

# India Tax Insights

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 In this issue



**EY**

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# Foreword

The COVID-19 pandemic has dealt a severe blow to an already stressed global economy. The severity of the pandemic across the globe has pushed countries and organizations into uncharted territories. The macro-economic impact of COVID-19 could result in a significant dip in GDP growth, an adverse impact on fiscal deficit and a substantial erosion of investor wealth. While the path to recovery is unpredictable, a prolonged “see-saw” shaped recovery looks most likely for India, leading to a “new normal”.


To cope with the crisis, the government has already announced a stimulus package amounting to INR 20.97 lakh crore, that is 9.8% of FY21 estimated GDP. Of this package, only 9.7% is the additional burden on the center’s FY21 budget. An analysis carried out by EY’s Tax and Economic Policy Group shows that, the center’s fiscal deficit in FY21 may be estimated at 7.1% if this additionality in the recently announced stimulus is to be provided for and the budgeted level of expenditures is to be protected.

In this edition of India Tax Insights, we present our analysis of the pandemic’s impact on Indian economy and finding our way through the new normal. The article on world trade post COVID discusses the potential new environment where countries may start to protect their vital supplies and increase tariff and non-tariff barriers while defending their existing domestic industries through trade remedial measures.

Besides economic and trade analysis, the magazine explores if the COVID experience will further foster online collaboration platforms to create the framework for a ‘Gig Economy’ as the new talent marketplace. The write-up on investment planning post COVID discusses the likely geographical rejig of manufacturing hubs and the possibility of India emerging as a globally preferred investment destination depending on its ability to align to international standards of industrial support.

This edition also includes articles on a number of contemporary tax topics such as India’s new regime for dividend taxation, tax dispute settlement scheme, impact of COVID-19 on international tax, transfer pricing, GST and cross-border mobility.

We hope you will find this publication interesting and insightful. We look forward to your feedback and suggestions.



*Sudhir Kapadia*

**Sudhir Kapadia**  
National Tax Leader, EY India

# In this issue



COVID-19 and beyond

# Road to recovery: key tax and policy changes

# Coping with COVID-19 induced economic collapse

■ Unprecedented global crises since the 1929 Great Depression

Multilateral institutions have assessed that the COVID-19 pandemic will leave the world economically worse than the 2008-09 global economic and financial crisis. Its impact may be more comparable with the Great Depression of 1929. The International Monetary Fund<sup>1</sup> (IMF) and the United Nations<sup>2</sup> (UN) have projected the global GDP to contract by (-) 3% and (-) 3.2%, respectively in 2020. As per the UN, two major emerging and developing economies, namely, India and China, are expected to show a low but positive growth at 1.2% and 1.7%, respectively in 2020. Other leading international institutions and rating agencies project this year's global growth to range from (-) 5.9%<sup>3</sup> (Deutsche Bank) to (-)1.1%<sup>4</sup> (JP Morgan).

1 IMF World Economic Outlook, April 2020

2 UN World Economic Situation and Prospects as of mid-2020 (13 May 2020)

3 <https://www.reuters.com/article/global-policy/column-markets-return-to-doldrums-set-to-summon-more-fiscal-firepower-mike-dolan-idUSL8N2BR5YX>

4 <https://www.bloomberg.com/news/articles/2020-03-19/wall-street-agrees-the-world-is-in-recession-disagrees-on-depth>



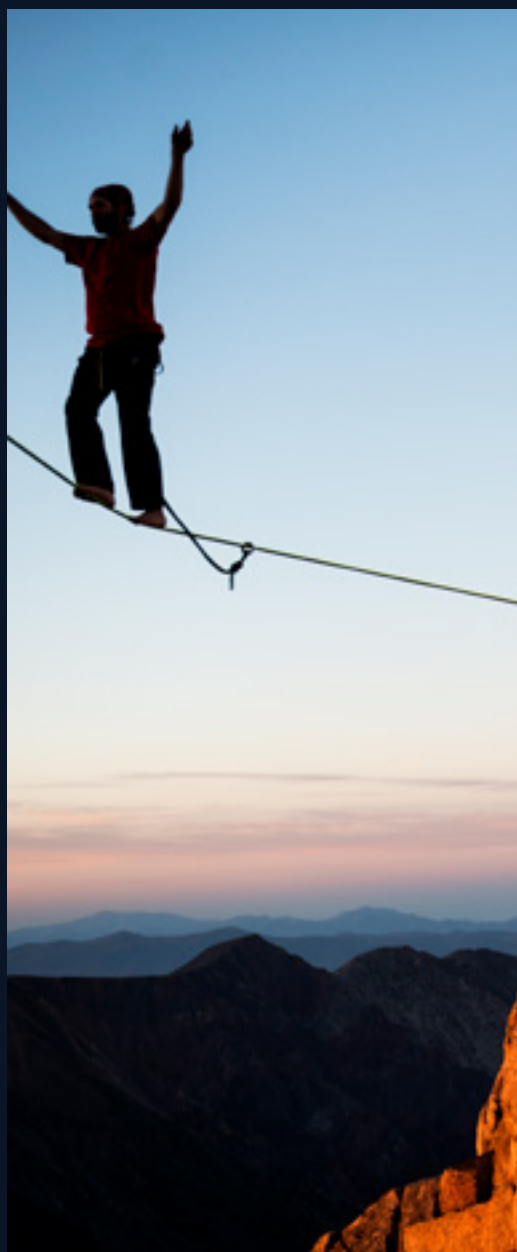
**Dr. D.K. Srivastava**

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The COVID-19 induced economic crisis is quite different from the 2008-09 global economic and financial crisis in some crucial respects. The roots of the 2008-09 crisis emanated from the housing market crisis of the US and excessive lending by global financial institutions to households based on poor quality collaterals. The credit markets across the world crashed, leading to a collapse of credit demand across the countries. This was a demand-led crisis that was addressed by individual and coordinated stimulus across the G-20 countries.

**These countries coordinated their stimulus action by reducing interest rates and increasing their debt-financed government expenditures. In some of the economies where stimulus measures were overdone, there was a sharp rise in inflation. The longer-term outcome was an increase in the indebtedness at the global level.**

Since the COVID-19 crisis may be deeper than the 2008-09 crisis, the reliance on fiscal measures would be even larger. In fact, in most developed countries, the interest rates are near zero and any monetary side stimulus may have limited effect. As such, the borrowing-based financing of government expenditure should serve to boost the demand in different countries. However, the current crisis is a combination of supply side disruptions and a sinking of demand. As demand is uplifted through stimulus, supply side disruptions may have to be simultaneously removed so that the two sides may come out of the crisis in sync. This calls for a carefully calibrated injection of demand stimulus which should be synchronized with the stages of the exit from the lockdown.



## India: slipping into a fall while already on a slide

India's current growth prospects are highly constrained as it has entered the COVID-19 crisis on the back of an economic downslide. The real GDP growth was estimated at 5% for FY20 as per the earlier Central Statistical Organisation's release dated 28 February 2020. As more recent information for 4QFY20 becomes available, this estimate may go down significantly. The UN has projected India's FY20 growth at 4.1%. Available forecasts for India's FY21 growth vary from (-) 5.2% (Nomura) to 4.0% (ADB), showing a wide range of 9.2% points. This indicates significant uncertainty in the assessment of the economic impact of COVID-19 on the Indian economy.

High frequency indicators highlight significant adverse impact of the COVID-19 pandemic<sup>5</sup>. Purchasing Manager's Index (PMI) manufacturing and services contracted to unprecedented levels of 27.4 and 5.4, respectively in April 2020. Reflective of the weakness in demand conditions, growth in bank credit remained subdued at 6.7% in the fortnight ending 24 April 2020. In March 2020, Index of Industrial Production contracted by (-)16.7%, its lowest level in the 2011-12 base series. Contraction in power consumption increased considerably to (-) 24.7% in April 2020, reflecting a sharp fall in domestic demand. At (-) 60.3% in April 2020, contraction in exports was the sharpest since 1991, reflecting global and domestic supply disruptions. With respect to automobile sales, information from major players in the sector indicates zero domestic sales in April 2020<sup>6</sup>. Gross tax revenues of the center contracted by (-) 0.8% during April-February FY20 with direct taxes contracting by (-) 3.5% and indirect taxes witnessing a subdued growth of 1.6%.

5 EY Economy Watch, May 2020 edition

6 <https://www.news18.com/news/auto/april-2020-to-go-down-in-india-history-as-the-month-of-zero-car-and-two-wheeler-sales-2600945.html>



## Fighting our way out: policy stimuli and preparing for the new normal

### a. Policy stimuli

On the monetary side, the repo rate was reduced to an unprecedented level of 4.0% on 22 May 2020 with a cumulated reduction of 115 basis points since 27 March 2020. Other relevant rates such as reverse repo rate, bank rate and marginal standing facility (MSF) rate have also been reduced. Numerous liquidity-augmenting and regulatory measures have also been undertaken since the end March 2020. Liquidity augmenting initiatives include a reduction in the Cash Reserve Ratio, targeted long-term repos operations (TLTROs), special refinance window for all India financial institutions, and eased overdraft rules for state governments.

The RBI also increased the limit under ways and means advances (WMAs) for the central and state governments. In TLTRO 2.0, as announced on 17 April 2020, an aggregate amount of INR50,000 crores was particularly aimed at supporting NBFCs. On 27 April 2020, the RBI announced an injection of INR50,000 crore through a special liquidity facility for mutual funds. The regulatory initiatives of the RBI include permitting commercial banks and financial institutions to provide moratorium of three months on payment of instalments in respect of all term loans outstanding as on 1 March 2020 and deferment of interest on working capital facilities for three months on all such facilities. These have been extended for another three months till 31 August 2020. According to government estimates provided on 17 May 2020, the monetary stimulus through liquidity enhancement measures amounted to INR8.01 lakh crores.

A stimulus package of a cumulated magnitude of INR20.97 lakh crore has been announced during the period 26 March 2020 to 17 May 2020 for the Indian economy, of which the additional budgetary cost is limited to only 9.7% of the total package. As compared to the FY21 budget estimates (BE), both the central and state governments would suffer a significant revenue erosion due to the lower FY20 tax base and lower growth prospects in FY21. Recognizing this, the central government has announced its revised gross borrowing program for FY21 uplifting its fiscal deficit from 3.5% to 5.7% of the GDP. Additionally, borrowing limit for states has also been relaxed from 3.0% to 5.0% of their respective gross state domestic products subject to certain conditions.

While the need for a large fiscal stimulus to support relief and stimulus measures is paramount, the available resources for the government appear to be highly constrained while matching the public sector borrowing requirement (PSBR) with the sources of its financing. India has stepped into the COVID-19 crisis on the back of two successive years of fiscal slippage where the central government had to provide for a countercyclical relaxation of 0.5% points of the GDP, each from their respective targets in FY20 (RE) and FY21 (BE). India is far more handicapped at present as compared to the 2008-09 crisis when we experienced five successive high growth years over the period FY04 to FY08. The average growth rate during this period was 7.9%. In FY08, the combined fiscal deficit of the central and state governments was also at its lowest at 4.1% of the GDP.

The total PSBR is estimated at 15.60% of FY21 GDP. This includes (a) fiscal deficit of 7.1% of GDP for the center which would be required to cover the shortfall in revenues and non-debt capital receipts, the impact of lower nominal GDP growth and to accommodate the stimulus package while maintaining the budgeted expenditures, (b) fiscal deficit of 5.0% of GDP for states and (c) borrowing requirement of 3.5% of GDP of public sector enterprises. Against this, the available sources of financing consisting of excess savings from household and private corporate sectors (7% of GDP), savings of the public sector (1.5% of GDP) and current account deficit (1% of GDP) add to only 9.5% of GDP, leaving a significant financing gap of 6.1% of GDP. Some of the channels through which this gap may be filled up include monetization of fiscal deficit, borrowing from multilateral institutions including the IMF, and borrowing from non-resident Indians (NRIs).

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## b. Exit strategy

India's lockdown has continued for more than two months. It was characterized by minimal economic activity. Whenever the economic activities resume, they may not normalize for a long period of time. In fact, their resumption needs to be undertaken according to a well-thought out exit strategy. Different output sectors may resume activities at a different pace as the pandemic is gradually brought under control. Sectoral targeting of fiscal stimulus should be synchronized with the opening up of the relevant sectors. India's FY21 growth would depend critically on the pace of opening up of the sectors and the effectiveness of monetary and fiscal stimulus.



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## Concluding observations

There is an urgent need to reprioritize budgeted expenditures in favor of health-related expenditures including health infrastructure. In terms of rebooting the economy, new manufacturing capacity needs to be attracted in India which would require additional budgetary allocation. In fact, both revenue and expenditure side estimates of the central and state budgets, which were only recently presented in the Parliament and respective legislatures, would need to be overhauled. As things begin to normalize, there may be a need to present new full year budgets since the existing budgetary numbers have been rendered irrelevant by the onslaught of the economic pandemic.

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# Trade policy scenario in post-COVID-19 era

The COVID-19 pandemic is likely to be that inflection point in the history which changed the nature of the post-World Trade Organization (WTO) global trade policy environment. The last time the world witnessed a similar situation was in 1995 when the WTO was established, creating a rule-based global trading system. As of December 2019, when China first informed the World Health Organization (WHO) about the corona virus<sup>1</sup>, the last of the judges at the Appellate Body of the WTO retired without their replacement being appointed by the WTO Members. This, in effect, has removed the most important tool by which the order was maintained by the WTO, impacting its ability to ensure adherence to its rules by its members.



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<sup>1</sup> <https://www.who.int/emergencies/diseases/novel-coronavirus-2019/events-as-they-happen>

The impact of COVID-19 on trade and economy is already visible. It has led to reduction in demand and collapsing trade flows. Supply-chain disruptions have questioned the resilience of production networks, whether regional or global, on which the world has been dependent on in the post-WTO period. Economists are comparing the lockdown with the Great Depression of 1930s and the financial crisis of 2008-09.

### ***The WTO estimates world trade to fall by 13% to 32% in 2020<sup>2</sup>.***

Global institutions are trying their best to soften the impact of this pandemic on the world's economy. The World Bank has released a guidance note on 'Dos and don'ts of trade policy in response to COVID-19'. The note encourages governments across the world to ease out the restrictions for trade in essential medical goods and food, by removing the need for applications, licenses, etc. It further encourages them to support exporters to maintain jobs and foreign exchange earnings, and to contribute to macroeconomic policy efforts to shield the economy from the downturn caused due to the pandemic. Whether countries heed this advice, or the protectionist tendencies strengthen is the question to ask.

Even before the pandemic struck, there were a series of disruptions in the global trade policy environment, led by unilateral and sometimes arbitrary actions. These were in the form of imposition of punitive import duties, withdrawal of Generalized System of Preferences (GSP) benefits and renegotiation of free trade agreements by a few countries. In India, too, the signs of the trade policy turning inward-looking were appearing.

These signs include India's hesitation in signing on to the Regional Comprehensive Economic Partnership (RCEP) Agreement without inclusion of specific measures to protect its interests, increase in anti-dumping and other trade protection actions and increasing its import duties and new import licensing requirements.

In the post-pandemic environment, many countries are likely to intensively dedicate their efforts towards rebooting their industries and protecting their vital and essential supplies. Ensuring availability of essentials for the future in case such a pandemic situation arises, can be achieved by protecting their critical domestic industries and diversifying their supply chains, both of which would require targeted policy measures. Trade policies can, thus, be expected to become more conservative.

The conservative approach is likely to be reflected in the national trade policy of countries in multiple ways, such as by increase in import tariff and covert or overt non-tariff barriers like licensing procedures, import and export quotas, and in maintenance of their strategic reserves. Countries may also look to defend their existing domestic industries through increased recourse to trade remedial measures, such as, antidumping duties, anti-subsidy duties and safeguard duties. This would be necessary for the domestic industries, not inherently efficient, to retain their profitability.

For India, the rising global uncertainties relating to the existing supply chain, including their competition with China, might surprisingly bring them an array of opportunities post the pandemic. Several reports suggest that some American and European manufacturers intend to relocate their factories out of China or at least have alternate sources in geographically diverse locations. Japan is reported to be offering support to its industries to relocate back home. Going forward, this may provide a good opportunity for India to attract foreign manufacturers to relocate their factories here. To this end policy measures that include focused investments in infrastructure and incentive measures that offset the inherent problems of operating here will be necessary. Creating a foreign investment-friendly policy environment, focusing on sectors that amongst other objectives, would also substitute India's import needs, may be India's best bet to get a head-start in reviving the economy.

**It will be interesting to see how the world will deal with me-first trade policies, especially with the WTO not in a position to enforce its own rules**

Contribution by:  
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<sup>2</sup> [https://www.wto.org/english/news\\_e/pres20\\_e/pr855\\_e.htm](https://www.wto.org/english/news_e/pres20_e/pr855_e.htm)

# COVID-19 impact on mobile workforce and PE implications



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COVID-19 has changed the way we live. The resultant international travel bans, immigration suspensions, lockdowns and restrictions on movement of people have transformed the way people work across the globe. This has also temporarily halted the cross-border movement of employees. However, for business continuity, employees are working remotely on their projects from their home countries, host countries or a country, where they may be stuck due to travel restrictions. This has triggered numerous implications for both employees and employers from immigration, social security, tax, labor and employment law perspectives.

Most employers and employees are aware of the implications of immigration violations. However, several other critical aspects also need to be considered. For instance, employees who are on assignments but are working from home countries due to the pandemic, can expose themselves and their employers to tax risks in both geographies. The following are some of the implications:



## Residential status of the employees ■

Under the domestic tax laws of most countries, residential status of individuals is determined based on the duration of their stay in that country. There are two possible scenarios:

1. Employees who were on short visits/casual visits to a foreign country, could attain tax residency in that country due to prolonged stay.
2. Employees who were on an assignment to a foreign country but returned to their home country for a visit, could attain tax residency in the home country.

## Taxation and reporting requirements ■

The above scenarios can result in requirements such as reporting of employees' worldwide income, paying tax in additional jurisdictions, payroll requirements for employer and double taxation for the employees in some cases. Also, the fact that employees are now working remotely for their host /home entity may expose the employers in the host/home country towards creating a Permanent Establishment (PE) in the home/host/a third country where the employee is present. Hence, both employers and employees should closely monitor the duration of the employees' stay and ensure appropriate tax compliances are undertaken in a timely manner.

The extended stay by employees in this case is force majeure and as a result of the pandemic. It is not due to the requirements of their employers/businesses or the employees' own will. Hence, it is essential for the Revenue authorities to make exceptions in tax laws in this situation. As per the recently published, OECD Secretariat Analysis of Tax Treaties and the Impact of the COVID-19 Crisis (the Analysis), "the exceptional and temporary change of the location where employees exercise their employment because of the COVID-19 crisis, such as working from home, should not create new PEs for the employer".

In the Analysis, it has also been noted that it is unlikely that the COVID-19 situation will create any changes to the PE determination.

Basis this, the Organisation for Economic Co-operation and Development (OECD) has recommended tax administrations across the world to provide guidance to address tax issues created by the cross-border employees due to various restrictions imposed currently, and to minimize unduly burdensome compliance requirements for the taxpayers.

The OECD recommendations are only guiding principles and are not binding on member countries. Hence, they have no impact on domestic tax laws. This could, however, encourage countries in making necessary amendments to their domestic tax laws as per their circumstances. Also, for non-member countries, although the recommendations are not applicable, they may act as a useful aid for determining the tax policy on cross-border tax issues arising in this unprecedented situation.

The tax authorities in the US, the UK, Ireland, Australia and India have issued guidelines on relaxation of tax laws for employees impacted by COVID-19. HM Revenue and Customs (HMRC) in the UK has introduced guidelines around exceptional circumstances that are to be considered, to establish if any time spent by individuals in the UK can be ignored for the purposes of the various counts of their presence in the UK for determining their residency. According to the guidelines, the days spent in the UK may be ignored if the individual's presence in the UK is due to exceptional circumstances beyond their control. This will usually apply to events that occur while an individual is in the UK and which prevent them from leaving the UK.

The US Treasury and Internal Revenue Service announced guidelines stating that under certain circumstances, up to 60 consecutive calendar days of US presence by an individual, presumed to arise from travel disruptions caused by COVID-19 will not be counted for the purposes of determining the individual's US tax residency. Similarly,

US business activity conducted by a non-resident alien or foreign corporation will not be counted for up to 60 consecutive calendar days in determining whether the foreign corporation has a US PE.

The Central Board of Direct Taxes (CBDT) in India, considering the genuine hardship caused by the lockdown has announced a relaxation in determining the residential status of individuals who have come to India on a visit prior to 22 March 2020. Their presence in India during the specified period (i.e., from 22 March 2020/ date of quarantine till 31 March 2020/ date of departure before 31 March 2020, as the case may be) will not be considered for determining residential status in India for tax year 2019-20. In addition, the Indian Government has also extended the due date for filing India tax return for individuals from 31 July 2020 to 30 November 2020. Further, the Government has reduced the rate of contribution to Provident Fund (PF) of both employer and employee for all establishments covered under the PF regulations from 12% to 10% each for the next three months.

## Way forward ■ ■ ■

Similar guidelines by the governments across the world would be a welcome move to put internationally mobile employees and their employers at ease in these testing times. Until then, it is essential for employers to keep abreast of these developments, track their employees and their stay and remain on top of the various compliances.

Contribution by:  
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People Advisory Services, EY India ■  
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# Countering Covid: a GST perspective

COVID-19 got its ignominious pandemic status from the World Health Organization on 11 March 2020. However, the global economy has already caught the flu. India got directly afflicted only in March and given the lockdown, tax collections (including GST) in the first quarter of this financial year is expected to be a washout. The fiscal implications are not minor.



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The pandemic is evidently an unprecedented crisis. Past crises were primarily financial in nature, which in turn impacted the other spheres of economic activity. The current one is primarily driven by cessation of economic activity and is threatening to turn into a massive financial flu.

The government has taken several steps to ensure that the financial contagion is arrested. Similar proactive measures in GST are perhaps imperative regardless of the fiscal strain.

## Decoupling the GST chain

GST rates in India are fairly high and to ensure compliance, the prescribed framework is rigid. A taxpayer cannot file returns unless they pay the entire tax due. Moreover, a customer is allowed input tax credit, to the extent that their supplier has paid taxes to the government. Further, unlike bulk of the GST world, India does not give any leeway to adjust tax liabilities in case of bad debts. It is evident that such an interlinked ecosystem has the potential of exacerbating the expected ensuing financial crisis and needs to be decoupled.

To enable this, the following needs to be done:

- ▶ Delinking payment of taxes from other compliance requirements and allow taxpayers an ability to pay taxes after a moratorium and in instalments.
- ▶ De-risk a taxpayer from the defaults of other stakeholders in the supply chain. Allow a taxpayer to collate credits basis invoices received and permit adjustment of taxes in case of debt defaults.
- ▶ Keeping in abeyance several amendments notified recently for exports. Just before the pandemic hit the economy, the government had notified amendments in relation to export refunds, disallowing refunds where consideration was not received. This will result in importing the global financial turmoil and materially impact Indian exports.





## Cash conservation

At present a taxpayer needs to pay their tax liability both on their sales and some defined procurements (such as imports). In most cases, the tax payable on procurements is akin to an advance payment of taxes, as taxpayers are entitled to claim input tax credit. There is an urgent need to relax norms that necessitate this advance payment. Taxpayers should be allowed to utilize accumulated credits for payments of both output and input taxes (reverse charge).

## Release refunds and incentives

Administration has been proactive in the release of GST refunds related to exports. However, there is a need for more to be done to ensure a more pervasive efficient administration of refunds. To this end, a campaign to drive refunds needs to be initiated at a structural level. Clarifications and instructions on issues that impede refunds should be issued and a robust mechanism to continuously removing roadblocks are required.

## Survival and revival equally relevant

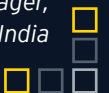
The government is looking at formulating financial stimulus and this could include deferral of tax payments and remission of taxes paid linked to employment. In this regard, ensuring availability of cash to sustain operations and investments is important.


Further, some of the impacted sectors are not going to witness any reasonable revenue at least for a few months. Their stress needs to be contained. Financial support can be given by as removing elements in the GST legislation that lead to cascading taxes. This includes considering micro elements such as expanding avenues that allow refunds of blocked input tax credits and inverted duties as also reducing the list of disallowed credits such as input tax credit of taxes paid on inputs that go into construction of civil construction such as airports, leased commercial buildings, as also macro reforms such as expanding the ambit to GST to include sectors such as aviation turbine fuel, petroleum, real estate, etc.

It is important to acknowledge that the changes in supply chain forced by the crisis come bearing opportunities. Incentives and schemes - encouraging production and employment, such as accelerated credit/refund regime, instituted under the GST law are effective. Similar schemes under the erstwhile VAT and excise laws have driven a lot of growth and investments in the past when conceptualized well. There are credible examples of the same and therefore should be considered.

*Contributions from -*

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Should tax  
keep pace with  
transformation,  
or help shape it?

[ey.com/en\\_in/tax](https://ey.com/en_in/tax) #BetterQuestions



Building a better  
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■ ■ ■  
The better the question. The better the answer.  
The better the world works.



# Has COVID-19 made India a more favorable investment destination?

The outbreak of COVID-19 has brought a dramatic transformation to how businesses ideate and operate, forcing them to critically reassess their future plans. The outbreak happened at a time when the global economy was already showing signs of a slowdown. This has fueled anxiety among institutional investors and led to immense anticipation among them about government support to the industry. It is also becoming increasingly evident that this pandemic would continue to have repercussions in the foreseeable future. Investors now need to focus on effective planning more than ever before.

Here, we have briefly touched upon the key factors currently affecting investor mindsets and decision-making towards India as an investment destination



**Bhavesh Thakkar**

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## The current geopolitical climate is causing a rejig of global investment destinations

Trade and industry mindset has shifted in recent years. Companies have increasingly started identifying Asia Pacific nations as manufacturing destinations. Among them, China has been a favorable destination in attracting investments due to its emergence as a global manufacturing hub.

The US-China trade conflict and Make in India are some of the agendas that institutional investors actively consider nowadays during strategic business discussions. Due to COVID- 19, many international investors with a manufacturing presence in China are facing unprecedented supply chain disruptions. News reports<sup>1</sup> indicate that countries hitherto heavily dependent on China may now consider other manufacturing destinations. In fact, Japan has taken a step further by announcing a US\$ 2 billion stimulus package to support Japanese investments moving out of China.

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Owing these developments, a massive geographical rejig of manufacturing hubs seems likely. Several developing nations are emerging as vying contenders. India, with its multifaceted industry initiatives may emerge as a globally preferred investment destination, if it is able to align to international standards of industrial support.

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<sup>1</sup> reported by News18 on *"India-South Korea Trade Ties to Further Improve in Post Covid-19 World With Make in India Boost"* on 21 April 2020, 12:25 PM IST



## Macro-economic scenario and incentives in India

Conventionally, institutional investors consider the availability of resources and infrastructure as key factors for investment decisions. However, the industry is currently experiencing an extraordinary liquidity crisis, further intensified by the currently prevailing lockdown in most countries. At such a time, any form of government support to keep operations afloat is a welcome measure. Generally, this support is extended by way of economic reforms and infrastructural support or fiscal incentives. Both have a direct positive impact on investor cash flows. Let's take a closer look at these factors.

### *Macroeconomic reforms and infrastructural support*

In India, the current situation has created additional stress on core sectors such as banking, financial services, power and telecom and also revealed some glaring deficiencies. The strength of these sectors determines the extent to which industries flourish. Further, to enable the industry, the government announced some ambitious measures such as:

- ▶ Creation of dedicated National Investment and Manufacturing Zones (NIMZ) and focus on industrial corridors which would serve as fully enabled plug and play facilities for manufacturing activities
- ▶ Creation of dedicated Coastal Economic Zones/ Units (CEZ/CEU) and industrial corridors to enable logistical ease

The steady implementation of several such initiatives led to a jump in India's Ease of Doing Business (EODB) ranking from 140 to 63 in October 2019. The implementation of these initiatives is likely to gain further momentum in the coming days.

### *Industrial incentives in India*

The Government of India took cognizance of investor needs and launched the noteworthy Make in India initiative, which has been quite successful. Multiple incentives schemes at the central and state levels were introduced under this flagship initiative. Further, a reduced income tax rate of 15% for new manufacturing companies was introduced to bring India at par with other developing nations. These initiatives have been applauded by domestic and foreign investors alike.

Recently, some lucrative incentives schemes for electronics manufacturers were also introduced, and are generating considerable interest. Similar initiatives for other sectors are also envisaged. The pandemic has also placed the limelight on sectors such as healthcare, retail etc. Incentives are also being announced to promote these sectors. For example, the state of Tamil Nadu has introduced fiscal incentives for the manufacture of drugs and equipment employed in the management of COVID- 19.

Thus, while it appears that too much is changing too fast, this may just be just the tip of the iceberg. Investor agility is now of paramount importance. Investors may lay higher emphasis on quicker returns now. Hence, infrastructure and incentives support assume even higher importance in decision making. At the same time, it is also foreseen that investors may adapt a cautious approach, leading to growth concentration in a few sectors.

**The need of the hour is empathetic, pointed relief measures for industry. As a nation, India should look beyond the current methodology and rapidly enable a unified approach where the center and state collectively work to build and sustain industry. Such measures are the key and may ensure that India adapts well to the geopolitical climate of tomorrow.**

# Will COVID-19 accelerate adoption of the talent marketplace model?

With everyone in lockdown mode, organizations and their people across sectors and across levels, have accelerated adoption of online collaboration platforms. While a lot is being said and done to focus on health and safety of people and the potential impact to the economy, sub-consciously, the talent in each organization has adapted to a new way of working.

This transformation enabled by online platforms has created the framework for the gig economy.

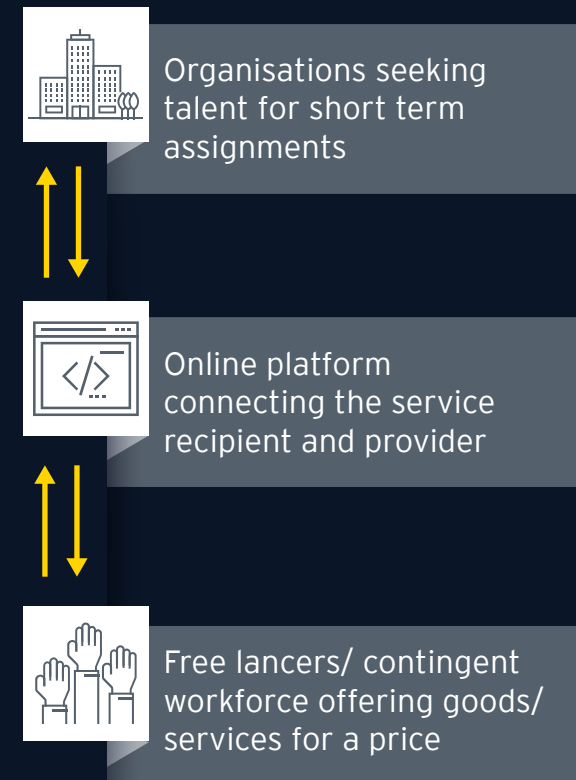
## Ajit Krishnan

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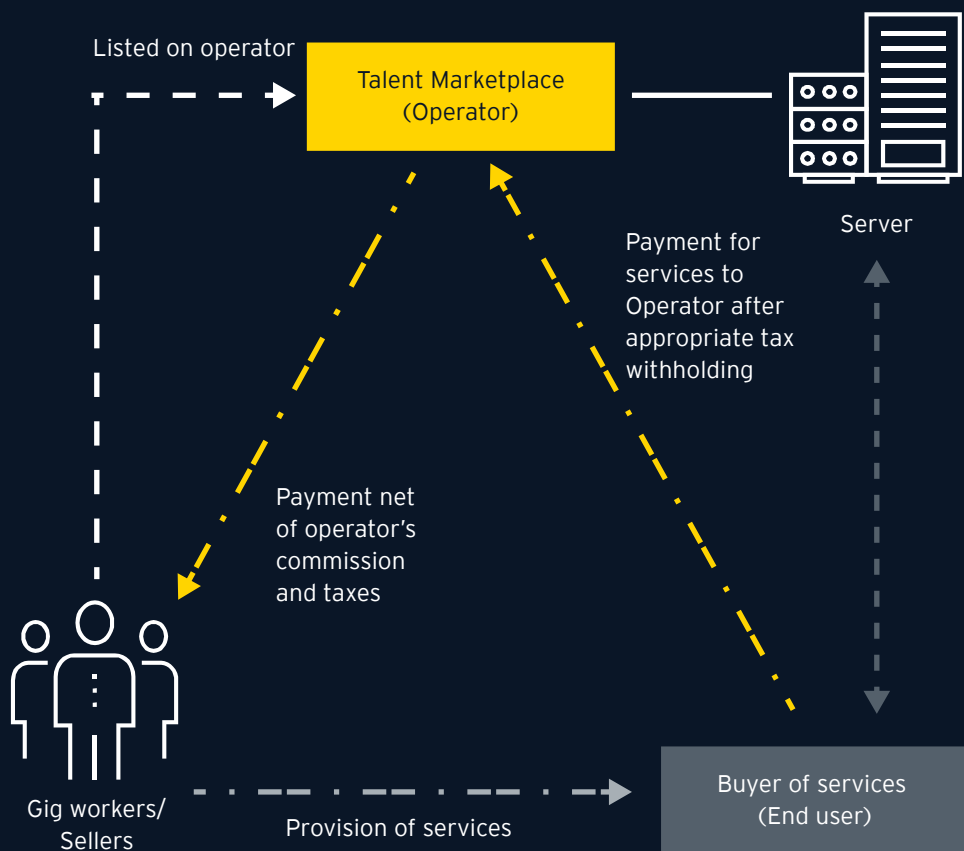


## What is gig economy?

A gig economy is a digital labour and talent market helping organizations meet their workforce demand for short-term engagements by hiring independent workers via online platforms that connect gig (temporary) worker with the organization.



A gig worker is not bound by an employment contract rather is engaged on a task-based assignment connected via an algorithmic matching system. The gig workers can work for multiple organizations at any given point in time.



## Tax and regulatory implications

### For talent marketplace

#### Taxability

An online talent marketplace, which qualifies as a non-resident e-commerce operator (ECO), would be subject to Equalisation Levy (EL) at the rate of 2% on consideration received or receivable against e-commerce supplies or services (provided such amount exceeds ₹ 20 million). The income on which such EL has been paid will be exempt from income-tax.

The non-resident ECO will have to ensure payment of EL to the Government treasury on a quarterly basis and will have to file an annual return to report such amount(s) deducted and deposited with the Government.

Where online talent marketplace is a resident, the income would be subject to tax as its business income. Taxes would be appropriately withheld under domestic law provisions by the buyer depending on nature of services rendered.

#### Withholding obligations

To widen and deepen the tax net, government also introduced withholding tax obligation on ECO for sale of goods or provision of service facilitated by it through its digital or electronic facility or platform (@1% on the gross amount paid to the e-commerce participant subject to an exception for individuals/ HUFs in some cases).

However, if gig workers qualify as employees, withholding would be required to be undertaken as salary payment.

## **GST obligations**

Under GST law, an online talent marketplace, irrespective of whether it is foreign or domestic, is required to collect and deposit Tax Collected at Source (TCS) at the rate of 1% on all taxable supplies made by other sellers in India, where consideration for supply is collected by them.

In case the service supplied by seller is exempt from GST, there should be no TCS requirement.

Foreign marketplaces will however need to appoint a person in India to take GST registration (authorized representative). Multiple GST registrations may be required depending on the States from which sellers are rendering services through marketplace.

Fee/commission earned by talent marketplace from gig workers/buyers may also be liable to GST at 18% (depending on whether the place of supply is in India).

## **Permanent establishment**

In case of online talent marketplaces which qualify as non-resident ECO, depending upon whether workers qualify as dependent or independent personnel, risk from permanent establishment perspective would need to be evaluated.

## **For gig workers**

### **Taxability**

Where the gig workers are resident under domestic tax laws of India, entire income accrued or received by such gig workers should be subject to tax in India. In case of certain eligible class<sup>1</sup> of gig workers, having a gross turnover less than ₹ 5 million, the presumptive tax mechanism provides for a 50% expense allowance. Consequently, the effective tax rate for such individuals could be lower compared to salary income from employment. Further, in case of double taxation, benefit under the Double Taxation Avoidance Agreement, if any, may be explored.

Where gig workers qualify to be non-resident under domestic tax laws of India, only income received in India should be subject to tax in India. Benefits under the respective Double Taxation Avoidance Agreement between India and the country of residence of such gig workers should be available.

<sup>1</sup> Legal, Medical, Engineering, Architectural profession, Accountancy, Technical consultancy, interior decoration and other professions as may be notified

The contract/ arrangement between the online talent marketplace and gig workers would need careful evaluation to determine whether the gig workers qualify as dependent or independent workers and whether payment received by such gig workers would be taxable under salary or professional fees. This could influence the preference of such individuals.

## **Labour laws/ social security benefits**

Applicability and consequences under labour laws, social security regulations, minimum wage guarantee, etc. would need to be evaluated depending upon whether gig workers are resident or non-resident and whether such gig workers qualify as 'employees', which would in turn depend on factors such as control over a gig worker, supervision and right to initiate disciplinary action.

## **GST implications**

In case a gig worker has an aggregate income of ₹2 million<sup>2</sup> and below, there is no requirement of GST registration.

Registered gig workers will be required to discharge GST at applicable rate, on services rendered to buyers through talent marketplace, provided place of supply of such services is in India. GST compliances would also need to be undertaken.

1% TCS collected and deposited by the talent marketplace will be available as credit to the seller.

## **For organizations availing services of gig workers**

### **Deductibility & withholding**

Payments made by organizations to platform operators should be deductible as business expense, however, such payments would be subject to withholding depending on whether the talent marketplace is resident or non-resident.

## **GST implications**

GST registered buyers should be eligible to take input credit of the GST charged by the seller or talent marketplace.

<sup>2</sup> ₹ 1 million and below for certain special category States

# Legal implications on talent marketplace model

## For talent marketplace

### Recognition under Code of Social Security, 2019 (Code) ■

The code recognises 'gig workers' and 'platform workers' and stipulates framing of welfare schemes for such workers. The talent marketplace may be required to make contributions in this regard and undertake compliances, once the code is notified.

### Terms of engagement agreement ■

Prolonged term of engagement, right to terminate, supervision or control by platform operator may accrue status of an employee to a gig worker thereby entitling the worker to employee benefits under Indian laws. Hence, the engagement agreement needs to be drafted carefully.

### Non-compete/ solicit ■

Non-compete, non-solicit clauses may need to be drafted appropriately, considering ability of gig worker to work on various platforms.

### Confidentiality ■

Stringent confidentiality obligations regarding information belonging to platform operator and/or customers may need to be expressly enumerated.

### Intellectual property ■

Right of ownership over intellectual property related to work product may become a challenge and may be mitigated by expressly stipulating in the engagement agreement.

### Compliance in multiple jurisdictions ■

Compliance with varied laws of different jurisdictions as well as industry specific laws may be required.

### Data privacy laws ■

The talent marketplace, as well as the gig worker, may be required to comply with stricter data privacy laws while collecting, handling, storing or processing information.

### Dispute resolution ■

Unlike a traditional industrial dispute that may be resolved by conciliation or negotiation, any dispute arising between the platform operator, gig worker and/or customer will be governed by their respective contracts/ terms of service and will be subject to consequent litigation.

## For Gig workers

### Health and Safety ■

Considering gig workers will not perform their work out of a fixed workplace, applicability of health and safety laws such as respective shops and establishment acts, sexual harassment laws may become a challenge.

### Compensation in case of accident ■

The applicability of laws providing compensation to gig workers in case of accidents is yet to be tested in courts.

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Stringent confidentiality obligations regarding information belonging to platform operator and/or customers may need to be expressly enumerated.

## Regulatory implications on talent marketplace model

### For talent marketplace

#### Intermediary/payment aggregator guidelines ■

In India, RBI has issued intermediary or payment aggregator guidelines, applicable primarily on marketplaces who are collecting any payments from buyers on behalf of sellers. Said guidelines stipulate the opening of separate bank (nodal) account and timelines within which the amount should be credited to bank account of sellers. Similar guidelines in other jurisdictions needs to be checked.

#### FDI guidelines on e-commerce on service marketplace ■

At present, regulators have not taken a consistent position on applicability of FDI related regulations in case the platform operator is an FDI entity in India. Hence, clarity on applicability of FDI guidelines would be critical.

#### Transactions with platform operator in one jurisdiction and both buyer and seller in same but different jurisdiction ■

Where the talent marketplace is overseas, and both the other parties are in India, there could arise a likely scenario where a rupee transaction is getting routed through overseas channel involving foreign currency and the same could pose a challenge under payment and settlement guidelines and FEMA. Similar challenge can also arise in a scenario when the platform operator is in India and both the other parties are overseas.

#### Receipt of payment on behalf of non-resident ■

Collections by payment operator in India on behalf of non-resident seller could be challenge under FEMA regulations and specific RBI approval may be required.

#### Applicability of import and export guidelines ■

In case where any of the three participants are located overseas, cross border payments would tantamount to import or export of services and hence, import/export guidelines as prescribed by RBI would need to be followed. In addition, applicability of third-party payment guidelines would also need to be analysed.

#### Reporting mechanism ■

Presently, RBI does not stipulate any reporting mechanism for the export/import of services (other than 'software' related exports/ imports). Hence, reporting mechanism in relation to such export/ import of gigs may be required to be designed to regulate this model.



## Should organizations in India migrate to a talent marketplace model?

Organizations can take advantage of the gig economy to drive their diversity and inclusion agenda. While such movement would bring certain challenges on one hand but alongside provides various benefits in improving operational efficiencies and reducing costs.

**On demand workforce:** Organisations can tap on idle hours among the talent pool by assigning them to different projects/ workstreams/ teams with shortage of manpower. It provides a much more effective and efficient talent pool to perform on projects and tasks.

**Promoting diversity and inclusion:** Companies can take advantage of the gig economy to get access to diversified and untapped talent and engage with specific talent communities for business collaboration. Such platforms also enable differently abled talent to also access job opportunities in a fair and transparent manner.

**Flexibility and improved productivity:** Migrating employees to a Talent marketplace model provides greater flexibility, diversified experience and continuous learning opportunities to the workers and alongside competitive advantage to the organisations.

**Controlled costs:** Having a talent marketplace instead of employees on payroll, can provide greater flexibility to re-allocate various costs associated with social security, labour laws, long service rewards based on the number of hours utilised.

**Manage uncertain business climate:** In times of business uncertainties, organisation can manage the risks of employee layoff.

**Improved employee satisfaction:** Given that the revenue model for gig workers is directly linked to their efforts, it would result in improved employee satisfaction and lesser resentment.

**Loss of employee status:** An employee migrated to a talent marketplace shall become ineligible for social benefits such as insurance, gratuity, medical benefits, provident fund etc.; and shall not have any employment-related rights provided under various labour laws.

**Exposure to litigation:** Unlike employees that are protected against litigation under the cover of the organisation to which they belong, a gig worker may be exposed to litigation for deficiency of services.

**Novation of contracts:** The organisation will have to enter into new engagement contracts setting out detailed and strict terms of engagement in lieu of existing employment agreements.

While there are challenges in implementation and regulating a gig economy, it has the potential to be the next big revolution in employment and workforce outlook. The current market situation has accelerated the need for agile organizational structures fuelled by agile talent. Therefore, large organizations, will begin their transition towards a gig economy.

**The immediate step however, would be to create an internal talent marketplace within the organization, to make sure that people can be deployed and utilised more effectively and efficiently. This would definitely enable greater efficiency without the challenges and complexities of transitioning from an employment agreement to an engagement agreement.**

It is however entirely up to corporations, legal specialist, lawmakers and workers' associations to start evolving the model, to keep pace with such shifts in their talent and labor market.

*Contributions from -  
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# Tax breaks for Covid-19 spend - ripe for amendment?

The Covid-19 outbreak in India has triggered significant demand for spend on related preventive, detective and remedial/relief measures. Alongside the government, a large number of companies have been contributing extensively in one or more of these areas. However, the current scheme of tax benefits available to such corporate spend is restrictive and merits a rethink.

## **Bharat Varadachari**

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## Section 80G

Section 80G of the Income Tax Act, 1961 ('Act') provides a 100% deduction (without limits) from the Gross Total Income (GTI) of a company for contributions inter alia to the PM National Relief Fund, CM Relief Fund and PM CARES Fund. Contributions to registered NGOs engaged in charitable activities are eligible for a 50% deduction (subject to a limit of 10% of GTI) of the company. Covid-19 targeted contributions to these funds or eligible NGOs are hence eligible for the related deductions.

By way of a welcome move, companies that have not opted for the concessional tax regime for FY21 and who make contributions between April 1 and June 30, 2020 can now chose to avail the Section 80G deduction for either FY20 or FY21. It has also been provided that companies availing the concessional tax regime who contribute between April 1 and June 30, 2020 can claim an 80G deduction for FY20 without compromising access to the concessional tax regime for FY21.

However, several companies prefer to undertake relief activities by themselves, directly incur the CSR spend or contribute in kind rather than contribute to a fund (for which they do not have any visibility on the spend). In these situations, there is lack of full clarity on tax benefits for such direct expenditure incurred by the companies. Besides, for those who do contribute to the above prescribed funds, the deduction is available for 100% of the donation subject to the GTI and in case of registered NGOs, to 50% of the donation subject to 10% of the GTI, as the case may be.

Conversely, a direct tax deduction in computing a company's business income may be more beneficial as apart from an unlimited qualifying amount, the deduction is also not subject to an overall ceiling (like in the case of the Section 80G deductions). This would enable a company to fully benefit from the spend by lowering its business tax base or enhancing its net loss position, if any, for tax purposes.

## Section 37

The current problem however, arises due to the explicit disallowance under Section 37 of the Income Tax Act (ITA) which provides that any expenditure incurred on **activities relating to CSR referred to in Section 135 of the Companies Act 2013 (CA)** shall not be deemed to be an expenditure incurred for the purpose of the business or profession. The argument provided by the government for the disallowance is that CSR represents application of income and allowing a tax deduction will result in subsidising one-third of such expense to be incurred by corporates by way of tax expenditure.

The Ministry of Corporate Affairs has clarified in its circular that spending CSR funds for Covid-19 related activities for promotion of health care including preventive health care and sanitation, and disaster management shall qualify as CSR expenditure and that these activities should be interpreted liberally for this purpose. Basis the above, spend on Covid-19 activities would automatically be treated as CSR activities and be disallowed in computing taxable income.

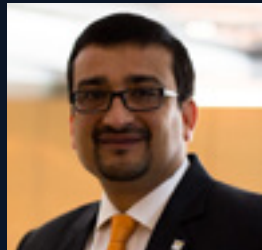
Several questions have arisen on the permissibility of the deduction in varying circumstances. Illustratively, whether Covid-19 expenditure in excess of the statutory obligation of 2% of the past 3 years' average net profits would be deductible? Whether Covid-19 expenditure that is voluntary in nature for a company not subject to CSR obligations would be deductible? Whether Covid-19 expenditure not treated / accounted by the company as CSR would be deductible? Basis the current law, expenditure in excess of the statutory CSR obligation is likely to be subject to a disallowance under Section 37 of the ITA, however, it is arguable that voluntary expenditure or expenditure not accounted as CSR is deductible, based on a specific judicial precedent.

The Government's speed in providing regulatory relief (compliance relaxations or extensions of time limits, indirect tax benefits for Covid-19 related imports etc) as a response to the unprecedented circumstances triggered by the Covid-19 crisis are commendable. For its part, corporate India has also come forward to contribute in a variety of areas - medical equipment, health kits, treatment facilities, provision of essential supplies, relief and prevention measures, training and education of public/healthcare workers and accommodation facilities.

In view of the above, apart from the Section 80G deduction/clarification on CSR eligibility and in light of prevailing ambiguity, the government might wish to consider allowing a full deduction under Section 37 of the ITA for any direct expenditure of a prescribed nature incurred towards Covid-19 activity, while computing taxable income for FY20 and FY21 even if the expenditure is classified as CSR for corporate law purposes. An external certification mechanism and inclusion of this item as part of the tax audit requirements under the ITA would help validate and verify the spend. This measure would go a long way in incentivizing corporates for their, direct social contributions in a stressed business environment.

# Indian conglomerates should employ strategies to retain and protect existing resources

With World Health Organisation declaring COVID-19 virus outbreak as a pandemic, governments across the world rushed to take steps to contain the spread of the virus. They included imposing restrictions on movement of people and announcing nationwide lockdowns. Naturally, businesses across the globe started to witness significant disruptions to their operations with issues arising on all fronts. These issues, impacting businesses and economies, comprise supply chains, workforce management, short-term finance management, and customer and brand protection. As true for businesses globally, Indian companies are also experiencing considerable disturbances in operations during these times. They are simultaneously giving rise to new business and tax risks, especially where cross border/ outbound structures are in place.

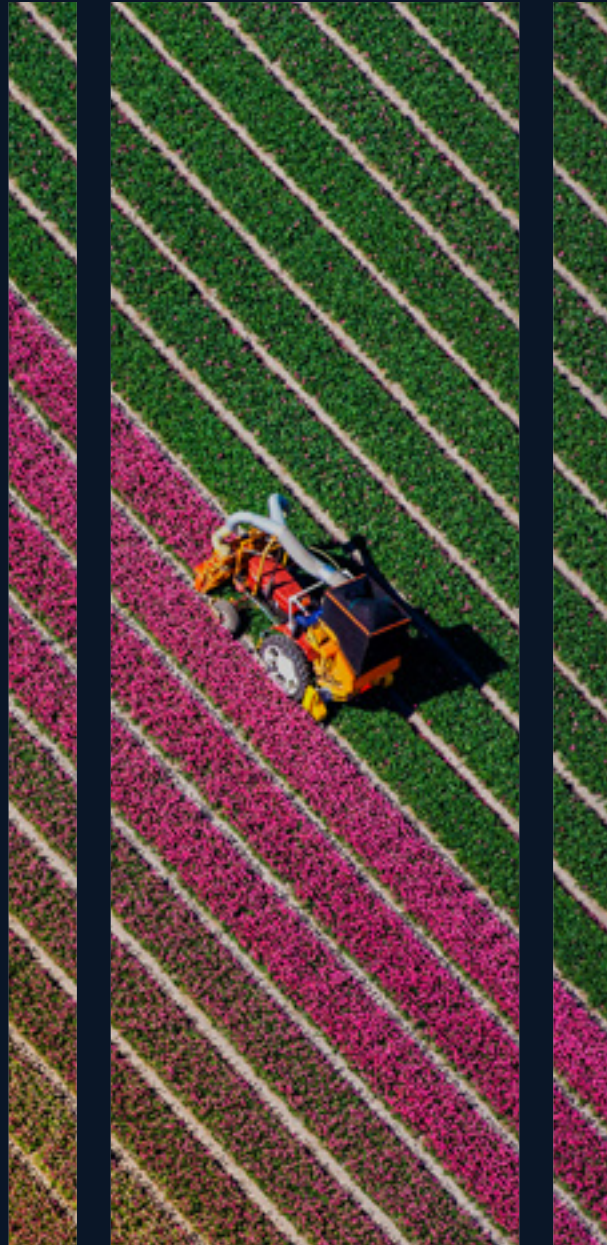


**Raju Kumar**

Tax Partner, EY India

## ||| Risk of creating permanent establishment (PE)

Employees travelling to an overseas country for work and getting stranded in the host country on account of travel restrictions may not only trigger domestic tax law residence for himself, but may also risk establishing a permanent establishment (PE) of Indian parent in certain circumstances. It is quite possible that in times such as present, employees may need to work in a country that is not their usual place of work/ residence for an extended period of time, which may lead to unusual tax implications that are beyond the control of employers and employees. Various companies have cited concerns related to the creation of PEs and change to residence status of individuals. To address the nervousness around these issues, the Organisation for Economic Co-operation and Development (OECD) has published guidance that encourages countries to team up to alleviate the unplanned tax implications and likely burdens arising due to effects of COVID-19 crisis.



## ||| Cash repatriation and movement strategies to be deployed

Considering disruptions to global supply chains and international trade, entities may potentially face working capital issues. In this situation, opportunities to generate cash from business operations may be limited. Further, there could be other factors that may augment liquidity exposure, including limited accessibility to capital markets and funding, and increased counterparty credit risks. In such a scenario, strategies to move cash within the group from cash rich entities would gain relevance - repatriation options and subvention payments could be analyzed keeping in mind the long-term strategy of the group. Needless to say, transaction costs and timelines to move cash would play an important role in arriving at a preferred strategy. Further, efficient and careful deployment of cash during the period of limited economic activity would go a long way in sustaining the entity during this time.

## ||| Impact of stimulus packages

Policy changes and stimulus packages have been announced in jurisdictions around the world in response to the COVID-19 crisis. Such measures range from deferral of compliance/ payment obligations to additional tax deductions for specified activities/ cash support in form of grants and loans. Multinational groups should consider putting in place a procedure for tracking and availing such stimulus packages to ensure maximization of value for their business. This could also open a window to optimize cash requirements of the group by availing deferrals on tax payments.

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### ||| Supply chain risks

Demand volatility due to evolving regulations and consumer sentiment coupled with rapidly changing supply constraints (raw materials, manpower and transport) can potentially lead to disruptions and have an adverse impact on business continuity. Supplier failures may necessitate the businesses to look for alternate ways to fulfil existing contractual obligations, including rapid re-alignment of distribution channels and product range. Further, creation of a manufacturing readiness plan to mitigate key operational risks across various demand scenarios should be a key aspect in formulating a supply chain response to the crisis.

### ||| PoEM concerns

Inability to travel by Indian residents who are members of the Board of overseas companies may raise concerns about a potential change in the Place of Effective Management (PoEM) of a company where Board meetings are done remotely or through tele-networking from India. The Indian tax laws retain a right to treat an overseas entity to be resident in India and consequentially tax global profits of the company where the PoEM of such company is held to be in India. Considering the extra-ordinary situation, due care should be exercised in conducting Board Meetings in such cases and potential relief under tie-breaker rule of double tax treaties should be evaluated.

### ||| Revisiting audit procedures for consolidation

Another practical issue that could come up is delay in preparation of financials of overseas subsidiaries leading to deferred finalization of consolidated financials in India. This may be especially relevant considering Indian entities follow a March year-end and a majority of consolidation exercises for listed groups, are conducted during the months of April and May. Further, considering restrictions on movement of people, unconventional audit procedures (like video verifications) may see the light of day.

### ||| Low valuations opening doors for new acquisition opportunities

While companies are drawn against a plethora of risks due to economic conditions during these times, they are also presenting certain opportunities, including prospects to enhance returns in the long run. Valuation of a number of potential acquisition targets may be low, given global economic volatility and rapid stock devaluations. It may be worthwhile to evaluate and revisit outbound investment/ acquisition strategies in line with resources available with the entity. Further, other restructuring opportunities such as joint venture partner buy-outs and minority squeeze outs may be cost efficient if the market valuation of shares is low.

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**Unpredictability as to how long the pandemic will last and decrease in overall commercial activity due to virus containment measures has led to a significant build up in economic uncertainty. In times such as these, it would be important for Indian conglomerates to remain patient and employ strategies that help to retain and protect existing resources, especially the ones that are key to business (staff, technology and business partners). Businesses should also evaluate opportunities to leverage off internal efficiencies and resources and look to strategize detailed plans to bounce back once the situation improves.**

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# The anti-corona prescription for transfer pricing

Today, humankind is faced with an unprecedented crisis in the form of the novel coronavirus (COVID-19). In a globally connected world, cross border movement of goods, services, people, intangibles and financial flows is imperilled. Consequently, all businesses are likely to be disrupted. While it is premature to conclude the full impact of this shock, it is opportune to understand its implications, prepare for consequences and maximize opportunities through a proactive approach.

Transactions between entities within multi-national groups (MNEs) is a significant part of global trade. Transfer pricing of these flows is a critical element of the world's supply chain and countries' tax ecosystems. MNEs often have entities performing centralized functions such as procurement or Intellectual Property (IP) management. They also engage specific companies within the group to contract manufacture goods, undertake R&D services and distribute products and services in identified territories. Management hubs support group companies in different regions to gain efficiency and foster better controls. Transfer pricing principles require each of these entities to get remunerated for the value they create and contribute to the supply chain. This, in turn, has consequences on the fiscal health of the countries where these entities are present.



**Ashwin Vishwanathan**

Partner, International tax and Transaction Services,  
Transfer pricing, EY India

In the present context, companies are likely to face the following challenges:

- ▶ Shut down of commercial operations due to government-initiated lockdowns
- ▶ Labour shortages due to restricted people movement
- ▶ Cost escalations due to supply chain interruptions
- ▶ Lack of demand resulting in inventory stockpiles
- ▶ Forecasting and budgeting issues due to change in demand and supply patterns
- ▶ Breakdowns in traditional distribution channels
- ▶ Financial exposure in terms of working capital and credit management, receivable collections, debt and banking covenants
- ▶ Impact on business continuity planning and governance

There could be many other direct and indirect effects on businesses. Companies will have to assess how to respond to these challenges and where the key decisions will be made. They may also need to determine as to whom such various risks and associated obligations belong in impacted intra-group transactions, and whether contracts between parties reflect this understanding. The financial ability of entities to bear such risks is likely to be tested.

Maintaining pre-agreed fixed compensation for related parties like contract manufacturers, contract service providers and limited risk distributors might become difficult given the uncertainty of profits and the looming spectre of losses. Underutilization of capacity due to shut downs and carrying costs of inventory will only compound this problem. Performance guarantees, product and service liabilities and similar legal obligations may get triggered requiring expending of costs and management time. Recognizing these early is, therefore, essential. Injecting an anti-Corona dose into transfer pricing and business planning is the need of the hour. Here are a few recommendations:

#### ◆◆◆◆ Assess

It is essential to start understanding the magnitude of this disruption and recognizing areas that need attention. It could involve rethinking the traditional value drivers in the business and how it stands transformed to cope with this crisis. Both demand and supply side factors merit consideration. Similarly, actual decision-making and risk bearing will have to be matched with what was done historically and inconsistencies will need to be explained.

#### ◆◆◆◆ Navigate

As the crisis evolves, companies have to re-imagine their business strategies. This could take the form of establishing alternate market routes, vertical and horizontal integration and divestment of unprofitable divisions. Termination of existing inter-company arrangements may require exit charge evaluation.

#### ◆◆◆◆ Test

Testing various scenarios and potential outcomes may be an important input for financial forecasting and analysis. These comparisons with actuals will be useful to quantify losses, decide on subvention strategies and manage funding requirements.

#### ◆◆◆◆ Identify

Internal and external market data should reflect the impact of the crisis and will have to be assimilated and synthesized for comparability and future decision making. Impact on existing policies might have to be examined.

#### ◆◆◆◆ Connect

A company's approach cannot remain siloed. It has to involve all stakeholders capable of connecting the dots and crafting a holistic response. Tax directors and CFOs should collaborate with business teams to put together a credible commercial strategy for inter-company transactions.

#### ◆◆◆◆ Operationalize

A revised transfer pricing design and policy may need to be envisaged for affected areas of business. Modifying existing practices and implementing new ones might need operationalizing through systemic alterations.

#### ◆◆◆◆ Reorient

Location of value creating activities and risk control functions may have shifted due to key executives being stranded, forced to relocate or working virtually. Reorienting the operating model to appropriately reflect Development, Enhancement, Maintenance, Protection & Exploitation (DEMPE) functions will occupy mind space and help decide future course of action.

#### ◆◆◆◆ Organize

Responding to the crisis will entail many decisions. Documenting this carefully ex-ante and building a strong body of supporting evidence for its underlying rationale is a necessity for reporting, compliance and audit defence.

#### ◆◆◆◆ Negotiate

Existing inter-company agreements, third party contracts and Advance Pricing Agreements (APAs) will need to be revised to factor the impact of the crisis. Companies will have to consider negotiating these terms again depending on their facts and circumstances.

#### ◆◆◆◆ Activate


The crisis is still unfolding. It is unknown whether it will end soon or be prolonged. Companies should activate a monitoring and response mechanism that is sufficiently agile to address short term, medium term and long-term dimensions.



Imagine an MNE with manufacturing factories in affected countries, distribution affiliates in Europe and Asia operating its R&D and shared services centre in India with regional management teams based in South East Asia and the Middle East. If one were to practically apply the above prescription, the group would have to consider the following steps:

- 1** Examine which of these critical functions are worst hit and prioritize actions accordingly. Manufacturing in affected countries is an obvious concern and will have to be addressed first.
- 2** Identify alternative manufacturing locations to ensure business continuity. Logistics would also have to be revisited.
- 3** Undertake a financial analysis to quantify potential cost increases, losses and evaluate the cash and tax impact.
- 4** Consider what other market players are doing and how they have been impacted.
- 5** Set up cross functional teams comprising legal, tax, finance and operations personnel to initiate contingency plans and spur alternate action.
- 6** Analyse the profits within the supply chain and recalibrate its allocation between manufacturing, distribution, services entities and the principal by repricing inter-company transactions.
- 7** Alter decision making matrices and organizational hierarchies to gain better control over processes and governance.
- 8** Establish internal processes to gather information and documents explaining various changes.
- 9** Revise already signed APAs and discussing ongoing APAs with the tax authorities to reflect new business realities.
- 10** Run a 'war room' or 'project management office' to maintain and build supply chain resilience.

While businesses are still trying to navigate this disruption, companies must act swiftly, understand and prepare. Involving professional advisors early in this lifecycle will help bring to bear deeper sector experience and insights and generate robust solutions.

 The old adage, “an ounce of prevention is worth a pound of cure” has never been more relevant or real.



# Key tax amendments and the way forward

# Dividend's tryst with taxation



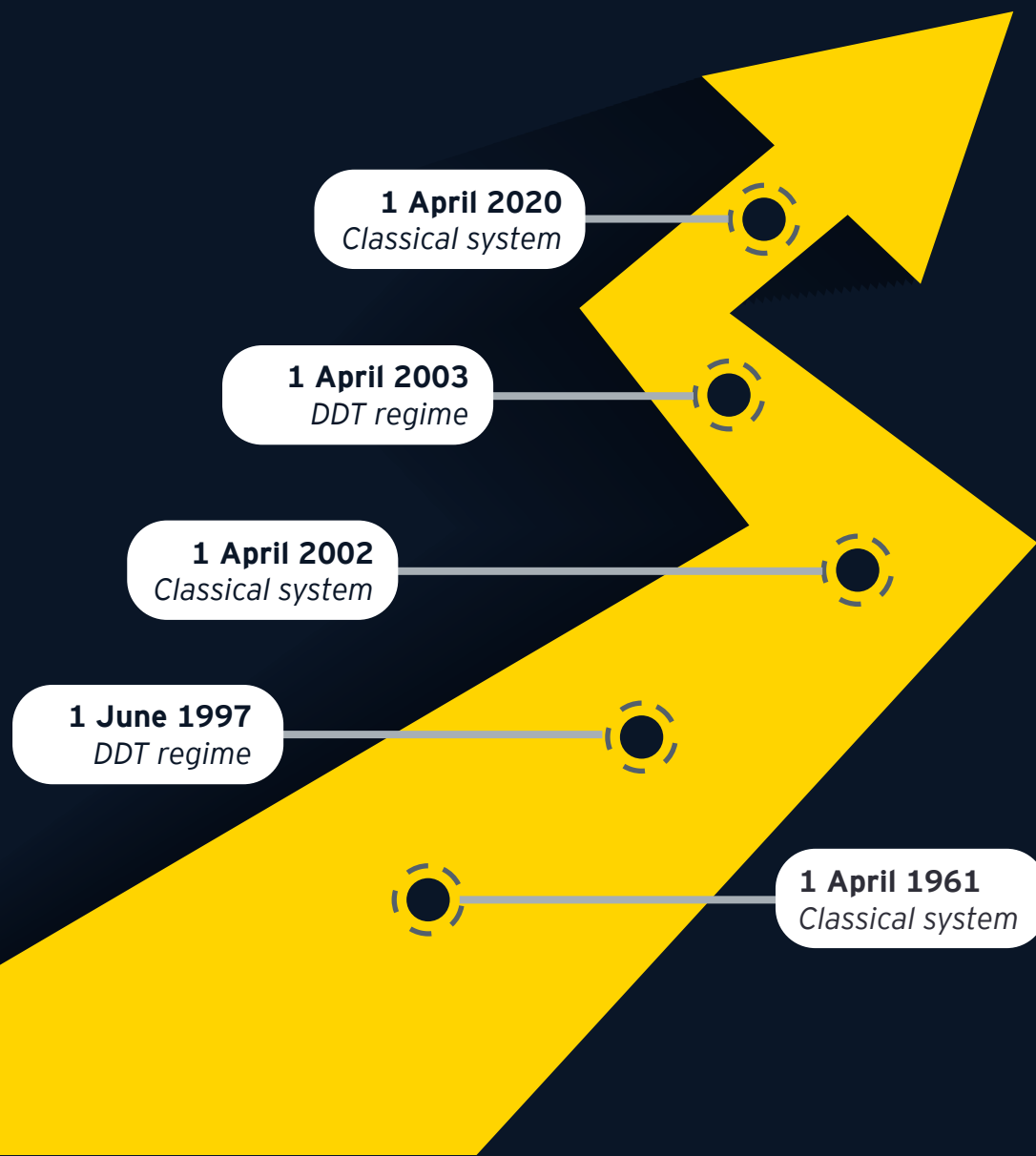
**Jayesh Sanghvi**

Partner, International Tax and Transaction Services, EY India

There have been frequent revisions and the introduction of new tax rates for almost a year. Reduction in corporate income tax and personal income tax rates has been a welcome change. The new corporate income tax rate at 25.17%<sup>1</sup> (or 17.16%<sup>2</sup> for new manufacturing companies), is well within a competitive range of the global/ OECD average of ~23%<sup>3</sup>.

Dividend Distribution Tax (DDT) for taxation of dividends has fomented debate regarding its desirability since its introduction in 1997, gathering more heat with the steadily increasing rate. With the proposal to remove the DDT and revert to the classical system, the government has answered another persistent demand of the industry.

- 1 Base rate 22% + Surcharge 10% + Cess 4%
- 2 Base rate 15% + Surcharge 10% + Cess 4%
- 3 Source - OECD corporate statistics database



To In the table we have attempted to capture the impact of this change from DDT to the classical system at the shareholder level (with certain assumptions on basis):

Particulars	DDT regime			Classical system <sup>4</sup>		
	Resident non-corporate	Resident company	Non - residents	Resident non-corporate	Resident company	Non - residents
Distributable profits	120.56	120.56	120.56	120.56	120.56	120.56
Less: DDT	20.56	20.56	20.56	NA	NA	NA
Dividend received by the shareholder	100.00	100.00	100.00	120.56	120.56	120.56
Less: Super rich levy (assumed individual shareholder with highest surcharge)*	14.25 (100 * 14.25%) <sup>5</sup>	-	-	NA	NA	NA
Less: Tax on dividends**	NA	NA	NA	43.26 (120.56 * 35.88%) <sup>6</sup>	30.34 (120.56 * 25.17%)	12.06 (120.56 * 10%)
Net cash inflow to the shareholder	85.75	100.00	100.00	77.30	90.22	108.50
Total tax outflow	34.81	20.56	20.56	43.26	30.34	12.06
ETR on distributable profits of 120.56	28.87%	17.05%	17.05%	35.88%	25.17%	10%

\*INR 10 lakhs exemption not considered for non-corporate resident shareholders. Further, rollover benefit under section 115-O considered

\*\*Assumed to be 10% for non-resident shareholders basis majority of India's tax treaties, highest level of tax for resident individuals and assuming no distribution of dividends by resident Company However, in case dividends are distributed by resident Company, deduction shall be available u/s 80M.

While the redistributive principals of taxation are met with the removal of DDT, the potential effective tax for the resident individual taxpayer now peaks at 35.88%. When adjusted for the 25.17% effective corporate tax by the dividend paying company the effective tax rate is ~52%. This behooves a question whether such level of taxation is fair for the risk taker/wealth creator amongst the Indian resident, who is so very important for the well-being and growth of the society. The issue is accentuated as it creates a potential bias in favour of non-resident, who has access to lower rates under the Double Taxation Avoidance Agreements (DTAA).

Double taxation of dividends has engaged tax policy over the years. Globally, economies while staying within the principles of classical system of dividend taxation have found some middle ground to address the issue of double taxation of dividends.

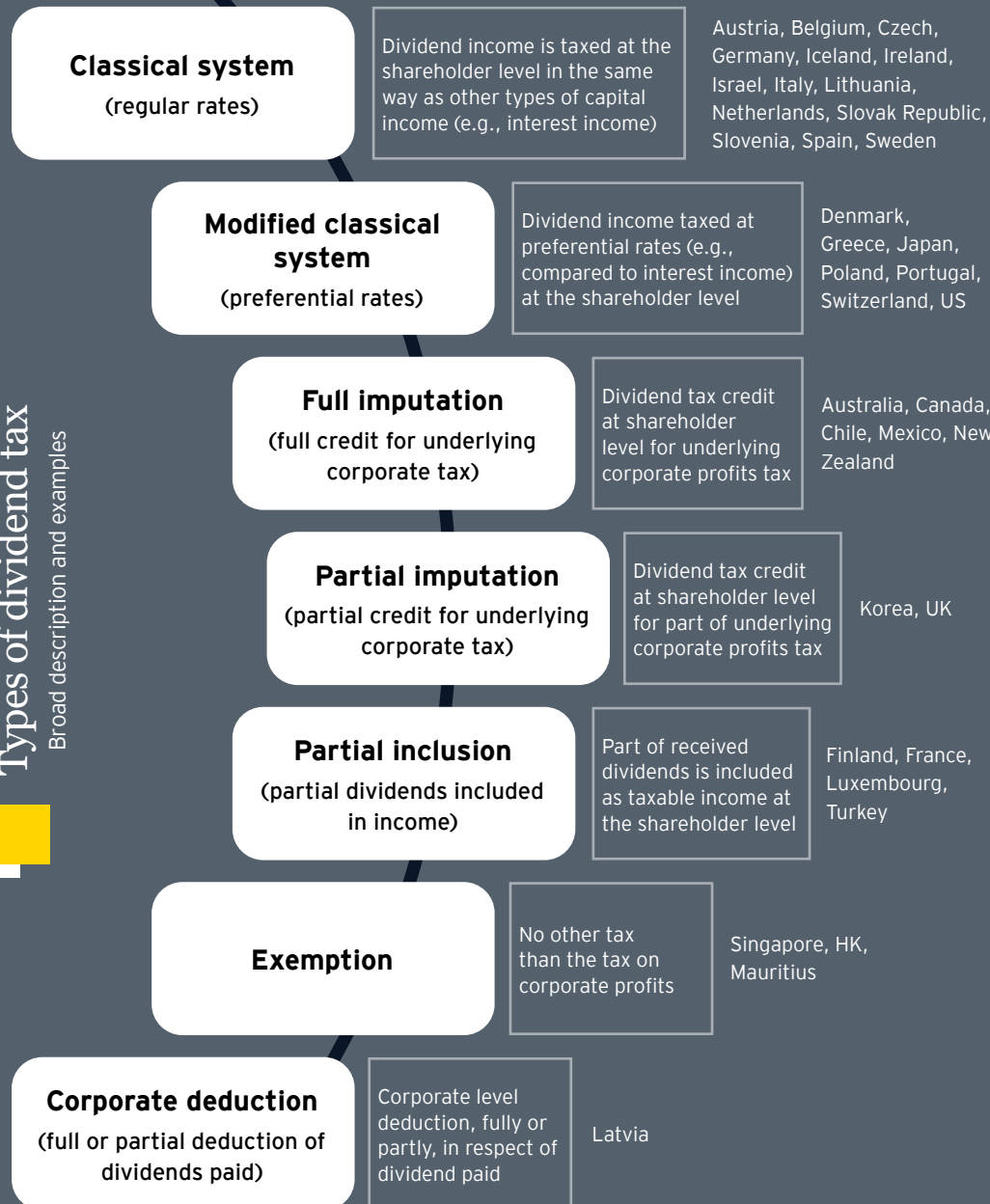
4 As per the provisions of Finance Bill 2020 passed by the Parliament

5 Base rate 10% + Surcharge 37% + Cess 4%

6 Base rate 30% + Surcharge 15% + Cess 4%

# Types of dividend tax

Broad description and examples



Source - Details obtained from country tax guides / public sources / OECD databases

The Budget proposes a classical system of tax while allowing a maximum 20% of dividend income as deduction of interest paid for making investment. However, the effective rate for the capital risk taker remains significantly tilted in favor of the non-resident. Such disparities have, in the past, influenced behavior like flight of risk capital. Rebalancing the classical system taxation, with a possibly modified preferential rate or a system of imputation, would ensure neutrality of treatment. Having said that, the proposal to allow tax deduction on upstreaming of foreign dividends to the shareholders is a welcome move.

A related question that emerges is regarding the relevance of Buyback Tax (**BBT**) which was introduced vide the Finance Act, 2013. BBT was introduced to eliminate the arbitrage between DDT and capital exemption under certain DTAAs. With the DTAAs having been amended through the Multi-Lateral Instrument (**MLI**), it may be worthwhile reverting buyback to capital appreciation and tax thereon as capital gains. BBT in its present form still creates opportunities for arbitrage vis-à-vis dividend taxation in certain instances.

The impact reversion to the classical system of dividend taxation on the fledgling but a promising market for REITs and InvITs is quite interesting. The REIT and InvIT have opened avenues for capital raise to fund the infrastructure needs of the economy, including very large public sector enterprises who are looking at monetizing their infrastructure/ real estate portfolios. In the current regime, DDT is relieved at the Special Purpose Vehicle (**SPV**) and the unitholder level. Under the classical system the dividend is taxable at the unitholder level if SPV opts for new concessional corporate tax rate of 25.17%<sup>7</sup>. Where the concessional rate is not opted by the SPV, dividends remain exempt for the unitholders. In a manner this change could be retrospective in its effect on existing REITs and InvITs. Furthermore, the taxability at the unitholder level would impact yields, making the investment attractive/ unattractive for the investor community.

Reversion to the classical system of dividend taxation is a positive message on tax policy. It paves the way for a universally consistent system of dividend taxation, avoiding tax credit leakages. If some of the measures mentioned above are adopted, it would enhance its neutrality and positive impact.

<sup>7</sup> Base rate 22% + Surcharge 10% + Cess 4%

# Tax exemption for sovereign funds to boost Infra investments in India

Given the state of the economy, there were widespread expectations that the Government of India would announce significant steps in the Union Budget FY21 to kickstart demand. While it abstained from introducing big measures, it rolled out a few far-reaching steps to ease the fiscal deficit targets, including the announcement of large expenditure proposals in the agriculture and infrastructure sectors.



**Gaurav Karnik**

Tax Partner and National Leader  
- Real Estate, EY India



To fund its infrastructure development plans, the government, in a welcome move, introduced an income tax exemption for investments by Sovereign Wealth Funds and Pension Funds. As per the proposal, income in the nature of dividend, interest and capital gains arising from investments made by Sovereign Wealth Funds and Pension Funds in specified infrastructure activities shall be exempt from income tax. This includes investments made in units of all types of Infrastructure Investment Trusts (InvITs), debt or shares of companies engaged in specified infrastructure activities (such as road, ports, airports, bridges, water treatment and sewage) and units of Category 1 and Category 2 Alternate Investment Funds (AIF), which have invested 100% of their funds in companies engaged in the infrastructure activities outlined earlier. The exemption is subject to the fact that the investments are made after 1 April 2020 and before 31 March 2024 and held for a period of three years. The government has also provided that they will have the powers to include other sectors for the income tax exemption as they deem fit in the future.

**This initiative is extremely encouraging as it will help attract long-term investors demand the highest standards of corporate governance.**

These investors have invested in large infrastructure projects globally as well as in India in the past and will continue to do so. The exemption is broadly based on the US income tax exemption provided to Sovereign Wealth Funds (commonly known as section 892) and one hopes that the government would look to interpret and apply the exemption in a liberal manner, keeping in mind the class of investors and the objective of attracting large-scale investments in the infrastructure sector.

Currently, SWFs have been defined to include:

- ▶ Wholly-owned subsidiary of Abu Dhabi Investment Authority, which is a tax resident of the UAE and makes investments out of funds owned by the Government of the UAE.
- ▶ Any other Sovereign Wealth Fund which satisfy the following conditions:
  1. It is wholly owned and controlled, directly or indirectly, by the government of a foreign country.
  2. It is set up and regulated under the law of such foreign country.
  3. The earnings of the said fund are credited either to the account of the government of that foreign country or to any other account designated by that government so that no portion of the earnings inures any benefit to any private person.
  4. The asset of the said fund vests in the government of such foreign country upon dissolution.
  5. It does not undertake any commercial activity whether within or outside India.
  6. It is specified by the central government, by notification in the official gazette, for this purpose.
- ▶ Pension funds which are:
  1. Created or established under the laws of a foreign country, including under the law of province, state or a local body.
  2. Not liable to tax in the foreign country.
  3. Satisfy other such conditions as may be prescribed.
  4. Specified by the central government, by notification in the official gazette, for this purpose.

The provisions also provide for a claw back provision to tax income which has been exempt in the earlier years. The provision triggers in the year of breach of any of the conditions relevant to exemption claimed in earlier years. The Central Board of Direct Tax is also authorized to issue guidelines in relation to the interpretation and implementation of the above provision. These guidelines need to be approved by the central government and laid before both Houses of the Parliament. They shall be binding on the tax authority as well as the specified person.

While on one hand the above exemption seeks to attract long-term institutional investors, on the other, budget announced in February 2020 sought to remove the exemption from income tax on dividends in the hands of unit holders of business trusts. This includes Infrastructure Investment Trusts/Real Estate Investment Trusts (InvITs/REITs) which could have led to the long-term investors potentially moving away from investing in the business trusts, which is at a nascent stage in India. Globally, such vehicles and their investors are subject to a single layer of taxation based on the rationale that the tax in the structure should be equal to the tax, had the asset was owned directly by the investor rather than through the structure.

The introduction of a blanket tax on dividends declared by a business trust at the unit-holder level, created two levels of taxation which could have jeopardized any fund raise through an InvIT/REIT by infrastructure and real estate companies. Simultaneously, it would have sent a negative signal to global and local investors, creating a perception of an uncertain policy regime in India - having introduced a dividend exemption and then removing it. The objective of a business trust, unlike a company, is to ensure that annuity income is distributed to investors and 90% of its net distributable cash surplus is distributed to its unit holders. To enable this, a tax exemption on dividends was accorded to the business trust, subject to conditions.

Keeping the above perspective in mind and in deference to the representations made by several stakeholders, the amended the Finance Bill, 2020 during final enactment has provided that as long as special purpose vehicle (SPV) from which dividend income is received by REIT/InvITs by way of distribution has not opted to be governed by lower rate of corporate tax of 22%, unit holders of REITs/InvITs will not be required to pay tax on dividend income distributed by the said REIT/InvIT. Besides this, there shall be no withholding obligation on distribution of such dividend income to their unit holders.

However, if the SPV opts for the lower corporate tax rate of 22% then dividends paid by the SPV would be taxable in the hands of the unit holders of the REITs/ InvITs. Accordingly, issuers of REITs/ InvITs would need to plan for alternate scenarios while finalizing their plans.

In conclusion, the government's move to provide Sovereign Wealth Fund and Pension Fund income tax exemption for specified infrastructure investments along with dividend exemption for unit holders of InvITs/REITs, signaled its intent to welcome long-term patient investors to invest in sectors which have significant backward and forward linkages with the economy. This may help in boosting the country's Gross Domestic Product and in generating employment opportunities.

# Direct Tax Vivad Se Vishwas Act 2020: settling the unsettled

The central government's focus on providing a business-friendly environment in the country has helped enhance ease of doing business, promote a non-adversarial tax regime and maintain a tax-friendly atmosphere.

Over the past few years, Central Board of Direct Taxes (CBDT), too, has taken several measures. The authority has rolled out press releases on the interpretation issues and has been proactive towards releasing circulars/instructions to make the tax administration's view clearer and to avoid possible litigation due to interpretation issues. The Ministry of Finance has also come up with the Advance Pricing Agreement (APA) process with a view to provide certainty to multinationals doing business in India.



**Rajan Vora**

Partner, Tax Litigation Advisory Group,  
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The government has also substantially increased the monetary tax limit for tax departments to file appeals before the appellate authorities such as the Income-tax Appellate Tribunal (ITAT), high courts (HC) and the Supreme Court (SC), which has helped in the reduction of disputes/litigations.

In wake of the motto of the government and looking at the success of the Sabka Vishwas Scheme announced earlier for indirect-tax laws, the Finance Minister announced the Vivad Se Vishwas Scheme (VSV Scheme), which literally translates into 'No Dispute but Trust scheme, for resolving pending litigations under the Income-tax Act, 1961 before Appellate Forums (viz. Commissioner of Income-tax (Appeals) (CIT(A)) and ITAT), as well as High Courts and the Supreme Court. The Direct Tax Vivad Se Vishwas Bill, 2020 was announced on 5 February 2020.

To make VSV Scheme a success, the government has been undertaking continuous conversations with stakeholders and taxpayers after the bill was introduced. Based on the suggestions and representation received from the stakeholders and taxpayers, the government introduced the amended bill in Lok Sabha on 4 March 2020, which was later approved by both the houses of Parliament and became an act on the receipt of President assent on 17 March 2020.

CBDT, on 4 March 2020, issued 55 FAQs on the scheme through Circular no 7/2020 to clarify open concerns pertaining to the scheme. Further, procedural rules, including the forms for making declaration under the VSV Scheme and the format of certificate to be issued by the Designated Authority (DA), were released on 18 March 2020. Also, CBDT on 22 April 2020 re-clarified the 55 FAQs announced in Circular no 7/2020 through Circular no 9/2020 so as to align the same with the approved 'The Direct-tax Vivad Se Vishwas Act, 2020'.

## A

### Key features of the scheme

- ▶ It can be availed by taxpayers to settle the appeals relating to tax arrears (including interest and penalty levied in respect, thereof), that are pending as on 31 January 2020.
- ▶ It grants complete immunity from prosecution and substantial relief from payment of interest and penalty.
- ▶ It can be availed to settle appeal filed by taxpayers or tax departments.
- ▶ The entire appeal will need to be settled if the taxpayer wishes to avail the scheme for any issue which is related to the appeal and cherry-picking of issues would not be allowed.
- ▶ The FAQs issued by CBDT also clarified that where an appeal involves various issues, and some are ineligible, the scheme cannot be applied.
- ▶ Taxpayer to withdraw appeal pending before CIT(A), ITAT, HC and SC (with leave of the court), or any arbitration, conciliation, mediation claim and submit its proof with the DA before a certificate is issued
- ▶ The scheme is applicable whether the tax is payable or not. Excess amount paid over the disputed tax will be refunded without consequential interest on refund.
- ▶ In case of loss returns, where losses have been reduced due to addition made by the tax department, the taxpayer will have the option to either accept the reduced loss (and not pay any amount) or pay notional tax on amount by which loss has been reduced and carry forward the full loss. The same principle is also applied for MAT credit as well as depreciation and to carry forward the losses.
- ▶ Filing of declaration will not set any precedence. Neither the department nor the taxpayer can claim in any other proceedings that the taxpayer or department has conceded its tax position by settling the dispute.
- ▶ The settling of issue containing transfer pricing adjustment would not have any effect on secondary adjustments and taxpayer would be required to bring the amount in India in respect of settled transfer pricing adjustment.
- ▶ VSV Scheme will be completely web-based, and thereby, is likely to be easily accessible to the taxpayers as well as the department. There will not be any physical interaction between the taxpayers and the DA.

## B Eligibility to avail VSV Scheme

The following matters/cases pending as on 31 January 2020 shall be eligible for admission under the scheme:

- ▶ Appeals before the SC, HC, ITAT or CIT(A)<sup>1</sup>
- ▶ Writ petitions pending before HC/SC
- ▶ Special Leave Petitions (SLPs) pending before the SC
- ▶ Cases where the time limit for filing appeal against an order has not expired as on 31 January 2020
- ▶ Cases where objections filed by the taxpayer against draft order are pending with Dispute Resolution Panel (DRP)
- ▶ Cases where DRP has given the directions but the assessing officer (AO) has not yet passed the final order
- ▶ Cases where the taxpayer decides not to file an application before DRP but is waiting for a final assessment order to be passed by the AO against which the taxpayer can appeal before the CIT(A)
- ▶ Search assessments where dispute tax is up to INR5 crores for each year
- ▶ Cases where revision application is pending before the principal CIT
- ▶ Disputes pertaining to Tax Deducted at Source (TDS)/ Tax collected at Source (TCS)

CBDT also clarified on certain eligibility scenarios in the FAQs issued under the scheme. These include:

Sr. no	Matter	Eligibility
1	Matters under arbitration, conciliation or mediation, although there is no appeal pending.	Yes
2	Assessment set aside for fresh examination (except where -the assessment has been cancelled and ordered to be framed de novo)	Yes
3	Matters heard by the appellate authorities on or before 31 January 2020 whose order is awaited	Yes
4	Disputes pending before Authority of Advance Ruling (AAR) (except writ petition pending before HCs against AAR's order will be covered. CBDT has also clarified that in such cases, if the quantum of disputed tax is not determinable, the cases would not be eligible for the scheme).	No
5	Notice issued under section 148 (reassessment) without passing an assessment order	No

### Cases that fall short of eligibility criteria

- ▶ Cases where prosecution has been initiated under the prescribed laws or where tax arrears include undisclosed income from source located outside India or asset located outside India or where assessment is initiated based on information received under Double Taxation Avoidance Agreement.
- ▶ Taxpayers against whom detention order is made under the Conservation of Foreign Exchange and Prevention of Smuggling Activities Act, 1974 (subject to specified conditions) or if taxpayers are notified under section 3 of the Special Court (Trial of Offences Relating to Transactions in Securities) Act, 1992, prosecution can be launched under various laws (including initiation of prosecution by income tax authority for offences punishable under India Penal Code or for the purposes of enforcement of civil liability or where taxpayer is convicted by such offence consequent to prosecution initiated by income tax authority).

<sup>1</sup> Including the matters before CIT(A) where enhancement notices have been issued

## C Payments to be made under the scheme is as under

Types of matters	Amount payable on or before 31 December 2020 (as per announcement made by Hon'ble FM in relation to 'AtmaNirbhar Bharat' on 13 May 2020)	Amount payable after 31 December 2020 till the last date
<b>Assessees' appeal</b>		
Matters involving disputed tax, interest and penalty thereon	Entire amount of disputed tax only (complete waiver of interest and penalty levied/ leviable) <b>Search cases - 125% of disputed tax</b>	Entire amount of disputed tax plus 10% of disputed tax <b>Search cases - 135% of disputed tax</b>
Matters involving disputed penalty, interest and fees	25% of the disputed penalty/interest/ fee	30% of the disputed penalty/interest/fee

- ▶ If the tax department has filed an appeal or where the issue has been decided in favor of the taxpayer by the ITAT/HC/SC then in any year and the same has not been reversed by a higher forum, the amount payable under VSV Scheme shall be 50% of the above mentioned amounts. The FAQ further clarifies that 50% will be available even if there is a favorable order of earlier years in the same forum.
- ▶ Where CIT(A) has issued a notice for enhancement, the disputed tax shall be increased by the amount of tax pertaining to issues covered in the enhancement notice

## D Impending matters

The closure date is not yet notified. The original date of closure was 30 June 2020 as proposed in the budget speech. But it is likely that this date may be altered depending upon the current COVID 19 situation.

## E Our thoughts

The announcement of VSV Scheme is a welcome move aimed at settling direct tax disputes. Certainly, this would help in reducing pending litigations, and to some extent, may help in ease of doing business in India. Such a move is likely to help the taxpayers focus their time, efforts and resources in doing business rather than fighting tax disputes. The scheme is also a one-time opportunity for taxpayers to clean up their balance sheets and to prepare themselves for the right cases.

Though there are some areas and issues on which taxpayers are keen to get further clarity, the CBDT is likely to issue another set of clarifications shortly.

## F Way forward

All cases where appeals are pending need to be examined to decide whether they require further litigation or settlement under the scheme. Issues which are in the HCs/SC, in favor and cases where the taxpayer is reasonably certain to win, may not be opted for.

The department is welcoming the taxpayers to avail the scheme. In case where the taxpayer has any apprehensions, or fact-specific issues, the taxpayer can approach the jurisdictional tax authorities proactively to seek clarifications.

In view of the amendments pertaining to the settlement of appeals and issues covered by order of the same forum or higher forums at 50% of the disputed tax, taxpayers facing doubts about the scheme (since they may have to forego full tax on certain favorable issues), will now have more comfort to avail the scheme.

However, in cases where there are recurring issues or where there is enough precedence/ support available, the scheme may not be opted for. Given the above, calculation of disputed tax becomes crucial to decide whether to avail the scheme or not.

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The scheme is a welcome move providing taxpayers an opportunity to close legacy litigation, giving them complete immunity from interest, penalty and prosecution. However, to make it operational, government needs to give clarifications so as to remove the hardships faced by taxpayers. For e.g., the amended bill clarifies to provide refund of excess tax paid by the taxpayer before filing declaration over the amount payable under the scheme. Accordingly, in cases where taxpayer has paid tax against a quantum order and penalty order for a particular year, whether the penalty paid will also be refunded to the taxpayers opting to settle the quantum proceedings, since in cases where penalty proceedings are merely initiated (but order has not been passed) are automatically covered under the scheme when quantum appeal is settled. The same needs to be clarified since cases where only quantum and penalty proceedings are pending before the appellate authorities should be treated at par with the taxpayers in whose cases quantum proceedings are pending and penalty proceedings are only initiated.

### **Ramesh Khaitan**

Senior Vice President, Lupin Limited



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VSV is a revolutionary and forward-looking step from the government. It will bring closure of the tax disputes from taxpayers' point of view and will also help the government to achieve tax collection targets. It is expected that government shall expand the coverage and proactively issue clarifications on various nuances of the scheme. Officers are also likely to support the taxpayers to avail maximum benefits of the scheme. The government shall consider the payment of settlement amount in instalments keeping the current economic scenario and liquidity stress in mind.

### **Rakesh Gupta**

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*Contributions from -*

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# Variable capital companies: a new opportunity for asset managers and lessons for India

Singapore's central bank, the Monetary Authority of Singapore (MAS) and the Accounting and Corporate Regulatory Authority (ACRA) launched the Variable Capital Companies (VCC) framework on 14 January 2020, to constitute investment funds across traditional and alternative strategies.

The VCC is a significant chapter in the development of Singapore as a full-service international fund management and domiciliation hub. VCCs are set to make Singapore an even more attractive fund management hub by providing fund managers with greater flexibility on the domiciliation of extensive range of investment funds. The VCC structure is tailored for collective investment schemes whether open ended or close ended, traditional as well as alternative be it private equity, hedge fund or real estate. The framework provides greater operational flexibility and cost savings and should give Singapore a distinct advantage and is expected to enable its fund management industry to leapfrog from good to great.



**Tejas Desai**

Tax partner, Financial Services, EY India



**Sameer Gupta**

Tax partner and Markets leader, Financial Services, EY India

## Overview of VCCs

VCCs are a corporate structure that can be set-up as a standalone fund or an umbrella fund with multiple sub-funds. Below are some key features of the framework:

- ▶ Regulated by MAS and ACRA
- ▶ VCCs can be incorporated with minimum of one shareholder. The shares of a VCC have no par value and actual value of the paid-up capital of the VCC is, at all times, equal to the NAV of the VCC
- ▶ Ring-fencing of sub-funds under an umbrella fund structure, i.e., assets and liabilities of each sub-fund would always be segregated
- ▶ VCC not restricted to paying dividends only out of profits as is the case with companies
- ▶ There are no capital maintenance requirements
- ▶ Every VCC must have an investment manager<sup>1</sup> who in turn would be regulated by the MAS in Singapore
- ▶ Flexibility to prepare financial statements as per internationally accepted methods
- ▶ Members may also redeem and sell their shares back to the VCC to exit their investment
- ▶ VCCs may only have one director subject to fulfilment of various conditions prescribed
- ▶ As per the framework, MAS would also provide information to foreign and domestic authorities in order to enable them to verify if the Anti Money Laundering (AML)/Countering Financing of Terrorism (CFT) requirements are adequately met by the VCCs
- ▶ From a tax standpoint, VCCs are considered as a single entity for Singapore tax purposes and should be eligible to access Singapore's tax treaty network. Existing tax incentives such as remission of GST, as well as lower tax of 10% on the fund manager, will be available in the context of a VCC

Owing to the above features, the said framework would provide fund managers with a greater choice of investment fund vehicles in Singapore that cater to the needs of global investment funds and investors. Fund managers would now be encouraged to use Singapore as a master fund platform, certainly for Asian investors but also for the American and European investors who have historically preferred jurisdictions such as Cayman Islands, Luxembourg or Ireland. To the existing structures located in the above countries, VCC regime also contains provisions to re-domicile in Singapore subject to various criteria prescribed by the MAS.

1 An investment manager should either be a holder of capital markets services license for fund management; or a registered fund management company

## VCCs – the Indian context

Singapore has evolved as a prominent global hub for the asset management industry, with its assets under management (AUM) close to US\$2.5 trillion<sup>2</sup>. It has also emerged as one of the top investing countries into India, with a cumulative foreign direct investment (FDI) exceeding US\$91 billion<sup>3</sup> over the years and portfolio (FPI) investment currently exceeding US\$43 billion<sup>4</sup>.

The Securities and Exchange Board of India (SEBI) has recently introduced the new FPI regulations 2019 under which a foreign fund will be eligible to a Category 1 FPI license, if either the fund or the fund manager is located in a Financial Action Task Force (FATF) member country and is appropriately regulated by the securities market regulator in the home country. The slight nuance in the context of VCCs is that they are regulated by ACRA, which is the regulator for companies in Singapore. The fund manager is however regulated by MAS, which is the securities market regulator. On that basis, the SEBI should consider regarding the VCCs as eligible to a Category I FPI license.

From a tax standpoint, while the India-Singapore tax treaty has been revised to do away with the capital gains tax exemption on sale of shares of an Indian company, it continues to exempt gains from other financial instruments (i.e., bonds, debentures, derivatives instruments, etc.). Singapore always provided a compelling story for fund managers looking to establish themselves in the Asia-Pacific region, given its political and legal certainty, as well as the thriving services sector supporting the asset management industry. The VCC framework with its ability to pool monies directly from investors in Singapore should thus, significantly strengthen the basis for choice of Singapore as a location for the fund and strengthen the case for treaty access in this post-General Anti Avoidance Rules (GAAR) and post-Base Erosion Profit Shifting (BEPS) Multilateral Instruments (MLI) era.

2 <https://www.mas.gov.sg/-/media/MAS/News-and-Publications/Surveys/Asset-Management/Singapore-Asset-Management-Survey2018.pdf>

3 Source - <https://dipp.gov.in/publications/fdi-statistics> as on 30 September 2019

4 Source- NSDL <https://www.fpi.nsdl.co.in/web/Reports/ReportDetail.aspx?RepID=88>

## Lessons for India

The Indian fund management industry has grown leaps and bounds since the economic liberalization of the country in 1991. The assets of the mutual fund industry today stand at US\$0.39 trillion<sup>5</sup>. Together with the growth in AUM, there has been a strong development of talent in the Indian mutual fund industry with the capability to manage foreign pools of capital. The total FPI investment into the country stands at US\$500 billion<sup>6</sup> and there is potential for a significant portion of that to be managed from India. The Economic Survey estimated that number to be US\$136 billion<sup>7</sup> in total assets. Additionally, the Economic Survey also estimated a further US\$82 billion<sup>6</sup> of private equity assets that also has the potential to be managed from India.

The introduction of the AIF Regulations by SEBI in 2012 has been another inflection point in the asset management industry with the total assets under custody of AIFs growing to US\$13.65 billion<sup>8</sup> in a short period of time, attracting significant domestic as well as foreign participation.

While the government and SEBI deserve credit for the huge growth of the fund management industry, more reforms in the context of the asset management industry would be necessary to bring back momentum lost as a result of the disruption in capital markets caused by Covid-19. Some of the reforms which the government and SEBI may consider are as under:

- ▶ Removal of restrictive conditions in section 9A of the Income tax Act to encourage management of offshore funds by talent in India.
- ▶ Introducing a specific tax regime for Category III AIFs to provide clarity on their tax treatment
- ▶ Exemption from GST on management fees on the portion of foreign money pooled into an AIF
- ▶ Granting exemption from indirect transfer provisions to all FPIs (whether Category I or II) as well to foreign vehicles which invest under the FDI route (there is basis to deal with this issue as the investing entities are already taxable on the direct transfer).
- ▶ Merger of NRI-PIS route to encourage greater NRI participation in the India growth story

As Singapore marches ahead on further globalizing its asset management industry, India too, can step up the game by adopting the reforms mentioned.

5 Source-AMFI (as on 31 January 2020)

6 Source- As per the Economic Survey of India net FPI in the first eight months of 2019-20 (Page 103)

7 Economic Survey of India 2019-20-Vol 2 (page 262)

8 Source-NSDL as on January 2020

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This is an opportune time for bringing in further reforms in the sector which will encourage greater domestic as well as foreign participation, boost employment and provide an overall impetus to the ‘Make in India’ vision for the financial services sector



**Umang Papneja**

CIO & Senior Managing Partner,  
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# Are ESOPs still lucrative for start-ups?

Start-ups typically use employees stock option plans (ESOPs) to attract talent from the market due to their inability to pay high cash compensation in their formative years. There is two staged taxation for ESOPs - first, at the time of allotment of shares and second, at the time of sale of shares. The tax on allotment of shares causes cash flow issues for employees since they are required to pay tax without monetization of their gain.



**Shalini Jain**

Partner, People Advisory Services, EY India

The Finance Act 2020 has partially addressed the cash flow issue by deferring the timing of payment of tax on ESOPs from allotment of shares to within 14 days from:

- 1 5 years from end of the financial year in which shares are allotted to the employees
- 2 Date of cessation of employment with the start-up company
- 3 Date of sale of shares by the employees, whichever is earlier.

There is no change in taxation of the ESOPs and they are still taxable at the time of allotment of shares - only the payment of tax is deferred to a later date. The above relaxation does not apply to all start-ups recognized by the Department for Promotion of Industry and Internal Trade, but only to those companies which are set up between 1 April 2016 and 31 March 2021 and are approved by the Inter-Ministerial Board of Certification, for the purposes of profit linked tax holiday under Section 80-IAC of the Income tax Act, 1961.

Given that the global economy is facing the much-feared slowdown owing to the ongoing COVID-19 pandemic, many companies are downsizing operations and cutting down manpower including skilled and managerial staff due to liquidity crunch.






Amidst all this uncertainty, companies especially start-ups could consider implementing an ESOP to compensate employees. By partially compensating them through ESOPs in lieu of cash compensation they may succeed in retaining key employees. In case the company already has an ESOP in place, now would be a crucial time to review the plan and perhaps undertake a re-pricing mechanism, if required, to make it more relevant for the employees.





# Global News

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-  OECD releases final transfer pricing guidance on financial transactions
-  Australian Taxation Office (ATO) issues Taxpayer Alert on non-arm's length arrangements and schemes connected with development, enhancement, maintenance, protection and exploitation of intangible assets
-  Spain publishes resolution on foreign look-through entities
-  Sweden: possible introduction of an economic employer concept
-  US IRS rules target's capitalized transaction costs do not create a separate and distinct intangible asset

## OECD releases final transfer pricing guidance on financial transactions<sup>1</sup>

On 11 February 2020, the Organization for Economic Co-operation and Development (OECD) released its final report with transfer pricing guidance on financial transactions. The report has been approved by the 137 members of the Inclusive Framework, and therefore, its importance stretches beyond the OECD member countries. The report has been published as a follow up guidance in relation to BEPS Action 4 and Actions 8-10. It aims to clarify the application of the principles included in the 2017 edition of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD TPG), in particular accurate delineation analysis under Chapter I, to financial transactions. For the first time, the report indicates that guidance on financial transactions is included in the OECD TPG, which should contribute to consistency in the application of transfer pricing and help reduce transfer pricing disputes and double taxation.

The report covers the accurate delineation of financial transactions, in particular with respect to multinational enterprises' (MNEs) capital structures. The report also addresses specific issues related to the pricing of financial transactions such as treasury functions, intra-group loans, cash pooling, hedging, guarantees, and captive insurance. It also provides guidance on the determination of risk-free rates of return and risk-adjusted rates of return where an associated enterprise is entitled to such return under the guidance in Chapter I and Chapter VI of the OECD TPG. The report also includes a number of examples to illustrate the principles discussed.

Key items discussed in the report include:

- ▶ Intra-group lenders without functional substance: Companies should evaluate whether they have any profit from intra-group lending in countries that do not have the people functions needed to manage and control the financial risks. Such a lender would be entitled to no more than a risk-free return, and the remainder would be allocable to the party exercising control over the investment risk.
- ▶ Actual delineation of guaranteed loans: Companies should evaluate whether any loans were made to a group company that could only borrow due to a guarantee by another group company and could not have raised the funds on its own. Such a transaction can be delineated as a loan to the guarantor followed by a capital contribution from the guarantor to the borrower.

- ▶ Actual delineation of the terms of funding: The report emphasizes the importance of the actual delineation of the transaction; for example, a 10-year term loan could be delineated as a series of ten 1-year revolving loans, or vice versa. Companies should evaluate all the terms of their intra-group funding and consider how to substantiate that the terms and conditions are at arm's length and are not merely the interest rate.
- ▶ Cash pools: The report indicates that, in general, a cash pool leader performs no more than a coordination or agency function. Given such a low level of functionality, the cash pool leader's remuneration as a service provider will generally be limited, although it acknowledges that cash pool leaders with more functionality can exist. Any company with material income in a cash pool leader should be prepared to substantiate that allocation of income based on the performance of control functions over credit, liquidity and other risks by employees of the cash pool leader. Thorough documentation is recommended.
- ▶ Credit rating: The report provides extensive guidance about both determining the stand-alone rating of group companies, and about taking into account the benefit of group membership ("implicit support," also known as the "halo effect"). Companies should consider their group's policies for determining credit ratings of subsidiaries in light of the report, and in particular consider the group's view on willingness and ability to support troubled group companies.

**MNE groups with intra-group financial transactions should assess whether their transfer pricing policies are aligned with the new guidance and ensure they have the supporting documentation in place to support these policies.**

<sup>1</sup> Refer EY Global alert titled "OECD releases final transfer pricing guidance on financial transactions" dated 11 February 2020

## Australian Taxation Office (ATO) issues Taxpayer Alert on non-arm's length arrangements and schemes connected with development, enhancement, maintenance, protection and exploitation of intangible assets<sup>2</sup>

ATO has issued the long-anticipated Taxpayer Alert, on aspects of intangibles migration out of Australia (TA 2020/1 "Non-arm's length arrangements and schemes connected with the development, enhancement, maintenance, protection and exploitation of intangible assets (DEMPE)").

ATO has identified that Australian companies (AusCo) are entering into various arrangements with (typically related) foreign companies (ForCo) involving the transfer of intellectual property (IP) developed in Australia into foreign jurisdictions using various techniques. The ATO considers that Australian participants in these arrangements are not properly recognizing the Australian obligations under transfer pricing rules, capital gains tax, outcomes under the capital allowance rules and the general anti-avoidance rule.

The following examples from the ATO Taxpayer Alert highlight the transactions that could be challenged from the perspective of the commercial nature of the arrangement to the Australian entity and/or not being aligned with OECD guidelines on DEMPE.

- ▶ Arrangement 1 - arrangements involving the bifurcation of intangible assets and mischaracterization of Australian DEMPE activities
  - ▶ AusCo continues to employ the same specialized staff and use its expertise and assets associated with the existing IP to manage, perform and control DEMPE activities associated with the new IP.
  - ▶ ForCo manages and performs limited activities and assumes limited risks in connection with the new IP.
  - ▶ At the time the contract R&D arrangement commences, ForCo does not have sufficient assets or employ sufficient qualified staff to primarily manage, perform or control the DEMPE of the new IP.
  - ▶ AusCo is remunerated by ForCo on a cost-plus basis.

- ▶ Arrangement 2 - arrangements involving the non-recognition of Australian DEMPE activities
  - ▶ The expected benefits received by AusCo under the Cost Contribution Arrangement (CCA) Agreement do not reflect the value of AusCo's contributions to the CCA including the extent or character of functions performed, assets used, and risks assumed by AusCo in connection with the intangible assets covered by the CCA.
  - ▶ AusCo's proportionate share of overall contributions to the CCA is not consistent with the expected benefits received. Specifically, AusCo does not obtain benefits proportionate with its contributions to the derivation of global income from the exploitation of the IP assets covered by the CCA, where those intangible assets are used and exploited by ForCo and international related parties in other jurisdictions.

**The underlying principles have already been identified in the ATO Diverted Profits Tax guidance. With the renewed ATO focus on IP as an area of risk and a perceived increase in these types of arrangements, the Taxpayer Alert was brought in. It is also part of a more systematic ATO initiative foreshadowed during 2019, about offshore migration of IP out of Australia.**

<sup>2</sup> Refer EY Global alert titled "Australian Taxation Office issues Taxpayer Alert on non-arm's length arrangements and schemes connected with the DEMPE of intangible assets" dated 23 January 2020


## Spain publishes resolution on foreign look-through entities<sup>3</sup>

On 13 February 2020, the Spanish Government published a resolution clarifying the interpretation of features to be considered for foreign entities to be seen as transparent for Spanish tax purposes. The resolution has binding effect as from 13 February 2020.

Spain's Nonresident Income Tax (NRIT) Law sets forth look-through tax treatment for entities whose legal nature is identical or analogous to that of look-through entities incorporated under Spanish law. In principle, this regime applies regardless of the tax treatment applicable in the country in which the entity is incorporated or in which the partners or members of the same reside. However, the Spanish law does not include any further guidance on what those legal features were and whether the tax treatment applicable in the country in which the entity is incorporated or in which the partners or members reside is relevant for these purposes. This has led to uncertainty.

The resolution lists the requirements in order for a nonresident entity to qualify as a look-through entity for Spanish tax purposes. The resolution also lists some of the rulings in which the characterization of foreign entities for Spanish tax purposes has been addressed. Some examples include, United Kingdom Limited Partnership (LP) and Limited Liability Partnership (LLP), the German Kommanditgesellschaft (KG) and the Dutch closed Commanditaire Vennootschap (CV).

In the resolution, three characteristics are listed that would make non-Spanish tax resident entities to be considered as a look-through entity for Spanish tax purposes:

- ▶ The income obtained by the entity is not taxed at the level of the entity.
- ▶ The income obtained by the entity is attributed to the persons who hold an interest in that entity (the members of the look-through entity), which are subject to tax in accordance with the applicable tax rules regardless of any distribution effectively made by the entity.
- ▶ The income allocated to the members of the look-through entity keeps the same characterization as it received when derived by the look-through entity.

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The content of the resolution is aligned with the criteria set forth by OECD in its 1999 report entitled “The Application of the OECD Model Tax Convention to Partnerships”. The fact that the Spanish approach will be aligned with that of the OECD will help prevent mismatches and ensure a more coordinated treatment at an international level.

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<sup>3</sup> Refer EY Global Alert titled ‘Spain publishes Resolution with additional guidance on foreign look-through entities’ dated 17 February 2020

## Sweden: possible introduction of an economic employer concept<sup>4</sup>

The Swedish government has expressed an intention to introduce an economic player concept with effect from 1 January 2021, which will affect international companies who assign employees to their Swedish subsidiaries and organizations who provide services to clients in Sweden using internationally mobile labor.

Under the current Swedish tax legislation, a formal employer concept is used. This means that the assessment of who is the employer of a worker for tax purposes is based on who is actually paying the employee's salary. When introducing an "economic employer" concept, several other factors will instead be taken into account such as:

- ▶ for whom the work is carried out
- ▶ who is responsible for the risks and output generated by the employee
- ▶ who bears employee costs rather than just the entity that pays employee salaries
- ▶ who provides direction to the employee

According to the main rule in Special Income Tax Act for non-residents (SINK), employees are tax liable in Sweden for work performed in Sweden. Some exemptions are given as listed below:

- ▶ The employee spends not more than 183 days in Sweden in a 12 month-period, and
- ▶ The remuneration is not paid by or on behalf of an employer who is domiciled in Sweden
- ▶ The remuneration is not borne by a permanent establishment that the foreign employer has in Sweden

The above exemptions will not be available in the proposed legislation if the employee's work can be seen as hiring of labor to a Swedish economic employer. In these situation, the basis of taxation would arise from day 1 in Sweden for foreign employees working temporarily in Sweden. However, it has been suggested that if a foreign employer and Swedish receiving company are part of same group, the regulation regarding hiring of labor should not apply if work is carried in Sweden is carried out for a maximum of 30 days per calendar year with any work period not exceeding 5 consecutive days. This will (to some extent) limit the number of foreign employees who are expected to become tax liable in Sweden.

**The Swedish Government is proposing that foreign employers without a PE in Sweden should be obligated to withhold preliminary tax for its employees, to the extent work has been performed in Sweden.**

**The Swedish Government will present its final outline of the legislation during calendar year 2020 which should be effective from 1 January 2021.**

<sup>4</sup> Refer EY Global alert titled "Sweden- Possible introduction of an economic player concept" released in January 2020

## US IRS rules target's capitalized transaction costs do not create a separate and distinct intangible asset<sup>5</sup>

In technical advice memorandum 202004010, the US IRS ruled professional and administrative fees paid by a Target corporation ('Target') in connection with the acquisition of its stock by Taxpayer did not create a separate and distinct intangible asset. Further, such fees were not deductible as a loss by Target upon the subsequent sale of Target's stock by Taxpayer.

### Facts

Taxpayer acquired Target's stock in a taxable reverse triangular merger. As part of the acquisition, Target paid professional and administrative fees to various law and professional firms. Target determined that a portion of fees is required to be capitalized as costs of facilitating the acquisition of Target's business under Treas. Reg. Section 1.263(a)-5(a). Additionally, Target determined that a portion of fees were facilitative success-based fees under Treas. Reg. Section 1.263(a)-5(f) and capitalized the same as an intangible asset. Taxpayer later sold Target to Buyer, which resulted in a capital loss. In its consolidated tax return, Taxpayer claimed a loss deduction for Target of the capital loss incurred on sale of Target by Taxpayer and also reduced the capitalized administrative and professional fee from taxable income of Target.

### Issue 1: Did the professional and administrative fees create a separate and distinct intangible asset under the applicable tax regulations?

Under the treasury regulations, a taxpayer must capitalize an amount paid to create or enhance a separate and distinct intangible asset. Further, it requires a taxpayer to capitalize an amount paid to facilitate a business acquisition or reorganization transaction. Taxpayer argued that Target paid the professional and administrative fees to create a separate and distinct intangible asset in the form of the synergistic benefits. Further, this conclusion is consistent with the Supreme Court's analysis in *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 86-90 (1992). Consistent with *INDOPCO* ruling, the IRS determined that the facilitative costs were incurred to acquire significant future benefits for Target's business and operations. Accordingly, the costs should be capitalized, not as costs incurred to create or enhance a separate and distinct intangible, but rather as fees incurred to facilitate Target's restructuring under the applicable regulations.

### Issue 2: Did Taxpayer properly claim a loss deduction for the professional and administrative fees for the year in which Taxpayer sold all of its Target stock to an unrelated third party?

Taxpayer argued that Target's previously capitalized fees are deductible as a loss to Target under the applicable regulations, because the asset created by the capitalization of these fees (i.e., the synergistic benefits), became worthless to Target when Taxpayer sold Target's stock. The IRS disagreed that the payment of fees "did not create or enhance an intangible asset separate and apart from Target's business, but rather were incurred to benefit Target's trade or business." And if the purpose of the expenditure has to do with the enhancement of a corporation's operations, then the useful life of the expenditures would be measured by the duration of those operations. Accordingly, a taxpayer generally could not recover these costs until the dissolution of the business enterprise or until the occurrence of another event that ends the useful life of the business. After the sale, Target continued as a corporation and operated its business under Buyer. The IRS concluded that Target was not entitled to a loss under the treasury regulations.

<sup>5</sup> Refer EY Global alert titled "US IRS rules target's capitalized transaction costs do not create a separate and distinct intangible asset" dated 31 January 2020



# EconoMeter

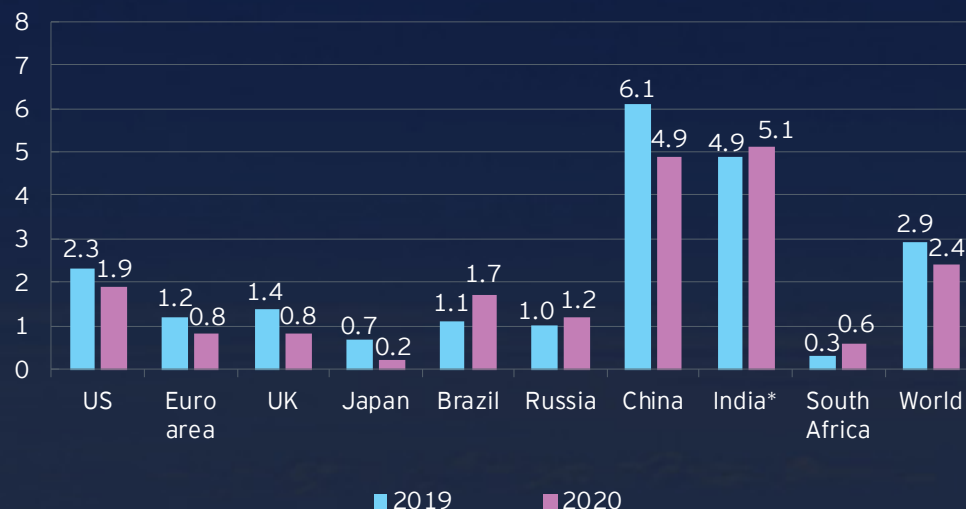
macro-fiscal trends

1

**Organisation for Economic Co-operation and Development (OECD) projected global growth to fall to 2.4% in 2020 from 2.9% in 2019 as a result of the COVID-19 epidemic; India's growth projection was revised down by 0.9% points to 4.9% in 2019.**

- ▶ As per the OECD (Interim Economic Assessment), global growth is estimated at 2.9% in 2019, weakest since 2009.
- ▶ Global growth is projected to fall to 2.4% in 2020, a downward revision of 0.5% points relative to November 2019 projections owing to COVID-19 outbreak.
- ▶ A longer lasting and more intensive coronavirus outbreak may lead to a sharp fall in global growth to 1.5% in 2020.
- ▶ Growth in India was sharply revised down to 4.9% in 2019 (FY20) and 5.1% in 2020 (FY21) with large non-performing loans and over-leveraged corporate balance sheets weighing on investment.

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



Source: OECD Interim Economic Assessment, March 2020

\*data pertains to fiscal year; estimates for 2019 and forecasts for 2020

2

**Real GDP growth fell to a 28-quarter low of 4.7% in 3QFY20; FY20 real GDP growth is estimated at 5% as per Second advance estimates of National Accounts.**

- ▶ As per the data released by Ministry of Statistics and Programme Implementation (MoSPI) on 28 February 2020, real GDP growth decelerated to a 28-quarter low of 4.7% in 3QFY20 from 5.1% in 2QFY20, its third consecutive fall since 4QFY19.
- ▶ From the demand side, growth slowdown was mainly driven by a sharp contraction in investment demand and subdued growth in private final consumption expenditure.
- ▶ Pointing to subdued investment demand, growth in gross fixed capital formation (GFCF) contracted for the second consecutive quarter by (-) 5.2% in 3QFY20.
- ▶ Growth in private final consumption (PFCE) improved only marginally to 5.9% in 3QFY20 from 5.6% in 2QFY20. Growth in government consumption expenditure (GFCE) continued to remain high at 11.8% in 3QFY20 but was lower as compared to 13.2% in 2QFY20.
- ▶ Contribution of net exports to growth has remained positive for the last five successive quarters. In 3QFY20, it was lower at 1.5% points as compared to 1.9% in 2QFY20.

**Table 1: real GDP growth (in %)**

	2Q FY19	3Q FY19	4Q FY19	1Q FY20	2Q FY20	3Q FY20	FY19	FY20*
Aggregate demand								
PFCE	8.8	7.0	6.2	5.0	5.6	5.9	7.2	5.3
GFCE	10.8	7.0	14.4	8.8	13.2	11.8	10.1	9.8
GFCF	11.5	11.4	4.4	4.3	-4.1	-5.2	9.8	-0.6
EXP	12.5	15.8	11.6	3.2	-2.1	-5.5	12.3	-1.9
IMP	18.7	10.0	0.8	2.1	-9.3	-11.2	8.6	-5.5
GDP	6.2	5.6	5.7	5.6	5.1	4.7	6.1	5.0
Net Exports Contribution to growth (% points)	-1.7	0.7	2.1	0.1	1.9	1.5	0.4	0.9

Source: Central Statistical Organization (CSO) MoSPI, Government of India; \*2nd Advance Estimates

AD: Aggregate demand; PFCE: Private final consumption expenditure; GCE: Government final consumption expenditure; GFCF: Gross fixed capital formation; EXP: Exports; IMP: Imports; GDPMP: GDP at market prices



## 3

### Real gross value added (GVA) growth decelerated to a 28-quarter low of 4.8% in 3QFY20.

- ▶ On the output side, GVA growth fell to a 28-quarter low of 4.5% in 3QFY20 as compared to 4.8% (revised) in 2QFY20 due to a contraction in the growth of manufacturing sector output, deceleration in the growth of construction sector and low growth momentum in the output of trade, transport and communications sector.
- ▶ GVA growth in the manufacturing sector contracted for the second consecutive quarter, although at a slower pace of (-) 0.2% in 3QFY20 as compared to (-) 0.4% in 2QFY20. Manufacturing sector has been struggling with excess capacity during the last couple of quarters owing to weak demand conditions.
- ▶ GVA growth in construction sector decelerated to an 11-quarter low of 0.3% in 3QFY20 from 2.9% in 2QFY20 with the sector's growth falling in each subsequent quarter since 3QFY19.
- ▶ Growth in public administration and defence slowed to 9.7% in 3QFY20 from 10.1% in 2QFY20. Lower growth in government revenues may further dampen the sector's growth performance.
- ▶ Growth momentum in trade, hotels, transport, communication and services related to broadcasting continued to remain weak at 5.9% in 3QFY20 even though it marginally improved from 5.8% in 2QFY20.
- ▶ Growth in the output of financial, real estate and professional services improved to 7.3% in 3QFY20 as compared to 7.1% in 2QFY20.
- ▶ GVA growth in agricultural sector increased to 3.5% in 3QFY20 as compared to 3.1% in 2QFY20.

**Table 2: sectoral real GVA growth (in %)**

Aggregate demand	2Q FY19	3Q FY19	4Q FY19	1Q FY20	2Q FY20	3Q FY20	FY19	FY20*
Agr.	2.5	2.0	1.6	2.8	3.1	3.5	2.4	3.7
Ming.	-7.0	-4.4	-4.8	4.7	0.2	3.2	-5.8	2.8
Mfg.	5.6	5.2	2.1	2.2	-0.4	-0.2	5.7	0.9
Elec.	9.9	9.5	5.5	8.8	3.9	-0.7	8.2	4.6
Cons.	5.2	6.6	6.0	5.5	2.9	0.3	6.1	3.0
Trans.	7.8	7.8	6.9	5.7	5.8	5.9	7.7	5.6
Fin.	6.5	6.5	8.7	6.9	7.1	7.3	6.8	7.3
Publ.	8.9	8.1	11.6	8.7	10.1	9.7	9.4	8.8
GVA	6.1	5.6	5.6	5.4	4.8	4.5	6.0	4.9

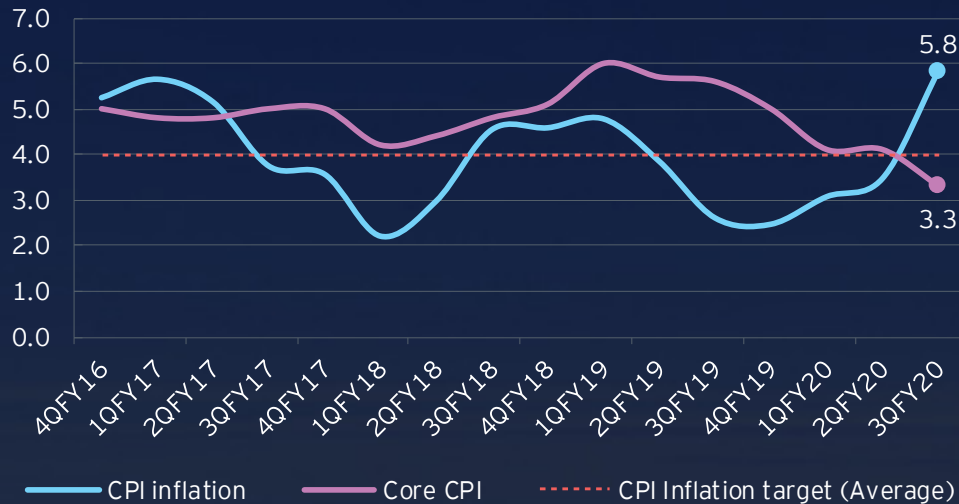
Source (Basic data): MoSPI; \*2nd Advance Estimates

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

**4** The RBI retained its policy repo rate at 5.15% while maintaining an accommodative policy stance in its February 2020 monetary policy review due to upward pressure on CPI inflation.

- ▶ Consumer Price Index (CPI) inflation increased to 5.8% in 3QFY20 from 3.5% in 2QFY20 mainly due to rising food inflation.
- ▶ On a monthly basis CPI inflation breached RBI's upper tolerance limit increasing to 7.4% in December 2019 and further to 7.6% in January 2020.
- ▶ Core CPI inflation<sup>1</sup>, fell to an all-time low (2011-12 series) of 3.3% in 3QFY20 from 4.1% in 2QFY20 reflecting the slowdown in overall demand in the economy.
- ▶ The RBI projects CPI inflation at 6.5% for 4QFY20, within a range of 5.4-5.0% for 1HFY21 and at 3.2% for 3QFY21.

**Chart 2: inflation (y-o-y; in %)**



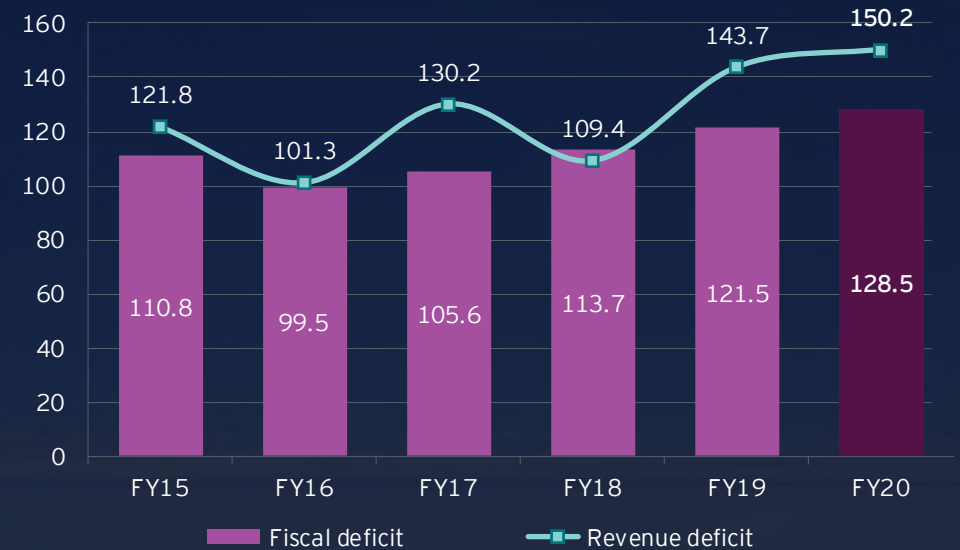
Source: MoSPI; Note: CPI stands for Consumer Price Index

1 Core CPI inflation is measured in different ways by different organizations/agencies. Here, it has been calculated by excluding food and fuel and light from the overall index.

**5** Center's fiscal deficit during April-January FY20 stood at 128.5% of the revised target.

- ▶ The center's fiscal deficit during April-January FY20 stood at 128.5% of the FY20 revised target, highest since FY01, as compared to 121.5% during the corresponding period of FY19.
- ▶ The center's revenue deficit during April-January FY20 stood at 150.2% of the FY20 revised target, highest since FY01, as compared to 143.7% during the corresponding period of FY19.
- ▶ In Union budget FY21, fiscal deficit targets for FY20 and FY21 were revised up to 3.8% and 3.5% of GDP respectively from their earlier targets of 3.3% and 3% of GDP.

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

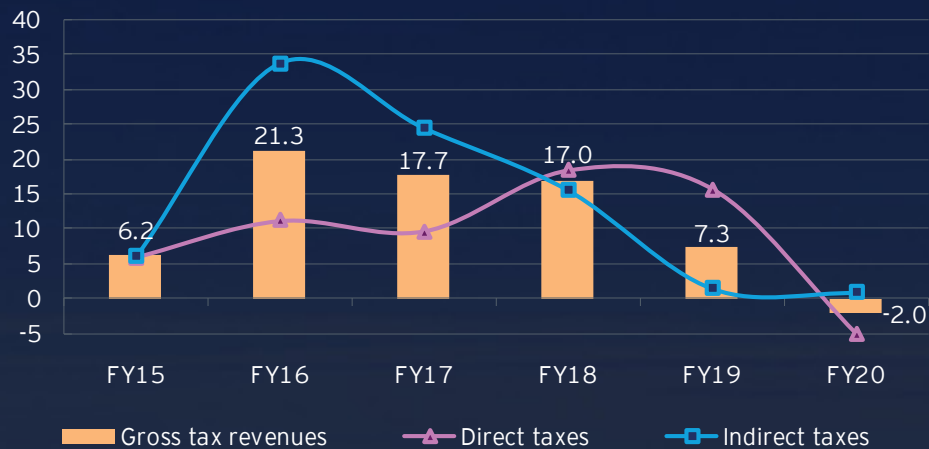


Source: Monthly Accounts, Controller General of Accounts, Government of India; Union Budget documents, various years

**6** Gross central taxes witnessed a contraction of (-) 2.0% during April-January FY20, the first such instance of contraction since FY10

- ▶ Gross central taxes during April-January FY20 contracted by (-) 2.0% as compared to a growth of 7.3% during the corresponding period of FY19.
- ▶ The last instance of a contraction in gross taxes during the corresponding period was witnessed in FY10, when gross tax revenues contracted by (-) 1.2%.
- ▶ Direct taxes contracted by (-) 4.9% during April-January FY20 as compared to a growth of 15.7% during the same period in FY19.
- ▶ The contraction in direct taxes until January FY20 reflects a sharp contraction in the corporate income tax (CIT) revenues partially due to the CIT rate reforms undertaken in September 2019.
- ▶ Indirect taxes showed a subdued growth of 0.9% during April-January FY20 as compared to 1.5% during the corresponding period of FY19.

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



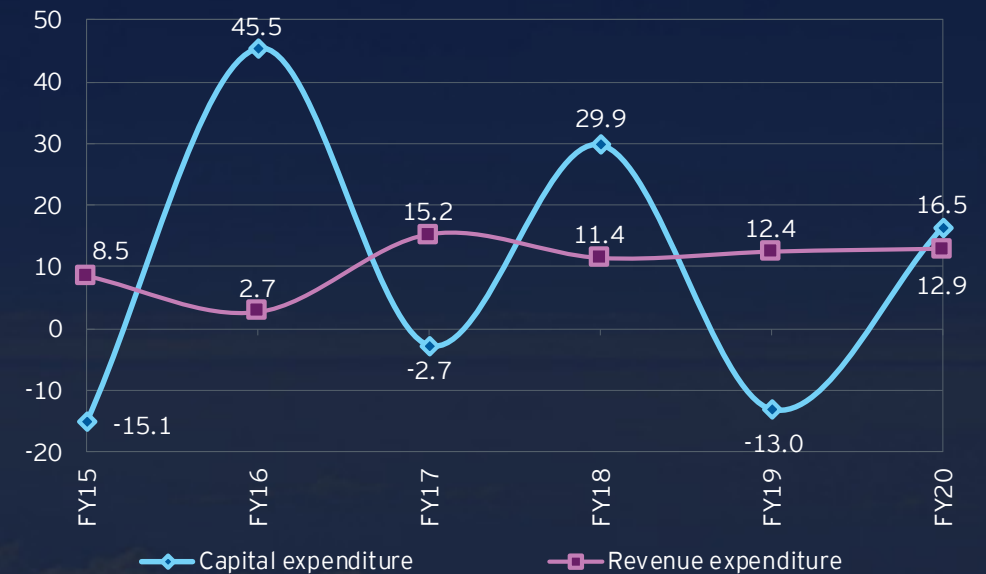
Source: Monthly Accounts, Controller General of Accounts (CGA), Government of India

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

**7** Center's total expenditure grew by 13.3% during April-January FY20; capital expenditure relative to GDP is estimated to increase marginally to 1.7% in FY20 (RE) and to 1.8% in FY21 (BE).

- ▶ Growth in center's total expenditure during April-January FY20 was at 13.3% as compared to 8.8% during April-January FY19.
- ▶ Growth in revenue expenditure was at 12.9% during April-January FY20, marginally higher than 12.4% during the corresponding period of FY19.
- ▶ Growth in center's capital expenditure was at 16.5% during April-January FY20 as compared to a contraction of (-) 13% during April-January FY19.
- ▶ As a proportion of the annual revised estimates, capital expenditure during the first ten months of FY20 stood at 76.7% while revenue expenditure stood at 85.1%.
- ▶ As per the Union Budget FY21, center's capital expenditure relative to GDP is expected to increase marginally from 1.6% in FY19 to 1.7% in FY20 (RE) and to 1.8% in FY21 (BE).

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



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

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