

India Tax Insights

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In this issue

Dissecting demonetization

GST: pitfalls and promises



Martin Kreienbaum

DG International Taxation, Germany and
Chair, OECD's Committee on Fiscal Affairs
(as of 01.01.2017)

He speaks on how tax certainty will
drive investments and growth.





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

Creatives

Jasmeet Kaur Jaggi

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 ninth edition of our magazine *India Tax Insights*.

With a GDP growth rate of 7.6%, India is now one of the fastest growing economies of the world and may be on a trajectory to achieve a double-digit growth in the coming years – something that has eluded it till now. The Indian Government recognizes that achieving this potential requires an ambitious reform agenda, including realizing visions such as Make in India, Digital India and Start-up India. This will require creating a tax environment that is competitive, predictable and transparent.

It was with this background that a high-level Tax Policy Roundtable was organized by EY in New Delhi on 30 September 2016 and 1 October 2016. The roundtable focused on tax initiatives, both direct and indirect, that can make India a more attractive investment destination. The roundtable brought together distinguished international experts from the OECD, IMF and World Bank, senior

Indian Government officials, academicians and representatives from business, sharing their perspectives on the tax reform process in India. Similarly, in the month of November, we conducted our 14th annual India Tax Workshop in Goa, focusing on the interplay of tax and technology, GST, global taxation issues and other critical elements from the prism of policy and taxation. The sessions witnessed exchange of views from key Revenue officials, academicians and industry experts. This issue of *India Tax Insights* contains a feature that provides a summary of the key tax and regulatory issues discussed and conclusions reached at both the Tax Policy Roundtable and the India Tax Workshop.

The measurement and use of marginal effective tax rate or METR have a profound influence on the policy environment within which tax is debated. METR is a measure used by policy makers around the world to gauge the impact of tax systems on investment incentives. Jack Mintz, President's Fellow, School of Public Policy, University of Calgary and National Policy Advisor, EY Canada explains the concept in more detail and whether there is scope for an METR-neutral corporate tax reform, when accompanied by GST.

Globally, the focus is shifting to the role that tax policy can play in driving innovation, supporting inclusive economic growth and bringing certainty in the business environment. Of course, tackling BEPS, improving transparency to fight tax evasion and addressing the tax aspects of the domestic resource mobilisation are challenges that will continue on the tax policy radar in the next few years. Leaders of G20 countries implicitly acknowledged in their September 2016 meeting that they need to avoid adding tax uncertainty, especially as countries go about implementing BEPS. Martin Kreienbaum, DG International Taxation, Germany and Chair, OECD's Committee on Fiscal Affairs

(as of 01.01.2017) in his interview to our magazine discusses the impact of tax uncertainty on economic growth.

With the Parliament approving the Goods & Services Tax Constitution amendment, the path is set for implementing a tax reform that is arguably the most ambitious and the most significant since the country gained independence in 1947. V S Krishnan, Tax Advisor - Tax Policy Group, EY writes about the challenges in its implementation and what lies ahead.

In the last couple of months, India's economic and political landscape has been dominated by the Government's sudden decision on 8 November 2016 to demonetize high value currency notes. In an insightful article, Dr. DK Srivastava, Chief Policy Advisor, EY dissects the economic impact of demonetization on the Indian economy and presents a balanced picture of the possible adverse effects and potential benefits of this move.

An updated version of the United Nations Transfer Pricing Manual for Developing Countries was presented to the UN Tax Committee for approval in October 2016. The revised draft of the Manual gives due consideration to the BEPS Action Plan. The updated version also includes a revised chapter on the practices and positions of the Indian tax administration. Monique Van Herksen, Transfer Pricing Subcommittee member and Consultant to United Nations discusses the relevance of these revisions from a developing country perspective, while Rajendra Nayak, Partner - Tax & Regulatory Services, EY discusses how India is charting a new course in the post-BEPS application of the arm's length principle.

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

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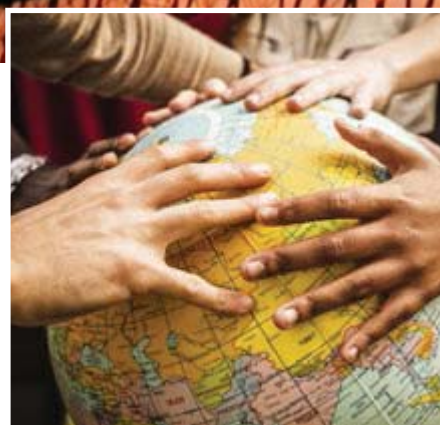
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DG International Taxation, Germany, and Chair, OECD's Committee on Fiscal Affairs, opines that tax certainty will drive investments and growth. He believes that there has been a great progress in the areas of transparency with the BEPS project and G20 will continue to have a leading role.

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Viewpoints of key stakeholders shared during the recent 'Tax Policy Roundtable' and 'India Tax Workshop' hosted by EY India



Dr. DK Srivastava

Chief Policy Advisor,
EY India



Dissecting demonetization: balancing losses and gains

India's 8 November demonetization has led to three inter-related but distinct policy challenges:

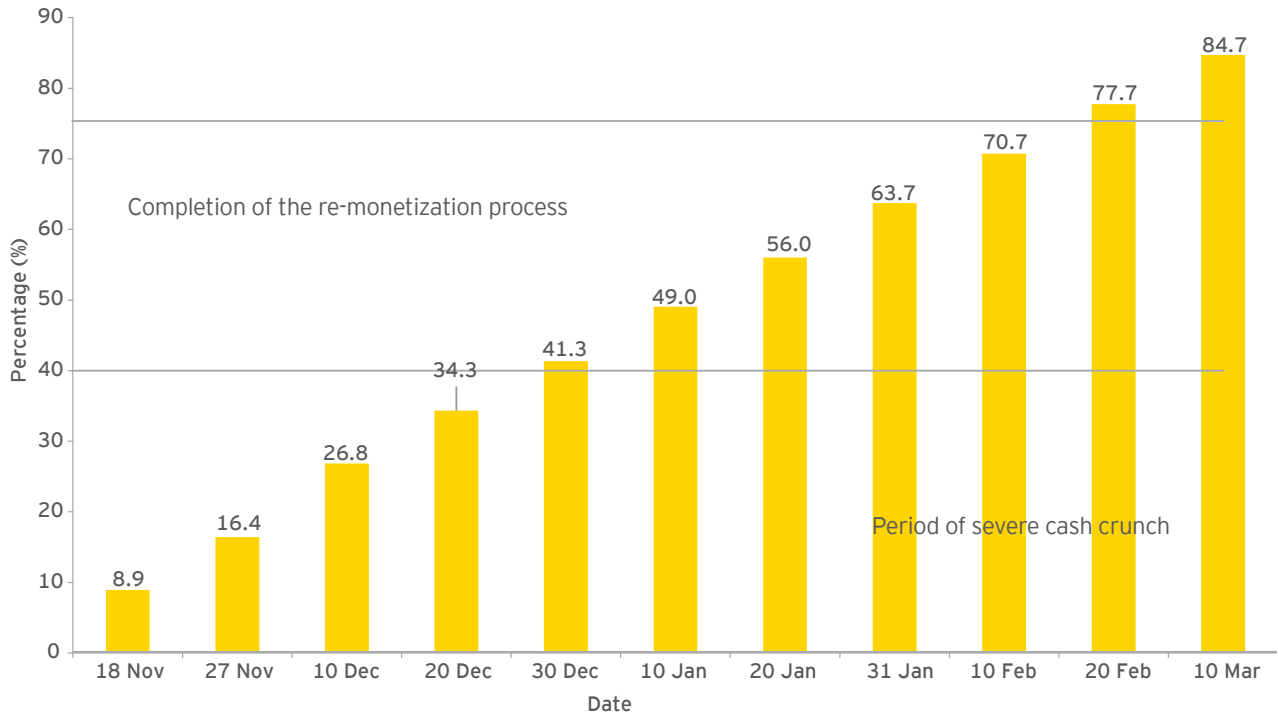
- (A) Containing its contractionary effects, compounded by a demand slowdown
- (B) Ensuring a lasting blow on the black economy
- (C) Uplifting digitization of transactions

1

Demonetization and re-monetization: the crippling imbalance

Demonetization happened in one stroke; however, re-monetization is constrained by the RBI's capacity to print and supply new currency, resulting in a severe cash crunch. According to available information from RBI¹, by 27 November 2016, 55.4% (by value) of the demonetized money had come back: only 16.4% (by value) through re-monetization and 39% (by value) through additional bank deposits value. This figure increased to 78% by 7 December 2016². We expect that the cumulative percentage of re-monetization will progressively increase and the cumulative share of additional bank deposits will fall after reaching a peak. These two trends are depicted in Charts 1 and 2. By the last week of February 2017, the cumulative re-monetization should exceed 75%, which may end the period of severe cash crunch.

Chart 1: Cumulative re-monetization (withdrawal and exchange) as a percentage of value of demonetized currency



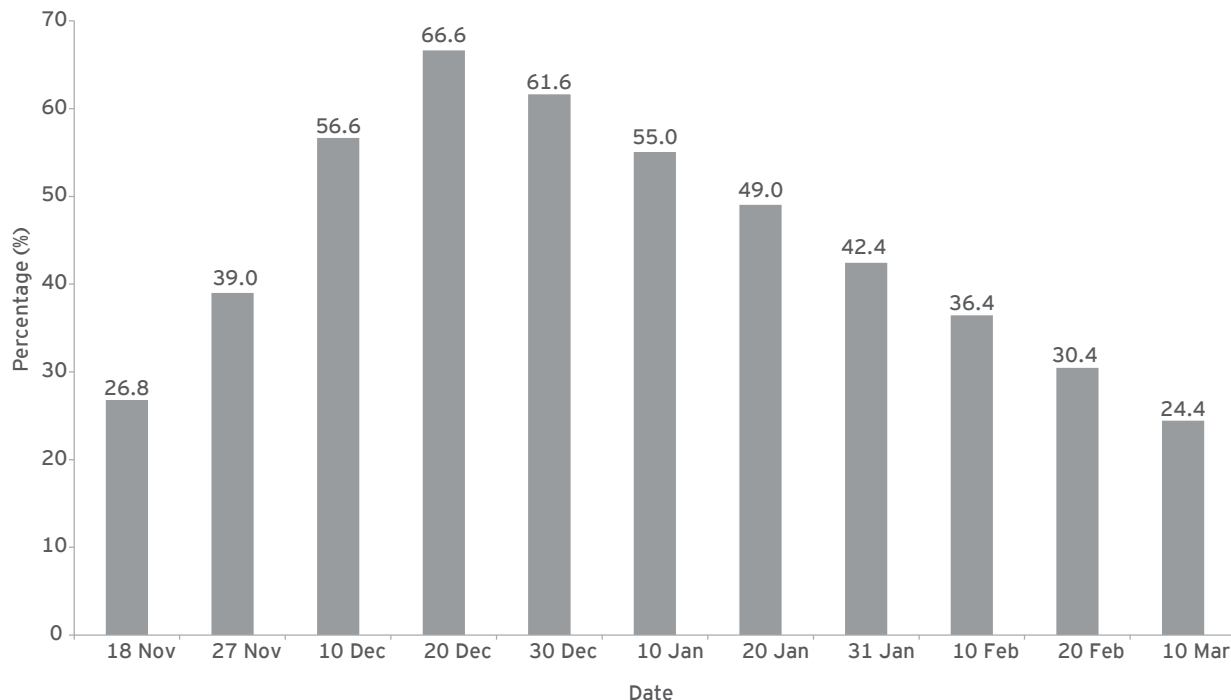
Source: Estimates based on available information; Ratios are indicative

Source:

1 RBI Press Release (28 November 2016) "Withdrawal of Legal Tender status of banknotes of Rs. 500 and Rs. 1000: Activity at Banks during November 10-27, 2016"

2 RBI Monetary Policy Press Meet dated 7 December 2016

Chart 2: Cumulative net additional deposits as a percentage of value of demonetized currency



Source: Estimates based on available information; Ratios are indicative

2

Contractionary effects: short-term growth impact

The cash crunch resulted in a sudden contraction of demand, adversely affecting growth and employment in sectors with a relatively high share of unorganized activities, such as agriculture, construction and some service sectors.

Table 1 gives a summary of assessments undertaken by the RBI and selected rating agencies on the impact of demonetization on GDP growth for FY17. Many of the recent assessments have revised down India’s FY17 GDP growth down to close to 7%.

Table 1: FY17 GDP growth estimates

Entity/rating agency	Post demonetization	Previous	Percent point change	Percent of previous estimate
The RBI	7.1	7.6	0.5	6.6
Care Ratings	7.6	7.8	0.2	2.6
ICRA	7.5	7.9	0.4	5.1
ICICI Securities	7.4	7.8	0.4	5.1

Entity/rating agency	Post demonetization	Previous	Percent point change	Percent of previous estimate
Morgan Stanley	7.3	7.7	0.4	5.2
Fitch	6.9	7.4	0.5	6.8
Goldman Sachs	6.8	7.9	1.1	13.9
Emkay Global	6.5	7.4	0.9	12.2
Ambit Capital	3.5	6.8	3.3	48.5

Source: RBI's Monetary Policy Review (7th December 2016) and Mint Research (24th and 30th November 2016)

3

Ensuring long-run growth: supplementary policy support

Contraction in money supply may result in a fall in GDP growth over the long run if the currency-to-money supply ratio remains constant. Furthermore, the contractionary effect may accentuate if investment demand remains weak. Recently released data shows that for three quarters in a row, gross fixed capital formation has contracted with an increasing magnitude. We expect that with digitization, the currency-to-money supply ratio may fall, the money multiplier may increase and its long-term contractionary impact may be neutralized.

Table 2: RBI assets and liabilities (INR billion)

Entity/rating agency	Post demonetization	Previous	Percent point change
Notes issued	13,072.5	Foreign currency assets	23,193.0
Deposits	8,961.0	Gold coin and bullion	1,367.9
Other liabilities	9,254.9	Rupee securities including Treasury bills	7,563.1
		Loans and advances	555.5
		Bills purchased and discounted	0.0
		Other assets	109.6
		Investment	23.2
Total liabilities	31,288.4	Total assets	32,812.5
		Excess assets	1,524.1
		FY17 GDP	1,50,650.1
		Excess assets as a percent of GDP	1.0

Source (Basic Data): RBI and EY Estimates (As on 11 November 2016)

This effort can be strengthened through a fiscal stimulus financed partly by a fiscal windfall resulting from extinguished currency, which may amount to about 1% of GDP, and partly through increased tax revenues. The former will require a rebalancing of the RBI's assets and liabilities (Table 2). Further stimulus may come from reduction in interest rates facilitated by the surge in bank deposits.

4

Combating the black economy

For a tangible dent on the black economy, supplementary policy interventions would include reduction in stamp duty rates, reduction and simplification of tax rates and tax codes relating to both direct and indirect taxes, effective and transparent provisions for financing of elections and an effective penalty regime concerning proven cases of black money generation. Exchange of information between India and the countries that serve as tax havens and complete abolition of "benami" property registration would provide sharper teeth to combat the menace of black economy.

5

Strengthening digitization

The Central Government is making a sustained effort to uplift the extent of digitization of transactions, particularly in rural areas and the informal sectors. In this context, the focus is on five main digital platforms: USSD (unstructured supplementary service data), UPI (unified payment interface), debit and credit cards at point of sale, PPI (prepaid payment instruments) and mobile banking. In December 2016, these platforms, except mobile banking (which has grown by 4% in value terms), have shown significant growth in value terms (598%, 419%, 31% and 45%, respectively) over November 2016 (extrapolating the data from the first 16 days of December for the full month)³. However, the weight of these platforms in total digital transactions is still small (less than 2%). To ensure success on the digitization front, these trends will have to be sustained for a long period.

³ RBI Data on Electronic Payment Systems - Representative Data (Updated as on 17 December, 2016) https://rbidocs.rbi.org.in/rdocs/content/docs/EPS03122016_AN.xls (website accessed on 19 December 2016)



GST: pitfalls and promises

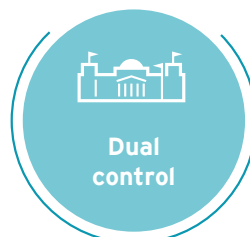
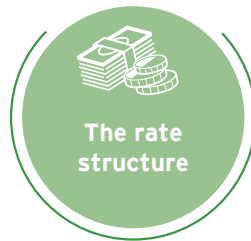
V S Krishnan

Tax Advisor - Tax Policy Group,
EY India

The implementation of the Goods and Services Tax (GST) has had a roller coaster ride, starting in 2006. It has been heralded as the most important economic reform in post-independent India. It is claimed with some justification that what Sardar Vallabhai Patel did for the political unification of India, GST would do for the creation of a unified Indian economic entity.

The passing of The Constitution (122nd Amendment) Bill on 3 August 2016, which provides the design for the GST, set the ball rolling for the implementation of GST. This legislation unifies what hitherto was a fragmented tax system into an integrated tax system in which the Center and the states would concurrently tax the entire value chain from raw material to retail. This will be achieved by legally empowering the states to tax manufacturing and services and the Center to tax value addition in trading. In addition, the Constitution

GST, from a tax practitioner's perspective, can be examined within the framework of the following three dimensions:



Amendment legislation deletes Entry 52 in List II in Schedule VII of the Constitution of India, which empowers states to levy an entry tax when goods enter its territorial jurisdiction. The removal of entry tax, therefore, creates conditions for free movement of goods and services, ushering in an Indian common market. There is much that still needs to be done, and the fulfilment of the economic potential of GST lies in getting many things right.

The deliberations of the GST Council on the proposed rate structure were watched intently by the industry, which seeks a more benign rate regime. After intense discussions, the Council agreed upon a four-tier rate structure – 0%, 5%, 12%, 18% and 28% – with a special rate for gold and jewelry to be decided later. It was also decided that a cess would be levied on four items – namely, pan masala, cigarettes, aerated water and luxury cars – at a rate that would represent the difference between the existing duty rate and the 28% rate. The consensus was that the cess proceeds that would accrue entirely to the Center would be used to compensate the states. The Council also decided that broadly, essential goods and goods consumed by the poorer sections of the society would be fitted into the exemption and merit rates, while certain goods consumed by the more affluent sections would be put into the 28% rate slot. The remaining items would fall under the standard rate of 18%. A Committee of Secretaries was constituted and directed to look at individual items and fit them into the rate slots based on the broad principles agreed by the Council.



Define the path for valuation and transition that minimizes dispute

The other important area is the whole GST legislation and rules that have been put in the public domain as a Draft Model Law. This again represents a product of discussions and conclusions reached jointly by the Center and the states. While a large number of representations have been received, the worrying feature relates to dispute-resolution, valuation and the transitional provisions.

One of the key concerns of the industry is that there must be certainty and uniformity in assessment across the country. This may require a centralized system of binding instructions in assessment cases vested in a technical secretariat or an assessment

directorate. The states also have to replicate this arrangement. This may require amendment in Section 157 of the revised Model GST Law relating to Miscellaneous Provisions so as not to forbid any centralized competent authority from issuing binding instructions to any GST officer on a particular assessment matter. In order to narrow the domain of disputes, it would be necessary to codify minor procedural infringements so that instead of imposing minor penalties, these are converted into non appealable administrative levies.

In the area of valuation, there is considerable concern in the industry on the introduction of the transaction

value concept in value-added tax. It might be more appropriate if the transaction value is replaced by invoice value representing the amount paid or payable.

Finally, trade and industry are also worried about the proliferation of disputes in the case of self-supplies made within the same legal entity. Here again, the definition of “supply” might need to be tweaked so that taxable supplies within the same legal entity are confined only to supplies for re-supply. The transitional provisions may also need to be modified so that firms are allowed to take credit of duties paid, such as Excise and CST lying with dealers/stock traders on the date of implementation.



Dig deep on dual control

Dual control is another vexing problem of GST. The trade and industry would ideally like to deal with one tax administration in the area of compliance verification. However, the GST Council is looking at two models – one a cut off based on turnover, and the other based on a vertical division wherein the Center and the states would exercise the rights for compliance verification of both goods and service entities based on a predetermined formula of percentage of units to be covered and an exchange of risk assessment lists, which might consist of various parameters such as trends in input credit and compliance

history. It may be a good idea at this juncture for each state to have a GST secretariat, which would bring senior Central and state-level officials of the Commercial Tax Department on a common institutional platform. This body could be registered under the Indian Societies Act, much like the Empowered Committee of the State Finance Ministries, and provided with a dedicated secretariat. This body could forge the bonds of trust and understanding between Central and state officials. The state GST secretariat may also provide a forum for trade and industry to jointly represent their views to both Central and state officials.

The GST journey has been a long and arduous one, and there is insufficient appreciation of how much the country has achieved in coming to this point. In a recent article, written jointly by the Chief Economic Advisor and the Secretary (Revenue), these thoughts were echoed quiet eloquently: “The time is ripe to collectively seize this historic opportunity; not just because the GST will decisively alter the Indian economy for the better but also because the GST symbolises Indian politics and democracy at its cooperative consensual best.”



“

**Tax certainty shall
drive investments
and growth**

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In conversation with:
Martin Kreienbaum
DG International Taxation, Germany and
Chair, OECD's Committee on Fiscal Affairs
(as of 01.01.2017)

Q. How is G20 factoring tax certainty into its agenda to provide a more conducive tax environment?

High level of tax certainty delivers trust and encourages further investment. Certain level of uncertainty will always exist with continual economic change. Also, legislators cannot foresee all circumstances, so they need to rely on a generic abstract language. But tax uncertainty can be as harmful as tax increases. Certainty is essential to avoid negative effects on overall investment, productivity and, ultimately, economic growth. G20, supported by Organisation for Economic Co-operation and Development (OECD), is in discussions on how tax policy can be used to achieve the G20's broader objective of strong, sustainable and balanced growth.

Q. How is OECD engaging with economies to bring in tax certainty?

We are entering a new phase of tax certainty. Tackling Base Erosion and Profit Shifting (BEPS), improving transparency to fight tax evasion and addressing the tax aspects of the domestic resource mobilization challenge in view of the 2030 Agenda remain the top priorities. In addition, 2016 saw the OECD supporting the G20 Finance Ministers launch a comprehensive discussion on the role that tax policy can play in achieving sustainable, balanced and inclusive growth and certainty in business environment. We have achieved a lot in recent years in bringing the G20 agenda forward and in adapting

international tax rules to progressive internationalization of our economies.

We have made great progress in the areas of transparency with the BEPS project. Although this work is not yet finished, the international tax policy landscape has already changed significantly. I am sure G20 will continue to have a leading role.

Q. Are tax policies focused on supporting and driving innovation?

Tax and inclusive growth, i.e., promoting strong, sustainable and balanced growth, remains the overall aim of the G20. We recognize that a tax system focused on driving innovation can play a key role in shaping the knowledge-based economy. Future growth will be led by new ideas and technologies.

One main challenge for policymakers will be to design policies that ensure that innovation contributes to social inclusiveness. This is very important so as to have the society also agree to the policies shaped by the G20, aligned to efficiency and equity.

Q. How can countries take forward the agenda of tax reforms to enable inclusive growth?

Innovation and inclusiveness do not have to be mutually exclusive. Digitalization fosters economic growth, and it is one of the key drivers of innovations. But at the same time, it has inclusive qualities. The internet has opened up new markets for products

and services. Market entry barriers have significantly lowered. It has helped create employment for people worldwide. A well-designed tax policy can contribute to this by avoiding barriers for innovative founders and also for employees.

At the G20 meeting in July, ministers were asked to share their views on the creation of tax systems that drive innovation and growth, while reducing inequalities at the same time. A very broad range of options emerged from the discussion. Broad base and low rate approach, simple and transparent tax system in place, reducing bureaucracy and keeping reforms sustainable to make sure that tax policy supports inclusive growth were some good ideas.

Alongside, some specific ideas were discussed, such as research and development (R&D) incentives for small enterprises – in particular, offering incentives for hiring high skilled workers, reducing the regressiveness of value added tax (VAT) and also capping personal income tax allowances. In the discussions, it was made clear that there cannot be a one-size-fits-all approach. Every country has to design its tax system and its tax laws specifically suited to its own systems and situations.

The challenge now is to focus on the tax system as a whole and introduce an appropriate mix of measures taking into account their interdependencies. This, in short, will ensure a balance between the aims of efficiency, equity, simplicity and revenue-raising.

There is, of course, a need for further analysis of how the efficiency and equity objectives may be reconciled. The tradeoffs between tax policies that pursue growth and equity objectives

have to be identified and the factors both within and beyond the tax systems that have an impact on those trade-offs have to be explored. The OECD, together with the International Monetary Fund (IMF), supports the G20 with more in-depth research on the topic. They are putting a really great effort on this, and I am very much looking forward to the research outcomes.

Q. What can we look forward to from the G20 agenda under Germany's leadership?

We will continue to stress on the importance of sustainable growth and economic inclusion. Our own priorities for the finance track will focus on strengthening resilience and shaping digitalization. In the tax field, we will continue the current international tax work in order to increase the reliability of the international tax system. For this purpose, we want to make sure that the G20 and OECD BEPS recommendations are implemented consistently. We will also continue to strengthen the work on tax transparency. Capacity building is another issue that we will be focusing on.

With regard to BEPS, we will now start the monitoring process to make sure that the BEPS recommendations are being implemented consistently by participating countries. 85 countries have already signed up to the BEPS commitment and we expect more countries to sign up as we continue to identify relevant countries. It is important to have everyone on board.

On transparency, the G20 has achieved a lot of progress over the past few

years. There are robust peer reviews. Various countries are living up to their expectations of sharing information on request, and there has been a global agreement on the new reporting standards.

Another central topic that we are focusing on is tax certainty related to cross-border investments.

Q. How can tax policies be made certain?

Tax policy can contribute to tax certainty by ensuring a stable, accountable and appropriate legal environment. This is important on both the domestic and international levels. The economic environment keeps changing over time. It is a dynamic process, and hence the need for corresponding tax reforms. However, tax reforms can also have unintended side-effects and can lead to uncertainty.

Well-designed reforms accompanied by informative communication strategies can contribute to the target of achieving tax certainty. Countries should communicate what they intend to do.

Tax administration must ensure transparent and swift procedures and fair and even application of the tax laws. Processes must be accountable and transparent. Similar cases that fall under the same legal provisions should be treated in the same way and should not lead to different results. In other words, enterprises must be able to assess the tax consequences of their investment projects before the final decision is taken.

Q. What are the possible instruments to improve tax certainty?

We expect on delivering concrete instruments to improve tax certainty. The first set of concrete instruments would be dispute-avoidance procedures such as joint audits. The second area would be of dispute-resolution procedures.

On dispute-avoidance procedures, it is important to make sure, as far as possible, that conflicts are avoided. For example, advance price agreements (APAs) are instruments to bring clarity at very early stages of cases and help avoid lengthy conflicts. Such procedures should be designed in a way that enterprise can get reliable results within a reasonable period of time. APAs should be open to as many cases as possible, and tax payers should also be in a position to get that certainty via APAs. Designing the right procedures and rules for dispute avoidance is also an important issue.

If it turns out that a conflict cannot be avoided, it is essential to have an effective and efficient dispute-resolution procedure in place. This aspect has been covered under BEPS Action Plan, under Action Item 14. The G20 countries have already committed themselves to improve the international dispute-resolution mechanisms and, in particular, the mutual agreement procedures.

Q. Are tax transparency and exchange of information moving along the desired track?

Some countries are more tax transparent and have identified the beneficial owners. Their legal systems and arrangements are completely transparent. However, many other countries are not yet transparent. There is a need to create a level playing field to foster growth and cross-border investments. Reliability of information, accuracy and completeness are also very important for exchange of information.

Q. How do you motivate governments to build consensus on various standards? Is the G20 planning to publish the information on various standards?

The whole idea of BEPS is to make things predictable, coordinate various countries' policies and agree to minimum and maximum standards. I disagree with the view that BEPS is creating uncertainty. Though we don't know yet how countries will be implementing the suggested policies, we do have agreement on certain minimum standards and timelines, which are binding. For instance, for country by country reporting, some conditions will be followed by the different countries. The G20 will pick up the initiative to get a political agreement on the issues. The rest of the work is supported by OECD and IMF.

Q. How does BEPS plan to take care of the diverse decisions by countries on a common issue? For instance, in a recent case, the EU decided that the OECD transfer pricing rules were against the EU State Aid norms.

In future, there will be a need to consider the link between harmful tax competition, state aids and World Trade Organisation (WTO) subsidies. I cannot comment on the specific case, as we will need to understand the full picture and learn more about the case.

Q. Finally, which areas need special attention for enabling tax certainty?

Coming to a workable result within an appropriate period of time requires a coherent institutional design of procedures and trained staff. For instance, in Germany, it has not been easy to get the right staff and the right number of staff. I do see a great need of action in this area.

The OECD has undertaken preparatory work in the area of tax certainty and I am sure that OECD and IMF together can provide us a solid foundation of further work in this area. I am certain that the tax certainty topic fits very well in both our G20 tax agenda and also the boarder G20 agenda, and I am looking forward to the coming year.





Viewpoints

EY Tax Policy Roundtable

A high-level Tax Policy Roundtable was organized by EY in New Delhi on 30 September 2016 and 1 October 2016. The roundtable focused on tax initiatives that can make India a more attractive investment destination. The roundtable brought together distinguished international experts from the OECD, IMF and World Bank, senior Indian Government officials, academicians and representatives from business, sharing their perspectives on the tax reform process in India. The 'viewpoints' presents a summary of the key points raised during the discussion as well as the insights shared by the participants.

India's tax-GDP ratio

India will be well placed until 2040 with the share of working-age people in total population rising to a peak of close to 69%. As per Budget estimates and EY analysis, in this period, the saving rate is expected to increase to more than 38%.

In order to take advantage of the demographic dividend, additional fiscal space needs to be created to finance increased expenditure on education and health so as to productively employ India's young population. Health and education expenditure can be

increased by 5% points of GDP by 2029–30 through the following measures:

Increasing the tax/GDP ratio by about 2% points from its current level of 16.5%, an additional 2% points through non-tax sources (land, spectrum, mineral resources and higher dividends) and 1% point through the reduction of subsidies. According to international evidence, GST helps improve the tax-GDP ratio when applied at inception to a broad base and at low rates.

GST could obviate the need for corporate tax incentives

There is extensive literature that shows that corporate tax incentives, particularly those that are targeted at specific industries or assets, are more distortionary than other types of tax incentives. The sole exceptions to this statement are R&D incentives. In turn, corporate tax incentives can be expensive, as the government has to forgo revenue.

One concern with the phase-out of corporate tax incentives can be a concomitant rise in the marginal effective tax rates (METRs), a measure used by policy makers around the world to gauge the impact of tax systems on investment incentives. This concern can be addressed in today's policy environment because of the incipient

implementation of the GST. There is scope for METR-neutral reform of the corporate tax code, when accompanied by the GST reform.

It is likely that many of today's corporate tax incentives serve the need for offsetting the negative impact of indirect tax cascading. Under a well-implemented GST regime, these cascades can be significantly reduced, removing the need for the corporate tax incentives in the first place. METR simulations for India show that a truncated GST that exempts electricity, petroleum, natural gas, and real property reduces the incremental benefits of the GST reform – in terms of additional investment and GDP growth – by about 80%.

Robust dispute-resolution mechanisms

The BEPS project recognizes that the existing dispute-resolution mechanisms in different countries need to be improved and supplemented. In India, the following areas need attention.

Commissioner of Income-tax (Appeals) (CIT(A)) and Dispute Resolution Panel (DRP)

- ▶ A single DRP route (i.e., panel consisting of three members) should be introduced.
- ▶ The Commissioners should have experience of working at the Income Tax Appellate Tribunal (ITAT) and should not be the administrative commissioners.
- ▶ APA commissioners can be appointed as members for specialized transfer pricing (TP) panels.
- ▶ Cases involving additions below INR50 lakhs could be decided by a single CIT instead of the DRP.

- ▶ All cases involving TP and international tax issues should be decided by the DRP.
- ▶ The number of DRP benches should be increased.
- ▶ Strict timelines need to be imposed for:

- ▶ Hearing/disposing of appeals filed before the DRP (12 months from the date of filing of appeal)
- ▶ Issuance of remand report (not more than 60 days from receipt of intimation)

- ▶ DRPs should have the power to grant stay in bona fide cases. Tax officers should not press demand recovery in case of appeals pending before DRPs, or, as a standard practice, stay should be granted on payment of 15% of demand.
- ▶ Close monitoring/tracking of cases and updates between CBDT and DRP is important. Every month, the Board should release guidelines to the DRP on the issues accepted by Board.
- ▶ There should be directive for the CCIT to have a meeting with the taxpayer and settle the dispute at the first level itself. This will help reduce litigation at source.

Authority of Advance Ruling (AAR)

- ▶ A mandatory time limit should be prescribed for passing the AAR order, i.e., within 180 days from the end of the month in which the application is filed.
- ▶ The composition of AAR should be reconsidered as under:

- ▶ Chairman: Retired/sitting High Court Judge
- ▶ Vice Chairman: Retired president of ITAT or retired vice president of ITAT or retired members as recommended by the president
- ▶ Members: CCIT with experience of at least two years in international tax

- ▶ Members should have a minimum tenure of three years.
- ▶ There should be no time gap between the date of retirement and new appointments of members and the chairman.
- ▶ Additional benches at Delhi and Mumbai should be set up at the earliest.
- ▶ The transaction limits and fees for approaching the AAR by a resident taxpayer should be revisited, as they are quite high.
- ▶ In order to expedite disposal of cases, the admission process can be dispensed with and cases can be heard in one go. Only technical conditions can be verified by the Secretariat, based on which application should be admitted or rejected. Other objections of the tax department can be heard at the time of final hearing.
- ▶ It is imperative to notify that the rulings of the AAR would be appealable directly to the Supreme Court.
- ▶ In spite of the CBDT directive of not seeking adjournment, it has been experienced that the special counsels and commissioners are not co-operative. This leads to delays in getting the ruling. Stricter guidelines should be put in place.

ITAT

- ▶ Specialized benches should be created at all locations – for TP, international tax and repetitive dispute areas of law.
- ▶ Capacity building should be undertaken across verticals.
- ▶ Regular trainings on technical matters should be provided to members.

Settlement Commission

- ▶ The scope and power of the Settlement Commission need to be redefined with the clear objective of resolving disputes.
- ▶ The composition of the bench should be changed to Chief Commissioner or Director General, sitting or retired member/vice

president of the ITAT and independent person with knowledge of business and trade.

- ▶ Officials should have a minimum tenure of three years.

Mutual Agreement Procedures (MAP)

- ▶ The power of CCIT to waive interest levied u/s 220(2) should be extended to waive interest on account of settlement of litigation under MAP.
- ▶ Amendment to Section 119(2)(b): The power of the Board should be expanded to include granting exemption or waiver etc. to individual

cases. This will enable certain companies to approach for waiver of interest in case of settlement under MAP.

- ▶ The scope of MAP should be expanded to accept applications once orders u/s 195 are passed.
- ▶ Information about pending MAP cases should be made available in the public domain.

Cooperative compliance

- ▶ Cooperative compliance offers opportunities for effective monitoring of tax compliance activities by larger taxpayers.

Overarching principles to guide India's tax policy on BEPS

- ▶ Implementation of the BEPS plan should be consistent with the Government's agenda of non-adversarial regime, spurring of growth, generation of employment, ease of doing business, simplified tax laws and litigation-free tax administration.
- ▶ Many of the concepts forming part of BEPS involve subjective considerations. Rigorous training and capacity building and accountability of tax personnel might be important.
- ▶ India has taken steps to introduce POEM, indirect transfer rules, buy-back tax, CbCR and GAAR, among others. The BEPS project should be coordinated and integrated with the existing provisions in a consultative manner, to ensure that multiple laws do not address the same subject.
- ▶ More focus should be put on options that eliminate the emergence of litigation.

Specific BEPS Action plans

Action 4: Interest Deductions: Before implementing Action 4, the prevalent trends should be analyzed to assess whether the presumption of interest cost being a base erosion strategy is indeed applicable to a vast majority of cases. The assessment should be done after factoring the impact of BEPS Action 2 on hybrid instruments. In India, many of the high cost debts are regulated. India also has provisions that extend tax concessions to lenders of certain forms of debt. The disallowance should be restricted to that portion of interest cost that is otherwise admissible after application of TPR, s.14A, s.43B, s.37 etc.

- ▶ Actions 8 to 10: Transfer Pricing Alignment with Value Creation: A cohesive, comprehensive determination of the limbs of development, enhancement, maintenance, protection or exploitation of intangibles (DEMPE) across territories and across years will be a subjective and daunting task. Different countries may have varying views on the significance of one or more functions and, hence, the risk of double taxation cannot be ruled out. Circulars or administrative guidelines should be issued to bring clarity on these matters and also ensure that the emerging trends of DEMPE functions and/or appraisal of CbCR do not influence the past assessments.
- ▶ Action 3: Control Foreign Company Rules: With the availability of a fairly robust TPR regime supported by thrust on DEMPE functions, POEM and CbCR, the scope of diverting income to low tax jurisdictions or away from the place of value creation to avoid tax will be reduced. The presence of GAAR may assist the tax authority to deal selectively with outliers. Considering this, India should defer introducing CFC rules and allow outbound investments to grow.
- ▶ Action 6: Abuse of Treaty Benefits: It should be ensured that the principal purpose test (PPT) rule does not apply adversely in case of a genuine business activity of substance. It should be recognized, including for GAAR, that a taxpayer who has commercial choice of establishing presence in more than one jurisdictions, can select a jurisdiction of their choice. This could also be a possible approach for regional HQ or holding companies. Clarity on treaty eligibility of certain structures such as pension funds, collective investment vehicles (CIVs) and PE investors from the perspective of treaty abuse and GAAR will be essential to reduce the areas of litigation.
- ▶ Integration of treaty abuse provisions with the GAAR Chapter could be a particular concern for cross-border investors. There is a need to soften the GAAR provisions, given that a number of ills have been already corrected in the form of SAARs through the introduction of buy-back tax, POEM test, indirect transfer rules, expanded source rules, EL, CbCR etc.
- ▶ Mauritius treaty amendments create opportunities for rationalization and simplification of capital gains taxation. The key objectives that should guide the new capital gains tax regime are neutrality (i.e., uniform treatment of all incomes and sectors), progressivity, simplicity, minimal adverse impact of lock-in effect due to realization basis of taxation, and stability/certainty.
- ▶ India has a capital gains regime as part of its domestic law, and it provides for a detailed computation mechanism. India has signed treaties with various countries, some of which

provide the right to tax capital gains on the sale of shares of an Indian company only to the country of the alienator (for instance, Mauritius) that aided in boosting foreign direct investment in India. A decade back, a specific exemption was introduced for long-term capital gains derived from the sale of shares on a recognized stock exchange, subject to the payment of securities transaction tax, to benefit both resident and non-resident investors. Recently, in August 2016, the India-Mauritius tax treaty was amended to provide India the right of taxation in case of capital gains derived from the sale of shares in an Indian company acquired after 31 March 2017, creating a level playing field between resident and non-resident investors to a large extent.

- ▶ This significant step coupled with the overall improving macro-economic scenario (improving FDI, current account deficit, inflation etc.), creates an opportunity to also relook at

the entire domestic capital gains regime for rationalization and simplification. The Indian tax law has evolved over the years, with several complexities getting effectively introduced. For instance, the threshold for qualifying as long term varies from 12 months to 24 months to 36 months for different instruments. Similarly, there are differential regimes for different instruments – for instance, there is preferential tax treatment for listed shares and certain mutual funds, while there is a differential indexation regime for debentures and bonds etc.

- ▶ Is it time to review whether the current capital gains tax regime is in line with simple and progressive tax system, whether it continues to be stable and certain and whether the regime can be made better? Is there a need to recalibrate the entire regime to serve the purpose of generating additional revenues in a simple, neutral and progressive manner?

Viewpoints

14th Annual EY India Tax Workshop

Reimagining a new world of tax

November 2016

1

APA in India

APA



52.1% have explored APAs

The majority (**50%**) have opted for unilateral APAs, while **25%** have preferred bi-lateral APAs

2

Preparedness on GST

51.7%

are happy with the proposed GST rate structure

48.3%

believe that it will complicate the process

40%

believe IT transformation as the biggest area of concern in the GST legislation

4

Cross-border taxation changes and impact on businesses

72.4%

are not ready for GAAR

81.8%

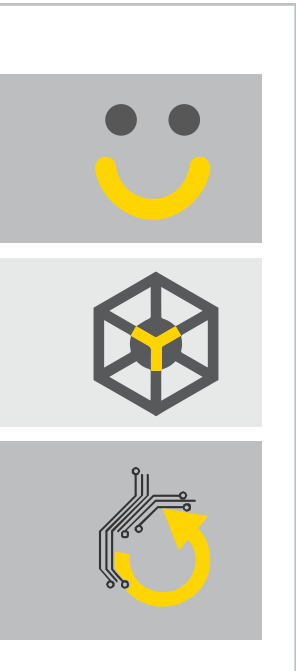
believe that changes in the tax environment, including GAAR and BEPS, necessitate a paradigm shift in the approach and thinking in terms of the way the way we currently do tax planning

5



42.8% have assessed the interplay between accounting and taxation in their business with the Ind AS and ICDS

In the month of November, we conducted our 14th annual India Tax Workshop in Goa, focusing on the interplay of tax and technology, GST, global taxation issues and other critical elements from the prism of policy and taxation. The sessions witnessed exchange of views from key Revenue officials, academicians and industry experts. The 'viewpoints' provides a summary of the key tax and regulatory issues discussed and conclusions reached at the India Tax Workshop.



3

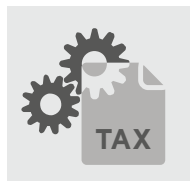
M&A trends and role of tax professionals



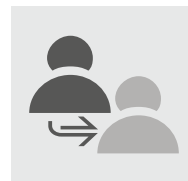
70% are currently evaluating an acquisition or divestment



80% stated that legal/ tax diligence is extremely important in an M&A deal



90% of tax heads are actively involved in the acquisition/ disinvestment process



41.2% of tax professionals expect not much change in the management of M&A deals in India

Interplay of accounting and taxation



72.7% are concerned about trained personnel, increasing complexity and litigation with the changing tax accounting landscape

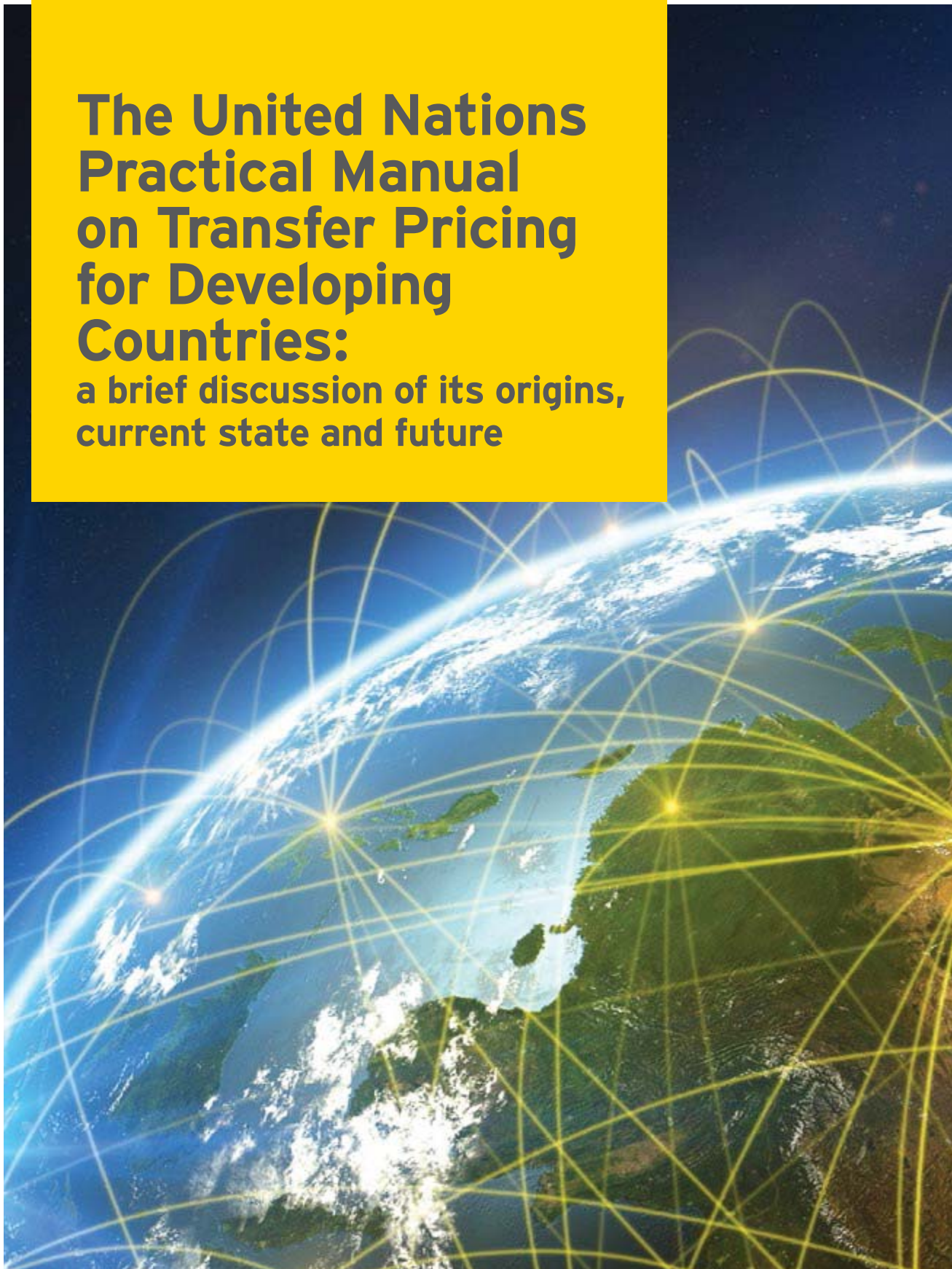
Glossary

- APA:** Advance Pricing Agreement
- GST:** Goods and Services Tax
- M&A:** Mergers and Acquisitions
- GAAR:** General Anti-Avoidance Rule
- BEPS:** Base Erosion and Profit Sharing
- ICDS:** Income Computation and Disclosure Standard
- Ind AS:** Indian Accounting Standards

The data is based on a live poll conducted among the delegates of the 14th Annual EY India Tax Workshop during 9-10 November.

The United Nations Practical Manual on Transfer Pricing for Developing Countries:

**a brief discussion of its origins,
current state and future**



The 2013 United Nations Practical Manual on Transfer Pricing for Developing Countries originated from discussions at the 2010 annual meeting of the UN Committee of Experts on International Cooperation in Tax Matters. At that annual meeting, it was recognized that the Commentary to Article 9 (regarding associated enterprises) of the UN Model Double Tax Convention between Developed and Developing Countries would benefit from an update. Considering the importance of transfer pricing and the increasing awareness of and concern regarding “mis-pricing,” it was also considered relevant to provide policy makers and administrators in developing countries with guidance on transfer pricing. As a result, a subcommittee was established with the mandate to prepare a Practical Manual on Transfer Pricing for Developing Countries (the Manual), which in particular would focus on practical issues and problem-solving rather than present a legislative framework. In essence, the Manual should try to address real transfer pricing issues for developing countries taking into consideration inevitable limitations that some developing country administrations have, as well as deficits in information and skills in those countries.

The mandate given to the subcommittee in charge of preparing the Manual clearly included adherence to the arm’s length principle, which is also embraced by the OECD in its Model Tax Convention and in the OECD Transfer Pricing Guidelines. There was never any intention to deviate from the arm’s length principle and introduce alternatives, such as formulary apportionment.



Monique Van Herksen

Transfer Pricing Subcommittee member and Consultant to United Nations

Furthermore, the subcommittee was instructed to include practical examples relevant to developing countries to the extent possible. Considering the strict mandate to adhere to the arm’s length principle, the subcommittee sought consistency with the OECD Transfer Pricing Guidelines, but, as technical issues were being discussed, it became quite clear that several developing country administrations encountered practical situations where the earlier version of the OECD Transfer Pricing Guidelines could be considered to not provide for sufficient recognition of the relevant facts as present in those

countries or of their tax policies. Multinational enterprises conduct business in developing countries for a myriad of reasons, such as access to a client/customer base for end products, availability of a skilled labor force at a relatively lower cost than in developed countries and creating a generally lower cost operations base because of, for example, a less complex regulatory environment in that country. Furthermore, often business is conducted in developing countries to gain access to valuable natural resources and to mine and extract these resources. One could

consider that the OECD Transfer Pricing Guidelines did not necessarily differentiate between these reasons and the impact they may have for the way business is conducted and could be valued.

The subcommittee discussed these situations at great length. Developing countries whose positions or practices were considered by the subcommittee members to be inconsistent with the arm's length standard were requested to include their positions and practices in the descriptions given by them in the separate Country Chapter to the Manual. That Chapter allows developing countries to share their transfer pricing regimes in general as an illustration of how different administrations handle transfer pricing issues. For example, some country practices prescribe fixed margins to be applied with certain transfer pricing methods. Although there is undoubtedly a great practicality and predictability argument in favor of such an approach, if those fixed margins are not (regularly) benchmarked against unrelated party transactions and no flexibility exists for taxpayers to provide evidence that the fixed margin is not at arm's length to opt out of the fixed margin, this approach does not qualify as being at arm's length. In other situations, due regard was given to the developing country-specific issues raised, such as inclusion of the concept of location-specific advantages and location rent in the Comparability Chapter.

The first version of the Manual was issued in the spring of 2013. Since

then, it has been used for capacity development training purposes in several countries, and efforts are being undertaken to translate the Manual in other languages, notably Spanish and French. Considering the short time within which the Manual was put together and the challenging international tax environment and changing opinions on transfer pricing, the Manual could greatly benefit from further work. Therefore, at its annual meeting in the fall of 2013, the UN Committee of Experts on International Cooperation in Tax Matters mandated the subcommittee, now reconstituted as the earlier mandate and subcommittee had expired, to update and enhance the Manual. Again, the mandate to the subcommittee explicitly included that the arm's length principle be adhered to. The update included addressing intra-group services and management fees and intangibles, and, to the extent necessary and appropriate, considering the OECD/G20 Action Plan on Base Erosion and Profit Shifting.

During its work, the subcommittee discussed at great length different positions and interpretations and views on how to interpret transfer pricing principles as applicable to intra-group services, intangibles and cost contribution arrangements. The subcommittee's mandate in particular emphasized that the update ought to reflect the realities for developing countries at their relevant stages of capacity development and that special attention should be paid to the experience of developing

countries. This led inter alia to the recognition of the so-called sixth method, or commodity method related to commodity transactions, in the Methods Chapter of the Manual. The new addition does not endorse the sixth method as being an arm's length method, but it describes the approach taken by several countries (many of them Latin American countries) and touches upon issues such as the anti-abuse nature of the sixth method, the risk of double taxation that it provides and what can be done to make the commodity method consistent with the arm's length principle. Furthermore, the Dispute Resolution Chapter was aligned with the UN Committee of Experts' efforts to enhance access to dispute resolution and arbitration. During the 2016 annual meeting of the UN Committee of Experts on International Cooperation in Tax Matters, the updated Manual was adopted.

Because of its mandate, the Manual discusses and emphasizes other aspects than the OECD Transfer Pricing Guidelines do. For example, benchmarking efforts are described in quite some detail in the Comparability Chapter, developing country transfer pricing practices are provided, and administrative issues, such as how a government might want to structure its transfer pricing units and audits, are touched upon. The Manual's layout has also undergone a change. It is now divided into three parts: Part A includes substantive issues as they relate to transfer pricing, Part B has guidance on administrative issues and Part C has country experiences.

Besides being a valuable practical training tool and guide for developing country administrations, the Manual offers great benefits to transfer pricing practitioners as well, in allowing them to get a sense of and anticipate developing country issues and positions. Although it remains important to note that the Manual is not equivalent to nor purports to include transfer pricing legislation. The future of the Manual will be determined largely through its de facto usage. Each capacity development training session provides an opportunity to assess whether further guidance and examples are needed. But also, as the Manual is inherently linked to Article 9 of the UN Model Double Tax Convention between Developed and Developing Countries and to the extent the Commentary to Article 9 recognizes the Manual, its role is likely to remain a relevant one for anyone working in the field of transfer pricing with developing countries.





**Post-BEPS
application
of the arm's
length principle:
India charts a
new course**



Rajendra Nayak

Partner - Tax & Regulatory Services,
EY India

An updated version of the United Nations Transfer Pricing Manual for Developing Countries (UNTP Manual) was presented to the UN Tax Committee for approval, at the twelfth session held in Geneva in October 2016, with a view to publish the revised UNTP Manual in 2017. The revised draft of the UNTP Manual (2016 Draft) gives due consideration to the outcome of the Organisation for Economic Co-operation and Development (OECD)/G20 Action Plan on Base Erosion and Profit Shifting (BEPS) relating to TP. The 2016 Draft also includes chapters on the practices and positions of emerging countries such as India, Mexico, China, South Africa and Brazil.

The Indian tax administration in the country-specific Chapter in the 2016 Draft has revised and updated its comments on a number of emerging TP issues from an Indian perspective, including issues pertaining to comparability analysis, allocation of risk, use of multiple year data, location savings, intra-group services and transactions involving transfer/use of intangibles. The India Chapter of the 2016 Draft also contains an acknowledgment of India's endorsement of the recommendations contained in the final report on TP under Actions 8–10 (Aligning Transfer Pricing Outcomes with Value Creation) and Action 13 (Transfer pricing Documentation and Country-by-Country Reporting) of the OECD/G20 Action Plan on BEPS.

India's position on BEPS Reports on Actions 8–10 and Action 13

After having endorsed the final reports of the BEPS projects on Actions 8–10, the Indian tax administration has acknowledged that some of the TP issues as addressed in the BEPS reports are in conformity with the long-standing views of the Indian tax administration, namely:

- ▶ The broad objective of “aligning TP outcomes with value creation”
- ▶ Giving importance to the development, enhancement, maintenance, protection and exploitation (DEMPE) functions in respect of intangibles for remunerating the group entities of multinational enterprises (MNEs)
- ▶ Testing of contractual allocation or contractual assumption of risk on the parameters of exercising control over risk and/or the financial capacity to bear the risk, and disregarding such contractual allocation or assumption of risk
- ▶ Harmonizing contracts with the conduct of parties, and identifying and accurately delineating the transaction by analyzing the economically relevant characteristics

- ▶ Preventing the “cash box” entities from contributing to base erosion or profit stripping
- ▶ Non-recognition of commercially irrational transactions that cannot be seen between independent parties

Accordingly, the Indian tax administration is of the view that the guidance flowing from the final report of the BEPS project on Actions 8–10 should be utilized by both transfer pricing officers (TPOs) and taxpayers in situations of ambiguity in interpretation of the law. However, India has not endorsed the guidance in the BEPS report pertaining to low value-adding intra group services under Action 10 and has not opted for the simplified approach. Further, India has endorsed the recommendations contained in the BEPS final report on Action 13, which supported the three-tiered documentation regime comprising a Local File, a Master File and a Country-by-Country Report and has already carried out legislative changes in its domestic law.

Key considerations for risks

BEPS Action Plans 8–10 provide detailed guidance on analyzing risks as an integral part of a functional analysis, including a new six-step analytical framework. In view of the assumption that increased risk should be remunerated by an increase in expected return, it is critical to determine which risks are assumed,

what functions are conducted in connection with the assumption or impact of risks and which party or parties assume these risks. The Action Plans provide that detailed guidance on risk does not mean that risks are more important than functions and assets, but arises from the practical difficulties introduced by risks. The Action Plans further state that if the associated enterprise (AE) contractually assuming the risk does not exercise control over the risk or does not have the financial capacity to assume the risk, then the risk should be allocated to the enterprise exercising control and having the financial capacity to assume the risk.

According to the India Chapter of the 2016 Draft, the Indian practice has been to evaluate risks in conjunction with functions and assets, and it is unfair to give undue importance to risk in the determination of an arm's length price (ALP) in comparison to the functions performed and assets employed. There is also reference to situations where research and development (R&D) functions are “controlled” by a related party situated outside India, while the actual R&D functions take place within India. The India Chapter states that the Indian tax administration disagrees with the notion that risk can be controlled remotely by (employees operating out of) the parent company and that the Indian entity engaged in core functions, such as carrying out R&D activities or providing services, can be risk-free entities. According to the India Chapter, the Indian tax administration believes that in many cases core R&D functions that are located in India require important strategic decisions by the management and employees of the Indian subsidiary and accordingly, in such cases, the Indian subsidiary

exercises control over operational and other risks and the ability of the related party to exercise control over risks remotely is very limited.

Intangibles generated through R&D activities

Globalization has led many MNEs to establish information technology, R&D and back-office operations in India in order to take advantage of savings inherent in its relatively moderate-cost-labor market. Typically, the Indian affiliates providing services operate

as “captive service providers” and are insulated from business risks and hence remunerated by providing a routine return for the functions performed. The India Chapter of the 2016 Draft observes that India-based R&D centers may take strategic decisions pertaining to the day-to-day activities and allocation of budgets to different streams of R&D activities. While funds for R&D activities are provided by the entity that bears the financial risk of the R&D activities, other important aspects of R&D activities, such as technically skilled manpower and know-how for R&D activities, are developed and owned by the Indian subsidiaries.





Budget

2017 - 18

Will the Government reduce personal tax rates or revise the threshold limit?
.....

Will there be a re-consideration on the phasing out of tax exemptions?
.....

Will there be a reduction in the corporate tax rates?



Stay tuned to our EY Budget website and social media platforms for exchange of views on the upcoming Budget 2017-18

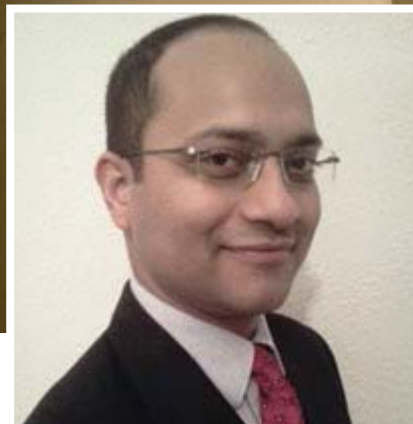


Measuring the investment impact of government tax policy



Jack Mintz

President's Fellow, School of Public Policy, University of Calgary and National Policy Advisor, EY Canada



Gaurav Ghosh

Senior Tax Professional, EY India

Government policies that matter significantly in emerging economies like India are those that spur capital investment. High investment levels lead to new businesses, growth in labor demand and rise in per capita gross domestic product and living standards. To improve the living standards of its citizens, the Indian government should, therefore, provide a favorable environment for investment. This could be achieved through various policy measures, including reducing the business tax burden on investments.

We consider the cost burden imposed by India's system of direct and indirect taxes on investment at the national and sectoral levels. We do this by developing an economic model of the Indian tax system and using it to evaluate changes to the tax system affecting investment costs and incentives. We particularly focus on the upcoming goods and service tax (GST) reform and changes in corporate income tax policies.

Our tool for evaluating the impact of the Indian tax system on investment incentives is the marginal effective tax rate (METR), which measures the tax wedge imposed upon the profitability of investments. This tax wedge is the difference between the pre-tax rate of return earned by a marginal investment project and the post-tax rate of return earned by its investors. The size of the tax wedge (and METR) is affected by direct taxes, sales

tax on capital purchases and other capital-related taxes such as stamp duties. The measurement also takes into account tax-related incentives such as initial allowances, accelerated depreciation and tax credits. High METRs reduce returns to investors, hurt India's competitiveness and discourage investment. Variations in tax burdens across business activities distort the allocation of capital that would otherwise be put to its best economic use. The discussion on how GST and changes in corporate income taxes (CIT) affect METRs and investment incentives follows below.

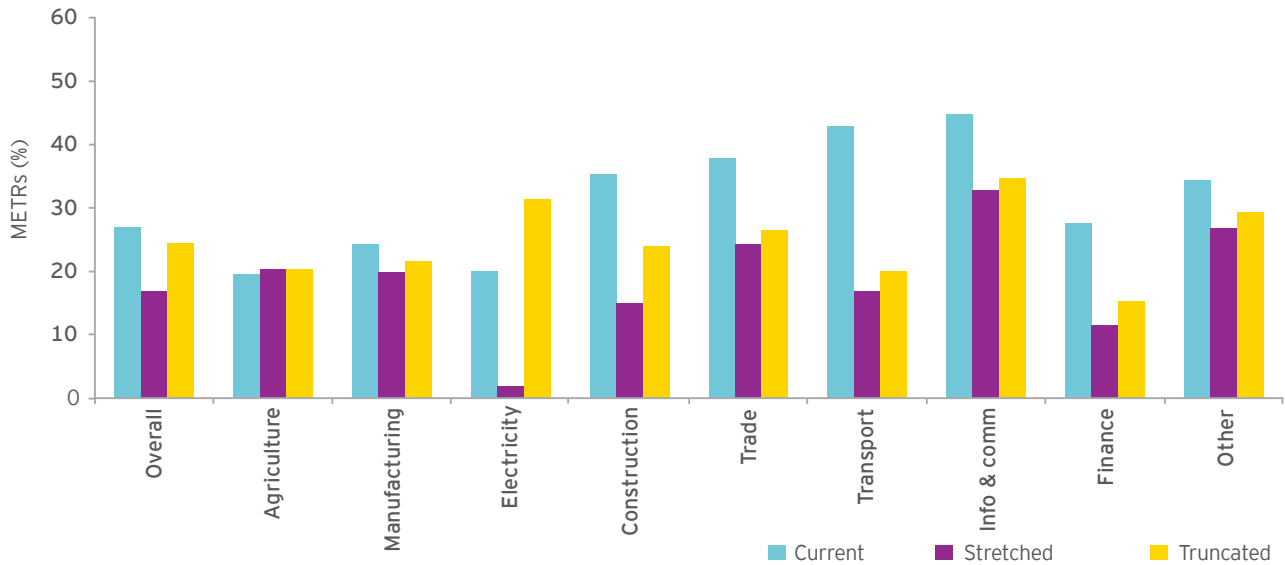
A GST is a value-added indirect tax and is therefore, by design, a tax upon consumption. As a well-designed consumption tax on final goods and services sold to consumers, it avoids taxes on businesses by rebating the GST paid on business intermediate and capital inputs. However, under the current Indian system, many sectors are exempt – neither are taxes paid on sales, nor are there rebates for GST on inputs. When an exempt business sells goods or services to other businesses, the GST gets imbedded in costs and cascaded into higher prices for consumers. To avoid cascading GST on business costs, exemptions should be minimized to remove the blockage of indirect tax credits. Firms would no longer need to bear indirect taxes paid on business inputs, but could claim them back through credits set against business income.

With this in mind, we motivate our GST analysis by considering three scenarios. The first scenario is the current pre-GST system of indirect taxation. The second scenario is a more comprehensive GST, which we characterize as the "stretched" GST because it is feasible by amending constitutional rules and "stretching" their scope. The stretched GST has no exemptions except for agriculture. The third scenario is the planned or real-world GST, based on media reports of the Government's current thinking. We refer to this as the "truncated" GST because of exemptions for large sectors such as petroleum, natural gas, electricity and construction.

We assume a GST rate of 18% for the purposes of our analysis. This is one of five slab rates decided by the GST Council: 0% for essential items, including food; 5%, for common use items; 12%; 18%; and 28%. We selected the 18% rate because it is anticipated to be close to the average rate across all slabs.

Our comparison of METRs under the three scenarios is shown in [Chart 1](#). The results are presented for all sectors and at the national level. The left-hand column is the current METR, the middle column is the METR under the stretched GST and the right-hand column is the METR under the truncated GST.

Chart 1: METRs under GST scenarios



In all sectors except agriculture, METRs are the highest under the current system of indirect taxes and the lowest under the stretched GST. This is to be expected because the stretched GST is explicitly designed to remove taxes on capital purchases. Overall, moving from the current system to the stretched GST reduces the METR from 27% to 17% – a significant improvement. The truncated GST leads to a 24% METR, which is a little lower than in the current system, but much higher than the stretched GST METR.

The result for the electricity sector is particularly notable, although the basic logic holds for the other sectors as well. The electricity sector currently has a low METR because of cost advantages from accelerated depreciation and initial allowances under the corporate income tax (CIT) and a wide range of indirect tax exemptions, particularly for large power-generating projects and renewables. The exemptions are

widely viewed as beneficial but are actually harmful from an investment perspective because they raise METRs, as can be seen in the truncated GST, where benefits provided by allowances are counteracted by blocked credits. These blockages are removed under the stretched GST, leading to a sharp fall in the METR.

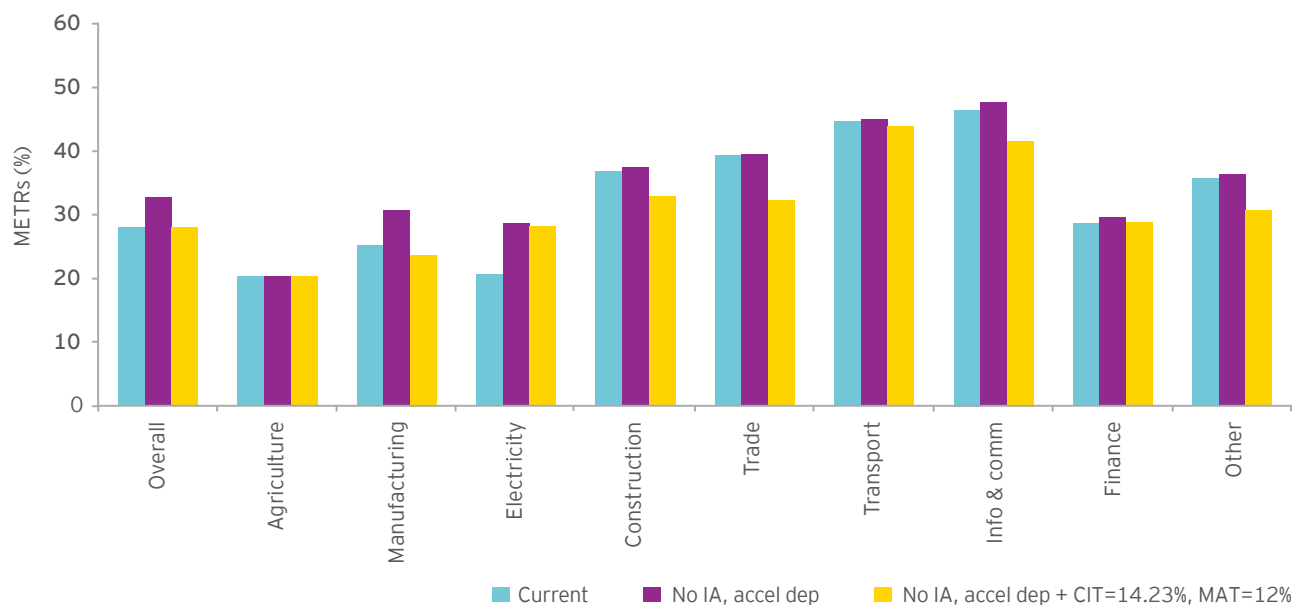
Our analysis, therefore, shows that the stretched GST is more beneficial than the existing system or the truncated GST from an investment perspective. Unfortunately, it appears that the stretched GST is unlikely to be implemented in India. Some sectors important to the economy such as construction and electricity are likely to remain exempt, inadvertently harming investment incentives.

Another concern from an investor's perspective is India's high CIT rates, which are among the highest in the world. Some investors, such as those

in the electricity and manufacturing sectors, are provided relief through accelerated depreciation and initial allowances for qualifying capital. However, these allowances distort capital markets by discouraging capital to be invested in their most profitable use, as well as lead to a loss in revenue.

Given the costs of high CIT rates and allowances, we studied whether changes in direct tax rules affect India's tax competitiveness or reduce the costs of incentives. Some METR results under the three scenarios are shown in [Chart 2](#). For each sector, the left-hand column is the current METR. The middle column presents METRs when accelerated depreciation and initial allowances are removed. The right-hand column presents METRs when, after depreciation and initial allowances are removed, CIT and MAT rates are adjusted such that the national METR is the same as at present.

Chart 2: METRs under different CIT scenarios



As expected, the removal of depreciation and initial allowances raises METRs across the board. Since these allowances are most beneficial for machinery, the METR increase is most pronounced in the machinery-rich manufacturing and electricity sectors.

After removing the allowances, the METR can be lowered by reducing direct tax rates. Our analysis shows that CIT rates can be brought down from the current 34% rate to about 14%! MAT rates can also be brought down from the current 18.5% to 12%. These sharp decreases in statutory rates are possible because the removal of allowances, in effect, significantly expands the tax base.

The core message from [Chart 2](#) is that a low CIT regime is feasible in India if depreciation benefits are removed. Instead of CIT and MAT rates of 34% and 18.5%, respectively, CIT rates of 14.2% and 12% could be offered. This would not much change the overall incentive for investment (because the aggregate METR does not change), but it would be a better signal to attract international investment as well as create more incentives to keep profits in India.

In summary, our analysis indicates that a GST reform has the potential to significantly reduce the costs of investment, which could be hugely beneficial to our economy. However, this potential can only be realized if the stretched GST were implemented

with minimal exemptions. If, however, the truncated GST is implemented as planned, with exemptions for key sectors of the economy, then much of the gains from the reform would be lost.

Under the stretched GST, the need for many special tax breaks such as accelerated depreciation and investment allowances would be redundant. But even without the stretched GST, we show that it is feasible to significantly reduce the statutory CIT rate without changing the investment tax wedge, through the simple expedient of removing all special tax preferences. Both GST and CIT reforms would ultimately make India tax-friendly for investment and improve the prospects for economic growth.

Global News





01

OECD releases multilateral instrument to modify bilateral tax treaties¹

On 24 November 2016, the Organisation for Economic Co-operation and Development (OECD) released the text of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (BEPS) under BEPS Action 15 (the multilateral instrument or MLI). The text and its related explanatory statement were formally adopted by approximately 100 countries at a ceremony hosted by the OECD following the conclusion of negotiations between the participants.

The intention of the MLI is to enable all countries to implement tax treaty-related measures established as part of the final BEPS package in a coordinated and consistent manner across the network of existing treaties without the need to bilaterally renegotiate each such treaty. The MLI will operate to modify tax treaties between two or more parties. It will not, however, function in the same way as an amending protocol to a single existing treaty, which would directly amend the

text of the tax treaty. Instead, it will be applied alongside existing tax treaties, modifying their application in order to implement the BEPS measures.

The tax treaty-related BEPS measures covered by the MLI include (elements of): (i) Action 2 on hybrid mismatch arrangements, (ii) Action 6 on treaty abuse, (iii) Action 7 on the artificial avoidance of the permanent establishment (PE) status and (iv) Action 14 on dispute resolution. The substance of the tax treaty provisions relating to these actions was agreed under the final BEPS package released in October 2015.

The MLI provides flexibility in adoption by:

- ▶ Allowing countries to specify the tax treaties to which the MLI applies
- ▶ Creating flexibility with regard to the provisions that relate to a minimum standard, in order to allow countries to choose the

option that fits them best

- ▶ Including the possibility to opt out of provisions when the provisions do not relate to a minimum standard
- ▶ Including the possibility to opt out of provisions for treaties with existing provisions with specific, objectively defined characteristics
- ▶ Allowing a choice to apply optional or alternative provisions, such as the optional provision on mandatory and binding arbitration

It is expected that the MLI will be open for signature as of 31 December 2016 and a first high-level signing ceremony will take place in the week beginning 5 June 2017. The MLI is a key part of the OECD's effort toward the implementation of the recommended BEPS measures. Currently, more than 3,000 of such treaties are in force. According to the OECD, the MLI could potentially lead to the amendment of at least 2,000 of these treaties in the coming years.

¹ Refer EY global alert "OECD releases multilateral instrument to modify bilateral tax treaties under BEPS Action 15" dated 25 November 2016



02

Australian Government releases an exposure draft of the proposed Australian Diverted Profits Tax²

On 29 November 2016, the Australian Government released an Exposure Draft (ED) of the proposed Australian Diverted Profits Tax (DPT) to apply from 1 July 2017. The public comments on the draft have to be provided by 23 December.

Once the provisions of DPT are effective, the Australian tax authorities will be able to tax certain profit-shifting schemes at a higher penalty tax rate of 40%, which will apply to an entity if:

- ▶ The scheme (or any part of a scheme) was carried out for a principal purpose of taking treaty benefit or both for obtaining a tax benefit and reducing a foreign tax liability.
- ▶ The relevant taxpayer is a member of a group with a global parent entity whose annual global income is at least AU\$1 billion

- ▶ The relevant taxpayer obtains a tax benefit in connection with a scheme involving a foreign associate

Exclusions from DPT apply where it is reasonable to conclude that one of the following tests applies:

- ▶ The turnover test: There is a de minimis threshold of AU\$25 million, provided no Australian-related entities "have artificially booked turnover outside Australia."
- ▶ The sufficient foreign tax test: The increase of the foreign tax liability is equal to or exceeds 80% of the Australian tax reduction.
- ▶ The sufficient economic substance test: This is to "apply only if the taxpayer provides information to satisfy the Commissioner that the activities of the relevant entity

have sufficient economic substance in relation to the income derived, received or made by the entity as a result of the scheme."

The purpose test incorporates existing anti-avoidance rules and requires consideration of the benefits to the taxpayer from foreign-related party dealings. A transaction involving a foreign-related party, with similar benefits and pricing as would apply with an unrelated party, should not invoke the DPT, but that should be clarified in the law. Because the test looks to any principal purpose, not the dominant purpose, the scope will be wider.

² Refer EY global alert "Australian Government releases Diverted Profits Tax Exposure Draft" dated 29 November 2016

03

Danish court rules that data center will not form PE of non-resident taxpayer³

In this case, a non-resident parent company indirectly owns a Danish subsidiary whose purpose is to establish a data center in Denmark. The subsidiary will enter into a hosting agreement with the parent company on market conditions for supplying website capacity. The subsidiary will own, lease and operate servers and other equipment. The servers and equipment will be used by the subsidiary for hosting the website and related activity for the parent company (sole customer). The subsidiary's employees will be responsible for the installation, operation, maintenance, and repairs of the data center and will work under the instruction and control of the management of the subsidiary.

Access to the data center will be limited to the subsidiary's employees and external service providers. However, a small group of employees of the parent company may from time to time be granted access to the data center by the subsidiary. The parent company's employees will handle the websites

through remote access. The remote access will allow the parent company to survey the efficiency of the data centers hardware and software, install and uninstall applications, maintain applications, and handle software and data in the data center.

The Danish Tax Board adjudicated on the issue whether the Danish subsidiary created a PE of the parent company.

The Danish Tax Board observed that:

- ▶ In relation to a fixed place PE, an internet website does not constitute tangible property, for which reason it cannot constitute a "place of business."
- ▶ On the other hand, a server on which the website is stored may constitute a "place of business" of the enterprise that operates that server. However, the parent company would only create a PE if it exercised control over the servers in a manner as if it, in fact,

owned or operated the servers. The parent company was not considered to exercise such control over the servers, as the parent company would not instruct the employees of the subsidiary, it would not exercise control over the work carried out by the employees, and it would not have physical access to or disposal of the servers.

- ▶ With regard to agency PE, the employees of the subsidiary would not be authorized to conclude binding contracts on behalf of the parent company.

In view of above, it was held that the data center in Denmark operated under a hosting agreement by the Danish subsidiary of the non-resident taxpayer, does not constitute a PE of the non-resident taxpayer.

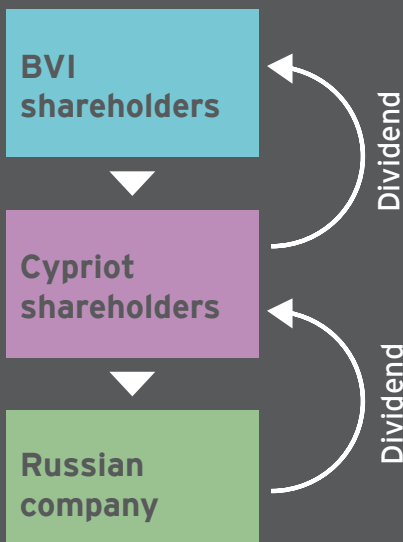
³ Refer EY global alert "Danish Tax Board rules datacenter does not create PE for nonresident taxpayer" dated 28 September 2016

04

Russian arbitration court issues ruling on “beneficial owner” of income⁴

In 2011, Severstal PAO (Russia Co or taxpayer) distributed dividends to four Cypriot shareholders. In doing so, the taxpayer applied the 5% withholding tax rate provided for in the tax treaty between Russia and Cyprus.

During the course of an audit, the tax authority discovered that the Cypriot companies had subsequently transferred the funds received as dividends, to companies registered in the British Virgin Islands (BVI).



In the tax authority’s view, the offshore companies were the actual recipients of the dividends, which meant that withholding tax should have been

charged at 15%, not 5% as per the Russia-Cyprus tax treaty. As per the tax authority, the transfer of funds took place on a transit basis. Further, the activities of the Cypriot companies were artificial in nature. They did not carry on any activities other than the receipt and transfer of funds.

According to the taxpayer, the possession of an actual right to the dividend income is sufficiently confirmed by ownership of shares in the Russian company. Further, the Cypriot companies were not subject to any constraints (under law or a contract) on disposal of the dividends received. The Cypriot companies independently exercised control over profits received and carried on investment activities.

The Russian court concurred with the tax authority that the reduced rate of withholding tax could not be applied as the Cypriot companies, which were “conduit” companies, did not have an actual right to the dividend income and could not, therefore, enjoy the benefits provided by the Russian-Cypriot tax treaty. The court considered the following facts to come to its conclusion:

- ▶ The shareholders of each of the Cypriot companies that received dividend were companies

registered in the BVI.

- ▶ To an inquiry sent by the Russian inspectors to Cyprus authorities, it was held that the Cypriot companies used the dividends received primarily to pay dividends to their shareholders in the BVI.
- ▶ The Cypriot companies had limited rights to dispose of the shares. The directors of the companies only had the right to make a decision to pledge the shares to one particular bank or to exchange them with affiliates, but did not have the right to make independent decisions on disposal of the shares.
- ▶ A part of the dividends was used to repay loans received from a company in the BVI
- ▶ The Cypriot companies had no assets other than shares in the Russian company. Dividends on shares in that company made up 99% of their income.
- ▶ Only the BVI-registered owners of the Cypriot companies had the right to make a decision to alienate the shares.
- ▶ It is evident from the cash flow statements of the Cypriot companies that they were able to pay dividends to shareholders only out of the dividends received from the Russian company.

⁴ Refer EY global alert “Russian arbitration court issues ruling on “beneficial owner” of income in favor of the tax inspectorate” dated 10 November 2016

05

India revises its comments on the TP chapter in the UN TP Manual⁵

The United Nations (UN) Tax Committee formed a subcommittee on transfer pricing (TP) at its fifth annual session in 2009 to meet the needs of developing countries in the area of TP. The subcommittee was mandated to prepare a practical manual on TP for developing countries. Subsequent to the work of the subcommittee, the UN Practical Manual on Transfer Pricing for Developing Countries (UN TP Manual) was adopted by the Committee in 2012.

Thereafter, the UN subcommittee worked on two different areas related to TP:

Revision of the Commentary on Article 9 of the UN Model Convention

Update and enhancement of the UN TP Manual

The subcommittee recently presented a proposed version of the updated UN TP Manual (the 2016 Draft) for the approval of the Committee, with a view to publish the revised UN TP Manual in 2017.

In carrying out its mandate, the subcommittee gave due consideration to the outcome of the OECD/ G20 Action Plan on BEPS relating to TP. The 2016 Draft also includes chapters on the practices and positions of emerging countries such as India, Mexico, China, South Africa and Brazil.

The Indian tax administration in the country-specific Chapter in the 2016 Draft has revised and updated its comments on a number of emerging TP issues from an Indian perspective, including issues pertaining to comparability analysis, allocation of risk, use of multiple year data, location savings, intra-group services and transactions involving

transfer/use of intangibles. The India Chapter of the 2016 Draft also contains an acknowledgment of India's endorsement of the recommendations contained in the final report on TP under Actions 8–10 (Aligning Transfer Pricing Outcomes with Value Creation) and Action 13 (Transfer Pricing Documentation and Country-by-Country Reporting) of the OECD/G20 Action Plan on BEPS.

The revised India Chapter states that the guidance flowing from these final reports should be utilized by the Indian revenue authorities as well as taxpayers in situations of ambiguity in interpretation of the law.

India has, however, not endorsed the guidance in the BEPS report under Action 10 pertaining to low-value adding intra-group services.

⁵ Refer EY global alert "India revises Country Chapter comments in UN Practical Manual on Transfer Pricing Issues for Developing Countries" dated 14 November 2016



EconoMeter

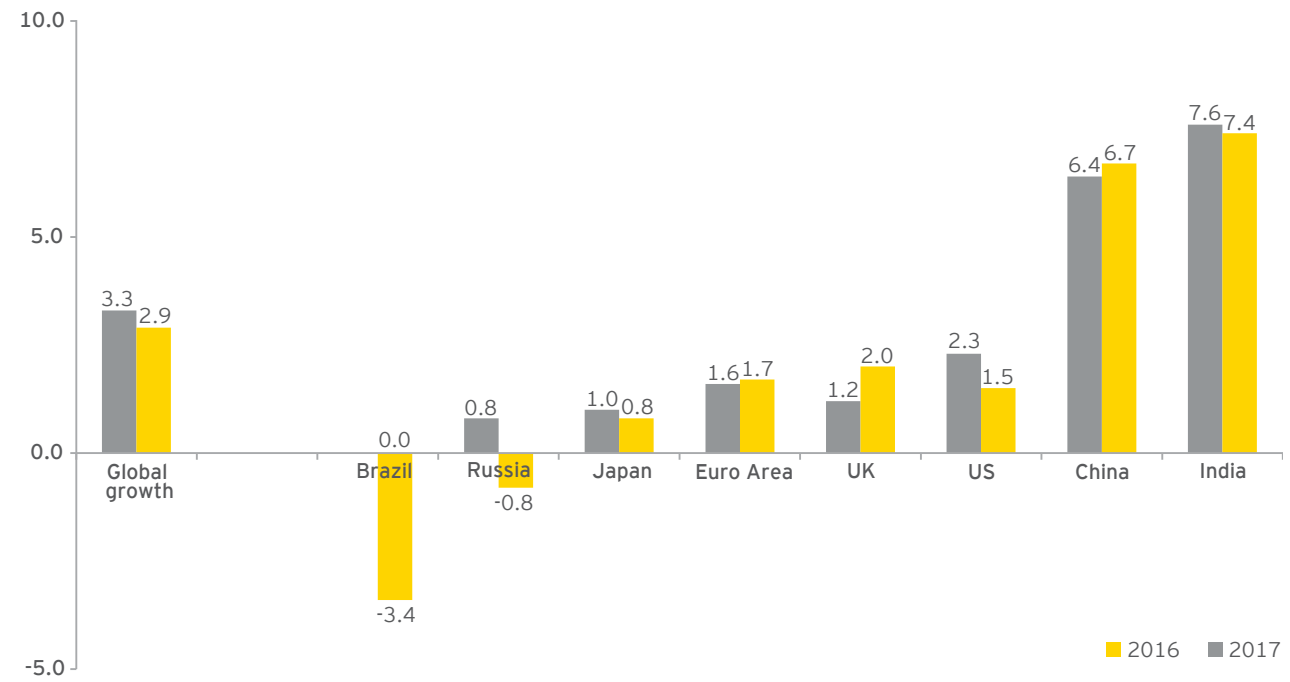
Macro-fiscal trends

1

After demonetization, the RBI and a number of rating agencies have revised India's FY17 GDP growth forecasts downward.

- ▶ Taking into account the contractionary impact of demonetization, particularly in the 3rd and 4th quarters of FY17, the RBI, in its December 7th Monetary Policy Review, reduced India's FY17 GDP growth forecast from 7.6% to 7.1%.
- ▶ A number of rating agencies have also revised their earlier forecast for India's FY17 GDP growth downward by varying margins.
- ▶ OECD projects global GDP at 2.9% in 2016 and 3.3% in 2017 based largely on strong fiscal support undertaken by most countries.

Chart 1: OECD Global Economic Outlook 2016



Source: OECD Global Economic Outlook 2016

2

On the output side, except for agriculture, construction and public services, there was an across-the-board reduction in the growth rates in 2QFY17 as compared to 1QFY17

- ▶ Agriculture, construction and public services showed marginal improvement.
- ▶ The fall in the growth of manufacturing, electricity and services is particularly notable.
- ▶ In November 2016, services Purchasing Managers' Index (PMI) dropped significantly to 46.7 from 54.5 in October 2016. Manufacturing PMI also fell from 54.4 to 52.3.

Table 1: GVA: annual and quarterly growth rates (% y-o-y)

Sector	1Q FY16	2Q FY16	3Q FY16	4Q FY16	1Q FY17	2Q FY17
Agr.	2.5	2.0	-1.0	2.3	1.8	3.3
Ming.	8.5	5.0	7.1	8.6	-0.4	-1.5
Mfg.	7.3	9.2	11.5	9.3	9.1	7.1
Elec.	4.0	7.5	5.6	9.3	9.4	3.5
Cons.	5.6	0.8	4.6	4.5	1.5	3.5
Trans.	10.0	6.7	9.2	9.9	8.1	7.1
Fin.	9.3	11.9	10.5	9.1	9.4	8.2
Publ.	5.9	6.9	7.2	6.4	12.3	12.5
GVA	7.2	7.3	6.9	7.4	7.3	7.1

Source (Basic Data): MOSPI GVA: gross value added

3

Demand conditions signal weakness due to weak investment and near-stagnant export demand

- ▶ Gross fixed capital formation, reflecting investment demand in the economy contracted from (-) 3.1% in 1QFY17 to (-) 5.6% in 2QFY17, registering its third consecutive quarterly decline.
- ▶ Growth in export demand nearly stagnated at 0.3% in 2QFY17.
- ▶ Discrepancies still accounted for a relatively significant portion of GDP in 2QFY17

Table 2: Growth in components of aggregate demand with 2011-12 as base (% y-o-y) at constant prices

AD component	1Q FY16	2Q FY16	3Q FY16	4Q FY16	1Q FY17	2Q FY17
PFCE	6.9	6.3	8.2	8.3	6.7	7.6
GCE	-0.2	3.3	3.0	2.9	18.8	15.2
GFCF	7.1	9.7	1.2	-1.9	-3.1	-5.6
EXP	-5.7	-4.3	-8.9	-1.9	3.2	0.3
IMP	-2.4	-0.6	-6.4	-1.6	-5.8	-9.0
GDP	7.5	7.6	7.2	7.9	7.1	7.3
of which % contribution of Discrepancies	2.0	1.2	2.1	4.1	0.9	1.5

Source: CSO, MOSPI, Government of India

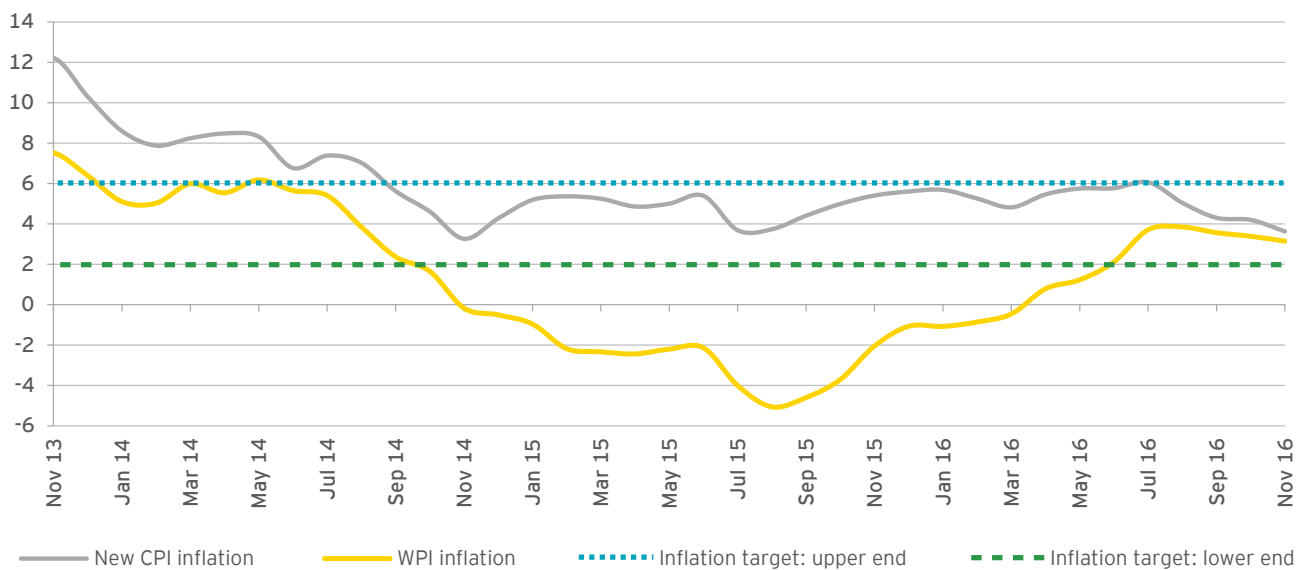
PFCE: Private final consumption expenditure; GCE: government final consumption expenditure; GFCF: gross fixed capital formation; EXP: exports; IMP: imports; GDPMP: GDP at market prices

4

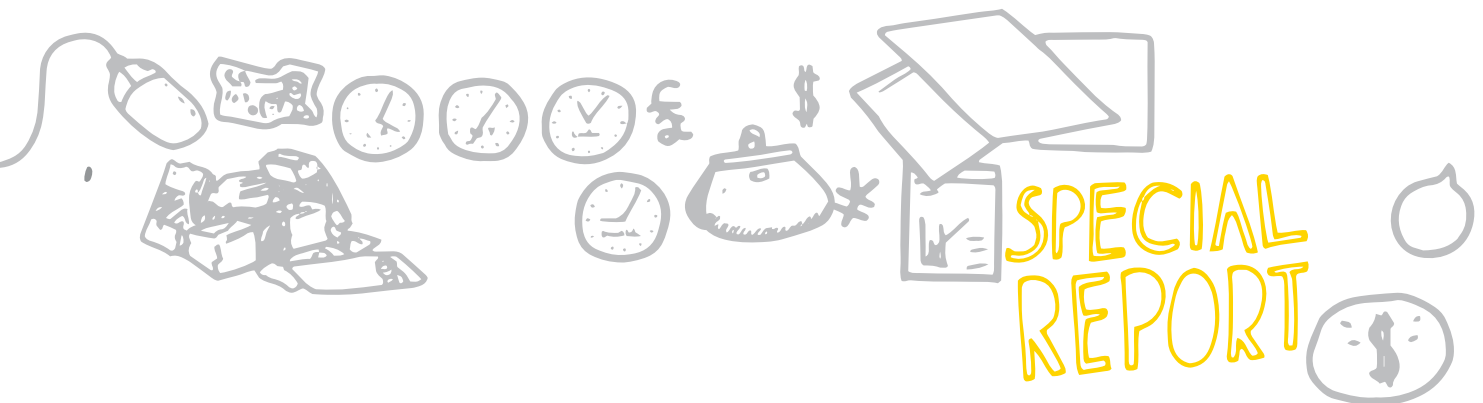
RBI postpones rate revision in view of domestic and global uncertainty

- ▶ RBI, in its December Monetary Policy Meet, has left the repo rate unchanged at 6.25% in view of heightened uncertainty, both in global and domestic economic conditions, belying market expectations of a rate cut.
- ▶ Contractionary forces have led to a fall in Consumer Price Index-based inflation, which at 3.6% was at a two-year low in November 2016.
- ▶ Wholesale Price Index-based inflation fell further to 3.2% (y-o-y) in November 2016 from 3.4% in September 2016 because of a decline in prices of agricultural items, including food and non-food articles.

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



Source: MOSPI, Office of Economic Adviser

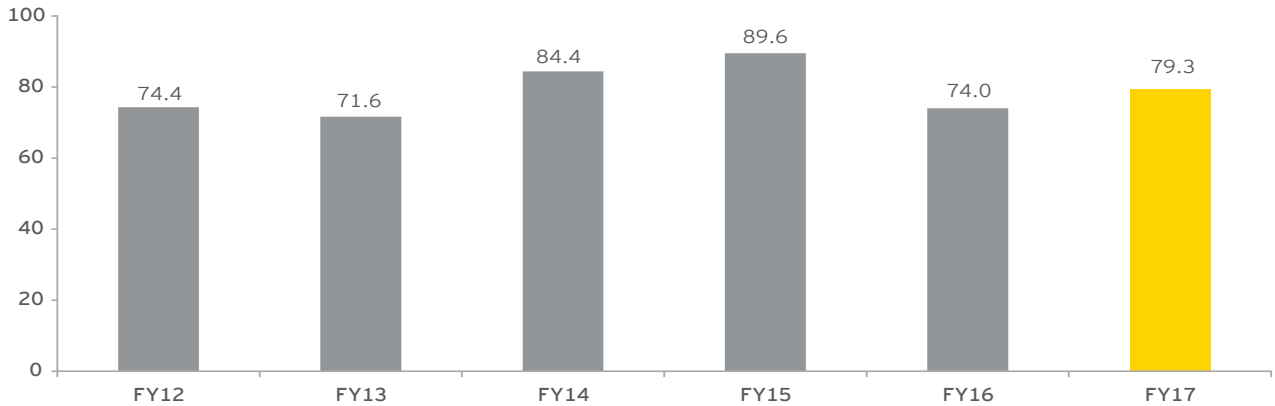


5

The Center's fiscal deficit stood at 79.3% of the annual budgeted target during April–October FY17

- ▶ The Center's fiscal deficit stood at 79.3% of the annual budgeted target during April–October FY17.
- ▶ Disinvestment proceeds stood at 59.5% of the annual budgeted target during April–October FY17
- ▶ as compared to 31.2% in the corresponding period of FY16.

Chart 3: Cumulated fiscal deficit up to October 2016 as a percentage of annual budgeted estimates for FY17



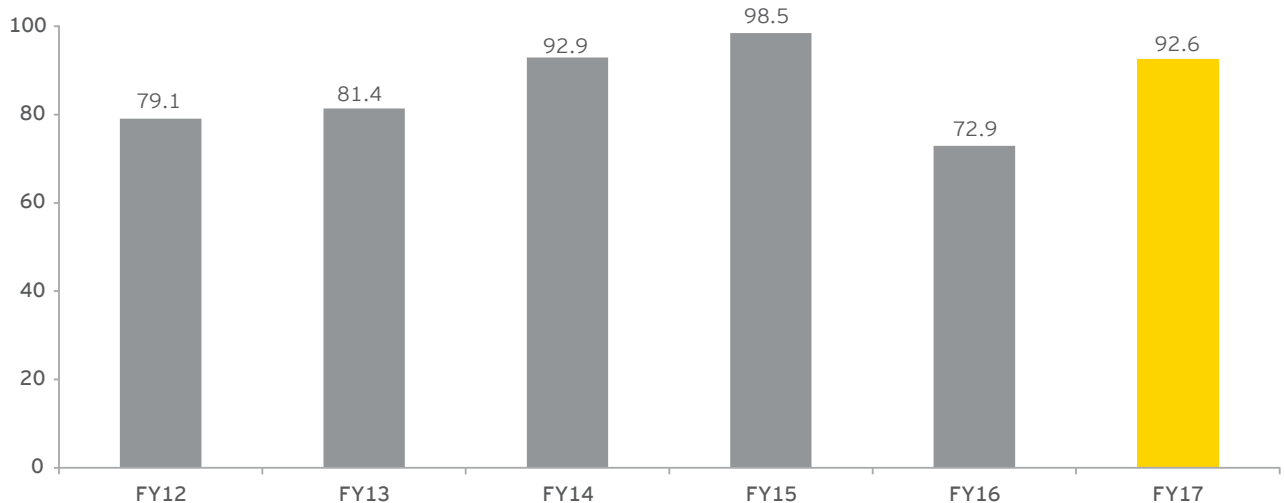
Source: Monthly Accounts, Controller General of Accounts, Government of India

6

The Center's revenue deficit stood at 92.6% of the annual budgeted target during April–October FY17

- ▶ The Center's revenue deficit increased to 92.6% of the annual budgeted target during April–October FY17 as compared to 72.9% during the same period in FY16.
- ▶ Huge payouts under the 7th Pay Commission kept the revenue spending elevated.

Chart 4: Cumulated revenue deficit up to October 2016 as a percentage of annual budgeted estimates for FY17



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

7

Tax revenues grew by 18% during April-October FY17, but growth in non-tax revenues has remained subdued

- ▶ Cumulated gross tax revenues grew by 18% during April-June FY17, compared to 23.1% during the same period of FY16.
- ▶ Direct taxes grew by 10.7% and indirect taxes by 24.6% during this period.
- ▶ Growth in non-tax revenues was low at 3.7% as compared to the corresponding value of 45.6% in FY16, largely due to a slowdown in dividends by PSUs

Table 3: Gross tax and non-tax revenues (annual and cumulated year till date, y-o-y)

Tax/non-tax revenue	FY14	FY15	FY16 (RE)	FY17 (BE)	April-October FY16	April-October FY17
Gross tax revenue	9.8	9.3	17.2	11.7	23.1	18.0
Non-tax revenue	44.6	-1.1	31.3	24.9	45.6	3.7

Source: Monthly Accounts, Controller General of Accounts, Government of India
RE: revised estimates; BE: budget estimates;

8

Except for corporation tax and customs duty, other major Central taxes have done well

- ▶ In terms of revenue growth during April-October FY17, three taxes did satisfactorily: Union excise duties (46.4%), income tax (19.3%) and services tax (24.5%).
- ▶ In the same period, in terms of revenue growth, two taxes underperformed: corporation tax (4.5%) and customs duty (4.9%). This trend reflects weakness in investment and import demand.

Table 4: Tax revenues (annual and year-to-date growth rates, y-o-y)

Tax revenues	FY14	FY15	FY16 (RE)	FY17 (BE)	April-October FY16	April-October FY17
Corporation tax	10.8	8.7	5.6	9.0	14.4	4.5
Income tax	20.8	8.7	12.9	18.6	14.0	19.3
Custom duty	3.8	9.2	11.4	9.8	17.1	4.9
Excise duty	-3.6	11.6	49.6	12.2	68.7	46.4
Service tax	16.7	8.6	25.0	10.0	23.5	24.5

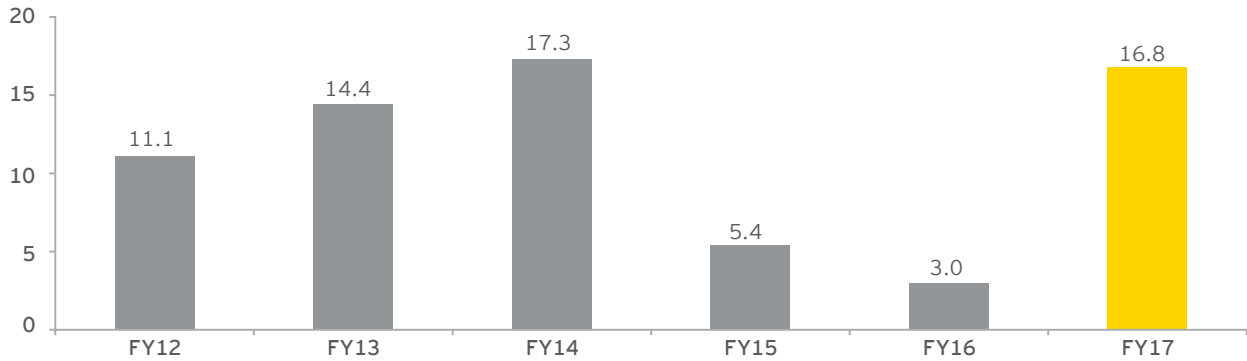
Source: Monthly Accounts, Controller General of Accounts, Government of India

9

The Center's revenue expenditure has increased sharply because of revision of salaries and pensions

- ▶ Total expenditures grew by 12.6% during April-October FY17 as compared to 6.2% in the corresponding period of FY16.
- ▶ Revenue expenditure increased sharply to 16.8% during April-October FY17 from just 3.0% during this period in FY16 because of the implementation of the 7th Central Pay Commission's recommendations.

Chart 5: Growth in cumulated revenue expenditure up to October 2016



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

10

The Center's capital expenditure contracted sharply in the first half of FY17

- ▶ The Center's capital expenditure contracted sharply by (-) 12.8% during April-October FY17.
- ▶ This was in contrast with the growth of 31% during the corresponding period of FY16.

Chart 6: Growth in cumulated capital expenditure up to October 2016



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

Thoughts

“ If people are not laughing at your goals,
your goals are too small ”

- Azim Premji

“ Balancing your money is the key to
having enough ”

- Elizabeth Warren

“ I think a simple rule of business is, if you do
the things that are easier first, then you can
actually make a lot of progress ”

- Mark Zuckerberg

“ Progress is often equal to the difference
between mind and mindset ”

- Narayana Murthy

“ If you really look closely, most overnight
successes took a long time ”

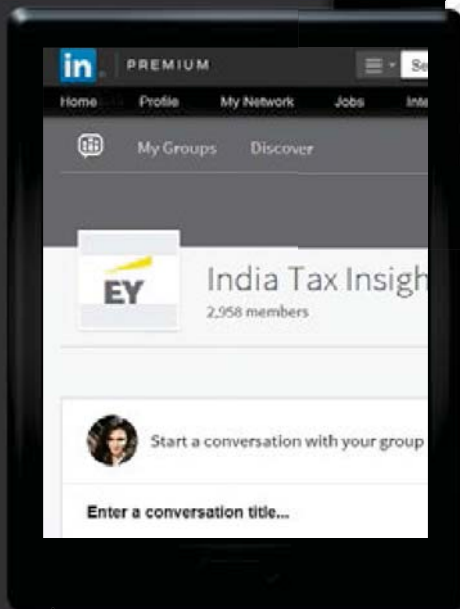
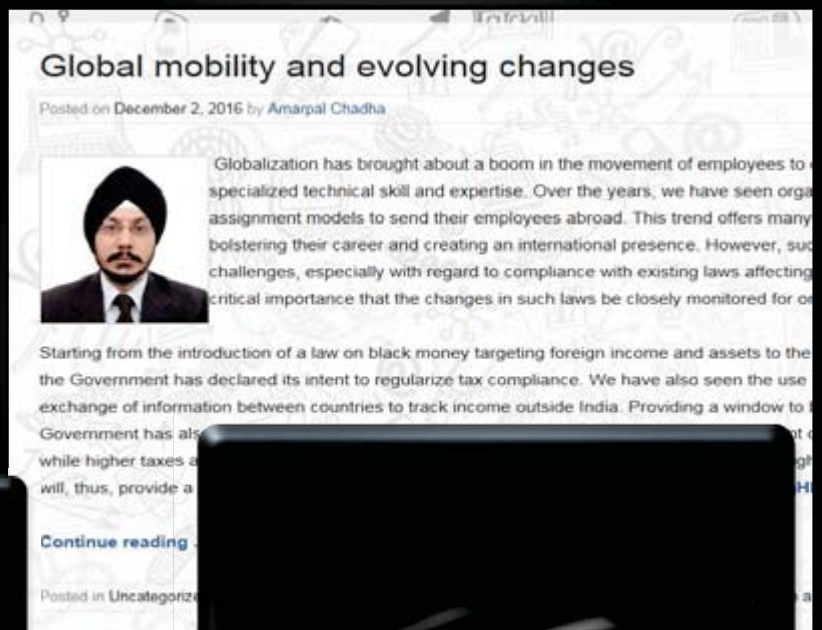
- Steve Jobs

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