India Tax Insights

Issue 7

April 2016

Did this Budget miss setting the stage for GST?

Impact of equalisation levy on online advertising

Is the Budget push enough for 'Start-ups'?

When the board is set, how will you make the next move?

Budget 2016 gives India its own "patent box" regime

Navigating between fiscal consolidation and growth

Nuances of Country-by-country reporting

Ernst & Young LLP

EY | Assurance | Tax | Transactions | Advisory

About EY

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

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

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

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

© 2016 Ernst & Young LLP. Published in India.
All Rights Reserved.

EYIN1604-039
ED None

This publication contains information in summary form and is therefore intended for general guidance only. It is not intended to be a substitute for detailed research or the exercise of professional judgment. Neither Ernst & Young LLP nor any other member of the global Ernst & Young organization can accept any responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. On any specific matter, reference should be made to the appropriate advisor.

AGK

EY refers to the global organization, and/or one or more of the independent member firms of Ernst & Young Global Limited

Team

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

Editorial Board:
Geeta Jani
Jayesh Sanghvi
Keyur Shah
Rajendra Nayak
Shalini Mathur
Sushant Nayak

Program Manager
Jerin Verghese

Program Support
Pushpanjali Singh, Tripti Panda

Creatives
Ashish George Kuttickal

Write to us with feedback/suggestions and contributions at Tax.Update@in.ey.com

Welcome

Sudhir Kapadia

Sudhir Kapadia
Partner and National Tax Leader, EY India

We are pleased to present the seventh edition of our magazine *India Tax Insights*.

The Union Budget for 2016, presented by the Finance Minister on 29 February 2016, has a transformative agenda built on nine distinct pillars: agriculture welfare, rural sector, social sector, education, skills and job creation, infrastructure and investment, financial sector reforms, governance and ease of doing business, fiscal disciple and tax reforms. The tax proposals in the Budget seek to revive growth and investment by promoting manufacturing and encouraging innovation and startup enterprises. The Budget has also introduced measures to reduce tax litigation and tax uncertainty. The Budget proposals reflect India's commitment to implementing anti-BEPS measures. This issue of *India Tax Insights* focuses on the key proposals contained in the 2016 Union Budget.

With the adoption of the BEPS package in October 2015, OECD and G20 countries laid the foundations of a modern international tax framework under which profits would be taxed where economic activity and value creation occur. To this effect, the Budget seeks to implement a new three-tier approach for transfer pricing documentation, an equalization levy to address BEPS risks (which stand exacerbated by the digital economy) and a nexus-based patent box regime. Vijay Iyer, Partner and EY India's Transfer Pricing Leader, explains what the new documentation regime could mean for multinational enterprises. A feature on digital economy taxation from a BEPS perspective provides the potential impact on business and way forward.

Rakesh Jariwala, Tax Partner, EY India, discusses the impact of the proposed equalization levy on the digital economy.

Innovation or patent box regimes, which provide for a preferential treatment in respect of profits derived from qualified intangible property with a view to promoting R&D, have been increasingly introduced in a number of countries. Patent box regimes need to be compliant with OECD's BEPS Action Plan 5 relating to harmful tax practices. Graham Samuel-Gibbon, Director, International Tax Services in EY UK, provides a global perspective on patent box regimes in light of BEPS. Rajendra Nayak, Partner, International Tax Services, EY India, reviews select design issues of India's proposed patent box regime to assess compliance with Action 5.

Harishanker Subramaniam, Indirect Tax Leader, EY India, in his article states that although the Budget promotes several good objectives, it fails to align with GST. Articles by Pramod Jain, Head of Tax, Flipkart and GV Krishna Kumar, Tax Partner, EY India, elucidates how the Budget has been weaved around India's fast-gaining reputation as a startup hub. This issue also carries a feature on the key achievements of the Make in India initiative along with comments from key industry representatives.

The Economic Survey for 2015–16 calls India "*... a haven of stability and an outpost of opportunity.*" Its macro-economy is stable, founded on the Government's commitment to fiscal consolidation and low inflation. Dr. D.K. Srivastava, an economist and chief policy advisor to EY India, shares his views on how the Budget navigates between fiscal consolidation and growth.

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.

Articles

06
2016 Union Budget gives India its own "patent box" regime
Rajendra Nayak anticipates that with a strong technology and knowledge driven economy, India may become a favourite destination for investors

09
Is India's "patent box" at par with global standards?
Graham Samuel-Gibbon delivers an international perspective from the prism of BEPS

22
Budget strengthens the start-up ecosystem in India
GV Krishna Kumar explains how Budget has been weaved around India's fast gaining reputation as a Start-up hub

24
Dawn of tax benefits for start-up companies
Pramod Jain of Flipkart, states that Government should extend further steps for greater impact

In this issue

Regulars

34
Global News
Latest tax news from various jurisdictions

38
EconoMeter
Key economic indicators

Features

18
Impact of Digital Economy Report of the OECD's BEPS project

28
Make in India - the performance so far

11
Union Budget: Navigating between fiscal consolidation and growth
D.K. Srivastava explains how this year's Budget was formulated under considerable constraints

14
Equalisation levy: India's action under the BEPS agenda for the digital economy
Rakesh Jariwala defines the impact of Finance Minister's bold step of equalisation levy to tax digital transactions

25
Did the Budget miss setting the stage for GST?
Harishanker Subramaniam states that though Budget promotes several good objectives, but it missed to align with GST

32
Country-by-country reporting: A new paradigm
Vijay Iyer elucidates what the new transfer pricing documentation regime could mean for multinational enterprises

2016 Union Budget gives India its own patent box regime

Rajendra Nayak
Partner,
International Tax
Services, EY India

A number of countries are increasingly introducing innovation or patent box regimes, which provide for a preferential treatment in respect of profits derived from qualified intangible property (IP) with a view to promote R&D. Such a regime typically grants a lower tax rate on profits from IP, "boxing" them off from the rest of the system. Historically, R&D incentive in India has been "input-based," i.e., by granting weighted or accelerated deduction on eligible expenditure. While the input-based regime is being phased out, the Budget 2016 proposes a new regime in the Indian tax law under which income earned by a qualifying taxpayer from the exploitation of a patent would be taxed at a preferential rate of 10%. No deduction of any expenditure or allowance would be allowed in computing the income under this regime, and the income qualifying for the preferential rate should be by way of royalty in respect of a patent developed in India. The qualifying taxpayer should be a person resident in India and a patentee holding a valid patent registered under the Indian patent law.

A patent box regime needs to be compliant with Action 5 of OECD's BEPS Action Plan, relating to harmful tax practices. Hence, it becomes important to review select design issues of India's proposed patent box regime to assess compliance with Action 5.

The nexus approach

The OECD BEPS report adopts a "nexus approach" for preferential IP regimes, requiring alignment of the benefits of these regimes with substantive R&D activity. The nexus approach looks at whether an IP regime makes its benefits conditional on the extent of R&D activities of the taxpayers receiving the benefits. This requires a direct nexus between the income receiving the benefit and the expenditures contributing to the income. R&D expenditure therefore acts as an indicator of substantial activities. It is not so much the amount of expenditure but the proportion of expenditure directly related to development activities that demonstrate the value added by the taxpayer and acts as a proxy for how much substantial activity the taxpayer undertook. The purpose of the nexus approach is to grant benefits only to income that arises from IP where the actual R&D activity was undertaken by the taxpayer.

The patent box regime proposed in Budget 2016 applies to a patent developed in India. The term "developed" has been defined to mean expenditure incurred by the taxpayer for any invention in respect of which a patent is granted. By linking the reduced tax rate on IP income to the expenditure incurred on development, the regime does appear to satisfy the nexus approach of Action 5. However, there could be situations where it becomes challenging to assess whether the nexus approach is satisfied — for example, an enterprise that acquires an "in-process" IP and thereafter incurs expenditure on further development, resulting in a patent, or a company that outsources R&D to a related party. The Action 5 report indicates that expenditure on IP acquisition or related-party outsourcing should be excluded in measuring qualifying expenditure for the nexus approach, subject to an "up lift" not exceeding 30% of the qualifying expenditure. Some of the elements of the Budget 2016 proposals may therefore need to be modified to satisfy the nexus approach of Action 5.

Qualifying IP assets

The proposal applies only to income from patents registered under the Patents Act, 1970. It may be necessary to extend the scope to IP assets that are functionally equivalent to patents — such as formulas, processes, designs, patterns, know-how and inventions — even though they may not be eligible for or may not have sought patent protection.

Creators of knowledge in the domain of computer related inventions (CRIs) have consistently endeavored for appropriate protection of their IPs. The Indian Patent Office in February 2016 issued guidelines for the examination of CRIs patent applications. The guidelines clarify that a number of CRIs such as computer programs per se, algorithms and mathematical models

may not be eligible for patent protection. While this may make a number of technology-driven companies ineligible for the regime, it must be recognized that CRIs arise from the type of innovation and R&D that IP regimes are typically designed to encourage.

Obtaining a patent registration may be a time-consuming process, while commercial exploitation of the IP may commence pending registration. Going by Budget 2016 proposals, income arising from the exploitation of an IP prior to obtaining a formal patent registration may not qualify for the preferential tax rate. An IP-intensive business may have a bundle of IPs that are exploited on an aggregate basis, while only some of the IPs may be patented. In such situations, breaking the aggregate income from IP exploitation and allocating it to patented IP may be a challenge.

Considering these situations, the scope of qualifying IP assets may need to expand beyond registered patents. Specifically, the issue should not be whether or not an IP is patented (or even patentable), but rather whether the IP is linked to qualifying R&D substantial activity and corresponding expenditure in the relevant jurisdiction. This will make a wider range of innovative and knowledge-based enterprises eligible to claim the benefits. It may be noted that Action 5 does not seek to limit the qualifying IP assets to only patents.

Qualifying IP income

IP income that qualifies for the preferential tax treatment under Budget 2016 is consideration earned from exploiting a patent by transfer of use or other similar rights, such as rendering of services in connection with such exploitation. Income from sales of goods manufactured is not a qualifying income. It may be noted that IP income may also be embedded in the sale of products and benefits may need to be granted to such an income as well. A consistent and coherent method – based on transfer pricing principles – may be needed for separating income unrelated to IP (e.g., marketing and manufacturing returns) from income arising from IP.

Expanding the coverage of qualifying IP income to IP income embedded in the sale of manufactured products would also support the Government's 'Make in India!' initiative by enabling active deployment of IP in manufacturing activities. The approach would also be compliant with Action 5.

The proposal to introduce a patent box regime in the Indian tax law is a welcome move. With a strong technology- and knowledge-driven economy, India may be in a sweet spot to attract investors in such a regime. Given the proliferation of IP regimes worldwide, India would be competing with a number of other countries to attract investors in their respective IP regimes. The Government should therefore consider further improving the regime to make it more attractive for investors.

Is India's "patent box" at par with global standards?

Graham Samuel-Gibbon,
Director, International Tax Services, EY UK

Innovation regimes around the world are in a state of flux as a result of the OECD Base Erosion and Profit Shifting (BEPS) project and various other factors. Existing regimes – including in the UK, the Netherlands and Luxembourg – are being or are expected to be amended to bring them into line with the conclusions of BEPS Action 5. Elsewhere, as with India, new regimes are being brought in to attract investment in a manner that is perceived as consistent with BEPS principles, such as Switzerland's proposed patent box and Ireland's new "Knowledge Development Box", which grants a 6.25% tax rate on profits from certain IP assets that arise from qualifying R&D activity carried out in Ireland[1]. As various other elements of the Swiss and Irish corporate tax regimes come under increasing international pressure, these new regimes are considered a more acceptable means of attracting investment through tax incentives. A patent/innovation box is also being discussed in the US (although any change in law would be some way off), seeking to stem the tide of other nations using such regimes to lure US corporate income.

As a potential new entrant to this rapidly moving and developing backdrop, India can take a view of the best practice among the key innovation box regimes and consider whether to adopt any elements and amend the current proposals. There are numerous elements to consider, but here are some considerations.

What Intellectual Property (IP) can benefit?

The tendency, at least historically, has been for the IP benefiting from incentive regimes to be drawn relatively narrowly. However, with new regimes introduced and existing regimes enhanced over time, a broader range of IP qualifies in a number of jurisdictions. The UK has rejected pressure to extend the rights that benefit from its patent box (which currently effectively covers patents and IP functionally equivalent to patents) on the grounds of it being too costly to extend the regime to cover other rights. The new Irish regime will cover patented inventions and copyrighted software. The Hungarian and Cypriot IP incentives extend to a broad range of IP rights, including patents, trademarks, knowhow and copyright rights. The Boustany-Neal US discussion draft innovation box legislation also stretches fairly broadly, covering inventions, formulas, processes, designs and patterns[2]. The driver here for India, as with for many factors, will have been one of balancing cost versus incentivizing industry and investment. The current approach adopted in the Indian proposals is fairly narrow.

In addition to the nature of IP, consideration would need to be given to whether qualifying IP should be restricted to IP self-developed in India (as in the current proposals) or whether it could extend to apply to purchased or in-licensed rights, as well as whether legal or beneficial ownership of the IP is required to qualify.

Calculation of profit

India has aligned with the modified nexus approach, the mechanism to which most OECD and EU jurisdictions (including the UK, the Netherlands and Luxembourg) are transitioning. The adoption of the modified nexus standard has caused some degree of concern in the US: that its widespread adoption may incentivize US businesses to shift their R&D activities and spending overseas to maximise the benefits of innovation regimes operating under the modified nexus approach. This prompted the US Portman-Schumer innovation box proposals in the US,[3] and the Indian regime proposed in Budget 2016 appears to follow this approach by applying to patents developed in India, seeking to be acceptable internationally while ensuring that investment in Indian R&D is not eroded.

The UK patent box provides benefits on the worldwide sales of products incorporating one or more qualifying patents. Most existing regimes benefit income from IP licensing and royalties, although a number of regimes as per the current Indian proposals do not generally apply to income embedded in the sales price for products and services (for example, the Cyprus and Maltese regimes). There is also the question of whether capital gains or disposal proceeds should be exempt (either under the specific regime or on general tax principles). Alternative "input based" approaches have been used elsewhere, such as Ireland's old regime prior to the introduction of its Knowledge Development Box, which provided for tax depreciation of the capital expenditure incurred on qualifying IP. It is unsurprising that India, as with other jurisdictions, has moved away from such an approach with its proposals.

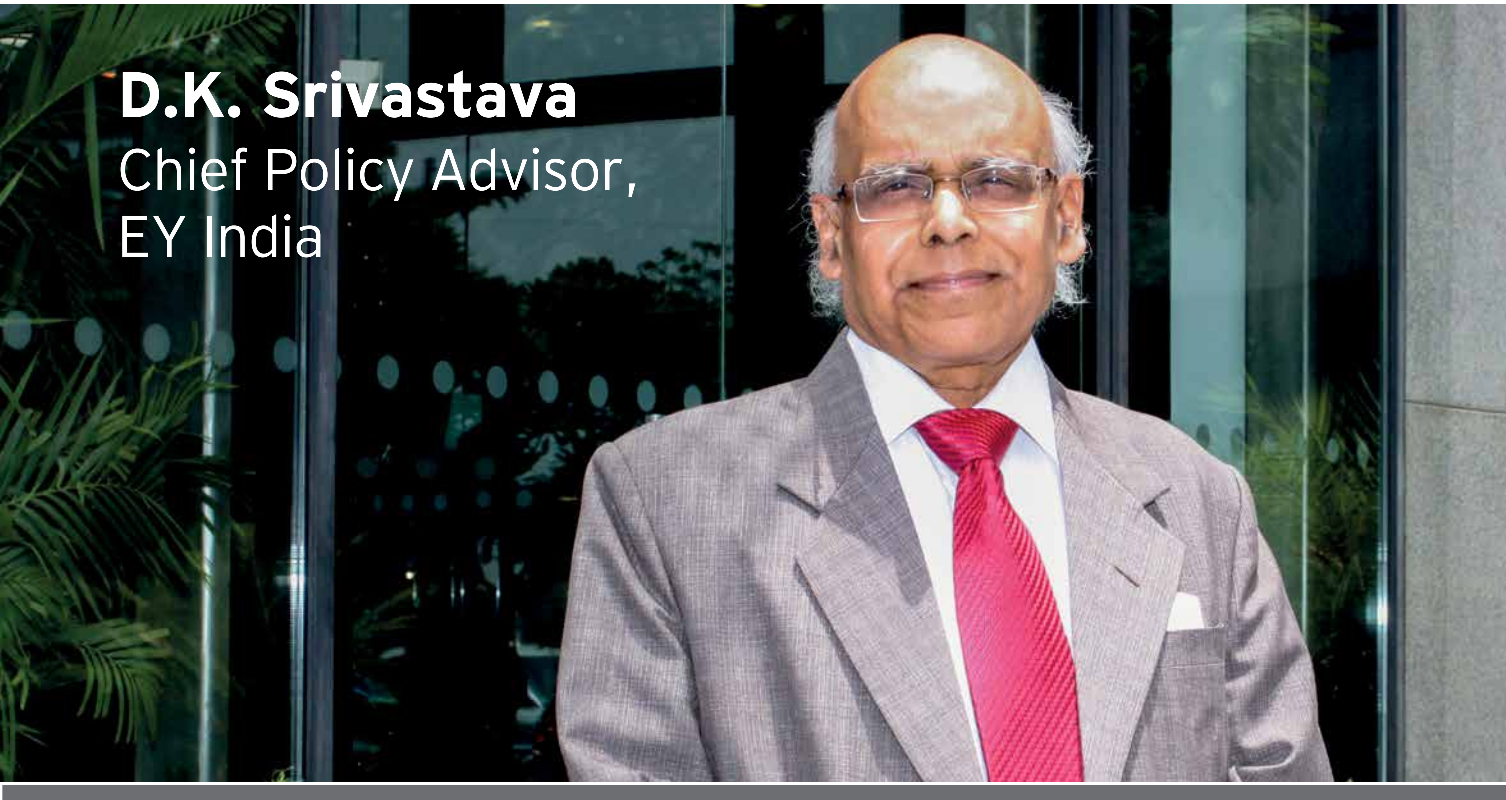
Rate of tax

Of course, India will also need to decide whether to retain the proposed 10% rate of tax to apply to qualifying income. The published effective rate of tax will be what grabs the headlines, but it will be a combination of this and the above factors that will determine the attractiveness and effectiveness of India's new regime.

Source:

1 External Client Alert Ireland publishes legislation on knowledge development box, October 2015

2,3 EY Life Sciences webcast on US tax issues, March 2016. Hungary/Cyprus High-level comparison of European IP regimes client work product signed-off by local EY teams October 2015



Union Budget: Navigating between fiscal consolidation and growth

India's Budget for 2016–17 was formulated under considerable constraints. India's exports have been falling for the last 15 months due to the global economic slowdown, particularly in China and other emerging market economies. Private investment demand in India has also remained weak due to the slowdown and falling prices of crude and other primary commodities. The stressed balance sheets of the corporates translated into non-performing assets (NPAs) for India's public sector banks, calling for policy and financial support from the Government. Keeping the Center's own balance sheet intact required adherence to the pre-announced fiscal consolidation path, limiting the fiscal deficit to 3.9% of GDP for FY16 and 3.5% for FY17[1].The challenge before the Government was to stimulate growth, while adhering to the fiscal consolidation path.

Fiscal consolidation and growth

Fiscal stimulus for uplifting growth calls for expanding government expenditure, preferably capital expenditure. However, the fiscal deficit targets actually forced the Central Government to reduce government expenditure as a percentage of GDP from 13.2% in FY16[2] to 13.1% FY17[3]. Furthermore, this involved a lowering of capital expenditure relative to GDP from 1.75 in FY16[4] to 1.64 in FY17[5].

Although a direct fiscal stimulus could not be provided through the Budget, the Central Government found an indirect method of boosting infrastructure expenditure by utilizing a number of specialized agencies[6]. These expenditures have been largely focused on road, rail and rural infrastructure. Estimates suggest that the amounts involved may supplement direct capital expenditure from the Budget by as much as 0.9% of GDP[7]. This infact has provided the ground for RBI's decision to reduce the repo rate by 25 basis points in its policy review in the first week of April 2016.

Meeting the fiscal deficit targets: some caveats

We must recognize, however, that certain unanticipated economic events and possible under-provisions for committed expenditures may make achieving the fiscal deficit target somewhat difficult. First, the assumed nominal GDP growth for FY17 at 11% may not be achieved as inflation may remain lower than anticipated. The assumption of an 11.5% nominal GDP growth for FY16 was belied by a margin of nearly three percentage points. Second, subsidies may have been underprovided and may need to be rolled over to the next year. Meeting the commitments on account of the recommendations of the 7th Central Pay Commission may also prove to be a challenge as only interim provisions have been made. Further, the growth assumptions with respect to non-tax revenues and non-debt capital receipts at 25% and 52%, respectively, in FY17 may also be underachieved. Third, meeting the tax revenue growth targets with respect to Union Excise Duties at 12.2% and income tax at 18.1% would prove to be a challenge. Crude prices are not likely to continue to fall, depriving the Government from reaping the bounty that it enjoyed in FY16 (Exhibit 1).

Growth stimulus based on structural reforms

Instead of relying on indirect fiscal stimulus, pursuing structural reforms might have provided a more sustainable route to supporting growth. First, subsidies could have been substantially reduced by limiting them to about 1% of GDP along with better targeting and delivery and weeding out unwarranted middle- to high-income beneficiaries. Second, the central ministries and departments — particularly those dealing with state subjects — could have been scaled down following the recommendations of the 14th Finance Commission. Third, a clearer path to GST could have been prepared by eliminating cesses. Cesses, however, ensure that revenues are spent on the stated objective. Although in the FY17 Budget the Government introduced a new Krishi Kalyan Cess, it should ensure that the amounts raised are spent on financing initiatives relating to the improvement of agriculture and the welfare of farmers. Fourth, a concerted effort to raise India's tax-GDP ratio from the range of 16–17% to 21–22%, considering central and state taxes together, should have been made as Economic Survey 2015-16 points out. This would require a coordinated effort by the Central and State governments.

The Budget has called for reviewing the center's Fiscal Responsibility and Budget Management (FRBM) Act. This is a positive initiative. The FRBM Act can be made more flexible so as to respond to the current economic situation. When the economy is doing well, the Government may borrow less than the permitted limit. It can borrow more than the permitted limit when there is a downturn. The matter is being referred to a committee. A suitable revision of the FRBM Act would open up fiscal space for enhancing public investment and stimulate growth.

Exhibit 1: Tax receipts

Receipts	2014-15 actual	2015-16 RE	2016-17 BE	% change in FY16 RE over FY15 actual	% change in FY17 BE over FY16 RE
Total gross tax revenue	12,44,885	14,59,611	16,30,888	17.2	11.7
Corporation tax	4,28,925	4,52,970	4,93,923	5.6	9
Taxes on income	2,65,733	2,99,051	3,53,174	12.5	18.1
Direct taxes	6,95,744	7,52,021	8,47,097	8.1	12.6
Customs	1,88,016	2,09,500	2,30,000	11.4	9.8
Union excise	1,89,952	2,84,142	3,18,670	49.6	12.2
Service tax	1,67,969	2,10,000	2,31,000	25	10
Indirect taxes	5,45,937	7,03,642	7,79,670	28.9	10.8

Source: Receipt Budget, Union Budget, 2016-17

We must recognize that certain unanticipated economic events and possible under-provisions for committed expenditures may make achieving the fiscal deficit target somewhat difficult.

Source:

1 Union Budget, FY16

2,4 Revised estimates (RE)

3,5 Budget estimates (BE)

6 The National Highways Authority of India, Power Finance Corporation, Rural Electrification Corporation, Indian Renewable Energy Development Agency, National Bank for Agriculture and Rural Development, and Inland Water Authority. The Ministry of Railways has also planned to raise off-budget funds for its ambitious investment plans.

7 Study by Credit Lyonnais Securities Asia published in Livemint, 9 March 2016 edition

Rakesh Jariwala
Tax Leader,
Media & Entertainment
practice, EY India

Equalisation levy: India's action under the BEPS agenda for the digital economy

EQL is currently introduced at **6%**

On 29 February 2016, India's Finance Minister (FM), in a bold step, introduced equalisation levy (EQL) to tax digital economy transactions as part of his budget proposals. While some action on the part of India under the Base Erosion and Profit Shifting (BEPS) agenda was anticipated, India's move to tax digital transactions, and that too by using the EQL option, was unexpected.

Following the issue of the BEPS action plan on "Addressing the Tax Challenges of the Digital Economy", the Indian tax authority has been vocal in expressing its commitment to tax the digital economy, in spite of the wait-and-watch approach suggested in the action plan. The genesis of this approach is not new, considering the difference in ideology of source-based UN models – such as the one followed by India – and residence-based OECD models. This apart, the ever growing digital economy and innovating valuation means adopted by private equity players –for instance, based on the number of active users in India – have surely added to India's desire to demand a fair share of revenue on source principles.

The traditional rules of a brick and mortar economy posed challenges to levy source-based taxation, considering the issues related to nexus, data and characterization – particularly in a treaty situation where the treaty was expected to provide for such income to be taxed only in the home country.

Following the digital economy action plan, the Central Board of Direct Taxes (CBDT) constituted a committee (the Committee) to study and issue a report on taxation in e-commerce, which ultimately led to the introduction of EQL in the Budget 2016. The Committee comprised of senior officials from the Finance Ministry and the Income Tax Department, industry representatives, Institute of Chartered Accountants of India (ICAI) representatives and independent professionals. The Committee examined the tax issues for new business models in the digital economy, as well as took cognizance of detailed discussion by the OECD in the digital economy action plan.

As per the Budget 2016, EQL would be levied on certain specified business-to-business (B2B) transactions exceeding the monetary threshold of approximately US$1,500 for specified services provided by non-residents to residents.

Highlights of EQL and what more is in store

- EQL is currently applicable on online advertisement, provision of digital advertising space and other facilities/services for the purpose of online advertisement.
- The Committee has already identified most of the other digital services, which include online marketing and advertisements; cloud computing; website designing, hosting and maintenance; provision of digital space; digital platforms; advertising on radio/television; and services relating to online sale of goods and services, and online use or download of software and applications. These services may be added over a period of time, through notifications.
- While Budget 2016 has introduced EQL in a simplified manner with reporting obligations only on the payer, the Committee believes that over a period, it could be implemented like withholding tax provisions such that the ultimate obligation is on the recipient of income.
- EQL has been introduced under a separate code under Budget 2016 and not under the Income-tax Act, 1961 (IT Act). EQL is currently introduced at 6%; however, the Committee believes that over a period, it could be increased to 8% or more.

The law, as it stand currently, also does not offer any clear guidance on dealing with a situation where a difference in view arises between the tax assessor and the payer on the applicability of EQL income tax on the payment concerned.

Digital Economy report and selection of EQL option

The BEPS report suggests three options to combat the tax challenges of the digital economy:

1. It is internationally accepted that physical presence tests are relevant only to traditional brick and mortar business and may not fit to tax in the digital economy; therefore, the first option of amendment in the definition of Permanent Establishment (PE) was conceptualized.

2. The second option was to introduce withholding tax on every digital economy transaction to take care of characterization-related tax issues.

3. The third option was the introduction of EQL, which works like an expenditure tax.

The Committee recognized that in order to ensure uniform tax treatment and to honor its bilateral treaty commitments, the first two options cannot be implemented unilaterally. However, since the third option would not be under the IT Act, it could be relatively simpler to implement without breaching international commitments. The Committee believes that EQL would bring in greater certainty and predictability for all the stakeholders, contributing to a more stable environment as compared to other options.

However, the only concern is that EQL would be implemented like an expenditure tax and hence, foreign credit would unlikely be available in the home country. This may ultimately inflate the procurement cost of such services.

Government intends to cover the entire gamut of services in the supply chain by proposing to levy EQL on facilities/ services used in connection with online advertising. This is likely to create uncertainties on the extent of coverage.

Implementation imperatives of EQL

While EQL is mentioned as one of the options in the Digital Economy report, India is the first country to seek to levy such a tax. The following are a few interpretation and implementation challenges:

- The Government intends to cover the entire gamut of services in the supply chain by proposing to levy EQL on facilities/services used in connection with online advertising. This is likely to create uncertainties on the extent of coverage.

  Given that the online advertising medium is still at a nascent stage, in case of composite contracts for online and offline advertising, an indicative methodology to bifurcate the considerations could be provided.

- The Budget 2016 provides that if a recipient is held to have a PE, EQL would not be levied and taxes as applicable under the normal provisions of the IT Act would be applicable. However, currently there is no mechanism provided to recover taxes already withheld when such PE is determined at a later stage.

- Considering the already existing litigation around the existence or otherwise of a PE for foreign digital service providers in India, we need to wait and watch whether EQL would ultimately provide certainty to assesses as envisaged in the regulations. This apart, the challenges relating to determining profits attributable to such a PE remain.

- In cases where the non-resident recipient does not have PE, the income recipient that has been subjected to EQL will be exempt from income tax. Currently, the onus is on the payer to determine whether the payment should be subjected to EQL or income tax.

- EQL is applicable on payments related to digital advertising. However, considering the innovative nature of businesses, the difference between advertising and sales promotion may be overlapping. For instance, it is not clear whether payments for preferential listing on aggregator websites or payment for acquiring keywords can be regarded as advertising. Similarly, whether payments for transactions such as online campaigns/contests, barter transactions and payments for push notifications would fall within the purview of EQL could be debated.

- In case of platforms and advertisement agencies/ intermediaries that are working on various models such as P2P and P2A, another issue that could arise is which stage the compliances should be carried out.

Equally, if EQL is applied on payments to an aggregator/ intermediary that may be operating on very thin margins, with the bulk of the payments going to the owner/licensee of the content IP, the margins could entirely vanish.

EQL is now a reality, as we await the date from which it becomes applicable. However, as the saying goes, it is easier said than done. Given that the intention is to provide certainty, detailed clarifications on the above aspects would go a long way in ensuring that the provisions are implemented as intended.

Nirav Shah, Director, Tax & Regulatory Services, EY India also contributed to the article

Impact of Digital Economy Report of the OECD's BEPS project

In October 2015, the OECD concluded more than two years of deliberations when the group released their final report under (Action 1) of the BEPS Action Plan. The document, Addressing the Tax Challenges of the Digital Economy (the Digital Economy Report or Final Report) acknowledges that special rules designed exclusively for the digital economy would prove unworkable.

What is the action trying to achieve?

The Digital Economy Report is targeting alleged taxpayer abuses. For example, Annex B of the 290 page document illustrates legal and tax structures that place pressure on the existing international tax framework. While the traditional taxing paradigm calculates liability in part by analyzing functions, assets and risks, this income tax framework is challenged by the following digital economy features – and more:

- Ecommerce (including B2B, B2C, and C2C models)
- App stores
- Online advertising
- Cloud computing

Essentially, the BEPS reports, including the Action 1 report, are intended to restore tax on "stateless" income derived by digitally active companies. The report suggests the limiting of offshore deferral or profit shifting via enhanced CFC rules (Action 3); prevent the artificial avoidance of PE (Action 7); and increase scrutiny in situations where transfer pricing has shifted profits to low tax jurisdictions (Actions 8 through 10). In the context of indirect taxation, the Final Report urges individual countries to implement Guidelines 2 and 4 of the OECD's international VAT/GST guidelines in order to minimize tax planning opportunities.[1]

Were any of the action recommendations unexpected?

The OECD's Task Force on the Digital Economy (TFDE – the OECD body tasked with developing Action 1) had a substantial project in front of them because evolutionary business models (beyond the e-commerce issues of the 1990's) are being disrupted, with new examples cropping up each day. Meanwhile, the OECD is under pressure from impatient nation-states troubled by a reduction of income they feel is a result of BEPS, the "sharing economy," "cloud computing," and the spread of "digital currencies."

Although the TFDE considered the adoption of – (i) a new nexus in the form of significant economic presence; (ii) a withholding tax on certain types of digital transactions; or (iii) an equalization levy, none of these recommendations were made in the Final Report. Likewise, the Final Report dismissed a multi-factor apportionment test, which could have acted as a safe harbor.

Is there any interaction between this Action and others?

The Final Report states that the work developed under other BEPS Actions took into account the digital economy's key features to ensure that the proposed solutions effectively address BEPS in the digital space. Chapter six notes that Action items 3, 7, 8, 9 and 10 will address issues raised in the digital economy.

Have any countries made specific comments in relation to this Action?

While many jurisdictions are putting in place new legislation which will guarantee a minimum amount of tax, other jurisdictions are taking a longer term approach. For example, in 2012, France set up a task force on the taxation of the digital economy which concluded that there is a clear link between tax and data-use issues. Nevertheless, the main message conveyed by the French report was that in the digital economy, the notion of a fixed place of business is not relevant for determining the place where the substance of a business

activity is carried on. As a result of this report, the French Tax Authority (FTA) has increased the number of tech company audits and often pushes these cases into the French court system – by arguing that the taxpayer has a French PE.

Ireland also supports the BEPS initiative, but from a different angle. The Irish Government has not hidden the fact that they are keen to exploit the BEPS report to improve their international competitiveness. For example, the Irish Government is committed to the 12.5% tax rate and recently introduced new depreciation and IP box regimes intended to increase Foreign Direct Investment (FDI).

Historically capital and technology importers, Latin American countries (particularly Mexico and Brazil), strongly support BEPS initiative and the recommendation derived therefrom. Faced with taxpayers relocating their valuable intangibles during the late 90's and the early 2000's many Latin American jurisdictions have already enacted and implemented several special regimes to prevent base erosion schemes. These include: transfer pricing rules, CFC regimes, thin capitalization standards, and in some cases, general anti-avoidance rules. In fact, during the process of enacting tax reform for year 2014, several BEPS-inspired statutes were discussed and passed through Mexican Congress (even against the OECD recommendation that clearly asked the member countries to wait for the final reports).

Australia and the United Kingdom, meanwhile, have both put in place tax legislation which is designed to tackle what UK has described as "diverted profits."

Q What's going to happen next and how uniform might implementation be?

Potential implementation of Action 1 recommendations falls across two distinct dimensions. The first dimension relates to those digital tax recommendations embedded within BEPS Action items 3, 7, 8, 9 and 10. Here, there is not yet a clear picture, and readers are directed to review the articles and insights of my colleagues on each of those Actions.

The second dimension addresses VAT measures. Here we saw many countries already move in this direction, well ahead of the recommendations of the Final Report. Many continue do adopt new VATs and we expect that number to grow in 2016.

As with all complex concepts, a final point on implementation addresses what could be described as "outliers" – those countries adopting additional measures, such as novel withholding taxes or concepts of digital permanent establishment.

Consider the view of jurisdictions like Hong Kong and Singapore. With comparatively low tax rates, the two island nations are common jurisdiction for e-commence principal companies that tend to capture a relatively bigger share of profits. Under these circumstances, both Hong Kong and Singapore would still have to pay attention to the relevant BEPS recommendations but probably from a different perspective.

Q What are the potential impacts on business?

With all this uncertainty, one thing is clear: as enterprises move towards a digital supply chain, tax directors need to be cognizant of new legislation targeting perceived abuses of common tax-operating models. An advised approach for tax directors to take is to ensure that the functions supporting IP (depending on the business) can be accurately articulated, and are supported by the people functions at the IP owner.

It is not unreasonable to expect digitally-active companies to face a gradual rise in their effective tax rate (ETR) over the short to medium term. Entities should review their current DEMPE (Design, Enhance, Market, Protect and Exploit) function models, considering whether their existing IP structures are sustainable. Businesses should assess and carefully manage the digital elements of the supply chain, ensuring it is documented and assessed from a digital tax perspective. This will probably require a deeper dive into the digital supply chain than most tax directors have hitherto undertaken. On a final note, tax departments must continue to improve their own adoption of internal digital technologies – as the more effective collection and remittance of GST and VAT is a key part of the Action 1 recommendations, and thus, potential source of tax risk.

Source:

1 EY Global Tax Alert, 'OECD issues final report on the tax challenges of the digital economy under Action 1', 23 October 2015

Recent digital tax developments

Direct tax developments

Australia
1 January 2016: new anti-avoidance measures for multinationals.

China
1 December 2014: preferential corporate income tax extended to "technology advanced service enterprises."

18 March 2015: transfer pricing rules set on outbound related party fee payments.

Colombia
1 January 2015: new wealth tax established for nonresident entities without legal presence.

European Union
2017: General Data Protection Regulation expected date of adoption.

France
February 2015: government recommends changing the definition of permanent establishment.

Greece
July 2015: proposed withholding tax on cross-border transactions withdrawn.

India
February 2015: lower corporate income tax rate proposed from 2016. Implementation of general anti-avoidance rule (GAAR) delayed.

Israel
April 2015: proposal to expand permanent establishment definition.

Italy
April 2015: new tax on the virtual presence of nonresidents considered.

Kuwait
September 2015: concept of virtual service permanent establishment introduced.

Russia
1 January 2015: new reporting requirements targeted at Russian distributors and importers.

Saudi Arabia
July 2015: concept of virtual service permanent establishment introduced.

South Korea
November 2014: patent royalties deemed not to be South Korean source income, therefore not subject to withholding taxes.

United Kingdom
April 2015: diverted profits tax comes into effect.

Indirect tax developments

Albania
1 January 2015: digital services supplied by nonresident supplier businesses to consumers (B2C) subject to VAT.

Australia
1 July 2017: consulting on potential goods and services tax (GST) registration for nonresident suppliers of digital services.

1 July 2017: proposed abolition of low-value threshold on importation of goods.

Bahamas
1 January 2015: VAT introduced at a rate of 7.5%.

Brazil
1 January 2016: sales of software in the state of San Paulo will be subject to State VAT (ICMS) on total sales price, rather than the equivalent of twice the value of the carrier medium.

Canada
2015: consulting on potential GST obligations for nonresident e-commerce businesses.

China
2015: VAT pilot expected to be extended to real estate and property, financial and insurance services, and lifestyle services.

Costa Rica
2016: plan to implement VAT to replace GST at a rate of 13% in 2016, rising to 15% in 2017.

Czech Republic
1 April 2015: domestic reverse charge extended to include mobile phones and laptops.

Egypt
2015: plan to implement VAT to replace GST announced but implementation date not confirmed.

European Union
1 January 2015: new rules on B2C place of supply for digital services introduced and Mini One-Stop Shop (MOSS) introduced for simplified VAT compliance.

Gulf Cooperation Council
9 May 2015: agreement reached to introduce VAT.

Hungary
2015: flat-rate internet tax proposed.

India
April 2016: new indirect tax regime proposed.

Iraq
1 August 2015: sales tax applied to domestic providers of mobile phone and internet plans.

Israel
2015: proposal to charge VAT on online advertising and other digital services.

Italy
2015: considering introducing "virtual permanent establishment" rules and withholding tax for digital services.

1 January 2016: 2015 budget proposes that digital newspapers and magazines will qualify for the 4% VAT reduced rate.

Japan
1 October 2015: reverse charge introduced for business to business (B2B) supplies of digital services.

Malaysia
1 April 2015: GST at rate of 6% implemented to replace existing sales and services tax.

New Zealand
2015: discussing introducing GST registration for nonresident suppliers of digital services.

Portugal
2015: excise tax on the sale of digital storage devices proposed.

Puerto Rico
1 July 2015: combined central government and municipal sales and use tax increased from 10.5% to 11.5%.

Romania
1 January 2016: the standard VAT rate will be reduced from 24% to 20%.

1 January 2017: the standard VAT rate will be reduced from 20% to 19%.

South Africa
1 June 2014: nonresident suppliers of electronic services required to register for VAT.

South Korea
1 July 2015: sales of mobile applications by nonresident suppliers subject to VAT.

Suriname
2015: VAT expected to be introduced. Implementation date postponed.

Tanzania
1 July 2015: nonresident suppliers of B2C telecoms and e-services required to register for VAT.

Thailand
2015: considering applying VAT to downloads of mobile applications.

Turkey
2015: proposing the introduction of the concept of an "electronic taxpayer" to apply income tax to nonresident suppliers of digital services.

United States
2016: Many US states and cities are considering, or adopting, measures to tax the digital economy. Examples include: Ohio discussion of "internet nexus" for sales and use tax and Chicago's introduction of an entertainment tax on digital activity.

Source: EY report, 'Global digital tax developments review', April 2016

EY
Building a better working world
Are India's states doing what it takes to *Make in India*?
Five of the top 10 states in India, ranked by the World Bank for ease of doing business in 2015, have been advised by EY on their economic reforms.
ey.com/in/makeinindia
The better the question. The better the answer. The better the world works.
© 2016 EYLLP. All Rights Reserved. ED None

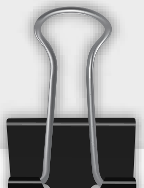
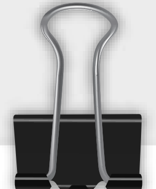
Budget strengthens the start-up ecosystem in India

The Modi Government is identifying levers to transform India, with the Make in India campaign filling last year's headlines. This year's theme has been around start-ups, recognizing India's fast gaining reputation as a start-up hub. Barely half a decade into this start up buzz, India has done well to produce half a dozen unicorns, i.e., start-ups with valuations in excess of USD1 billion.

The need of the hour really is to understand the pain-points of these feisty entrepreneurs and offer a targeted package that can make a difference. The Start-up India action plan is a step in the right direction and goes beyond tax concessions. In keeping with the promise of improving the ease of doing business in India, the action plan sets out a compliance regime based on self-certification of identified labor and other laws and the introduction of a mobile app and portal for registrations, filings for compliance, mentoring and, above all, support on funding.

As for taxes, following up on the announcement at the Start-up India event, a three year tax holiday has been introduced for "eligible start-ups." However, to be eligible for the tax holiday, start-ups need to meet certain criteria and have to procure certification from the Inter-Ministerial Board. There will, however, be no respite from the Minimum Alternate Tax (MAT), which would still apply. Given the restrictive scope of this tax holiday, and the fact that many start-ups are loss-making in their initial years, the impact of the tax holiday is likely to be limited.

GV Krishna Kumar
Tax Partner, EY India

The Budget also proposes a concessional corporate tax rate of 25% for newly set-up companies engaged in manufacturing, provided inter-alia that the companies do not claim tax holiday benefits. This concessional tax rate could be a boost for manufacturing-led start-ups that are not eligible for the start-up tax holiday.

Under the IP box regime proposed in the Budget, royalty income earned from patents developed and registered in India will attract a concessional tax rate of 10%. The Government would do well, however, to not restrict the concession to "patents" alone but to extend it to other forms of technology IP as well. Broadening the scope of the IP box regime to include other forms of IP as well would further India's start-up policy, which incentivizes new products, processes and services that are driven by any kind of technology or IP, and not necessarily patents alone.

The Budget has also proposed a 6% equalization levy inter-alia on online advertisement services provided by non-residents to Indian businesses. This is likely to adversely impact start-ups, which typically have large spends on online advertisement and other digital services. This adverse impact may especially be felt in cases where the non-resident service providers choose to pass this levy onto their Indian customers through incremental service fee levels. This levy is also likely to introduce additional compliance burden on start-ups.

The Government also increased the effective rate of service tax by 0.5% to 15%. This is likely to increase the cost of doing business for start-ups.

The industry expected the Government to either do away with or at least dilute the start-up tax, which is applicable on amounts received toward share capital in excess of the fair value of the shares. However, the Budget does not propose any change to these provisions. As earlier, start-ups will need to demonstrate that the price at which they have issued shares meets the fair value test to avoid the "start-up tax" liability.

Recognizing the key role of investors in the development of the start-up ecosystem, the Budget has proposed a set of tax incentives for them. Taxpayers can now claim tax exemption where capital gains are reinvested in the start-up focused "fund of funds" set up by the Government. The tax treatment of alternative investment funds has been further clarified, especially in the case of treaty-protected non-resident investors. This should encourage foreign investment in India-based funds. The Budget has also clarified the availability of the concessional 10% long-term capital gains tax rate on the sale of shares of privately held companies by non-residents. Extending this concessional capital gains treatment to domestic investors should bring in parity.

To bring about greater tax certainty and reduce litigation, the Budget has proposed a number of well-targeted tweaks, such as a new dispute resolution scheme and wider availability of "e-assessment." These measures should increase investor confidence.

With measures targeted at both start-ups and investors, the Budget proposals would certainly strengthen the foundation for a vibrant start-up ecosystem in India. However, as most wonder, 'can this momentum sustain?', India played it bold when it came to incentivizing the then-sunrise sector, IT services, and the results have surpassed most expectations. Can it once again take the right steps to make these unicorns world-beaters?

Start-up

Dawn of tax benefits for start-up companies

Pramod Jain
Head of Tax, Flipkart

There has been tremendous amount of curiosity and excitement around the tax package for the government's much-publicized initiative "Start-up India." The tax proposals in the Budget are a good beginning and the Government should progressively review this and extend further steps to make a greater impact. Illustratively, the following could be looked at:

1 The ceiling of INR25 crore on annual turnover in any of the five years to be eligible for the tax holiday can be counter-productive. The condition for obtaining a certificate from the Inter-Ministerial Board could, in itself, be a sufficient check against any apprehension of the Government about the scheme being misused. However, the composition of the Inter-Ministerial Board, the application form for seeking certification and the process for obtaining registration should be kept simple and timebound.

2 The present package does not offer any indirect tax benefits. Indirect tax costs are significant during the initial phase of a start-up and concessions could boost the sector. This could be made akin to Software Technology Parks (STP) scheme, under which taxes such as excise duty, customs duty and central sales tax were either exempt or reimbursed based on compliance with certain conditions.

3 The limit of INR50 lakhs for long-term capital gains tax exemption on investments in specified funds could be revisited to ensure a meaningful domestic funds flow into start-up ventures.

4 The capital gains exemption on the sale of residential house property and investment into a start-up could be extended to other assets as well. Further, the 50% shareholding condition could be diluted since most ventures are started with close friends and family members.

Did the Budget miss setting the stage for GST?

This year's Union Budget was, as per indications, expected to unveil several changes in excise and service tax as a precursor to GST, more so with the continued delay in the passage of the Constitution Amendment Bill, resulting in the delay in GST implementation. The idea was to come closer to the central GST structure from a base and rate perspective. What it unveiled, though, were changes that were selective around specific themes. In my view, this was a missed opportunity to change the central levy structure and align to the proposed GST. This would have sent a strong signal to carry on with reforms within the Government's control and set the stage for eventual transition to GST.

From an indirect tax perspective, the Budget was around three clear themes:

- Incentivizing domestic manufacturing to promote "Make in India"
- Reducing litigation and providing certainty
- Simplifying and rationalizing

Incentivizing domestic manufacturing to promote "Make in India"

The Budget announced changes across customs and excise, including the removal of identified exemptions to specified goods, increase in basic customs duty of finished goods and exemptions to specified parts. These changes were primarily to incentivize and drive domestic manufacture.

What was also clear was that in sectors such as telecom and IT hardware, the theme was to incentivize value-added manufacture. For example, the telecom sector, especially the mobile industry, saw changes in the last budget that made local manufacture more lucrative than imports because of differential duty benefits. This year, the changes were aimed more at

Overall, it is an industry-friendly budget that can act as a catalyst at this crucial juncture. With respect to indirect taxes, the proposals had a few dampeners in the form of increase in normal limitation periods coupled with another attempt on clearing the ever-confusing Rule 6 of Cenvat Credit Rules (CCR). As regards GST, one would have expected more certainty with at least a road map announcement. Revamping of deductions and phasing out holiday benefits with clear goal posts help in certainty of the tax regime.

Sridhar Raman
Vice President Taxation,
Hindustan Coca Cola Beverages Pvt. Ltd.

Harishanker Subramaniam
Partner and National Leader, Indirect Tax, EY India

value-added domestic manufacture, with an increase in the duty of several imported goods such as populated boards, battery and chargers. Even sectors such as defence saw exemptions phased out for imports to drive domestic manufacture, though this will lead to increased cost of procurement as most inputs are still imported.

These changes were also accompanied with procedural simplification, which may help in easing compliance for domestic manufacturers.

Another key proposal has been an amendment in Cenvat Credit Rules, which may enable credit distribution to an "outsourced manufacturing unit" for products that are subject to payment of excise duty under Rule 10A (job work where excise duty is paid on price of principal) and 4A (MRP valuation). These are indeed very salutary provisions and recognize the fact that "job work" and "contract manufacturing" are business models intrinsic to several sectors such as telecom, IT, consumer electronics, FMCG, retail and pharma and will go a long way in incentivizing competitive domestic manufacture.

Yes, the proposed rules will require some attendant changes to avoid any ambiguity, and I am sure the Government will make those changes to further the laudable initiative of incentivizing domestic manufacture.

The Budget sought to avoid a rate increase in service tax, which was widely expected, but instead chose to levy a new Krishi Kalyan Cess of 0.5% on all taxable services effective 1 June 2016. This cess is proposed to be creditable with a one-on-one nexus and hence will be a pass through for service providers; however, for manufacturers, it will be a cost in the absence of any output services. This could be deterrent to the "Make in India" campaign.

Overall, the theme was strongly toward the "Make in India" policy thrust. These are welcome moves and over time will encourage an ecosystem for sustained domestic manufacture in these sectors.

Reducing litigation and providing certainty, rationality and simplicity

The increasing quantum of litigation and the inordinate time taken to deal with them have been serious concerns for the revenue authorities. Equally important for the Government was to create an environment of tax certainty that would help the overall objective of reducing litigation and helping in the ease of doing business.

The previous year saw the concept of mandatory deposits for central levies at various appellate levels for automatic stay to do away with stay proceedings, allowing appellate authorities to focus more on merit hearings.

This Budget announced several proposals in continuance of this objective of reduced litigation, the most important one being the Indirect Tax Dispute Resolution Scheme 2016 at the first appellate level of Commissioner Appeals. In case of indirect tax, what is important to remember is that at the level of Commissioner Appeals, the power of adjudication is INR5 million; therefore, cases where the taxes and duties are up to this value can seek dispute resolution under the scheme.

The idea of this scheme being applicable at the first appellate level could be to resolve the volume of smaller cases to avoid protracted litigation. This scheme has prima facie not found much traction within the industry. Lower penalties could have made this more attractive as similar provisions are within the law even today. Also, unlike in the case of direct tax the threshold in case of indirect tax is INR5 million, so one wonders whether there is a case for tweaking this threshold for wider traction. Nonetheless, this is a window for the industry to explore depending on the merits of cases.

The proposal to create additional benches of the Customs Excise and Service Tax Appellate Tribunal (CESTAT) is a move in the right direction, though the effective implementation by creating a quorum for quick functioning of benches is paramount for its success. Also, the reduction in interest rate to 15% from 18% on delayed duty/taxes – except in cases where such duties/taxes are collected and not deposited, where the rate of interest will be 24% – was a very welcome move.

Budget sought to avoid a rate increase in service tax but instead chose to levy a new

Krishi Kalyan Cess of 0.5%

on all taxable services effective 1 June 2016.

The Cenvat Credit Rules also saw rationalization with several salutary changes that may provide the necessary clarity and certainty and avoid unnecessary litigation. An example is the changes in methodology for Cenvat credits for dealing with exempt and taxable supplies, which was really welcome and may have a positive impact on several sectors.

There could have been an attempt to further improve the credit chain, but revenue considerations would have held back these moves. Let us hope that these reflect in GST.

The Budget brought several other changes — for example, the "Infrastructure Cess" on motor vehicles ranging from nil to 4% depending on the category, size and engine capacity of the vehicle. This will have some impact on the automobile industry, increasing price and affecting demand.

The Budget also seeks to expand the scope of services to include the right to use radio frequency spectrum and its subsequent transfer as a declared service. By classifying it as a declared service, I wonder what the states' view will be in such transactions. What accompanied this change was an amendment in Cenvat credit that pro-rated credits in case of first assignment of spectrum and other natural resources over the period of assignment, which is a concern for the industry. This would significantly reduce the quantum of credit availability for the industry, for example, in case of telecom, which needs some serious re-thinking. Another change that was surprising was the levy of service tax on inbound freight, which already attracts customs duty under customs valuation. This equally needs a rethink as it will impact domestic freight industry.

Overall, the Budget was workmanlike, with several good measures that promote the stated objectives of the Government.

Continuing simplification and rationalization of federal indirect taxes was the prime focus in the proposals presented in Budget 2016. The key objective was enhancing the ease of doing business in India. This was coupled with pruning of tax concessions, while extending tax coverage to some sectors, namely, branded garments and jewellery, perhaps as a precursor to GST. The emphasis on procedural simplification was unmistakable and was welcomed by the industry.

A lame attempt to reduce humungous levels of litigation (pending at first appellate level) was done by way of introducing an Indirect Tax Dispute Resolution Scheme. The scheme requires payment of interest, and a 25% penalty as a reward for waiving prosecution. This significant monetary detriment militates against the efficacy of the scheme to meet its intended objective.

Conspicuous was the absence of any announcement of a time for the introduction of GST — indeed a bitter disappointment to the industry, which continues to see GST as a panacea to the convoluted indirect tax structure that it suffers in India.

Atul Gupta
Indirect Tax Leader, GE India

Make in India

Key achievements

FDI

- FDI inflows have increased by 37%, for the period October 2014-February 2016, after the launch of ‘Make in India’

- Diesel and electric locomotive manufacturing facility to be set up by GE and Alstom in a joint venture with Indian Railways; orders worth US$20b to be supplied to the Indian Railways
- India’s first bullet train project approved with a funding arrangement of over US$15b, with the Government of Japan agreeing to fund 81% of the total project cost
- Metro rail planned in 36 cities, which will encourage domestic production of coaches, signaling equipment, track etc; investment potential of approximately US$15b
- Highest level of motor vehicle production in 2015
- Financial assistance of 20% for ships built in India
- The National Waterways Bill introduced to build a strong network of inland transportation to provide logistic support for industries at reduced cost of transportation

Electronics

- Electronic manufacturing grown sixfold
- Fifty handset makers setting up manufacturing facilities in India

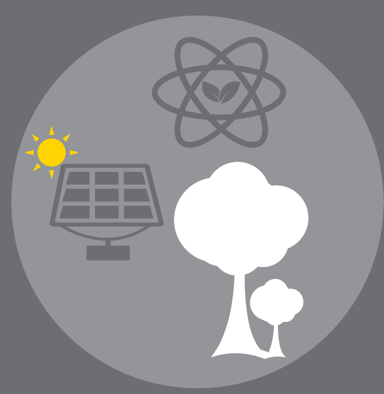
Make in India

Key achievements

Defence

- The Defense Procurement Policy (DPP) 2016 introduced a new category for indigenously designed, developed and manufactured products, which will be given the highest preference; planned expenditure of US$50b for defense procurement by 2019

Natural resource enhanced



- Transparent allotment of natural resources led to the highest ever coal production in 2015
- Incentivised policy for offshore wind assets to encourage green energy production in deep sea
- Simplified policy for the development and exploitation of oil and gas assets to encourage fresh investments to the tune of US$20b
- Centralized procurement of energy-efficient lights (LED), energy meters and energy-efficient appliances manufactured in India under the Ujwal Discom Assurance Yojna (UDAY)
- Tightened emission norms for thermal power producers present a US$20b opportunity for the capital equipment sector

Import duties

- Rationalization of duty structure to encourage manufacturing in India by way of incentivizing the import duties on components and disincentivizing import of finished products

Make in India

Viewpoints

The Government has rightly selected the Make in India program as a key initiative to transform the Indian economy. The benefits from the program are likely to be many and can address issues related to economic growth, employment generation and fuelling consumer demand.

Semiconductors/electronic goods have the second-largest share in global trade, behind oil and oil products. India is a large importer of these products currently, and to reduce dependence on imports, the Government has taken policy initiatives to attract investments in the manufacturing, assembly and component industry. Similarly, giving the highest priority to domestically designed and produced equipment for defence procurement under the new defence procurement policy will give a boost to local manufacturing. Budgeted government spending on infrastructure, inland waterways, railways, metro lines etc. has also caught the attention of global players in the respective fields, and the potential business will drive entrepreneurs to consider setting up a deeper manufacturing presence in India.

There is healthy competition among States to improve the ease-of-doing-business score and streamline policies and regulations toward self-certification to reduce red tape and delays. Logistics and transportation costs in India are significantly higher than those in neighbouring countries. Encouraging the use of inland waterways, improving port efficiencies and reducing turnaround time at ports would help in making products made in India competitive.

In addition, the cost of capital is an important component of manufacturing costs and there is a tough task ahead for the Reserve Bank of India to enable reduction in credit costs. Make in India can succeed only if India is able to builds capabilities to manufacture world-class products at competitive prices.

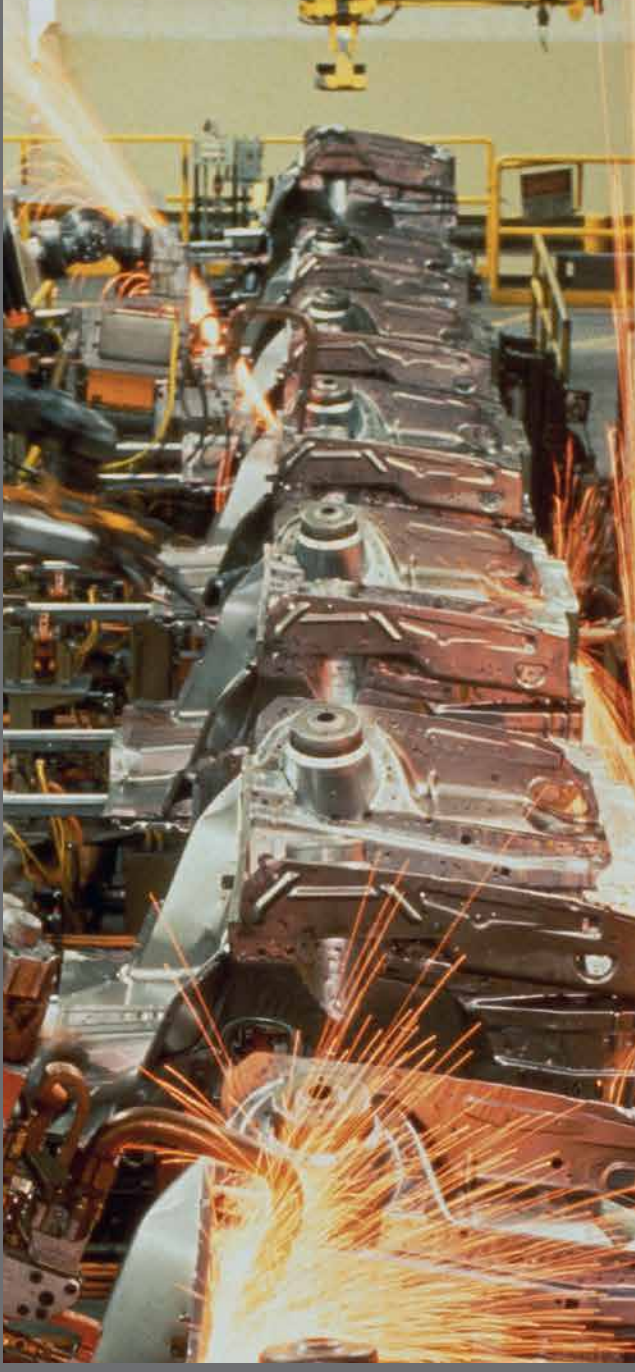
Keval Doshi
Partner,
Tax and Regulatory Services,
EY India

As an impetus to Make in India, duty rates were restructured to incentivize domestic value addition across various sectors such as IT hardware, wind energy, defence, chemicals and petrochemicals. No significant additional tax burden on any sector, other than on the usual suspects – tobacco products, aerated waters and luxury vehicles.

Atul Gupta
Indirect Tax Leader, GE India

The industry expectations were suitably addressed in the Budget, which focussed on the Make in India initiative. As regards to indirect taxes, the integration of contract packing service tax credits, and in direct taxes, legislation regarding the tax regime on patents when located in India, are all triggers toward Make in India.

Sridhar Raman
Vice President Taxation, Hindustan Coca Cola Beverages Pvt. Ltd.



The automobile industry has a large role to play in converting the Make in India project into a successful one and making it a pillar of growth than a political gimmick. On the positive side, initiatives taken for the improvement of infrastructure — railways, roads and ports — will go a long way in creating the desired growth in automobile manufacturing. Automotive exports have been increasing steadily and generating the desired Forex reserves. The Skill India initiative too, although in a nascent stage, stands to help the automobile industry to attract the right talent.

On the other hand though, there are also challenges faced by the automobile industry. All automobile manufacturers are competing with their fellow subsidiaries for export market share. Continual increase in input costs renders us at a disadvantage commercially and globally. For instance, steel is a major raw material for the automobile industry and the customs duty on steel has been increased twice over the last one year along with the imposition of safeguard and anti-dumping duties. This increases costs and makes India less competitive in the global markets. Reforms are also required at the customs for prompt clearance of goods, which is currently an expensive, cumbersome and time-consuming process.

The export incentives to automobiles have been also reduced by 50%, which makes us uncompetitive in other markets because of the high logistics costs. For instance, in the case of Mexico, which is one of the largest importers of India-made vehicles, the export incentives in the form of Merchandise Exports from India Scheme (MEIS) are not sufficient to meet the additional costs of exporting the vehicles.

The tax reforms are eagerly looked forward to in the form of GST, and if the Government can take care of the tariff barriers, free movement of goods, adequate compensation for logistics costs in the form of export incentives, commitment to infrastructure development and successful execution of the Skill India initiative, the automobile industry is going to surely get the Make in India lion roar.

Puneet Sabharwal
Chief General Manager,
Accounting & Taxation,
Volkswagen India Pvt. Ltd.

Source:

1 'PM Narendra Modi's 'Make in India' pushed FDI higher by 37%: Govt', Businesstoday.in, 27 April 2016
2 'Indian Railways signs $6bn contracts with GE and Alstom for 1,800 locomotives', Railway-technology.com, 1 December 2015
3 '50 cities to get metro rails for Rs 500,000cr', Metrorailnews.in
4 'India's great Metro-Rail opportunity', Business-standard.com, 20 January 2015
5 'Automobile Production Trends', SIAM data
6 'India got 50 new mobile phone factories in last 10 months: DeitY', Business-standard.com, 3 February 2016
7 'Local shipbuilders to get back subsidy they lost eight years ago', Livemint.com, 1 September 2015
8 'Make in India: Shipyard industry gets infrastructure status, move expected to bring down costs', Economictimes.com, 15 January 2016
9 'India Announces $600 Million Shipyard Subsidy', Maritime-executive.com, 12 October 2015

Country by country (CbC) reporting: *A new paradigm*

Vijay Iyer
Partner and National Leader, Transfer Pricing, EY India

In October 2015, the Organisation for Economic Cooperation and Development (OECD) rolled out the final reports on Base Erosion and Profit Shifting (BEPS). This marked the culmination of about three years of intensive deliberations involving the OECD member countries and some other members of the G20. That the OECD succeeded in getting more than 40 countries to agree to a set of minimum standards in the various BEPS action items was a huge achievement. Most people were sceptical about the ability of OECD and the G20 to come to a consensus on such complex issues. India has been an active member in the BEPS deliberations and has contributed significantly to the evolution of the global tax philosophy. One of the significant achievements of the BEPS initiative is the consensus on greater transparency regarding global supply chain profits for transfer pricing risk assessment by tax authorities. Action 13 – pertaining to revised standards of transfer pricing documentation – proposes to significantly enhance the level of transparency in transfer pricing compliance. This includes a template for the CbC reporting of income, taxes paid and certain measures of economic activity, which has been agreed as a "minimum standard."

The Indian tax authorities have always canvassed for disclosure of global supply chain profits to assess the reasonableness of cross-border inter-company transaction prices. India has been a strong supporter of the "transparency" agenda in BEPS and hence has been in the forefront of the implementation of the conclusions of the OECD report on Action 13. India's Finance Minister, in the Union Budget 2016, has proposed the introduction of additional documentation requirements in line with the recommendations of the OECD. According to the proposed amendment, an international group with its ultimate parent resident in India is required to file a CbC report in the prescribed format prior to the due date of filing tax returns. This amendment, effective from 1 April 2016, and data pertaining to financial year 2016-17 would need to be filed before the due date of filing tax returns in India. In case of an international group that has its ultimate parent resident outside

CbC report would apply for international groups whose revenue exceeds threshold of **EUR750 mn** (approx. INR54 bn)

non-compliance with CbC reporting would attract penalties ranging from **INR 5k - 50k**

India, an Indian entity that is a member of the group would need to comply with the requirement of filing a CbC report in India in the following situations:

- The international group has not nominated an alternate reporting entity for purpose of CbC reporting on behalf of the group.
- The ultimate parent of the group or, as the case may be, an alternate reporting entity is resident in a country with which India does not have an agreement for exchange of CbC reports.
- Unless the Indian entity of the international group has itself been nominated by the group to be the alternate reporting entity for filing a CbC report on behalf of the group, the Indian entity would have an obligation to merely notify the Indian tax authority on the details of the parent entity or alternate parent entity, if any, for the international group and the country of residence of the parent/alternate reporting entity. The CbC report would apply for international groups whose consolidated revenue exceeds a prescribed threshold – expected to be EUR750 mn (approx INR54 bn).

There are penalties prescribed for non-compliance with CbC reporting. In case of failure to file the CbC report within the prescribed date, penalties could range from INR5,000 per day to INR50,000 per day. Filing inaccurate particulars in the CbC report could result in a penalty of INR500,000.

Apart from CbC reports, the Budget also proposes additional documentation requirements – namely, Master File documentation as recommended in BEPS Action 13 – for international groups, which would be prescribed in the rules subsequent to the enactment of the Budget tax proposals. This Master File, which would need to be prepared in addition to the local documentation, has the following features as per Action 13 Final Report:

- It has a global scope and may provide a global overview.
- A description of the supply chain for the group's largest products and service offerings will have to be included.
- Important transactions with respect to intangibles, financial transactions and business restructurings must be listed.
- It should contain a list and brief description of the group's existing unilateral advance pricing agreements and other tax rulings relating to the allocation of income among countries.

These differences will require companies to review their existing documentation and their process for preparing the documentation. The Master File may need to be prepared at the central level by the group to ensure consistency. It should also be made available to the group entities in other countries. In case of groups that are headquartered outside India, the Indian company should proactively procure the Master File in order to comply with the documentation requirements that may be introduced soon. Introduction of the relevant rules will bring about more clarity on the Master File and the documentation requirements.

It is evident that there is a big push toward greater transparency and information exchange, and this may increase the compliance burden of taxpayers. It may also increase the amount of data and information available with the tax authorities for their risk assessment. It is likely that tax audits would get more detailed and take more management time. Taxpayers would need to prepare for this change by planning their strategies in advance and creating bandwidth to deal with more intensive questions and information requests from the tax authorities.

Global news

31 countries sign the Multilateral Competent Authority Agreement (MCAA) for the automatic exchange of country-by-country (CbC) reporting information[1]

On 27 January 2016, 31 countries[2] signed the MCAA for the automatic exchange of CbC reports. This development marked a key milestone in the implementation of the G20/ Organisation for Economic Co-operation and Development (OECD) Base Erosion and Profit Shifting (BEPS) Project and heralds a significant increase in cross-border cooperation and information exchange in relation to tax matters. In addition to the 31 jurisdictions that signed the MCAA, more are expected to do so in due course.

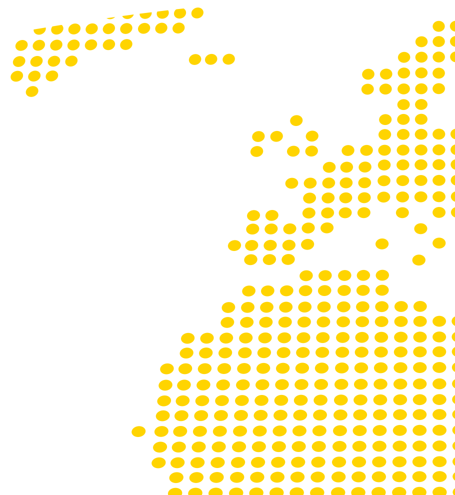
The following are the key features of the MCAA:

- The MCAA sets out the parameters for the automatic exchange of CbC reports among jurisdictions, ensuring that those jurisdictions that have passed (or plan to pass) legislation requiring MNEs to file CbC reports have a clearly defined, mutually agreed set of protocols governing such exchanges. It avoids the need for several bilateral agreements to be concluded.
- Confidentiality of data: All information exchanged under the MCAA is subject to the confidentiality rules and other safeguards provided for in the OECD Convention on Mutual Administrative Assistance in Tax Matters, including the provisions limiting the use of the information exchanged.
- Usage of data: Information in CbC reports will be used for assessing high-level transfer pricing and BEPS-related risks and not used as a substitute for a detailed transfer pricing analysis of individual transactions. There is no prohibition on using the information for making further inquiries into the MNE group's transfer pricing arrangements or into other tax matters in the course of a tax audit and, as a result, appropriate adjustments to the taxable income of a constituent entity may be made.
- Collaboration on compliance: Competent authorities (CAs) will collaborate to notify each other of any error that may have led to incorrect or incomplete information reporting or if there is a non-compliance in reporting. The notified CA will take appropriate measures available under the domestic law to address the errors or non-compliance described in the notice. If further inquiries lead to undesirable economic outcomes, the CAs of the jurisdictions of the reporting taxpayer's residence should consult each other and discuss with the aim of resolving the case.
- The MCAA also provides for various other aspects such as terms of agreement, amendment of the MCAA and the date of coming into effect.

The US Treasury Department (Treasury) releases a revised US Model Income Tax Convention[3]

On 17 February 2016, the Treasury released a revised US Model Income Tax Convention (the 2016 Model Treaty), which is the baseline text the Treasury uses in negotiating tax treaties. It was last updated in 2006.

The 2016 Model Treaty is not currently accompanied by a technical explanation, but it is planned to be released later in 2016, as stated in its preamble. Some



of the significant changes included in the 2016 Model Treaty are as follows:

- **Modifications to the Limitation of Benefit (LOB) article:** The 2016 Model Treaty introduces new provisions and changes into the LOB article that would tighten pre-existing LOB tests. In general, the 2016 Model Treaty requires that, in order to be entitled to treaty benefits, the resident must be a "qualified person," within the meaning of that paragraph, at the time when treaty benefits are claimed. The definition of a "qualified person" includes a so-called ownership base erosion test and a derivative-benefits test during a particular period.
- **Subsequent changes in law:** The 2016 Model Treaty includes a new article entitled "subsequent changes in law" (Article 28), which enables either the US or its treaty partner to cease granting treaty benefits in certain circumstances when changes to domestic tax laws are enacted after the treaty has been signed.
- **Preamble to the 2016 Model Treaty:** The preamble to the US Model Treaty includes a notable change that incorporates recommendations from the work on Action 6 (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances) of the OECD BEPS Project. In particular, the change incorporates explicit language to clarify that, in entering into a tax treaty, the treaty partners intend to eliminate double taxation with respect to taxes on income without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance.
- **Triangular provision:** Under the updated triangular provision, treaty benefits would be denied when a resident of a Contracting State earns income from the other Contracting State through a permanent establishment (PE) situated outside of the Contracting State of residence, and the resident is subject to a significantly lower tax rate on the income attributable to the PE.
- **Special tax regime (STR):** The 2016 Model Treaty includes a definition of STR, which, in conjunction with changes made to Articles 11 (Interest), 12 (Royalties) and 21 (Other Income), operates to deny benefits under the treaty for certain items of income when the resident benefits from an STR with respect to a particular related-party interest payment, royalty payment or guarantee fee that is within the scope of Article 21 (Other Income).
- **Permanent establishment:** The 2016 Model Treaty does not adopt the recommendations made under Action 5 of the OECD BEPS Project relating to defining a PE except for Article 5(3). Article 5(3) is modified to include a rule intended to protect against splitting up contracts in order to come within the 12-month exception relating to building, construction or installation projects.
- **Article 7 (Business Profits):** This article has been amended to include a new provision that reduces the potential for double taxation when one Contracting State adjusts the profits attributable to a PE in the other Contracting State. In this event, the other Contracting State must also adjust the taxable income of the PE to the extent that it agrees with the adjustment. To the extent that the other Contracting State does not agree with the adjustment, the two Contracting States must resolve the issue through mutual agreement.

Saudi Arabia (SA) clarifies on "virtual" service PE concept

The Government of SA recently issued an official letter (the Letter) clarifying on when a non-resident service provider is considered as having established a service PE in SA[4]. The Letter follows internal guidelines issued by the SA tax authorities last year[5], introducing the concept of a "virtual service PE" that takes into account only the duration of the contract rather than the actual activities (or physical presence) of the service provider in SA. The Letter now formally communicates the position of the SA tax authorities for the first time.

Service PE in majority of the tax treaties entered by SA is based on the provision of the United Nations Model Convention 2011 (UN MC). The Letter clarifies that:

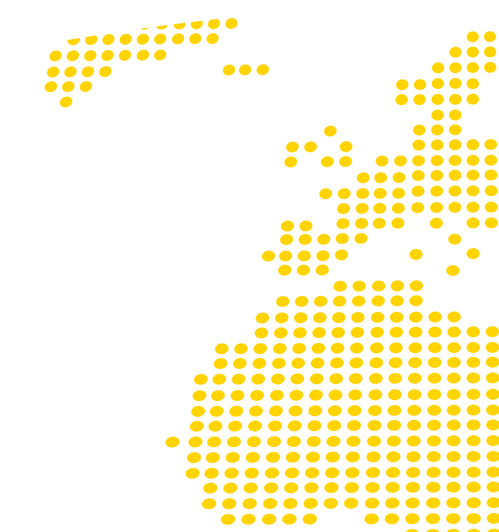
- A Service PE arises if the period of provision of services to a customer in SA lasts for 183 days or more in a calendar year or a 12-month period. The activity and the profits from the contract then become taxable in SA, subject to all related tax filing requirements.
- In most cases, the conduct of cross-border services does not require physical presence of the service provider in SA, as the services can be largely performed remotely. This also indicates that the traditional "service PE" concept as stated in the UN MC may have become obsolete.
- The tax authorities in SA believe that the service PE provision does not require any physical presence as a criterion for establishing a PE in SA with respect to the provision of cross-border services.
- For evaluating the creation of service PE, it is the duration (continuation) of the provision of services "inside SA" that should be the triggering factor for a PE of a non-resident service provider.

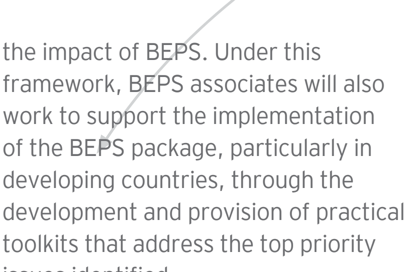
Interestingly, the Letter acknowledges the ongoing discussions within the UN on the issue. As per the latest UN consultation paper, the traditional interpretation of the current service PE provision requires the physical presence of the service provider in the source state. It also suggests that countries that believe that no physical presence is required for a service PE to emerge, should clarify this diverging interpretation by way of a publically available international law instrument.

OECD establishes a new forum for interested countries for BEPS implementation[6]

In 2015, OECD issued the final reports on 15 BEPS Actions. The OECD and G20 countries are committed to work toward and monitor the implementation of the BEPS Actions by assessing compliance with the agreed minimum standards. On 23 February 2016, the OECD agreed to a new framework that would allow all interested countries and jurisdictions to join in efforts to update international tax rules. According to the OECD, the framework establishes a new forum that allows all interested countries and jurisdictions to participate as BEPS associates. As BEPS associates, they would participate on an equal footing with the OECD and G20 members on the remaining standard-setting under the BEPS Project, as well as the review and monitoring of the implementation of the BEPS package.

The framework's mandate will focus on the review of the implementation of the four BEPS minimum standards, in the areas of harmful tax practices, tax treaty abuse, CbC reporting requirements for transfer pricing, and improvements in cross-border tax dispute resolution. It will also ensure ongoing data gathering on the tax challenges in the digital economy and measurement of





the impact of BEPS. Under this framework, BEPS associates will also work to support the implementation of the BEPS package, particularly in developing countries, through the development and provision of practical toolkits that address the top priority issues identified.

This agreed framework constitutes an important step toward the implementation of the BEPS package around the world in the coming years, as well as for the review and monitoring of such implementation.

New Italian decree for claiming foreign tax credit

The Italian government recently published a decree that impacts how it applies foreign tax credits for Italian resident individuals with income from other countries[7].

Prior to the issue of this decree, in order to claim this credit, it was a requirement that the foreign tax be considered as definitively paid in the other country by the Italian tax return filing deadline. Such a credit for taxes was also based on a double tax treaty.

This decree has increased the scope of claiming foreign tax credit for Italian resident individuals. In particular, the decree provides for the following:

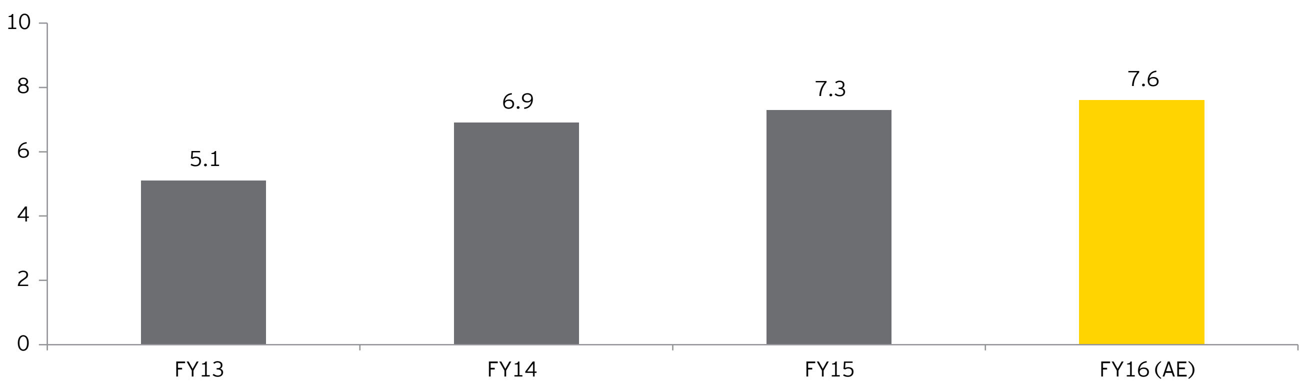
- The immediate recognition of the credit in the tax return related to the year in which the foreign income is subject to tax in Italy, even if the foreign taxes will only become definitive within the deadline for the following year's tax return
- The ability to claim foreign tax credit on income taxes that are not expressively listed in Italy's double tax treaties: For this purpose, taxpayers are entitled to apply for a ruling in order to ascertain whether certain taxes paid abroad may be recovered in Italy, such as local taxes
- The possibility to carry back or forward any excess foreign tax credit not used to offset Italian taxes for up to eight years: This credit should be used to relieve Italian taxes exceeding the foreign tax credit from the previous eight years of Italian tax returns or for the next eight years.

Source:

1. EY Global Alert- Thirty-one countries sign tax cooperation agreement enabling automatic sharing of country-by-country reporting information dated 28 Jan 2016
2. Australia, Austria, Belgium, Chile, Costa Rica, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Japan, Liechtenstein, Luxembourg, Malaysia, Mexico, Netherlands, Nigeria, Norway, Poland, Portugal, Slovak Republic, Slovenia, South Africa, Spain, Sweden, Switzerland and United Kingdom.
3. EY Global alert- US Treasury Department releases 2016 US Model Treaty including new provisions to combat base erosion and profit shifting dated 26 February 2016
4. EY Global Alert on 'Saudi Arabian Government clarifies Service PE concept' dated 16 February 2016
5. Refer EY Global Alert on 'Saudi Arabian tax authorities introduce Virtual Service PE concept' dated 30 July 2015
6. EY Global tax alert- OECD releases plan to establish inclusive framework for BEPS implementation dated 24 February 2016
7. EY HR and tax alert- Italy publishes decree easing rules on claiming foreign tax credits dated 11 February 2016

EconoMeter

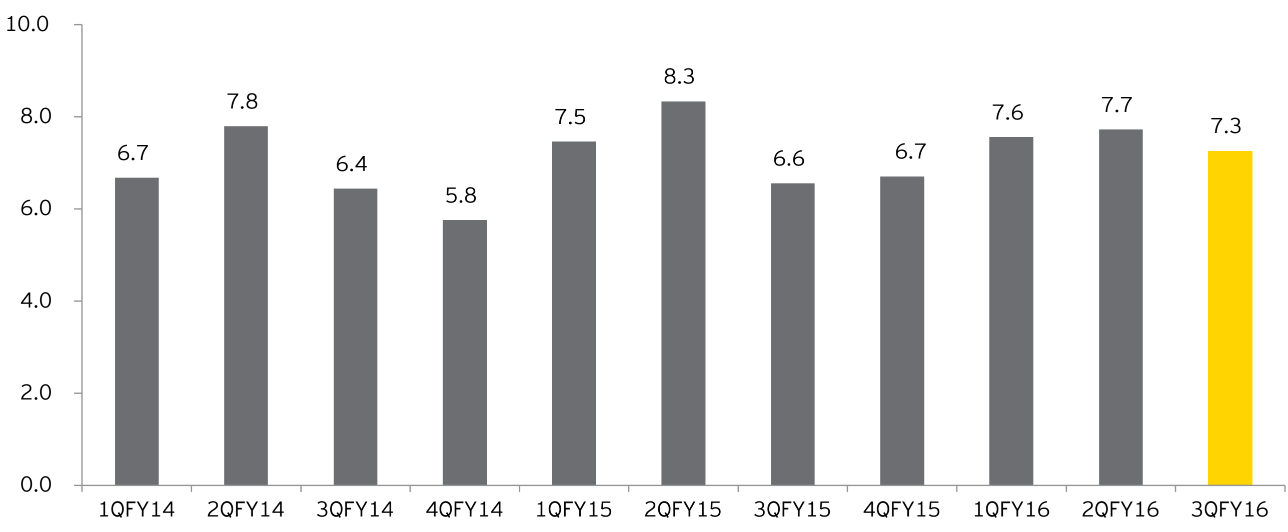
Exhibit 1: Economic growth (gross domestic product at market prices [GDPMP]), 2011-12 prices



Source: CSO, Ministry of Statistics and Plan Implementation, Government of India and Union Budget FY16
AE: advance estimates

According to the AE of National Accounts, India's real GDP growth was 7.6% in FY16 as compared to 7.3% in FY15. The Economic Survey 2015-16, while forecasting a 7%-7.75% GDP growth for FY17, also warned about the downside risks to growth from a weak global growth outlook.

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



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

India's real GDP (2011-12 prices) growth moderated to 7.3% (y-o-y) during 3QFY16 compared to 7.7% in 2QFY16, led by a fall in domestic investment and sustained weakness in external demand.

Exhibit 3: Growth in components of aggregate demand with 2011-12 as base (% y-o-y)

	Private final consumption expenditure	Government final consumption expenditure	Gross fixed capital formation	Exports	Imports	GDP at market prices
FY14	6.8	0.4	3.40	7.8	-8.2	6.6
FY15	6.2	12.8	4.85	1.7	0.8	7.2
FY16 (AE)	7.6	3.3	5.26	-6.3	-6.3	7.6
1QFY15	8.2	9.0	8.3	11.6	-0.6	7.5
2QFY15	9.2	15.4	2.2	1.1	4.6	8.3
3QFY15	1.5	33.2	3.7	2.0	5.7	6.6
4QFY15	6.6	-3.3	5.4	-6.3	-6.1	6.7
1QFY16	6.4	1.0	5.2	-5.8	-5.0	7.6
2QFY16	5.6	4.3	7.6	-4.3	-3.4	7.7
3QFY16	6.4	4.7	2.8	-9.4	-10.8	7.3

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

Growth in private final consumption expenditure (PFCE), the key driver of domestic demand, improved to 6.4% (y-o y) in 3QFY16, while growth in investment fell to 2.8%. Weighed by sluggish global demand, India's exports growth continued to contract for the fourth straight quarter at (-) 9.4% y-o-y in 3QFY16.

Exhibit 4: Sectoral output growth at 2011-12 prices (% y-o-y)

	FY14	FY15	FY16 (AE)	FY15 3Q	FY15 4Q	FY16 1Q	FY16 2Q	FY16 3Q
Agriculture and allied activities	4.2	-0.2	1.1	-2.4	-1.7	1.6	2.0	-1.0
Industry	5.0	5.9	7.3	3.8	5.7	6.8	6.4	9.0
Mining and quarrying	3.0	10.8	6.9	9.1	10.1	8.6	5.0	6.5
Manufacturing	5.6	5.5	9.5	1.7	6.6	7.3	9.0	12.6
Electricity, gas and water supply*	4.7	8.0	5.9	8.8	4.4	4.0	7.5	6.0
Construction	4.6	4.4	3.7	4.9	2.6	6.0	1.2	4.0
Services	7.8	10.3	9.2	12.9	9.3	9.0	9.4	9.4
Trade, transport and communications**	7.8	9.8	9.5	6.2	13.1	10.5	8.1	10.1
Finance, insurance, real estate and professional services	10.1	10.6	10.3	12.1	9.0	9.3	11.6	9.9
Public administration and defense	4.5	10.7	6.9	25.3	4.1	6.1	7.1	7.5
Total Gross Value Added (GVA) at basic prices	6.3	7.1	7.3	6.7	6.2	7.2	7.5	7.1

Source: CSO, MOSPI, Economic Survey 2014-15
*Includes other utility services
** Includes repair, hotels and restaurants, and storage services

According to AE, real gross value added (GVA) grew by 7.3% in FY16 as compared to 7.1% in FY15. This growth was driven by improvement in the growth of the industrial sector, which increased to 7.3% in FY16 from 5.9% in FY15. Real GVA at basic prices grew by 7.1% during 3QFY16, moderating from 7.5% in 2QFY16.

Exhibit 5: Inflation based on consumer price index (new series): combined index for rural and urban areas (% change over corresponding month of the previous year)

	General	Food beverage	Pan, tobacco and intoxicants	Clothing, bedding and footwear	Housing	Fuel and lighting	Miscellaneous
FY13	10.3	11.7	11.1	11.1	11.0	8.5	7.6
FY14	10.0	11.4	9.5	9.6	11.6	7.3	7.3
FY15	5.9	6.5	8.1	7.3	6.9	4.2	4.6
Feb 2015	5.4	6.8	9.2	6.4	5.0	4.7	2.9
Mar 2015	5.2	6.2	9.2	6.3	4.8	5.1	3.0
Apr 2015	4.9	5.4	9.4	6.1	4.7	5.5	3.2
May 2015	5.0	5.1	9.5	6.1	4.6	6.0	3.8
Jun 2015	5.4	5.7	9.7	6.3	4.5	5.8	4.2
Jul 2015	3.8	2.9	9.8	5.9	4.4	5.4	3.4
Aug 2015	3.7	2.9	9.4	5.9	4.7	5.8	3.1
Sep 2015	4.4	4.3	9.3	5.9	4.7	5.3	3.3
Oct 2015	5.0	5.3	9.5	5.6	4.9	5.3	3.5
Nov 2015	5.4	6.1	9.5	5.8	5.0	5.3	3.8
Dec 2015	5.6	6.3	9.3	5.7	5.1	5.4	4.0
Jan 2016	5.7	6.7	9.0	5.7	5.2	5.3	3.9
Feb 2016	5.2	5.5	8.3	5.5	5.3	4.6	4.4

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

Consumer price index (CPI)-based inflation declined to 5.2% (y-o-y) in February 2016 from 5.7% in January 2016 with a sharp decline in inflation from major non-core categories such as food and beverages, fuel and lighting.

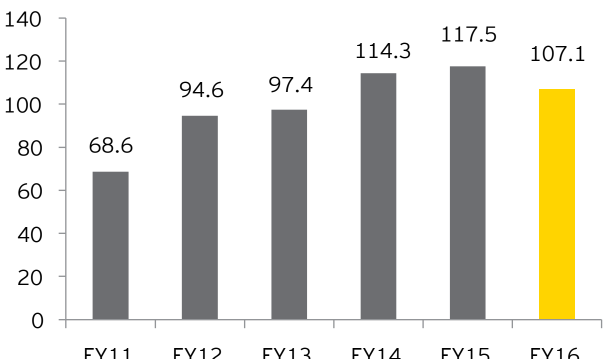
Exhibit 6: Growth in Index of Industrial Production (major industries) (% change over corresponding month of the previous year)

	General Index	Mining	Manufacturing	Electricity
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
FY15	2.8	1.4	2.3	8.4
Jan 2015	2.8	-1.8	3.4	3.3
Feb 2015	4.8	1.6	5.1	5.9
Mar 2015	2.5	1.2	2.7	2.0
Apr 2015	3.0	-0.6	3.9	-0.5
May 2015	2.5	2.1	2.1	6.0
Jun 2015	4.2	-0.4	5.2	1.2
Jul 2015	4.3	1.3	4.8	3.5
Aug 2015	6.3	4.5	6.6	5.6
Sep 2015	3.7	3.5	2.7	11.4
Oct 2015	9.9	5.3	10.6	9.0
Nov 2015	-3.4	1.9	-4.7	0.7
Dec 2015	-1.2	2.7	-2.2	3.2
Jan 2016	-1.5	1.2	-2.8	6.6

Source: Office of Economic Advisor, Government of India

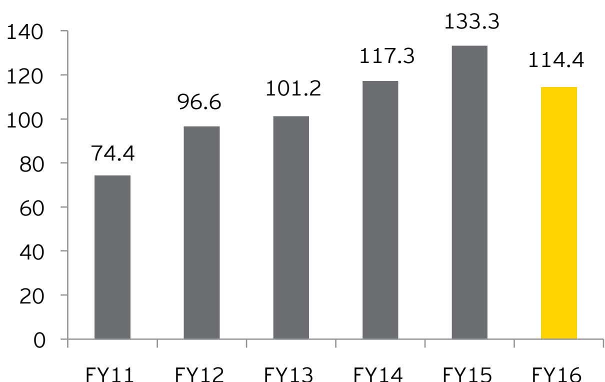
Industrial production, as measured by the Index of Industrial Production (IIP), contracted for the third straight month in January 2016 by (-) 1.5% y-o-y as compared to (-) 1.2% in December 2015. This was mainly due to the decline in manufacturing sector growth which was (-) 2.8% in January 2016 and (-) 2.2% in December 2015.

Exhibit 7: Cumulated fiscal deficit up to February 2016 as % of annual revised target for FY2016



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

Exhibit 8: Cumulated revenue deficit up to February 2016 as % of annual revised target for FY2016



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

Cumulated revenue deficit rose to 114.4% while cumulated fiscal deficit reached 107.1% of the annual revised target in the first 11 months of FY16. The Union Budget FY17 was presented on 29 February 2016. While the Government looks set to meet this year's fiscal deficit target of 3.9%, achieving the 3.5% fiscal deficit target for FY17 would be a challenge due to under-provisions with respect to subsidies, pay and allowances, and pensions.

Exhibit 9: Major heads of Central Government revenue (INR billion)

Revenue heads	FY15 (actuals)	FY16 (RE)	FY17 (BE)	% change in FY16 RE over FY15 actuals	% change in FY17 BE over FY16 RE
Gross revenue receipts	14,427	16,712	17,182	15.8	2.8
Tax revenue (including states' share)	12,449	14,596	16,309	17.2	11.7
Corporation tax	4,289	4,530	4,939	5.6	9.0
Taxes on income	2,657	2,991	3,532	12.5	18.1
Customs	1,880	2,095	2,300	11.4	9.8
Union excise duties	1,900	2,841	3,187	49.6	12.2
Service tax	1,680	2,100	2,310	25.0	10.0
Non-tax revenue	1,979	2,586	3,229	30.7	24.9

Source: Union Budget, Controller General of Accounts
RE: revised estimates, BE: budget estimates

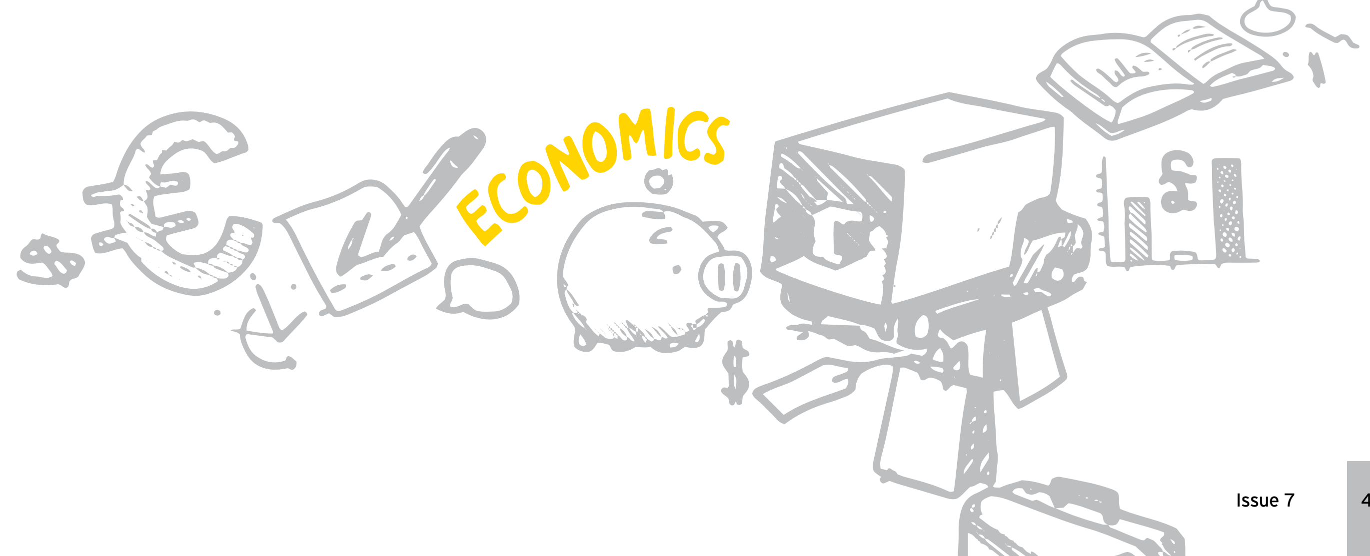
Central tax revenues grew at a much higher rate primarily due to higher collections from excise duty and service tax. Keeping up this growth momentum in indirect tax revenue would be a challenge in FY17. A much lower growth rate of 2.8% is targeted for gross revenue receipts in FY17.

Exhibit 10: Major heads of Central Government expenditure (INR billion, %)

Expenditure heads	FY15	FY16 (RE)	FY16 (BE)	% change in FY16 RE over FY15 actuals	% change in FY17 BE over FY16 RE
Total expenditure	**16,637**	**17,854**	**19,781**	7.3	10.8
Revenue	**14,670**	**15,477**	**17,310**	5.5	11.8
Capital	**1,967**	**2,377**	**2,470**	20.9	3.9

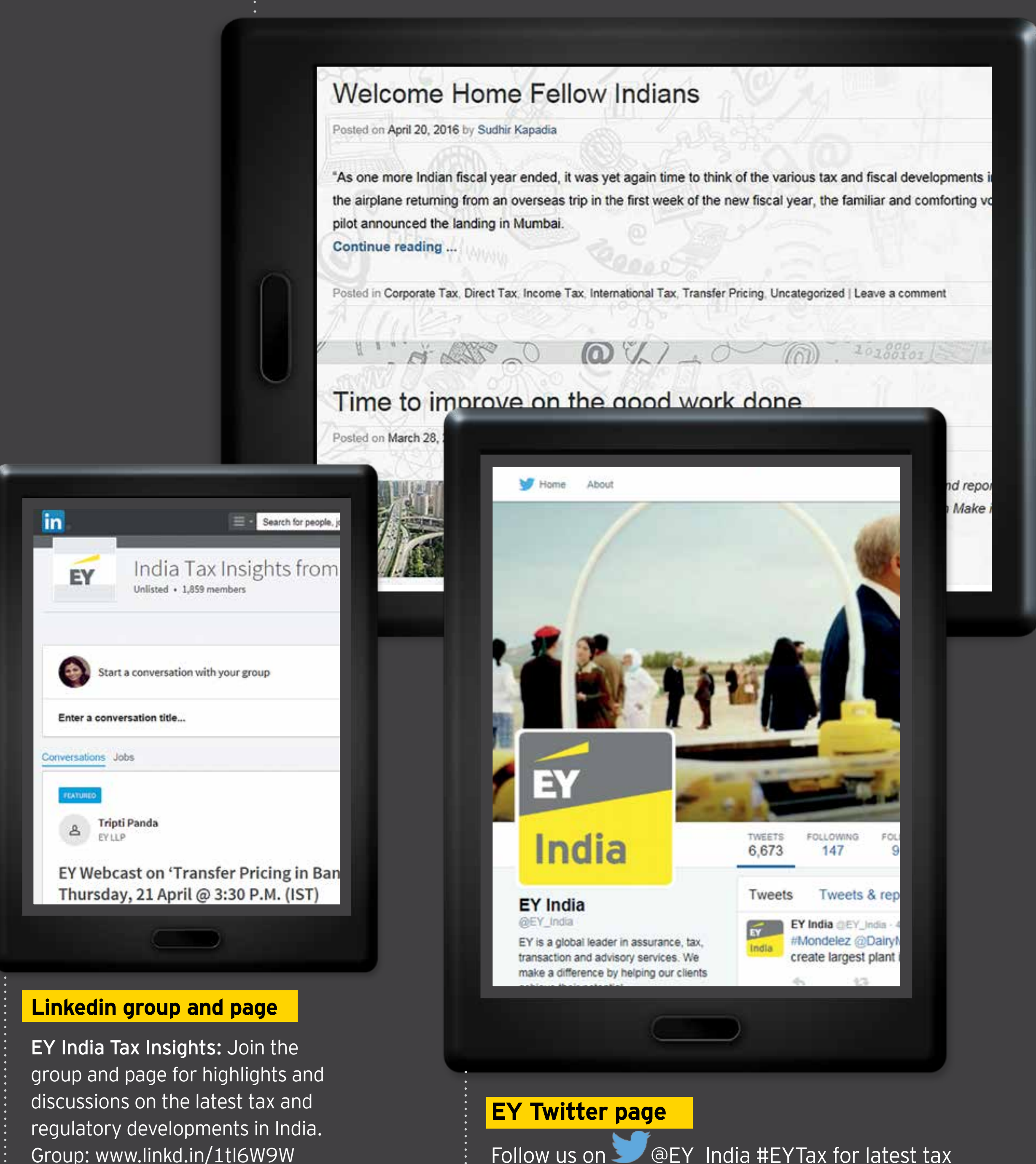
Source: Union Budget

The total Central Government expenditure for FY17 is budgeted at 13.1% of GDP. Growth in capital spending in FY16 increased to 20.9%. However, it is budgeted to increase at a much slower pace of 3.9% in FY17. Revenue expenditure is budgeted to increase at a much faster pace of 11.8% in FY17 as compared to 5.5% in FY16 due to the impact of the Seventh Pay Commission.



EY India Tax Insights blog

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

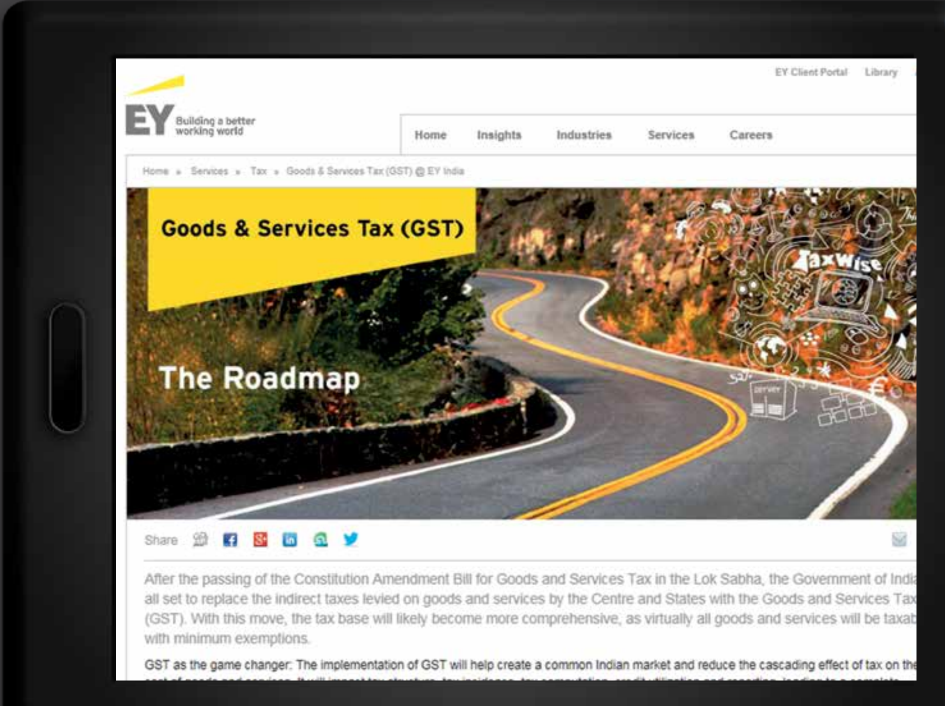


Linkedin group and page

EY India Tax Insights: Join the group and page for highlights and discussions on the latest tax and regulatory developments in India.
Group: www.linkd.in/1tl6W9W
Page: www.linkd.in/1qYJ9zh

EY Twitter page

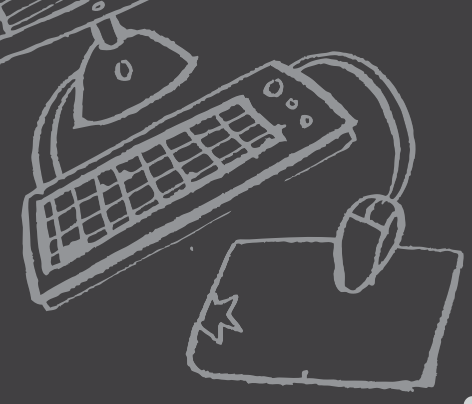
Follow us on @EY_India #EYTax for latest tax updates and insights



EY India GST webpage

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

Catch us online



Magazine on the web

Find articles from every issue of India Tax Insights Magazine at the click of a mouse
www.ey.com/indiataxinsights

Thoughts

"It's clearly a budget. It's got a lot of numbers in it."

George W. Bush

"A budget is just a method of worrying before you spend money, as well as afterward."

Anonymous

"A budget tells us what we can't afford, but it doesn't keep us from buying it."

William Feather

"It was as true... as taxes is. And nothing's truer than them."

Charles Dickens

"Taxes grow without rain."

Jewish Proverb

Budget
means
'leather bag'

The word Budget was derived from the Middle English bowgette, which came from Middle French bougette, which in turn is a diminutive of bouge, meaning a leather bag.

In *Girl with a Pearl Earring*, Vermeer used the Fibonacci sequence to create a composition of perfect proportion, harmony and beauty.
EY
Building a better working world
Can you understand the full picture without seeing what lies beneath?
ey.com/IN/en/Services/Tax
#BetterQuestions
The better the question. The better the answer. The better the world works.
© 2016 EYGM Limited. All Rights Reserved. ED 0616.