpone the cash inflow of the gains for them. Withholding tax should be adjusted to the status of a taxpayer (treaty residents, domestic-exempt institutions, etc.).

In addition to the special tax regime, the Finance Minister also announced that foreign investments will be permitted in AIFs. While the formal press note on this is still awaited, it is expected that foreign investment in AIFs may be permitted, subject to some conditions under the automatic approval route (i.e., without need for obtaining approval from the Foreign Investment Promotion Board).

It is expected that AIFs should wholeheartedly welcome the focus on the sector that they have all along aspired for. They are a vital source of risk capital and significantly contribute to investment-related activity across many sectors, which, in turn, promotes employment and growth. The ability of AIFs to raise foreign capital with a reduced number of hurdles should also pave the way for enhanced mobilization of funds by them. All of these, once fully implemented, along with the recommendations mentioned above, should enable AIFs to contribute significantly to the 'Make in India' campaign and propel the growth of the Indian economy.

A portrait of Ajit Krishnan, a man with dark hair, wearing a dark pinstriped suit jacket, a light blue checkered shirt, and a pink tie with a small pattern. He is looking slightly to the right of the camera with a neutral expression. The background is a blurred office setting with bookshelves.

Ajit Krishnan

Tax Partner & National Leader
Real Estate & Infrastructure sector
EY India

Making REITs successful in India

Real Estate Investment Trusts (REITs) were introduced as a concept in the US¹ in the 1960s, and now, more than half a century later, have been initiated in India with a new nomenclature, Business Trusts, which have two components –REIT for real estate assets and the Infrastructure Investment

Trust (Infra Trust) for infrastructure assets. While the Securities and Exchange Board of India (SEBI) has introduced separate guidelines for REIT and Infra Trusts, the tax treatment accorded them is largely similar.

¹ <https://www.reit.com/investing/reit-basics/reit-industry-timeline#0>

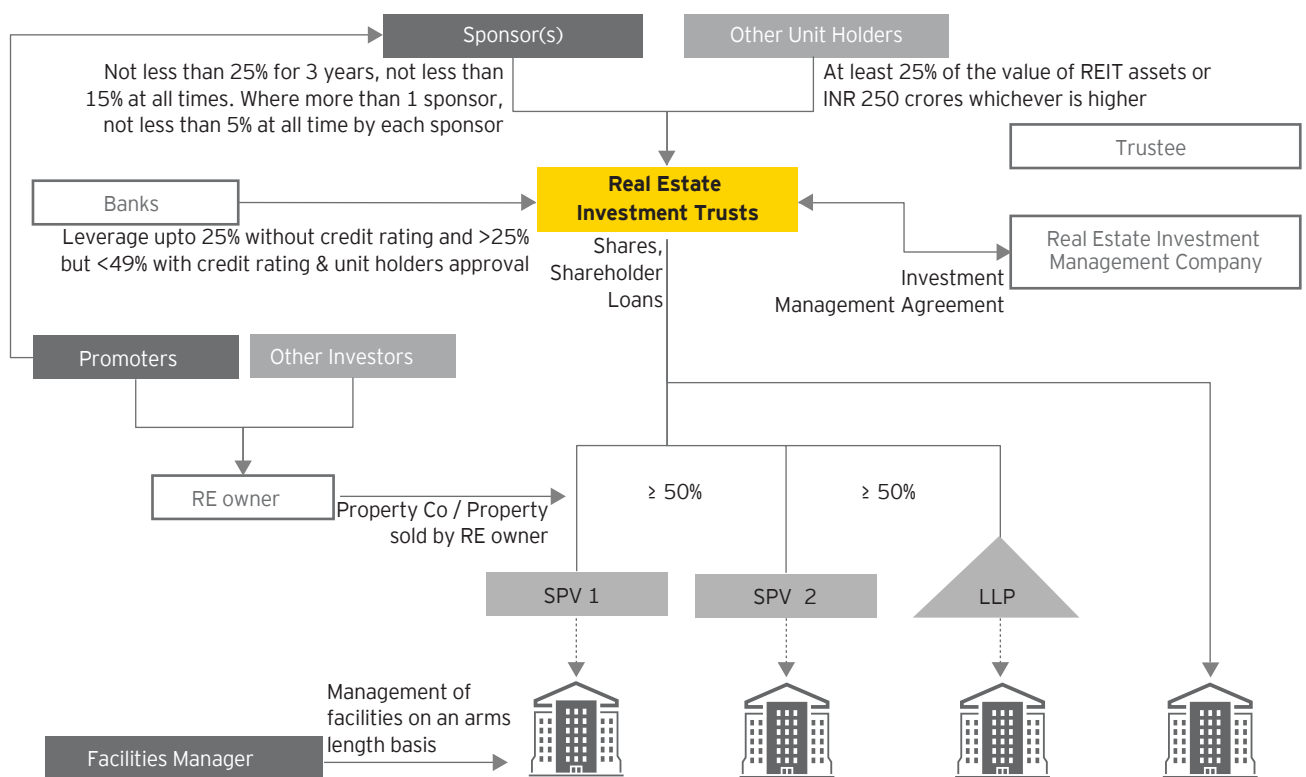
REIT is a trust that owns income-producing real estate and offers units to investors like any other stock that represents ownership in a business. Its two unique features are to manage income-producing properties and distribute free cash flows to investors.

REIT regulations were released in India by SEBI on 26 September 2014. The first set of tax regulations for REIT was introduced by the Finance Minister in Budget 2014, followed by a few more changes in Budget 2015. India is poised for REIT due to the presence of a "critical mass" of Grade A rent-yielding assets built up over the last two decades in the country. REIT is likely to be successful in India, since it provides a new source of funding to

the real estate sector, which currently has a debt-overhang. Moreover, the traditional sources of funding are now minimal in the real estate sector. With sales being tepid, funding earlier available from banks and private equity sectors has also reduced substantially.

In such a scenario, REIT will provide a new source of funding, and thereby, extend a lifeline to the sector. When real estate developers are able to monetize a part of their blocked capital through REIT, they will be able to deploy this in projects that are stuck for want of funding and deliver these to their end customers. This should help to revive the business cycle in the sector, which has come to a standstill.

"India is poised for REIT due to the presence of a "critical mass" of Grade A rent-yielding assets built up over the last two decades in the country."





Some of the key features of SEBI (Real Estate Investment Trust) Regulations, 2014 published by SEBI:

Specific eligibility criteria to be satisfied for each stakeholder, i.e., sponsor, manager, trustee, principal and valuer

Mandatory public float of 25%, minimum unit size of INR100,000 and subscription size of INR200,000 per investor

Mandatory for all units of REIT to be listed on a recognized stock exchange



Investment-related conditions

- ▶ Only allowed to invest in securities, properties or mortgage-backed securities in India; cannot invest in vacant land, agricultural land or mortgages
- ▶ Not allowed to invest in units of another REIT
- ▶ Allowed to invest in properties through an SPV provided:
 - ▶ REIT holds controlling interest and not less than 50% of equity shares of SPV
 - ▶ SPV holds at least 80% of assets directly in properties and does not invest in any other SPVs
- ▶ REIT to hold at least two projects, directly or through an SPV, with not more than 60% of the value of assets in one project



Asset-related rules

- ▶ Value of REIT assets should not be less than INR 5 billion.
- ▶ A minimum of 80% of the value of REIT assets should be invested in completed and rent-generating properties. A completed property is one that has been granted an occupancy certificate from the relevant authority. Furthermore, a rent-generating property has been defined to mean one in which not less than 75% of the area has been rented leased out.
- ▶ The remaining 20% of the value of REIT assets can be invested in other specified assets including developmental ones, listed and unlisted debt, governmental securities, etc.
- ▶ Not more than 10% of the value of REIT assets is to be invested in developmental properties with a restriction of three years.



Income-related rules

- ▶ Not less than 75% of the revenues of REIT (other than gains arising from disposal of properties) are to be from rental, leasing and letting of real estate assets.



Distribution-related rules

- ▶ Compulsorily distribute at least 90% of its net distributable cash flows to the unit-holders on at least a half yearly basis.



Leverage

- ▶ Aggregation of consolidated borrowings and deferred payments of a REIT should never exceed 49% of the value of its assets.
- ▶ If aggregate consolidated borrowings and deferred payments of REIT exceed 25% of the value of REIT assets, for any further borrowing, the following requirements need to be fulfilled:
 - ▶ Credit rating from a credit rating agency registered with SEBI
 - ▶ Approval of unit holders



Other key features

- ▶ **Related party transactions**
Stringent conditions have been imposed on related party transactions including on detailed disclosures, valuation-related requirements, approval from the majority of investors, related parties' abstaining from voting, restrictions on leasing of assets to related parties, requirement of fairness opinion for a lease, etc. With respect to any properties leased to related parties of the REIT, a fairness opinion is required to be obtained from an independent valuer before and after the initial offer, in the following circumstances:
 - a. The lease area exceeds 20% of the total area of the underlying assets.
 - b. The value of assets under the lease exceeds 20% of that of the total underlying assets.
 - c. Rental income obtained from such leased assets exceeds 20% of the value of that from all underlying assets.

A fairness opinion from an independent valuer shall be obtained by the manager and submitted to the trustee and approval of unitholders in accordance with the regulations.



Rights of unit-holders

- ▶ The approval of not less than 75% of unit-holders (by value and by number) needs to be obtained in a number of cases, e.g., specified related party transactions, borrowings in excess of the prescribed limit, transaction value exceeding 15% of a REIT's assets, etc.



Having explained the typical structure of a REIT, we have tabulated below the tax treatment of REITs

Entity	Tax incidence	Tax rate
Investor/ Unit Holder - taxation of distributions received from REIT		
Dividend income	Exempt	Not applicable
Interest income	Taxable	Domestic @ 34.61% Foreign @5.41%
Rental income	Taxable	Domestic @ 34.61% Foreign @43.26%
Disposal of units on the exchange	Capital gains (CGT)	LTCG exempt; STCG Rate Domestic: 17.30% Foreign: 16.22%
Sponsor - taxation at the time of creation of REIT and receipt of distributions		
Capital gains		MAT Rate
▶ Exchange of SPV shares against REIT units	Exempt but subject to MAT	Domestic: 21.34%
▶ Exchange of assets/interest in partnership firm against units of REIT	Capital gains	LTCG Rate Domestic: 23.07% Foreign: 21.63%
		STCG Rate Domestic: 34.61% Foreign: 32.45%
Others - dividend income, interest income, rental income, disposal of units	Same as other unit-holders	
REIT (Trust) - taxation of income of REIT		
Dividend income (contribution of equity)	Exempt	Not applicable
Interest income (contribution of debt)	Exempt	Not applicable
Rental income from assets held directly	Exempt	Not applicable
Capital Gains/Other income	Maximum marginal rate	LTCG @ 23.07% Other @ 34.61%
SPV (company/partnership/LLP) – taxation of income of SPV and distributions by SPV		
Net income	Corporate tax/ MAT or AMT	34.61%/ 21.345%
Interest expense	Tax shield available	Not applicable
Share of profits	Dividend Distribution Tax	20.358%

* The above tax analysis is a high level tax comparison based on the tax regime for REITs in the existing Finance Act and that proposed through Union Budget 2015. Application of the same needs to be evaluated on a case to case basis.





While the REIT framework published by SEBI compares well with REITs regulations in developed jurisdictions, tax regulations need to be amended to make these a viable solution in India. Tax regulations need to ensure that the tax impact is the same whether an investor owns real estate directly or through a REIT. Once that is substantially achieved, we should see REIT as a vehicle of choice to access public capital markets in India.

While the introduction of a REIT framework and tax regime is a positive move, some amendments still need to be made to make REIT a successful story in India. The key questions and the rationale including the following:

1. Foreign Direct Investment (FDI) up to 100% under the automatic route, investment in foreign portfolios and access to external borrowings should be allowed in REITs to enable foreign capital providers to channel their investments into India. This will also enable capital (specifically earmarked for REITs) to find its way into the country.
2. The eligibility criteria for sponsors – a minimum experience of five years in the real estate industry – should be amended to enable those who are not real estate players, i.e., corporate organizations with real estate assets, to sponsor REITs. This will expand the target audience for REITs and provide an opportunity to non-real estate players to also tap REITs to raise capital.
3. Exemption from Capital Gains Tax should be provided at the time of transfer of assets/interests in partnership firms/ LLPs by sponsors to REIT in exchange for units of REIT to bring taxation at par for all modes of creating a REIT.
4. Exemption from MAT should be provided at the time of transfer of assets/shares in SPVs and interests in partnership firms/ LLPs by sponsors to REITs, since there is no real gain and the transactions constitute exchange of asset/shares in SPVs, interests in partnership firms/LLPs in consideration for units in REITs. MAT is applicable on gains arising on sale of units of REITs.
5. Exemption from dividend distribution tax on dividend paid by SPV to the REIT should be given as only then will REIT as a vehicle be truly a 'pass through'. This will also be in line with the REIT tax laws of other jurisdictions.
6. The period for holding the units of a business trust for it to qualify as a long-term capital asset should be 12 months in order to be at par with the shares of a listed company.

India should be able to see a potential REITs listing once some of the key questions asked by players in the sector are answered to their satisfaction. This will make REIT do-able. However, all investment products will have to include a risk disclosure and disclaimer in their prospectuses. It is therefore critical to educate investors on REITs as an investment product. This needs to be specifically geared to essential elements such as how the performance of a REIT, its assets and its manager is to be evaluated. REIT has the potential to become a significant game changer, and enable India to access and channelize global and domestic sources of capital to building smart and new cities, and create world-class infrastructure in these.



01 UK enacts new Diverted Profits Tax¹

In a key development, a new diverted profits tax (DPT) has been introduced in the UK, which is to apply from 1 April 2015. Pursuant to a public consultation process, the DPT has been introduced as part of the UK Finance Act 2015 and was enacted on 27 March 2015. The DPT is an anti-avoidance provision in line with measures implemented by the OECD on Base Erosion and Profit Shifting (BEPS). It is a unique and complex legislation. Its broad highlights DPT include the following:

- ▶ The DPT is a new tax, levied at the rate of 25% of "diverted profits" on business conducted in the UK.
- ▶ The DPT is to apply to large multinational enterprises with business activities in the UK, which enter "contrived" arrangements to divert profits from the country by avoiding a UK-taxable Permanent Establishment (PE) and/or by other contrived arrangements between connected entities.

- ▶ It is triggered if it is "reasonable" to conclude that a foreign enterprise has avoided PE in the UK and/or taken steps or engaged in a series of transactions (lacking economic substance) to create a mismatch. It also includes sale of land and buildings, which give rise to an avoidable PE.
- ▶ DPT is unlikely to arise where there is the following:
 - ▶ Sufficient substance in offshore asset-owning companies
 - ▶ Arm's length transfer pricing (TP) through the international value chain
 - ▶ A taxable presence in the UK, e.g., through a PE or an onshore distributor/reseller

Exclusions are made in the case small and medium-sized enterprises, based on tests conducted on their sales and expense thresholds.

- ▶ The DPT is separate from Income Tax or Corporation Tax. Payment of DPT is ignored in its entirety for

the purpose of calculating Income or Corporation tax.

- ▶ The DPT also applies to taxpayers that are resident in treaty territories if there are indicators of "avoidance." Credit is available for foreign taxes paid on profits on which the DPT is levied in the UK. This includes any Controlled Foreign Companies (CFC) charge on the same profits that have been paid in overseas jurisdictions.

The DPT has been introduced to counter aggressive tax planning in the UK. However, it is perceived as being highly subjective and there is significant uncertainty about its application. While it has been widely reported that it is targeting the digital sector, it will, in fact, apply to a very wide range of transactions across all the industry sectors. Other countries may see the DPT as a model they can adopt to tackle perceived tax avoidance in their own jurisdictions.

¹ Refer to EY Global Tax Alert dated 5 December 2014, 20 March 2015, 26 March 2015

Global news

02 France publishes official report on taxation of digital economy

The Government of France published a report, *Taxation and the digital economy: a survey of theoretical models* (the report) in March 2015².

The report notes that the tax base of major internet platforms is reduced because of difficulties in locating activities in specific geographical jurisdictions and major elements in revenue-generating chains, such as use of personal data uploaded by users, do not result in financial transactions. It provides the background of the features of a digital economy and develops models to analyze the effect of taxation on it. It also recommends the following:

- ▶ Development of a statistical apparatus to measure the activity of internet platforms
- ▶ Determination of a sharing rule relating to corporate profits,

reflecting the number of users in the jurisdiction of a tax authority

- ▶ In the absence of a fair sharing rule on corporate profits, consideration of the use of a specific tax base
- ▶ In the absence of a fair sharing rule on corporate profits, and if taxes on revenues generated in the country cannot be implemented, considering the use of a specific tax, based on activity (number of users, flow of data or number of advertisers)
- ▶ Differentiation of tax rates according to the origin of revenues (generated by onetime access) taxed at lower rates than that generated by exploitation of data
- ▶ Platforms being encouraged to offer menus of options

with different degrees of data exploitation and users being compensated for uploading personal data

- ▶ Strengthening of technology to anticipate future changes in services, quality and market structure; provision of targeted tax breaks and subsidies to encourage innovation
- ▶ Generalization of principle of destination and harmonization of level of taxation on sales

The report concludes that models presented in the report set the stage for an analysis of the effect of taxation in the digital economy, but leave a number of questions unanswered. It seeks relevant input to set a direction and advance the discussion on taxation of the digital economy.

² http://www.strategie.gouv.fr/sites/strategie.gouv.fr/files/atoms/files/ficalite_du_numerique_10_mars_corrige_final.pdf

03 China issues rules on outbound related party payments³

On 18 March 2015, China's State Administration of Taxation (SAT) issued its SAT Announcement [2015] No.16 (Announcement 16), setting forth transfer pricing rules on outbound related party payments.

Announcement 16 mandates that outbound payments to overseas related parties should follow the arm's length principle. It specifies the following outbound payments that will be treated as non-deductible:

- ▶ Fees paid to overseas related parties that do not perform functions, assume risks and do not have substantial operations
- ▶ Fees paid for the following services received from overseas related parties, which do not directly or indirectly benefit Chinese enterprises:
 - ▶ Not related to the functions, risks and operations of Chinese enterprises

- ▶ Control, management and supervisory activities that guarantee the interest of direct or indirect investors
- ▶ Services that have been purchased from a third party or functions already performed by an enterprise
- ▶ No specific services provided although Chinese enterprises to gain from additional benefits due to their affiliation with multinational groups
- ▶ Services that have been compensated as part of other related party transactions
- ▶ Other services that did not directly or indirectly economically benefit Chinese enterprises
- ▶ Royalty paid to overseas related parties that merely own the legal rights, but have not contributed to value creation of intangible assets

- ▶ Royalty paid for additional benefits to overseas related party in a jurisdiction where enterprises often establish holding or financing companies for the purpose of public listing

The rules given above to be applied subsequent to anti-avoidance investigations (launched in China in July 2014) on substantial amounts of service fees and royalty payments⁴ and are in line with the country's overall efforts against the BEPS.

Announcement 16 became effective on 18 March 2015.

³ Refer to EY Global Tax Alert dated 24 March 2015 | ⁴ Refer to EY Global Alert dated 3 September 2014

04 Denmark introduces international GAAR⁵

Denmark's Minister of Taxation recently published a draft bill that introduces two General Anti-avoidance Rules (GAARs) in domestic Danish law with the aim of preventing abuse of tax treaties and direct tax directives from the European Union (EU). The two GAARs include:

- ▶ A directive GAAR, worded along the lines of GAAR in the EU's Parent-Subsidiary Directive, but also applicable to directives on interest, royalties and mergers

- ▶ A tax treaty GAAR, based on the OECD's proposal under BEPS Action 6 with respect to prevention of abuse of treaties

The two rules, although they are not identically worded, are perceived to normally apply to the same types of situations. Under both the rules, taxpayers cannot gain from the benefits of a directive or tax treaty if obtaining these benefits was one of the main purposes of any arrangement or transaction they have entered and the arrangements/

transactions have not been subjected to certain tests on the results of the benefits. The new rules will be applicable for conduit companies. However, other situations may also be captured under the rules. Once the draft bill is enacted as law, both the GAARs will be applicable from 1 May 2015 and will apply to existing and new arrangements/ transactions (with no grandfathering rule).

⁵ Refer to EY Global Tax Alert dated 9 February 2015

05 Hong Kong extends exemption from offshore funds to private equity funds⁶

Currently, Hong Kong's Offshore Funds Exemption rule (the exemption) does not apply to transactions in most shares and other related interests in private companies. Accordingly, profits derived by offshore Private Equity Funds for investing in private companies are subjected to Hong Kong's Profit Tax.

It is proposed, as a part of Hong Kong's Budget 2015 (introduced on 25 March 2015), that Offshore Fund Exemption will be extended to private equity funds.

The key amendments introduced in the Budget include:

- ▶ Extending the exemption to transactions in the securities of, or issued by, certain private companies incorporated outside of Hong Kong
- ▶ Extending the exemption to Special Purpose Vehicles (SPVs) established to hold (directly or indirectly) one or more private companies incorporated outside of Hong Kong

- ▶ Waiving the requirement for transactions to be carried out through or arranged by a person licensed with Hong Kong's Securities and Futures Commission (SFC) in the case of a bona fide private equity fund

The new rules have been designed to exempt offshore private equity funds from tax in Hong Kong in respect of investments made outside the country. Furthermore, the rules should not impact offshore funds already subject to the current exemption regime.

⁶ Refer to EY Global Tax Alert dated 3 April 2015

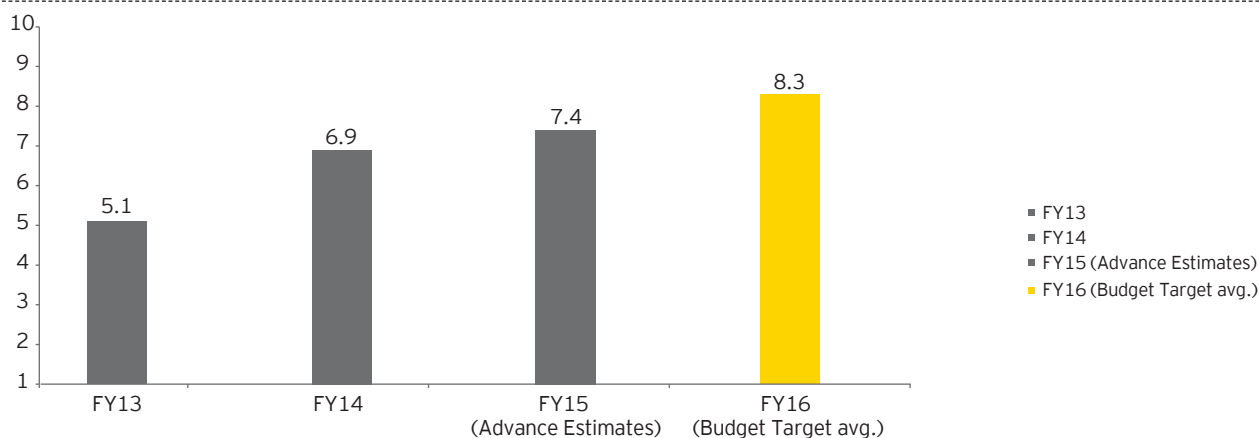


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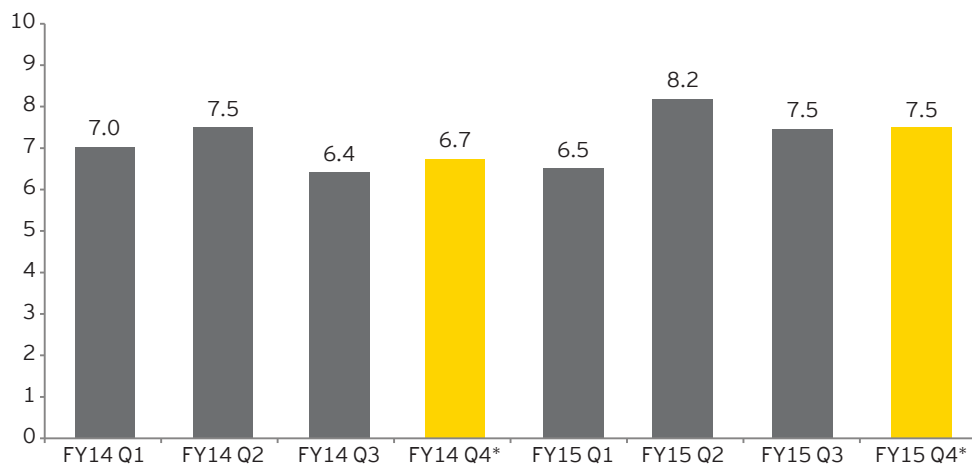
Chart 1: Economic growth (GDPMP, 2011-12 prices)



Source: Advance Estimates of National Income 2014-14 - CSO, MOSPI and Union Budget FY16

As per the new GDP series (2011-12), real GDP shows a growth of 7.4% in FY15. In the Union Budget FY16, the government has targeted a growth in the range of 8.1% to 8.5% (mid-point 8.3%)

Chart 2: Quarterly economic growth (GDPMP, 2011-12 base)



* Derived data

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

GDP Growth fell to 7.5% year on year basis in FY2015 Q3 after improving to 8.2% in Q2. FY15Q4 growth is also estimated at 7.5%.

EY Macro Monitor

Table 1: Growth in Components of Aggregate Demand (2011-12 base)

	Private final consumption expenditure	Government final consumption expenditure	Gross capital formation	Exports	Imports	GDP at market prices
FY2013	5.5	1.7	-0.3	6.7	6.0	5.1
FY2014	6.2	8.2	3.0	7.3	-8.4	6.9
FY2015 (AE)	7.1	10	4.1	0.9	-0.5	7.4
FY2014Q1	7.7	27.3	2.3	2.6	-3.5	7.0
FY2014Q2	5.6	5.3	6.3	-1.6	-8.4	7.5
FY2014Q3	4.6	11	5.3	15.7	-14.2	6.4
FY2014Q4*	7.0	-7.2	-1.4	14.1	-7.0	6.7
FY2015Q1	4.3	-2.0	7.7	9.3	-3.6	6.5
FY2015Q2	8.7	5.8	2.8	-3.8	1.2	8.2
FY2015Q3	3.5	31.7	1.6	-2.8	1.1	7.5

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

*Data for FY14Q4 is derived based on the Advance estimates published by the CSO.

Growth in both private consumption expenditure and investment moderated during FY15Q3 while export demand continued to remain in the negative territory during the third quarter.

Table 2: Sectoral output growth at 2011-12 prices

	FY13	FY14	FY15 (AE)	FY15 Q1	FY15 Q2	FY15 Q3
Agriculture & allied activities	1.2	3.7	1.1	3.5	2.0	-0.4
Industry	2.3	4.5	5.9	6.1	6.0	3.9
Mining and quarrying	-0.2	5.4	2.3	5.1	2.4	2.9
Manufacturing	6.2	5.3	6.8	6.3	5.6	4.2
Electricity, gas and water supply*	4.0	4.8	9.6	10.1	8.7	10.1
Construction	-4.3	2.5	4.5	5.1	7.2	1.7
Services	8.0	9.1	10.6	8.6	10.1	13.5
Trade, Transport and communications**	9.6	11.1	8.4	9.4	8.7	7.2
Finance, insurance, real estate and professional services	8.8	7.9	13.7	11.9	13.8	15.9
Pub. Admin., and defence	4.7	7.9	9.0	1.9	6.0	20
Total GVA at basic prices	4.9	6.6	7.5	7.0	7.8	7.5

Source: CSO, MOSPI, Economic Survey 2014-15

*Includes other utility services

** Includes repair, hotels, restaurants and storage services

Industries and services sector growth remained strong in FY15 leading to a robust growth in GVA during FY15 while the primary sector growth moderated due to deficient monsoon.

Table 4: Inflation based on Consumer Price Index (new series): Combined index for rural and urban areas
(Month over corresponding month of previous year: % change)

	General	Food, beverage	Pan, tobacco and intoxicants	Fuel and Lighting	Housing	Clothing, bedding and footwear	Miscellaneous
FY13	10.21	11.82	10.82	8.58	11.33	10.89	7.3
FY14	9.51	10.9	9.21	7.36	10.56	9.33	6.94
Jan-14	8.83	8.9	9.77	6.24	11.15	9.38	7.68
Feb-14	8.15	7.59	9.4	6.02	11.16	9.37	7.35
Mar-14	8.31	9.15	8.81	6.29	9.89	8.96	6.78
Apr-14	8.59	9.64	8.68	5.89	9.73	8.68	6.77
May-14	8.28	9.22	8.15	5	9.18	8.79	6.92
Jun-14	7.46	7.96	7.7	4.73	9.15	8.65	6.54
Jul-14	7.96	9.14	8.71	4.47	8.94	8.66	6.56
Aug-14	7.73	9.15	8.79	4.15	8.48	8.39	5.86
Sep-14	6.46	7.62	8.43	3.45	8.11	7.59	4.7
Oct-14	5.52	5.75	7.76	3.37	8.12	7.45	4.69
Nov-14	4.38	3.64	7.92	3.42	7.93	6.9	4.2
Dec-14	4.69	4.3	8.41	3.2	5.83	6.7	4.02
Jan-15	5.19	6.3	8.3	3.83	5.11	6.15	3.07
Feb-15	5.37	6.76	9.24	4.72	4.98	6.38	2.89

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

Retail inflation, continues to remain below 5.5% for the fifth straight month but has been rising since Nov 2014 largely driven by rising food prices. Unanticipated rains in March-April 2015 are likely to put pressure on food prices.

Table 5: Growth in Index of Industrial Production (major industries)
(Month over corresponding month of previous year: % change)

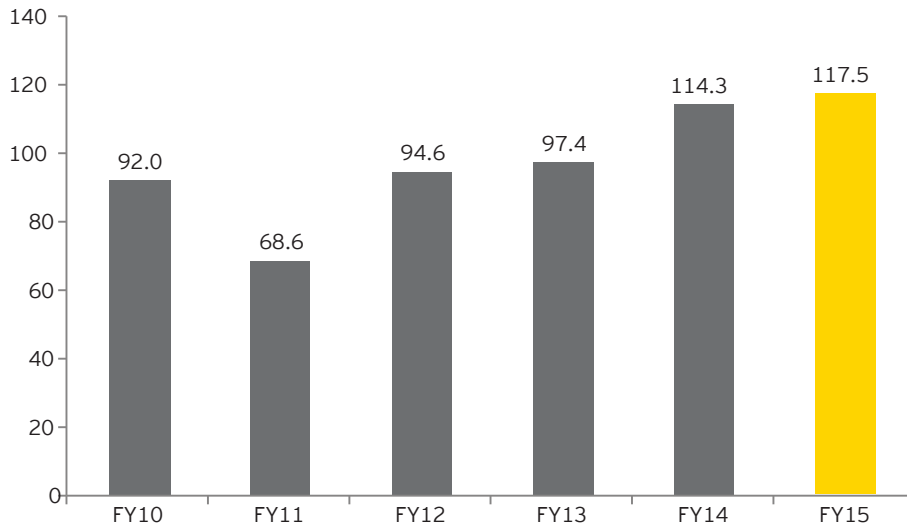
	General Index	Mining	Manufacturing	Electricity
FY11	8.2	5.2	9.0	5.5
FY12	2.9	-2.0	3.0	8.2
FY13	1.1	-2.3	1.3	4.0
FY14	-0.1	-0.6	-0.8	6.1
Jan-14	1.1	2.7	0.3	6.5
Feb-14	-2.0	2.3	-3.9	11.5
Mar-14	-0.5	0.5	-1.3	5.4
Apr-14	3.7	1.7	3.0	11.9
May-14	5.6	2.5	5.9	6.7
Jun-14	4.3	4.8	2.9	15.7
Jul-14	0.9	0.1	-0.3	11.7
Aug-14	0.5	1.2	-1.1	12.9
Sep-14	2.6	0.1	2.7	3.9
Oct-14	-2.7	4.5	-5.6	13.7
Nov-14	3.9	3.9	3.1	10
Dec-14	3.2	-2.1	3.8	4.8
Jan-15	2.6	-2.8	3.3	2.7

Source: Office of Economics Advisor, Government of India

IIP growth moderated in Jan 2015 as output growth of manufacturing and electricity sectors slowed during the month.

EY Macro Monitor

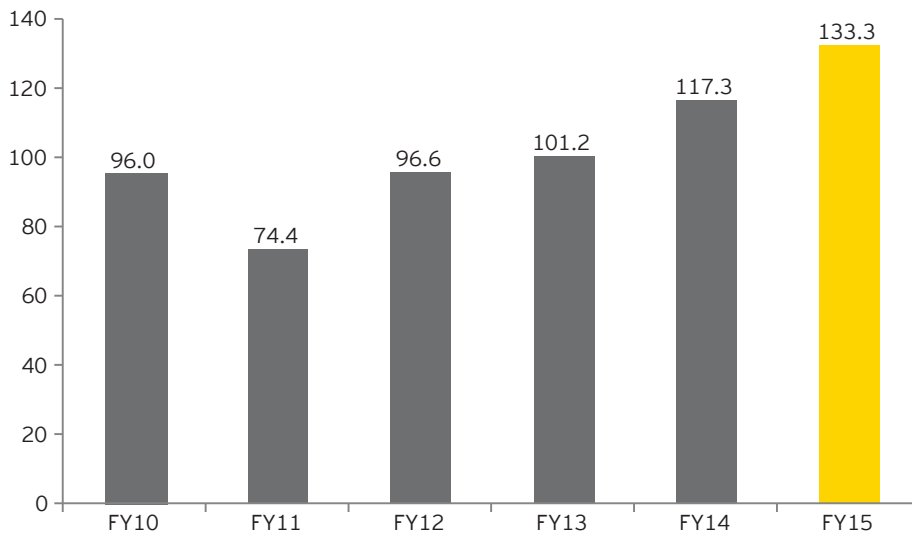
Chart 3: Cumulated Fiscal Deficit up to February 2015 as % of Revised Estimates



Cumulated fiscal deficit up to February 2015 is at 117.5% of the budgeted target for the entire year. The government still expects to meet the fiscal deficit target for FY15 at 4.1% of GDP.

Source: Controller General of Accounts, Government of India

Chart 5: Cumulated Revenue Deficit up to February 2015 as % of Revised Estimates



Cumulative revenue deficit by February 2015 reached an all-time high of 133.3% of the budgeted target

Source: Controller General of Accounts, Government of India

Table 6: Major heads of central government revenue (INR Crores)

Expenditure Heads	2014-15 (BE)	2014-15 (RE)	2015-16 (BE)	% Change in FY15 RE over FY14 Actuals	% Change in FY16 BE over FY15 RE
Gross Revenue Receipts	1577029	1469222	1671223	9.8	13.7
Tax Revenue (incl. states share)	1364524	1251391	1449490	9.9	15.8
Corporation Tax	451005	383027	415382	8.0	8.4
Taxes on Income	284266	259167	303991	14.7	17.3
Customs	201819	188713	208336	9.7	10.4
Union Excise Duties	207110	185480	229808	9.0	23.9
Service Tax	215973	168132	209774	8.6	24.8
Non Tax Revenue	212505	217831	221733	9.5	1.8

Source: Union Budget documents

Central taxes, as per RE, showed much lower growth than BE.

Table 7: Major heads of central government expenditure (INR Crores)

Expenditure Heads	2014-15 (BE)	2014-15 (RE)	2015-16 (BE)	% Change in FY15 RE over FY14 Actuals	% Change in FY16 BE over FY15 RE
Non-Plan Expenditure	12,19,892	12,13,224	13,12,200	9.7	8.2
Plan Expenditure	5,75,000	4,67,934	4,65,277	3.2	-0.6
Total Expenditure	17,94,892	16,81,158	17,77,477	7.8	5.7
Major Subsidies	2,51,397	2,53,913	2,27,388	3.8	-10.4
Fertilizer Subsidy	72,970	70,967	72,969	5.4	2.8
Food Subsidy	1,15,000	1,22,676	1,24,419	33.3	1.4
Petroleum Subsidy	63,427	60,270	30,000	-29.4	-50.2

Source: Union Budget documents

Retaining the budgeted fiscal deficit target of FY15 at 4.1% of GDP while revenues grew at much lower rate than the BE has implied that expenditure growth has to be curtailed. This gave government's fiscal policy a contractionary stance.

The impact of uncontrollable externalities is so high on Budgets that it reinforces faith in GOD. The Budget thus feels almost like a prayer.

Jayesh Sanghvi
National Leader
International Tax Services
EY India

As incredible India readies itself to transform into a global manufacturing hub, one hopes that the 'Make in India' campaign evokes an experience as flavourful as the 'Grown in India' and internationally savoured Alphonso mangoes!

Sushant S Nayak
Tax Markets Leader
EY India

Quick bites

The Prime Minister has made the revival of Indian manufacturing a top priority, reflected in his 'Make in India' campaign and slogan. The objective is as laudable as the challenges it faces are daunting.

Rajendra Nayak
Partner
Tax & Regulatory Services
EY India

'Make in India' - an ambitious and directionally right strategy reminds India of its demographic wealth ; a democratic process of vital legislative reforms continues to remind us to be a patient like a potter.

Geeta Jani
Partner
Tax & Regulatory Services
EY India



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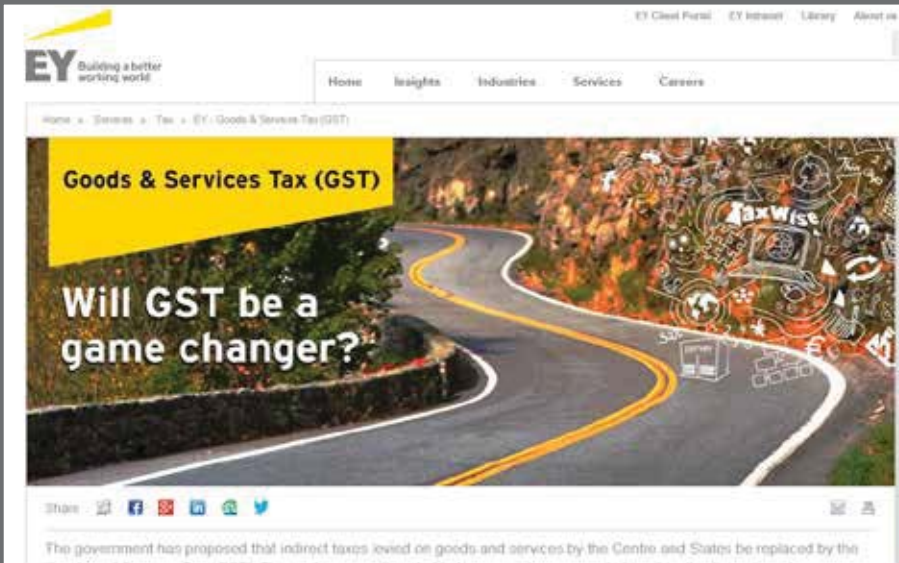
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