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Building a better working world

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Foreword

Sudhir Kapadia
Partner and National Tax Leader, EY India

We are pleased to present the 17th edition of our magazine, India Tax Insights.

Amid the foreboding business ambiance, on 20 September 2019, the Finance Minister presented a truly bold and transformative pre-Diwali package for the corporate sector. Instead of the half-hearted attempts made previously on reduction of corporate tax rates selectively for small and medium-sized companies, there was an across-the-board reduction in the corporate tax rate to 25.17% (including surcharge) for companies of all sizes and in any sector of the economy in lieu of not availing any tax exemptions or incentives. This will effectively leave companies in the erstwhile nominal tax rate of 35% with a direct cash booster of 10% of their profit before tax across all sectors. As a further sweetener, for a new company making a fresh investment in manufacturing, with an option to pay tax at the rate of 17.16% (including surcharge) the direct cash booster can be 18% of a new company's profit before tax. This should result in a virtuous cycle of increasing investments, consumption and growth. The new tax rates also present India as one of the most attractive investment destinations viz.-à-viz. other ASEAN countries. This positions India well to avail investment opportunities in the global supply chains, which are otherwise disrupted due to the ongoing trade disputes between the US and China.

On 9 October 2019, the Organisation for Economic Co-operation and Development (OECD) released a public consultation document outlining a proposal from the OECD Secretariat for a "unified approach" under Pillar One of the ongoing project titled "Addressing the Tax Challenges of the Digitalisaton of the Economy", what is commonly referred to as BEPS 2.0. The proposal provides suggestions on the scope of the new rules being developed, an approach to the new nexus concept, and an approach for new and revised profit allocation rules. It is intended to facilitate negotiations among the countries, with the aim of achieving a political agreement among the Inclusive Framework jurisdictions by the first half of 2020. These proposals may lead to significant changes to the overall international tax rules under which multinational businesses operate and might have important consequences in terms of businesses' overall tax liability and countries' tax revenues. It is important for companies to follow the upcoming developments closely and to consider engaging with the OECD and policymakers at both national and multilateral levels on the business implications that these proposals might accompany. It is pivotal for the companies to evaluate the potential impact that these changes might have on their business models.

This edition of our magazine contains insightful articles covering the recent tax developments, with the lead feature on impact of the recent corporate tax rate reduction on the competitiveness of the Indian economy. Additionally, we have articles discussing on other fiscal measures that are required for stimulating the economic growth, disruption in the global trade and India's foreign trade policy, impact of the Multilateral Instrument on business and how the new OECD proposals on BEPS 2.0 will impact the business.

In this shifting tax environment, keeping abreast of changes is essential. We hope this publication helps you monitor the issues and understand the drivers behind the key tax and regulatory developments and the changes taking place in India and around the globe. We look forward to your feedback and suggestions.

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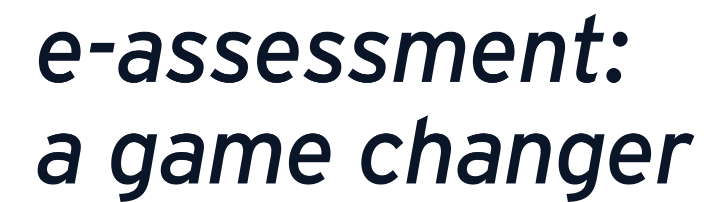


e-assessment: a game changer

Garima Pande

Partner and National Leader - Global Compliance and Reporting, EY India

Dhanashree Chaoji

Associate Partner Tax & Finance Operate, EY India

Indian Government seems to be bolting faster than the fastest sprinter in the world, Usain Bolt, while adopting digital tax administration. The pace of change has been tremendous, so much so that India Inc now feels the urgency to catch up.

We saw the implementation of digitally-administered GST, which has significantly transformed the way in which tax compliances can be performed. With government sending pre-populated tax returns with the relevant sources of income and withholding/advance taxes, which the taxpayers can confirm digitally, India has been progressing on its plan to digitally transform the individual tax compliances.

Project Insight, a flagship project of the Income Tax Department, to widen tax base and increase compliance, has already started using contemporary technology for data mining, research and analytics against black money and tax evasion by sourcing the taxpayers' data. Sharing taxpayers' data across direct taxes and GST administration is also becoming a reality.

As part of this action-packed agenda, the Central Board of Direct Taxes went ahead and notified the faceless e-assessment scheme under the Income Tax Act[1].The scheme is expected to cause some disruption in the short-term. However, in the longer run, it is believed that the scheme will advance to a progressive system of assessment, providing greater

1 Excludes discrepancies

consistency in tax assessments nationally and offering ease to taxpayers.

As per the scheme, National e-Assessment Centre can assign scrutiny of any case to an Assessment Unit in any Regional e-assessment Centre through an automated allocation system. In case, the regional centre requires additional information or clarification, the national center can only fulfil these requirements. After considering the inputs received, the assessment unit will pass a draft order, which will be examined by the national center and reviewed by the review unit before a final order is provided to the taxpayer, with or without modifications.

Considering the above, the scheme does envisage a robust process to achieve the objectives of transparency, accountability and efficiency. However, one of the most fundamental questions that needs to be answered today is whether the taxpayers and the tax authority are prepared with the right systems and infrastructure to conduct and conclude e-assessments.

Since all communication will be done electronically, there is a need for taxpayers to ensure that the documentation/details submitted to the tax authorities are in a clear and simplified manner as an evidence to substantiate their tax filing positions. This is also essential as the taxpayers will have a very limited or no interaction with the tax authority which might make it difficult for the authorities to understand the taxpayer's complex business transactions and tax positions based on the information submitted electronically.

In this context, it is pivotal to see what parameters or risk management strategy will be deployed to examine or review the submitted information and the opportunity that the taxpayers will get to explain their tax data and positions before any adverse conclusions are drawn against them. This critical aspect may determine how taxpayers need to prepare themselves to handle the information request and show cause notices. While the notification currently appears to be restricted to certain cases/classes to be notified by the CBDT eventually, it will be critical for the tax administration to consider the complexity of different classes of taxpayers while taking the decision on implementation of e-assessment.

It will be critical for the government to ensure appropriate investment in technology and infrastructure to manage and maintain huge amount of data and documentation that will be submitted by the taxpayers. Technical glitches could affect the timelines of scrutiny and quality of assessment. In addition, maintaining data security and confidentiality on taxpayers' data, which is submitted and maintained online, would be extremely critical to build greater comfort of taxpayers (corporates in particular).

The CBDT's press release highlights the key features and benefits of the faceless assessment and states that there would be a state-of-the-art digital technology for risk management under the scheme by way of automated examination tool, Artificial Intelligence and Machine Learning, with a view to review the scope of discretion of the officers of Income Tax Department.

Simply put, the scheme aims to remove arbitrariness by eliminating the interface between taxpayers and tax authority. Latest technology including Artificial Intelligence and Machine Learning is likely to be used to reduce any scope of discretion. This is indeed a step in the right direction and with any new process, there will be a wait and watch period to see how the implementation pans out. All in all, there is no doubt that directionally we are seeing a focused march towards transparency through digital means and the sooner India Inc will take steps towards transforming their own internal tax function and in adopting technology for their internal tax administration, the better placed business entities will be to navigate the new world of digital tax administration.

Insolvency and Bankruptcy Code: The journey so far

Pranav Sayta
Tax Partner and National Leader, International Tax and Transaction Services, EY India

The Insolvency and Bankruptcy Code, 2016 (the IBC or the Code) is considered as one of the key structural reforms to resolve India's non-performing assets conundrum. Three years since its introduction, it seems appropriate to assess the key tax challenges of the potential buyers and companies against whom corporate insolvency resolution process has been initiated (IBC companies) and any turnarounds in this regard.

Concerns	Remarks
Minimum Alternate Tax (MAT) on waiver of debt and liabilities	Increased MAT liability due to write-backs of debt and liabilities being reflected as income in the profit and loss statement has been a matter of concern since the enactment of the Code. Partial relief was brought vide budget 2018 which allowed IBC companies to claim an aggregate of brought forward losses and unabsorbed depreciation as a deduction from profits as per books of account. Despite this in most cases, MAT was payable as the quantum of waiver agreed under the resolution process and far exceeded the total amount of book losses and unabsorbed depreciation. Hence, to facilitate a burden-free resolution, it was urged to provide a blanket exemption of MAT on such write-backs by the IBC companies. Recently, with the promulgation of the Taxation Laws (Amendment) Ordinance, 2019 by the President of India, a ray of hope emerged for IBC companies, whereby MAT provisions shall not be applicable if IBC companies decide to opt for the preferential lower corporate tax rate of 25.17%, provided no specified exemptions/incentives under the Income-tax Act, 1961 (IT Act) are availed. However, it may be imperative to undertake a cost-benefit analysis to understand the differential tax outflow under the preferential tax regime over the period.
Provisions of gift tax	Section 56(2)(x) of the IT Act causes gift tax for recipient of share and securities if received for a value less than its fair market value as computed in accordance with Income-tax Rules, 1962 (IT FMV). In a situation, wherein a listed company is facing proceedings under the Code, it may be possible that the intrinsic value is less than the IT FMV (prevailing listed price in this case). This may create unwarranted hassles for the acquirer as provisions of gift tax will trigger if shares are acquired at less than IT FMV. In 2019 budget, it was acknowledged that normative determination of IT FMV invites issues pertaining to consideration for transfer of shares where the consideration is approved by certain authorities and parties do not have control over the determination made by the regulators. Accordingly, effective 1 April 2020, the power is provided to the Central Board of Direct Taxes (CBDT) to prescribe transactions undertaken by certain class of persons to which the provisions of section 56(2)(x) of the IT Act shall not apply. While the CBDT has not yet notified the transactions and the classes of person for non-applicability of these provisions, it is believed that CBDT's notification shall cover transfer of shares of distressed companies under competitive bidding process where price is approved by the National Company Law Tribunal (NCLT). Such notification can be construed as a positive step in the right direction and aid potential buyers to acquire IBC companies.
Carry forward of unabsorbed business loss	As per Section 79 of the IT Act, the benefit to carry forward unabsorbed business loss is lost in a scenario if the shareholding of a closely held company changes by more than 49% in a tax financial year as compared to the year in which the loss was incurred. Pursuant to the 2018 budget, the applicability of these provisions for IBC companies was relaxed. However, the proposed amendment also provides a rider that the approval of the resolution plan should be given after affording a reasonable opportunity of being heard to the jurisdictional principal commissioner or commissioner. While it seems from the amendment, that the income tax department may have some sort of standing to present its view before the NCLT, the department however, does not seem to give them the ability to object or veto the resolution plan.
Carry forward of tax losses upon merger	In a scenario where the buyer intends to consolidate the business of the IBC company into its existing business by way of merger for synergies, etc., it may not be able to carry forward the past tax losses of the IBC company unless it fulfils certain prescribed conditions. Under these conditions the amalgamated company should hold, from the date of amalgamation, at least 75% of the book value of fixed assets of the amalgamating company for a minimum period of five years or achieve a level of production of at least 50% of the installed capacity of the amalgamating undertaking before the end of four years. Satisfaction of these conditions may be deterrent for buyers as certain IBC companies may be carrying fictitious/not worthy assets and may not be able to satisfy the threshold requirements. The government could consider liberalizing these conditions for restructuring measures adopted by IBC companies.

While the amendments in Indian tax law have tried to address certain key challenges faced in bankruptcy law from a direct tax stand point, certain critical aspects (discussed below) still remain, which include:

Plausible burden of any unidentified/non-materialized matters relating to pre-IBC resolution period which were not considered/ identified during the IBC process:

This uncertainty coupled with the fact that the NCLT, in the past, has rejected the proposal for blanket waiver of liabilities, could entail additional waste of money, time and efforts in cleaning-up the past matters that would have otherwise been utilized for revival. Acquirers would accordingly need to critically evaluate the potential tax liabilities that pertains to IBC/pre-IBC period but which could possibly materialize after acquisition of the IBC company and undertake a cost-benefit analysis associated with it along with cash flow mechanics.

To bolster the revival process, it is important to get rid of all liabilities that materialize post approval of resolution plan but relate to pre-IBC period to make the acquirers fairly certain on how to deal with the assets and focus on revival.

Due diligence of stressed assets remains a challenge as:

- All the information and access are not provided as the resolution professional himself is struggling with managing the business; and
- Given that these are stressed assets, it is possible that the IBC companies are not compliant; either they may have not paid taxes or there may have been delays in paying taxes or may be defaults/delays/failures in filing of tax returns and related compliances.

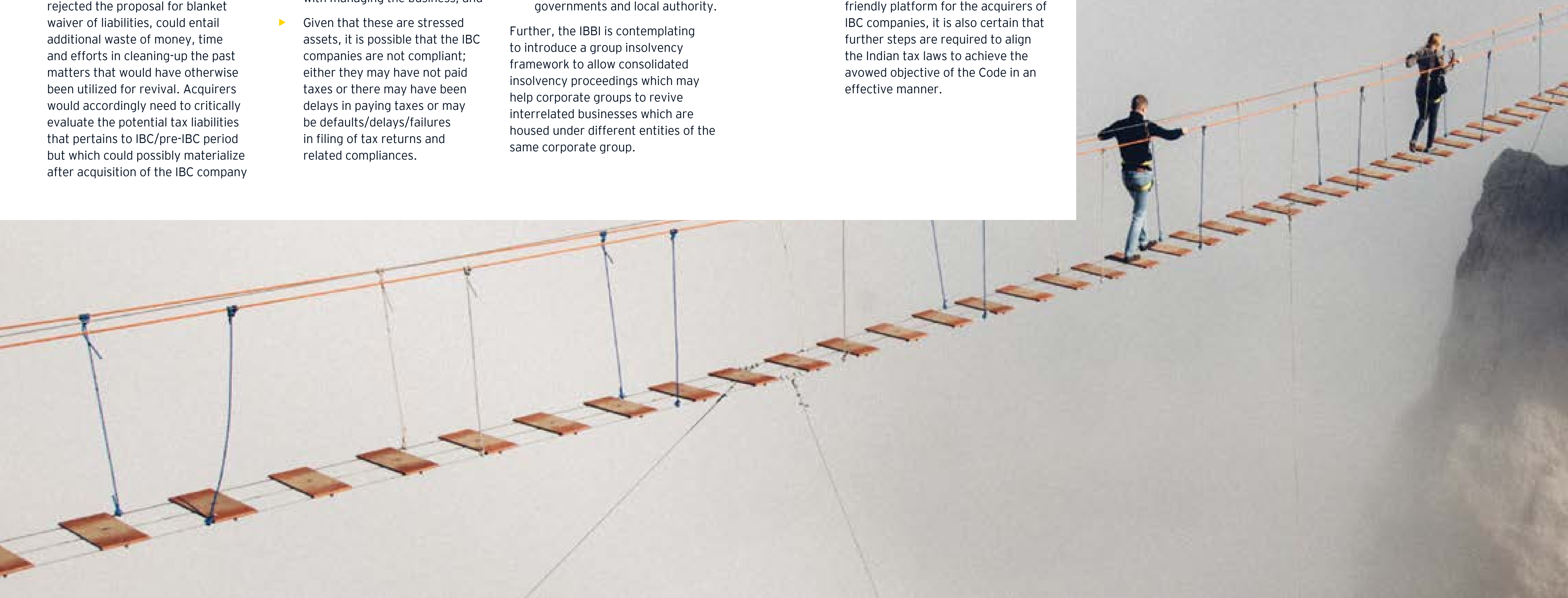
However, from an operational standpoint, the Insolvency and Bankruptcy Board of India (IBBI) in June 2019 amended the Code taking a cue from various stakeholders and based on the experience from implementation of the Code and judgements on the Code. Some of the key amendments which have further streamlined the process, inter alia, include:

- Inclusion of comprehensive restructuring schemes like merger, demerger, etc.
- Mandatory completion of insolvency process within 330 days, otherwise liquidation.
- Binding nature of resolution plan on the central government, state governments and local authority.

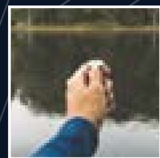
Further, the IBBI is contemplating to introduce a group insolvency framework to allow consolidated insolvency proceedings which may help corporate groups to revive interrelated businesses which are housed under different entities of the same corporate group.

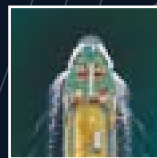
Also, the IBBI is working towards having a regulated fast-track resolution process, commonly called as a pre-packaged insolvency resolution, whereby most groundwork involved in negotiating the resolution plan and obtaining an approval of financial creditors can be achieved before commencement of insolvency process. Once a mutually-acceptable resolution plan is achieved, it could be expeditiously presented to the committee of creditors to be voted upon under the insolvency process. Hence, pre-packs could be an experiment worth considering to facilitate swift and effective resolutions without interruptions.

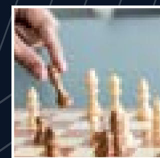
To conclude, while the government has made efforts to build an investor-friendly platform for the acquirers of IBC companies, it is also certain that further steps are required to align the Indian tax laws to achieve the avowed objective of the Code in an effective manner.



Sunrise for the economy


Reviving growth through two-sided policy push


India's trade policy: version 2.0 in the making


Private Equity sector: A catalyst for India's economic growth

Reviving growth through two-sided policy push

Dr. D.K. Srivastava
Chief Policy Advisor, EY India

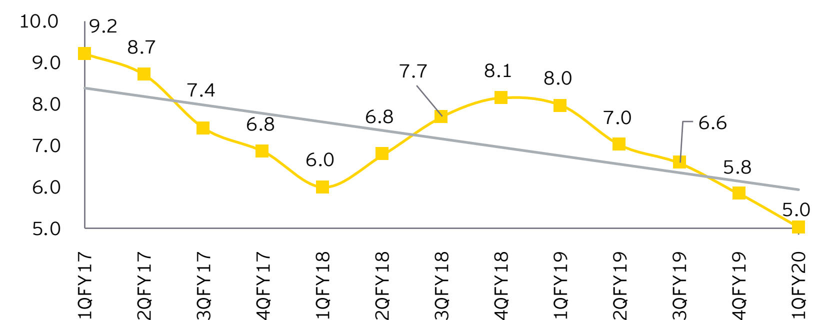
With an aim to reverse the ongoing economic slowdown, the government has used both monetary and fiscal policy options. The key issues now pertain to understanding how long it would take for the recovery to become visible and what more can be done to accelerate this process.

Persistence of economic slowdown

Chart 1 shows a continuous fall in GDP growth from its most recent peak of 8.1% in 4QFY18 to 5% in 1QFY20, a fall of 3.1% points within five quarters. On the demand side, the lowest growth segments relate to private final consumption expenditure (PFCE) and gross capital formation (GCF)[2], which grew at 3.1% and 3.7%, respectively, in 1QFY20 as compared to 8.8% and 11.8%, respectively, in 4QFY18. On the supply side, manufacturing sector witnessed the weakest growth at 0.6% (y-o-y) in 1QFY20. On the external front, the contribution of net exports to GDP growth, which remained negative for the last two years, turned marginally positive at 0.1% points in 1QFY20. Furthermore, the fall of nominal GDP growth to 8% in 1QFY20 has serious implications on the growth of tax revenues which depends on nominal growth and tax buoyancy.

2 Excludes discrepancies

Chart 1: GDP growth (in %, y-o-y)



Source (basic data): MoSPI, GoI

Two-sided policy response

In combating the current growth slowdown, the government had initially shown heavy reliance on monetary policy by reducing the repo rate five times from 6.5% in February 2019 to 5.15% in October 2019, thereby delivering a cumulated reduction of 135 basis points. However, due to slow transmission of the lower repo rate to lending rates[3], these measures could not arrest the continuing decline in the growth rate. Therefore, banks and non-banking financial institutions have remained affected by Non-Performing Assets (NPA) problems and liquidity constraints.

The government's fiscal policy initiative started in earnest after the presentation of the central government's annual budget in July 2019. The most significant initiative was on corporate income tax (CIT) reforms, announced on 20 September 2019. As per this reform, the basic CIT rate for domestic companies was reduced from 30% to 22% and for new investment in manufacturing, it was lowered to 15% from 25%. These revisions, after considering cesses and surcharges, amount to a reduction of nearly 10% points and 12% points[4], respectively. These rate reductions are effective from FY20 onwards[5]. Further, in the context of exports, remission of duties on export products were also introduced[6].

Table 1: Adjustments relative to budget estimates for FY20 (in INR crore)

Item	Total	Center	States
Revenue cost of CIT reform	98,579	62,463	36,116
Revenue cost of export subsidy	50,000	31,682	18,318
Revenue cost of downward revision of Budget Estimates	2,14,006	1,35,602	78,404
Total revenue cost	**3,62,585**	**2,29,747**	**1,32,838**
Less: additional dividends from RBI	86,051	86,051	
Net revenue loss	**2,76,534**	**1,43,696**	**1,32,838**
Net revenue loss as % of GDP*	**1.3**	**0.7**	**0.6**

*Source (basic data): Statement of Revenue Impact of Tax Incentives under the Central Tax System: Financial Years 2017-18 and 2018-19 (Union Budget 2019-20) and Authors' estimates; *reassessed GDP for 2019-20*

Assessing the impact of fiscal reforms

Revenue costs of the fiscal initiatives are quite significant. Furthermore, relative to the budget estimates, growth in central taxes has so far been much lower. Controller General of Accounts (CGA) data from April 2019 to August 2019 shows a growth of only 4.2% against a budgeted growth of 18.3% (with respect to FY19 CGA actuals) in center's gross tax revenues. A recent analysis by Rangarajan and Srivastava (2019)[7], after taking into account factors such as additional RBI dividends, estimated the fiscal impact of CIT reforms and export incentives at 1.3% of GDP, of which 0.6% points may have to be borne by the states. Table 1 provides a summary.

Companies may use the likely benefit of the CIT rate revision in a variety of ways including higher dividends, higher investment, price reduction, lowering of corporate debt and supporting buybacks. It should be noted that the CIT reforms are primarily supply-side reforms aimed at increasing the profitability and productivity of investment. India's CIT rates have now become globally competitive. There is intra-sectoral neutrality across industry and services except for new manufacturing which has got an added boost.

Prospect: need for a direct demand push

Growth prospects for FY20 remain sluggish. The RBI, in its October 2019 review, reduced its FY20 growth forecast from 6.9% to 6.1%. The IMF has also reduced its global growth forecast.

Policy measures taken so far are largely structural in nature. Their success would depend on the response of the private sector, including both investors and consumers. For reviving the economy in the short-run, we may still need a direct demand stimulus from the government in the form of additional infrastructure investment. However, the scope for this may be limited given the sluggish performance of government revenues and the potential fiscal slippage resulting from the fiscal measures already initiated. The government may have to go beyond the budgeted disinvestment and non-tax revenue targets for creating additional space for a direct demand stimulus.

3 The monetary policy statement released on 4 October 2019 stated "As against the cumulative policy repo rate reduction of 110 bps during February August 2019, the weighted average lending rate (WALR) on fresh rupee loans of commercial banks declined by 29 bps. However, the WALR on outstanding rupee loans increased by 7 bps during the same period."

4 The government estimates the revenue forgone at INR 1.45 lakh crores on account of CIT rate reduction

5 https://pib.gov.in/PressReleseDetail.aspx?PRID=1585641

6 The government estimates the revenue forgone at INR 50,000 crores on account of this measure

7 "The macro arithmetic of corporate tax cuts", C. Rangarajan and D.K. Srivastava (published in Hindu Business Line on 4 October 2019); https://www.thehindubusinessline.com/opinion/the-macro-arithmetic-of-corporate-tax-cuts/article29586882.ece

India's trade policy: version 2.0 in the making

Agneshwar Sen
Associate Partner, Tax and Economic Policy, EY India

In September 1994, the Uruguay Round of negotiations concluded with an agreement to create the World Trade Organization (WTO). This heralded the age of a multilateral system that effectively upheld the rule of law for international trade among its members. Twenty-five years later, while the WTO has been effective in enforcing its trade rules through the dispute settlement system, it has not achieved the same level of success in making new rules for the challenges that globalized trade faces today. Thus, many countries, including India, are re-thinking about their post-WTO trade policy.

Present state of India's Foreign Trade Policy

India's Foreign Trade Policy (FTP) consists of schemes to support the domestic exporting community. These include development policies that help set-up special trade and economic zones in different parts of the country.

On 14 March 2018, the US filed a complaint at the WTO claiming that India was violating its WTO obligations by maintaining export promotion schemes that are inconsistent with WTO rules prohibiting export subsidies[8]. The legal basis for the challenge is the provisions under the WTO Agreement on Subsidies

8 For all documents related to this dispute, see: DS541 – India – Export related Measures, available at: https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds541_e.htm (accessed on 8 November 2019).

and Countervailing Measures (SCM agreement) which, collectively disciplines subsidies, including those linked to exports. The WTO panel established to examine the complaints, in a report released on 31 October 2019, has concluded that certain benefits arising out of India's export promotion schemes violate India's obligations to not maintain export subsidies.

This decision may impact Indian businesses significantly. The schemes under the challenge have historically supported Indian exports and have provided incentives for the reduction of cost of exports and thus, have helped in devising export strategies such as exploring new markets. The broad macro-economic context within which this challenge has been initiated is equally important. The ongoing trade wars between US-China, Europe, etc. are already creating uncertainties for businesses globally including in India. Further, the overall health of Indian manufacturing sector is sub-par at best. The Indian economy has witnessed a decline over the past few years due to both cyclical and structural reasons. Given this backdrop, several of India's primary exporting sectors like automobile, pharmaceutical, electronics and IT, and textiles and clothing, are likely to be particularly impacted.

India's dilemma on regional trade agreements

Comprising of the ASEAN members, China, Japan, Korea, Australia and New Zealand, in addition to India, Regional Comprehensive Partnership Agreement (RCEP) is poised to be the world's largest free-trade agreement. With a combined GDP of US$49.5 trillion, about 39% of the global GDP, RCEP would cover nearly 3.4 billion people[9]. There are significant outstanding issues that remain for India till the recent summit that took place in Thailand on 2-4 November 2019. India is negotiating RCEP and has informed its intention to walk-out of the negotiations if its concerns are not addressed in a satisfactory manner. In a statement issued by RCEP's joint leaders on 4 November 2019, it has been mentioned that all the participating countries will work together to resolve India's outstanding issues in a mutually satisfactory way[10]. India's final decision to sign up or otherwise to the RCEP Agreement will depend on the outcome of the discussions to be now undertaken with the other participating countries.

While joining the RCEP is expected to help cut through the spaghetti bowl of free-trade agreements that India has signed with various Asian countries, the agreement poses its own challenges. India currently runs a goods-trade deficit of US$104 billion with 10 out of the 15 RCEP partners.

The country is particularly concerned with competition that products from China will offer upon signing of this agreement. Appropriate emergency safeguard measures to prevent damaging import surges is a necessity but this is yet to become a part of the RCEP architecture. India's comparative advantage lies in making adjustments in the trade deficit in goods by counterbalancing it with services trade. However, most developed RCEP countries where India can export services, have been unwilling to negotiate wide-ranging disciplines in services that are capable of creating new market access for trade in services in this region.

9 See, The Economic Times, Is India ready for RCEP embrace? (29 October 2019), available at: https://economictimes.indiatimes.com/news/economy policy/is-india-ready-for-rcep-embrace/articleshow/71802490.cms.

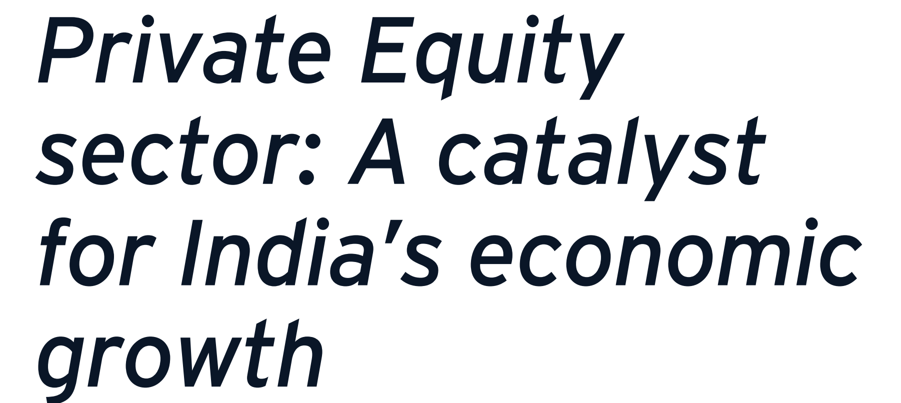
10 Joint leaders' statement on RCEP, available at: https://asean.org/storage/2019/11/FINAL-RCEP-Joint-Leaders-Statement-for-3rd-RCEP-Summit.pdf (accessed on 8 November 2019).

A unique time to redo the trade policy

The current regional and global trade dynamics collectively make a strong economic and strategic case for India to relook at its trade policy afresh and comprehensively, keeping India's investment and industrial policies in mind. India should also utilize the time-out from RCEP negotiations to carefully examine the lessons learnt from the existing free-trade agreements.

The Government of India is already taking proactive steps. To address the declining private investments, corporate taxes have been recently slashed. A new WTO compatible export support scheme called the Remission of Duties or Taxes on Export Products (RoDTEP) has been announced by the Finance Minister of India, which is expected to replace the primary export incentive scheme that has been declared ultra vires by the WTO dispute panel. Given the complexity of applicable WTO rules, there is a need to provide a similar level of support as is given to the present schemes. To show compatibility with WTO-rules, it is essential for the government to carefully work out sufficient details for drafting the scheme. While doing so, it is also imperative for different industry sectors to help provide the details/ peculiarities of their sector to the government.

Similarly, the WTO panel decision allows India to recast its trade development and promotion efforts, such as through the special economic zones, to meet its developmental objectives. Extensive input from businesses and other stakeholders, alongside systematic coordination with various domestic regulators may help India firm up its negotiating position and update its trade policy to version 2.0 which will account for the contemporary economic realities as well.



Private Equity sector: A catalyst for India's economic growth

Padmanabh Sinha

Chairperson, Indian Private Equity & Venture Capital Association (IVCA)

The recent sharp reduction in corporate tax rates has signaled the intent on part of the government towards creating a progressive, enabling and competitive business environment in the country. This, along with a very attractive corporate tax rate of ~17% for new manufacturing investments, is likely to drive a wave of new investments into India, kicking off a virtuous cycle where investment, jobs, productivity, exports and demand feed into each other. A key source of equity investments to kick off this investment boom, apart from corporate investments, would be Alternative Investment Funds (AIFs). Globally and in Indian context, AIFs (also known as private equity and venture capital or PE/VC) are seen as a major source of capital for private companies driving entrepreneurship, jobs and economic growth.

Indeed, over the last 15 years, PE/VC funds have added over US$200b in Indian businesses, mainly for growth[11].In addition to the volume of capital, PE/VC capital is one of the highest quality sources of capital, which is largely institutional, long term in nature, stickier and steadier than other sources like capital markets. PE/VC capital also helps in streamlining and professionalizing businesses making them more scalable and globally competitive. While helping entrepreneurship, PE/VC capital also

11 https://www.livemint.com/opinion/online-views/opinion-pe-investor-and-promoter-need-to-work-together-1564509759558.html

supports government's objective in formalizing the economy and instituting better governance. India's PE/VC activity has grown and now exceeds the annual deal value of ~US$26.3b[12] across segments, but it needs to be stepped up significantly to meet India's investment, job creation and GDP growth requirements.

So how can India further leverage AIF as a source of capital as well as garner a larger share of global wallet? First and foremost, India will have to put in place a globally competitive tax regime for PE/VC investments. The good news is that the government has been taking the right steps in this direction. For example, during the 2019 budget, tax benefits were announced for International Financial Services Centres (IFSC) that currently exist at GIFT City, Gujarat. Another important change was the angel tax exemption given to AIFs Category I and II, thus improving ease of doing business by reducing the risk of frivolous tax disputes.

But more can and needs to be done.

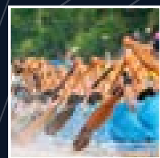
Firstly, with regards to the rates at which India taxes its domestic investors on private market sales made by AIFs, while taxes on public market sales are more competitive to other jurisdictions, India needs to re-look at how it taxes private markets sales by broad-based institutional pools of capital like AIFs viz.-a-viz. public market sales. Major economies like the US, the UK, Germany and Japan as well as Asian/BRIC economies like Singapore, Brazil and South Africa have a parity between private and public sales which is not in India's case. Indian risk capital is being punished by charging significantly higher tax rates (in spite of longer holding time period to qualify as long-term capital gains) in comparison to public share sales. For example, resident Indian investors in an AIF (structured typically as a trust) pay a tax at 28.5% (on sale consideration less indexed cost of acquisition) as compared to foreign investors who pay 14.25%, when realizing the sales prior to a listing. All public market investors, on the other hand, pay a tax at 11.96% with lower holding period requirements. Despite the AIF investments into private companies incur higher risks, they are illiquid for several years and usually provide primary growth and expansion capital.

Additionally, investors into AIFs are not allowed tax deductibility of legitimate fees and expenses incurred by the AIFs when their capital gain is computed. This results in the management fees being a dead loss for investors, unlike in mutual funds and other public market funds. The investors thus pay taxes on an amount higher than their real gain. There is no logic to support this anomaly, which must be corrected.

Finally, AIFs managed by India-domiciled fund managers are liable to GST of 18%, even when a majority of the AIF capital is sourced from overseas. Instead, if this capital was pooled overseas and only managed from India, fund advisory services to overseas investors would have qualified as exports and exempted from GST in India. The government has rightly targeted to pool more PE/VC capital through Indian AIFs because of the related economic activity and the benefits of creation of financial hubs in India. However, financial hubs in other parts of the world allow significant GST/VAT rebates as they recognize PE/VC as a global business and often as an export of fund management services. The 18% GST on foreign funds being pooled into Indian AIFs is a significant friction cost to deter on-shoring of funds and merits being urgently looked into. A city like Mumbai has a great opportunity in the context of the current global order to become a PE/VC hub, with the right approach to issues like GST on deemed exports of services and the creation of an IFSC here.

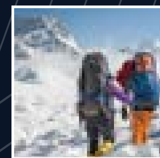
Thus, while the government and regulator have shown the right intent to spur up the economy, the understanding and recognition of the role of long term, sticky and risk-taking private capital in the growth of companies, job creation, higher tax revenues and thereby economic growth, is imperative. The three critical steps, highlighted above, will go a long way in aligning policies that will attract larger flows from marquee global investors like sovereign funds, insurance companies, foundations and endowments into the Indian PE/VC asset class. Given India's size, scale and ambition to quickly reach the US$5t GDP mark, the benefits are obvious.

Global
tax world



How does OECD BEPS 2.0 impact your business?

Multilateral Instrument: a new dawn for tax treaties



Impact of multilateral instrument on international tax treaty network

How does OECD BEPS 2.0 impact your business?

Rajendra Nayak

Partner and National Leader, International Corporate Tax Advisory, EY India

The digital economy has revolutionized the traditional ways of conducting business across the world. Emerging production and consumer models along with new technologies have created a set of fresh tax challenges and have strained the existing international tax rules which have been slow to adapt to the new business environment. It is against this backdrop that governments of different countries are demanding greater transparency and introducing new rules and regulations for the digital economy.

The prelude

In January 2019, the OECD released a policy note communicating that the renewed international discussions will focus on two central pillars: Pillar One and Pillar Two. Pillar One the reallocation of taxing rights. However, the common aspects in these proposals will allow to resolve the technical issues under Pillar One by grouping these issues into three building blocks, namely, new profit allocation rules, new nexus rules and implementation of new market jurisdiction taxing right. The workplan sets out three different methods – modified residual profit split method, fractional apportionment method and distribution-based approach – to quantify the amount of profit to be reallocated to market jurisdictions and methods to determine how the profit should be allocated. The workplan stated that OECD will explore the development of remote taxable presence and a new set

of standards for identifying the existence of such taxable presence. will address the broader challenges related to the digitalization of the economy and will focus on the allocation of taxing rights, and Pillar Two will sort out the remaining BEPS concerns. In May 2019, the OECD released the "Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy" (the workplan). The workplan's timeline summarizes a long-term solution to address the digitalization challenges, which is to be submitted to the BEPS Inclusive Framework for an agreement in January 2020, and work on elaborating the policy and technical details of the solution will continue in 2020 to deliver a consensus agreement on the new international tax rules by the end of 2020.

The workplan

Pillar One contains three alternative proposals: the user participation proposal, the marketing intangibles proposal and the significant economic presence proposal. These proposals differ in the objective and scope of the reallocation of taxing rights. However, the common aspects in these proposals will allow to resolve the technical issues under Pillar One by grouping these issues into three building blocks, namely, new profit allocation rules, new nexus rules and implementation of new market jurisdiction taxing right. The workplan sets out three different methods – modified residual profit split method, fractional apportionment method and distribution-based approach – to quantify the amount of profit to be reallocated to market jurisdictions and methods to determine how the profit should be allocated. The workplan stated that OECD will explore the development of remote taxable presence and a new set of standards for identifying the existence of such taxable presence.

Response of business community on the developments

Multinational enterprises (MNEs) are concerned with the unilateral measures adopted by countries increasing the risk of double taxation and multi-jurisdictional disputes. MNEs are not in the favour of "ring fence" or carve-out business models or industries as both could incentivize/disincentivize businesses to move away into certain activities. Various stakeholders have shared their comments with the OECD on the possible solutions to tackle the tax challenges associated with digitalization of the economy[13]. These are:

A company with a digital business model

In its comment to the OECD, the company had preferred the marketing intangibles proposal as it recognizes that an element of an enterprise's residual profit is related to the value of a market jurisdiction in which the MNE operates and yet does not discriminate between the companies on how they access that market.

13 http://www.oecd.org/tax/beps/public-comments-received-on-the-possible-solutions-to-the-tax-challenges-of-digitalisation.htm

A fast-moving consumer goods company

This company believes that if correctly and consistently applied, the arm's length standard works to allocate taxable profits and/or losses. The company has illustrated its business model, and as a result, has observed that marketing intangible proposal tends to allocate entrepreneurial profit to the lower levels of its management hierarchy. Moreover, the company believes that the success or failure of its business is dependent upon the contributions from both marketing and trade intangibles. Before contemplating the changes to the international tax rules, it is important to consider the impact of digitalization across different industries. This would help in the company to make changes to accommodate the diverse and evolving business models, while maintaining a consistent approach to meet the needs of the inclusive framework tax administrations.

A pharmaceutical company

The company, in its comments, has expressed apprehensions on the process, which determines system profit, routine returns, etc. Drawing on its experience, the company believes that the profit split methods will cause disputes in the current environment when applied using the arm's length standard. The company's proposal is to avoid subjectivity in difference of opinions between taxpayers and country tax authorities and provide an objective solution. This entails that all countries agree that if the taxpayer pays the tax in accordance with the results determined by the method, then disputes are limited to the calculation of the method. The company's proposal involves use of a formulaic solution to calculate local market profits, beginning with a base rate and using three levers to adjust the profit target for a country. While a formulaic method is proposed, the company believes that the arm's length standard is the only viable solution to deal with the complexities ranging from high-risk product development to multi-location high-value manufacturing.

OECD's proposal for a "unified approach"

On 9 October 2019, the OECD released a public consultation document[14] outlining a proposal from the OECD Secretariat for a "unified approach" under Pillar One. The scope of the Secretariat Proposal covers highly digitalized business models and consumer-facing non-digitalized businesses. The proposal also includes a new nexus concept that is not dependent on physical presence and is largely based on sales but is proposed to be separate from the existing permanent establishment concept. The new nexus would operate regardless of whether taxpayers have an in-country marketing or distribution presence or the taxpayers sell through related or unrelated distributors. In addition, the proposal contains a three-part approach to new and revised profit allocation rules, which would provide a formulaic method to allocate deemed non-routine profits to market jurisdictions under the new nexus concept. Besides this, the approach provides a formulaic approach for a fixed return to baseline marketing and distribution activities in situations where there is nexus under the existing principles, and an approach for allocating additional profit to the market jurisdiction where the local activities exceed such baseline activity. Finally, the proposal contemplates binding effective dispute prevention and resolution mechanisms that would cover all three parts of the profit allocation approach. The proposal acknowledges that further technical work is required and includes an annex with a series of specific questions for public comment on significant policy, technical and administrability issues.

India's perspective

India began its digital tax journey in 2012 with the amendment of the term "royalty" in the domestic tax law which now captures most technology/digital economy transactions. Further, the concept of permanent establishment (PE) as a nexus for taxing business profits has come under significant pressure, with tax authorities sometimes asserting virtual PE under the definition of traditional PE.

India was also the first country to implement an equalization levy of 6% of the amount received or receivable by a non-resident for providing specified digital services and facilities.

India also sought to introduce the concept of Significant Economic Presence (SEP) to amend the rules on profit attribution to a PE. However, Central Board of Direct Taxes (CBDT) is yet to prescribe these rules

14 https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf

Conclusion

The reallocation of taxing rights under Pillar One has fundamental implications on the international tax framework. Thus, it is essential for all jurisdictions to implement such changes simultaneously to avoid double taxation. The proposals could bring significant changes to the overall international tax rules under which multinational businesses operate and could have important consequences on the overall tax liability of businesses and tax revenues of the countries.

As a significant contributor to the user base, India's reaction to the proposals would be keenly watched. It is presently unclear whether a consensus may be achieved within the ambitious timeframe set by the Inclusive Framework (i.e., end of 2020) and whether a "one-size-fits-all" approach would be feasible. This uncertainty, coupled with uncoordinated and unilateral measures adopted by different countries, is likely to exacerbate the double taxation woes of companies – something which is not in the interests of taxpayers as well as the policymakers. Therefore, it is important for companies to follow the developments closely and consider engaging with the OECD and policymakers at both national and multilateral levels on the business implications that these proposals might bring. Companies should also start evaluating the potential impact of these changes on their business models.

Shweta Pai, Director - International Tax & Transaction Services, EY India has also contributed to the article.

Multilateral Instrument: a new dawn for tax treaties

Geeta Jani
Tax Partner, EY India

International tax rules are in an evolutionary phase and are moving towards substance-based taxation, which may be achieved with countries adopting greater transparency and consensus-based approach Mr. Akhilesh Ranjan, a former member of Central Board of Direct Taxes[15], at a recent conference, indicated "multilateralism" as an evident change in the global tax arena, where the focus of countries has shifted to multilateral discussions and consensus building[16].

The development of multilateral instrument (MLI) can be considered as an epitome of the global co-ordination and co-operation where over 100 jurisdictions participated on an equal footing to develop a single instrument which is expected to change more than 3,000 existing tax treaties. With 90 MLI signatories already on board, the fruitful implementation of the MLI has proved to be successful.

15 India's apex tax administration
16 India CFO Forum, New Delhi in October 2019

Modification of Indian treaties through MLI

India has been an active participant in BEPS project and was one of the first signatories to the convention on 7 June 2017. India also completed the ratification process and deposited the instrument of ratification, along with its final positions on MLI provisions, with the Organisation for Economic co-operation and development (OECD) on 25 June 2019.

The MLI entered into force for India on 1 October 2019 and will be effective for 20 of India's tax treaties from 1 April 2020. These include treaties with some of the key trade and investment jurisdictions such as Australia, France, Ireland, Netherlands, Japan, Singapore and the UK. However, some of key Indian tax treaties, such as that with the US, Mauritius, Germany and China currently remain outside the realm of MLI.

Impact on India's tax treaty network

An overview of India's position and its impact on certain key Indian treaties in respect of various MLI provisions is discussed below:

Prevention of treaty abuse

Prevention of treaty abuse was one of the key BEPS concerns and to effectively counter this concern, MLI included various provisions including minimum standards, such as modification of the preamble of the existing tax treaties and insertion of principal purpose test (PPT), that all MLI signatories, including India, are bound to accept.

1 The preamble

To comply with BEPS minimum standard, India has accepted to modify the title and preamble of its tax treaties to specifically include that the intention of the tax treaties is not only to eliminate double taxation but also to prevent non-taxation or reduced taxation through tax evasion or avoidance. Additionally, MLI contemplates an optional inclusion which provides that the treaty is also for development of economic relationship and co-operation in tax matters. Though India has not adopted this optional inclusion, it is unlikely for such non-inclusion to have an impact as it is merely a codification of an underlying object of the treaty. Even before MLI, some of treaties that India had signed such as treaty with Russia and Mauritius were also done to promote economic ties between the countries.

2 Principal Purpose Test (PPT) and Simplified Limitation of Benefits (SLOB)

PPT is a minimum standard and primarily comprises of two parts:

Reasonable purpose test: PPT seeks to deny benefit under the treaty in every case where it is reasonably possible to conclude that in the facts of the case, one of the principal purposes of an arrangement or a transaction, is to obtain a tax benefit, directly or indirectly.

Object and purpose test carve out: The latter part of the PPT provides for a carve-out or an exception by observing that, despite the desire of obtaining tax benefit(s) under the treaty, the benefit(s) will not be denied so long as the grant of the benefit is in accordance with the object and purpose of the relevant provisions of the treaty.

Additionally, on an optional basis, MLI contemplates inclusion of SLOB which provides for objective parameters such as listing, ownership, activity and specified entities which may need to be fulfilled by a person to be regarded as qualified persons entitled to treaty benefit.

India has opted for PPT and SLOB for testing the eligibility of the income recipient of the other country. India has also expressed its intention to adopt PPT as an interim measure with an option to modify the same in future with LOB clause to further tighten the noose around treaty shopping. This position seems to be adopted considering that though SLOB has been opted by India and only a handful of treaties involving India will be modified to include the SLOB standard due to MLI matching principle[17].

An interesting question on the applicability of PPT is on its impact on capital gains exemption under the India-Singapore treaty, as per which the shares of an Indian company acquired prior to 1 April 2017 are grandfathered while the treaty permits source-based taxation in India for the shares acquired on or after 1 April 2017. Technically, PPT, as a non-obstante provision, applies to all treaty benefits and therefore may eclipse even grandfathered benefits. However, a taxpayer may wish to contend that (i) the granting of the benefit is in accordance with the object and purpose of treaty framers who evolved such exceptional benefit to provide for a smooth transition from residence-based taxation to source-based taxation; (ii) accordingly, the benefit is protected at least by object and purpose carve out of PPT. It may be recollected that in India-Singapore treaty, PPT gets inserted from 1 April 2020 and this debate will have no applicability to gains made from transfer of shares effected prior thereto.

17 In general, MLI matching principle means that MLI provision will impact a tax treaty if both the parties to the treaty agree to apply that MLI provision.

Permanent establishment (PE)

Another key concern of BEPS was what the OECD believed to be the "artificial avoidance of PE status" through which businesses were able to mitigate taxation in country which contributed to sales. As a measure, MLI includes various provisions which broaden the PE realm such as:

- An extended dependent agency PE (DAPE) rule which covers a person who habitually plays the principal role leading to the conclusion of contracts.
- Stricter independent agent exclusion rule denying exclusion to the agents who work exclusively for an enterprise and its closely-related enterprises (CREs).
- Availability of specific activity exemption only if such activities qualify to be of preparatory or auxiliary (PoA).
- An anti-fragmentation rule to prevent artificial disintegration of cohesive business activities done to avail specific activity exemption as POA.
- Anti-splitting rule to prevent artificial splitting of contracts between related parties such that each contract covers a period which does not exceed the time threshold provided under the relevant treaty for trigger of construction PE.

While India has accepted all the above changes to PE definition provided in the MLI, a number of India's treaty partners have not followed the same suit. For instance, Canada, Sweden, Switzerland and the UAE have placed reservations with respect to all PE provisions of MLI. Accordingly, basis the matching principle, the PE definition in such Indian treaties will not be modified. Further, some countries have opted in only specific PE provisions of MLI and have opted out for others.

i. Dependent agent permanent establishment (DAPE)

Basis the matching principle, it is unlikely that the extended DAPE rule would be incorporated in most of India's tax treaties pursuant to the MLI. It may, however, be noted that as compared to OECD patterned treaties, the DAPE definition in many Indian treaties is broader even before MLI was rolled out. For instance, many treaties signed by India with Japan, Russia, Singapore, Australia and the UK contain a scope for covering persons who habitually secure orders which converges with the MLI proposal.

ii. PoA exemption, anti-fragmentation rule and anti-splitting rule

MLI provision related to PoA exemption, anti-fragmentation and anti-splitting of contracts is currently not part of any of the existing treaties that India has signed, and these will be evaluated while analyzing PE provisions, provided India's treaty partner has also adopted such provisions. Some of India's tax treaties which would be modified as result of one or more of these changes include Australia, Ireland, Japan, the Netherlands, Russia and the UK.

Conclusion

Most of the developed and developing economies have joined the BEPS initiative to keep up with the changing international landscape and updated tax rules to preserve their tax bases. Significant upgradations are being made to the domestic laws as well, especially those related to digital economy. In addition, substantial reporting requirements and automatic information exchange intend to upgrade a transparency quotient between the countries by several notches.

India's changes in its domestic laws as well as the choices made under the MLI, reflect the Indian tax administration's commitment to align with OECD's approaches.

With many BEPS changes already seeing the light of day and with more action expected with the MLI/treaty amendments, there is a need for multinational enterprises to actively monitor the developments in various countries where these multinational enterprises have their business presence, trade relations and where they can assess the impact of these changes in their current as well future business arrangements.

Impact of multilateral instrument on international tax treaty network

Matthew Mealey
Global ITTS content innovation leader, EY

Globalization has increased the economic impact of gaps between different countries' tax systems. As a result, double tax treaties were designed to eliminate double taxation and to facilitate cross border trade and investment, but these treaties can also lead to untaxed income and may invite legal effects. However, this may not represent the economic relationships between the countries.

As a consequence, a significant workstream of the OECD's base erosion and profit shifting (BEPS) initiative focused on entitlement to treaty benefits.

In the author's view, another key part of the BEPS initiative has been to introduce less certainty and greater subjectivity into the analytical framework for profit attribution (the arm's length standard) through amendments to the OECD transfer pricing guidelines. Such uncertainty makes profit shifting across borders less sustainable and increases the risk of double taxation as multiple countries assert tax jurisdiction over the same income. Hence, another key part of the BEPS initiative was to improve the dispute resolution procedures to reduce the risk of double taxation. These changes also require alterations to the global network of bilateral taxation treaties.

The sheer number of bilateral treaties makes it difficult to update the current tax treaty network. Even where a change to the OECD Model Tax Convention is based on a global consensus, it takes a substantial amount of time and resources to introduce it into multiple bilateral tax treaties. The current network is also not well-synchronized with the model tax conventions and it takes long time to address the issues that arise over time. For this reason, governments agreed to explore the feasibility of a Multilateral Instrument (MLI) that would have the same effects as a simultaneous renegotiation of thousands of bilateral tax treaties.

On 5 October 2015, the OECD released its final report on developing a Multilateral Convention for Implementing Tax Treaty Related Measures to Prevent BEPS (the MLI) to modify bilateral tax treaties under its BEPS Action Plan (Action 15). On 7 June 2017, in a signing ceremony in Paris, 68 jurisdictions signed the MLI to enable all the jurisdictions to meet the treaty-related minimum standards that were agreed as part of the final BEPS package. These include the minimum standard for the prevention of treaty abuse under Action 6 and the minimum standard for the improvement of dispute resolution under Action 14. Given that each of the minimum standards can be satisfied in multiple ways and that a broad range of jurisdictions are involved in the negotiations, the MLI was designed flexibly to accommodate the positions of different jurisdictions. The MLI is also drafted to provide flexibility to provisions that do not reflect the minimum standards by:

- Allowing the jurisdictions to specify the tax treaties to which the MLI applies.
- Creating flexibility with the provisions that relate to a minimum standard in order to allow countries to choose the option that fits them the best.
- Including the possibility to opt in or out of provisions in case the provisions do not relate to a minimum standard.
- Including the possibility for a country to opt out of provisions for treaties that have existing provisions with specific and objectively defined characteristics.
- Providing a choice to apply optional or alternative provisions, for example the optional provision on mandatory and binding arbitration.

The signing ceremony also saw a key milestone with the implementation of the treaty-related BEPS minimum standards. The signatories submitted a list of their tax treaties in force that they would like to designate as Covered Tax Agreements (CTAs), i.e., to be amended through the MLI. It was expected that over 1,100 tax treaties will be modified after matching the specific provisions that jurisdictions wish to add or change within the CTAs nominated by the signatories. Together with the list of CTAs, signatories also submitted a preliminary list of their reservations and notifications (MLI positions) in respect of the various provisions of the MLI. The definitive MLI positions for each jurisdiction was to be provided upon the deposit of its instrument of ratification, acceptance or approval of the MLI.

The MLI entered into force following the deposit of the fifth instrument of ratification on 22 March 2018. MLI's entry within one year after the signing ceremony underlines the strong political commitment to a multilateral approach to address BEPS. As of 18 October 2019, the MLI already covers 89 jurisdictions and additional jurisdictions are expected to join in the coming months. In the meantime, the existing signatories are making progress in their ratification processes, with 36 jurisdictions already having deposited their instruments of ratification.

The effects of the provisions of the MLI on a specific bilateral tax agreement can easily be analyzed by using the MLI Matching Database, a tool developed by the OECD as a depositary of the MLI. It provides a tabulated data extracted from the list of MLI positions provided by each party to the MLI. The database automatically generates information by matching the MLI positions and on its consequential impact on CTA. The main interface of the database allows users to select the jurisdiction that pairs with others to analyze the matching outcome. It is a valuable tool for both taxpayers and governments.

MLI also includes certain treaty measures on hybrid mismatch arrangements, treaty abuse and permanent establishment. The MLI strengthens provisions to resolve treaty disputes, including mandatory binding arbitration, which has been taken up by 28 signatories. However, the most significant impact of the MLI on the international tax treaty network is likely to be the implementation of the minimum standard of BEPS Action 6 on Treaty Abuse.

The compliance with the Action 6's minimum standard requires members of the OECD/G20 inclusive framework to include in their tax treaties:

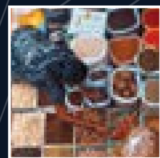
1. A new preamble statement that the common intention of the parties to the treaty is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements, and

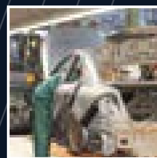
2. An anti-abuse treaty provision. The anti-abuse provision can be the principal purposes test (PPT), the PPT and a simplified limitation on benefits (LOB) provision or a detailed LOB and anti-conduit rules.

From the MLI positions that have been deposited so far, all CTAs will at least include the new preamble language and the PPT provisions, bringing those over 1,360 agreements up to the Action 6's minimum standard. At the same time, jurisdictions are actively renegotiating treaties on a bilateral basis to bring the remaining agreements up to standard. Consequently, most of the bilateral tax treaties in force and listed by the MLI signatories in their country positions will have been updated to implement the Action 6 minimum standard when the bilateral agreements and the MLI enter into force and effect in respect of all signatories.

The first modifications to bilateral tax treaties have already been implemented. Given the anticipated time needed for ratification, it is expected that more treaty changes will enter into effect in the coming months. The expectation that over 1,360+ tax treaties will be modified as a result of 89 jurisdictions signing the MLI constitutes an unprecedented development in the international taxation. Apart from those countries who have already included limitation on benefits clauses in their tax treaties (most importantly the US), the PPT effectively becomes the new global standard that limits treaty benefits by reference to commercial nexus rather than basing treaty entitlements mainly on the legal relationships between countries. While it is different from a comprehensive LOB, a PPT has, in many cases, the same consequence of restricting treaty benefits in similar circumstances. Multinational enterprises with economic flows where tax treaties materially impact taxation (especially dividends, interest, royalties and capital gains) will need to closely monitor the impact of these changes on their business structures.

Sector focus


How is GST re-defining the retail sector?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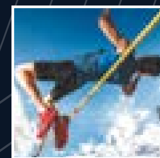

Reduction in corporate tax: a boost for the financial service sector

How is GST re-defining the retail sector?

Suresh Nair
Partner, Indirect Tax, EY India

The Goods and Services Tax (GST) has had a roller coaster ride for India Inc and the effect of the same is visible on the retail sector. Twenty-eight months since the launch of GST, the GST Law continues to evolve. The government is likely to introduce New GST Returns from 1 April 2020, making it essential for companies to gear up to implement the changes in their compliance processes. This, along with introduction of e-invoicing, would require another round of investments into the retail sector, to get the desired processes, in place. The GST Law has been amended to introduce a restriction on claiming input tax credit in case vendors fail to upload transaction details when compared with the credit otherwise eligible as per books of accounts. The process of undertaking reconciliation of credit is effort-intensive, and the retail sector may need customized automated solutions. If not managed properly, this amendment could potentially trigger an impact on the working capital.

The following are the key GST-related challenges for companies in retail sector:

- It takes substantial manual efforts and time-consuming processes for extracting transactional level data from Point of Sale billing software for filing GST returns.
- Unavailability of input tax credit on civil construction costs adds costs on retail sector companies who regularly update new stores and renovate their existing ones.

Retail sector companies should focus on exploring opportunities for automation of processes relating to GST compliances including data extraction and GST return preparation. Further, these companies should gear up for assessments and audits by the department and start collating data, back up workings/ documents and review of GST positions taken.

How are the developments in GST shaping the automobile sector?

Abhishek Jain
Partner, Indirect Tax, EY India

With GST ranging between 28% and 50% for most conventional cars, the auto players, in general, assumed that a rate reduction approval by the GST Council, in its meeting on 20 September 2019, would be the best fiscal respite for addressing the slowdown in this sector. However, given the revenue implications and other factors, the expectation and request of the sector did not sail through, except for a limited category and specification of vehicles.

The GST Council, however, did address a major apprehension and concern of the automotive sector, the tax implications on various discount schemes offered by the auto companies. In June 2019, the government had issued a circular clarifying the taxability of discounts with some of the clarifications not being aligned to the tax positions adopted by the industry. The GST Council had approved rescission of the said circular, thus bringing considerable relief to the sector before the upcoming festive season.

However, enquiries/investigations on classification of parts of automobiles specifically on imports (on aspect of whether they have been classified as parts of automobiles triggering a higher rate of GST or in their specific classification triggering a lower rate), rate of GST on freight (whether a GST rate equal to that applicable on vehicle has been discharged or not), applicability of excise duty on value of designs, drawings, etc. provided by brand owners to auto component manufacturers still exist in the recent times.

Reduction in corporate tax: a boost for the financial service sector

Keyur Shah

Partner and National Tax Leader, Financial Services, EY India

The central government and Reserve Bank of India (RBI) have taken cognizance of India's economic slowdown and undertaken several measures to overcome these challenges. Some of the initiatives, inter alia, include the four step repo rate reduction since February 2019, introduction of special window to fund non-performing assets and non-National Company Law Tribunal affordable and middle-income housing projects, consolidation of public sector bank and offering enhanced credit support to housing finance companies and partial credit guarantee scheme for the purchase of pooled assets of NBFCs and HFCs.

To further augment the impetus to the economy, taking an unorthodox approach, the Finance Minister of India on 20 September 2019, announced the biggest reduction in the basic corporate income tax (CIT) rate in almost 28 years from 30% to 22% (effective tax rate being 25.17%, including surcharge and cess). The CIT rate for new investments in manufacturing has been reduced from 25% to 15%. Such option, once exercised, cannot be subsequently withdrawn and companies that plan to do so are exempt from provisions of Minimum Alternate Tax (MAT).

The international committee has welcomed India's move to cut the CIT rate and roll back the increased surcharge introduced in the Union Budget 2019 with the statistics on both FDI and FPI investment looking promising.

The reduction of CIT rate is likely to have a positive impact on the financial services sector. According to a report by CARE Ratings[18], the financial services sector (banking, finance and insurance companies) is expected to save the highest amount of CIT, estimated at INR17,679 crore of the

18 http://www.careratings.com/upload/NewsFiles/SplAnalysis/Corporate%20Tax%20Rate%20Cut%20Sept2019.pdf

total estimated savings of INR41,555 crore, the savings are likely to have a positive effect on the availability of credit in the economy.

The rate cut also creates some interesting business propositions. One of the most compelling ones could be for foreign banks' operating in India through branches. With the headline tax rate for foreign branches still being at 43.68% (including surcharge and cesses), the effective tax rate for a subsidiary works out to 37.93% (including surcharge and cess of 25.1% and dividend distribution tax of 12.76%) assuming all the post-tax profits are distributed as dividends. While a host of regulatory and commercial considerations may need to be considered for setting up a subsidiary in India, the fact that a subsidiary may not be restricted in terms of claiming allocation of head office expenses [like a branch of a foreign bank is under section 44C of the Income tax Act, 1961, (IT Act)] may make this an interesting proposition.

While the overall impact of the CIT rate seems to be positive, some wrinkles need to be ironed out. To address some of the concerns raised, the CBDT in a circular has clarified that in the absence of any timeline for exercising the option to claim 22% CIT rate, the domestic company, if it desires so, may opt for this rate after it has exhausted the accumulated MAT credit and unabsorbed additional depreciation by being governed by the regular taxation regime existing under the IT Act prior to the ordinance. For companies having units in the International Financial Services Centre (IFSC), the choice of lower CIT rate comes at the cost of the 10-year tax holiday prescribed under the IT Act (section 80LA). This provision requires to be reconsidered to ensure that IFSC units do not lose their attractiveness in the process of implementing the CIT rate cut.

In the recent past, we have seen countries cut their tax rates to incentivize businesses and attract investment. Due to this, the recent tax rate cuts have also put India in a competitive position. This, coupled with the fiscal incentives given to the financial industry, should give the banking and capital markets a much-needed push to propel growth of the economy.

Deeksha Manchanda, *Senior Manager Tax and Regulatory Services, EY India has also contributed to the article.*

Global
News

The OECD takes next step on BEPS 2.0: proposal for a unified approach for additional market country tax[19]

On 9 October 2019, the Organisation for Economic Co-operation and Development (OECD) released a public consultation document outlining a proposal from the OECD Secretariat for a unified approach under Pillar One (Secretariat Proposal) of the ongoing project titled "Addressing the Tax Challenges of the Digitalization of the Economy" (the Consultation Document). The Secretariat Proposal does not represent the consensus view of countries that are members of the Inclusive Framework on Base Erosion and Profit Shifting (BEPS) but is intended to facilitate negotiations among the countries, with the aim to achieve the objective of a political agreement among the Inclusive Framework jurisdictions by the first half of 2020.

The scope of Secretariat Proposal suggests that a "unified approach" under Pillar One should focus on large consumer-facing businesses. This would cover highly-digitalized business models and also businesses interacting with final customers. In this regard, the Secretariat Proposal notes that further work is needed to articulate the scope of the "unified approach," including how to define a consumer-facing business.

The Secretariat Proposal includes a new nexus concept that is not dependent on physical presence and is largely based on sales. This new nexus is proposed to be separate from the existing permanent establishment concept, and it would operate regardless of whether taxpayers have an in-country marketing or distribution presence or sell through related or unrelated distributors.

In addition, the Secretariat Proposal contains a three-part approach (three-tier mechanism) to new and revised profit allocation rules, which would provide a formulaic approach to allocating deemed non-routine profits to market jurisdictions under the new nexus concept, a formulaic approach for a fixed return to baseline marketing and distribution activities in situations where there is nexus under existing principles, and an approach for allocating additional profit to the market jurisdiction, where the local activities exceed such baseline activity. Finally, the Secretariat Proposal contemplates binding and effective dispute prevention and resolution mechanisms that would cover all three parts of the profit allocation approach.

The Secretariat Proposal acknowledges that further technical work is required and includes an annex with a series of specific questions for public comment on significant policy, technical and administrability issues.

19. *Refer EY Global Alert titled "The OECD takes next step on BEPS 2.0 – Proposal for a "unified approach" for additional market country tax" dated 10 October 2019*

Singapore High Court addresses independent contractor versus employee[20]

The High Court in Singapore ruled on the issue of whether a gym instructor should be classified as an employee or as an independent contractor. The High Court set out the appropriate legal test that should be applied when classifying an individual as an independent contractor or employee. It also concluded that there is not one definitive test and that the many factors to be considered are dependent on the surrounding circumstances unique to each individual.

The High Court emphasized that the following factors are indicative of the instructor being an independent contractor:

- The contracts signed between the instructor and the club stated that they were "contract(s) for service" and explicitly referred to the instructor as an independent contractor.
- The contracts also stated that the terms should not be construed as creating an employer-employee relationship.
- The instructor was allowed to conduct programs for the public at the club's facilities outside the stipulated work hours.
- The instructor was not part of the club's headcount and was not invited to staff events such as dinner and dance, which was compulsory for all employees.
- Unlike the club's employees, the instructor was not required to sign personal data protection forms.
- The instructor was only given access to the gym and not to the club's office, unlike other employees.
- The instructor's identification number was also distinct from those given to employees.

The High Court also identified the criteria, which though indicated a degree of control over the instructor, but were not considered relevant to the assessment of employment status as there were reasonable explanations for the same. Those factors are as follows:

- The requirement to clock in and out of work.
- The instructor's work hours were fixed by the Club in his contracts and the Club was able to alter them at its sole discretion.
- The instructor was a trained expert in his field and carried out his work with little or no supervision.
- The contract terms required the instructor to perform his duties personally, i.e., no ability to delegate or substitute.

20. *Refer EY Global alert titled "Singapore High Court addresses independent contractor versus employee" dated August 2019*

US IRS issues proposed regulations addressing cloud-based and other digital transactions[21]

On 9 August 2019, the United States (US) Treasury Department (Treasury) and the Internal Revenue Service (IRS) released proposed regulations addressing cloud-based transactions and other transactions involving digital content, such as gaming and social media. The proposed regulations apply for purposes of determining the treatment of software and cloud transactions under certain provisions enacted as part of the Tax Cut and Jobs Act (TCJA).

Rendition of service vs. lease of property: weighing the factors

The proposed regulations effectively function to bifurcate cloud-based transactions into one of the two categories, the rendition of service or a lease of property. For these purposes, the "a cloud transaction" would be broadly defined as a "transaction through which a person obtains a non-de minimis on demand network access to computer hardware, digital content or other similar resources.

The classification of a cloud transaction as either the provision of a service or a lease of property is a fact-intensive inquiry, requiring consideration of nine factors set forth in the proposed regulations. Each of these factors are to be given equal importance. Further, not all factors may be relevant to given transaction and thus may be disregarded. The following nine factors would bear on the classification of a cloud transaction as a rendition of service:

- The customer is not in physical possession of the property.
- The customer does not control the property, beyond the customer's network access and use of the property.
- The provider has the right to determine the specific property used in the cloud transaction and replace such property with comparable property.
- The property is a component of an integrated operation in which the provider has other responsibilities, including ensuring the property is maintained and updated.
- The customer does not have a significant economic or possessory interest in the property.
- The provider bears any risk of substantially diminished receipts or substantially increased expenditures if there is non-performance under the contract.
- The provider uses the property concurrently to provide significant services to entities unrelated to the customer.
- The provider's fee is primarily based on a measure of work performed or the level of the customer's use rather than the mere passage of time.
- The total contract price substantially exceeds the rental value of the property for the contract period.

Modernization of software regulations

The proposed regulations would provide a sourcing rule for the sale of a copyrighted article through a digital medium. The proposed regulations would source such sales to the location of download or installation onto the end-user's device. In the absence of information on the location of download or installation, sales would be deemed to have occurred at the customer's location (determined based on recorded sales data for business or financial reporting purposes).

The proposed regulations also clarify that the regulations apply to transfers of all "digital content" – not just "computer programs". The proposed regulations would define "digital content" as

"a computer program or any other content in digital format that is either protected by copyright law or no longer protected by copyright law solely due to the passage of time, whether or not the content is transferred in a physical medium".

21. *Refer EY Global Alert titled "US IRS issues proposed regulations addressing cloud-based and other digital transactions" dated 15 August 2019*

Czech Republic proposes introduction of new digital tax[22]

On 5 September 2019, the Czech Government published a revised draft of its proposal regarding a new digital tax (the revised bill). The revised bill is based on the European Union (EU) model of the Digital Services Tax (DST). The revised bill presents many issues regarding its practical implementation. The proposed tax rate in the revised proposal is 7%.

The DST would apply to the provision of a taxable service for consideration in the Czech Republic (CR). Service to another member entity within a group would be exempt from tax.

Taxable service for this purpose is defined as below:

A targeted ad campaign provision

- Placement of a targeted ad on a digital interface with the provision of a service supplementary to the targeted ad placement.

Use of a multilateral digital interface

- Multilateral digital interface enables the user to search for and interact with other users. Multilateral digital interface is used for:
- Executing a transaction between users of a multilateral digital interface enabling related supplies of goods or services.
- Affording access to the multilateral digital interface by users.
- The revised bill also provides for a negative list of what is not considered as use of multilateral digital interface.

Provision of user data

- Provision of data set collected about digital interface users and acquired (or created) on the basis of their activity on this interface, with the exception of the provision of data obtained from a sensor or by a regulated financial entity

The person subject to DST would be a member entity of a group that provided a taxable service during the effective period and whose required threshold limits are crossed.

22. *Refer EY Global Alert titled 'Czech Republic proposes introduction of new digital tax' dated 26 September 2019*

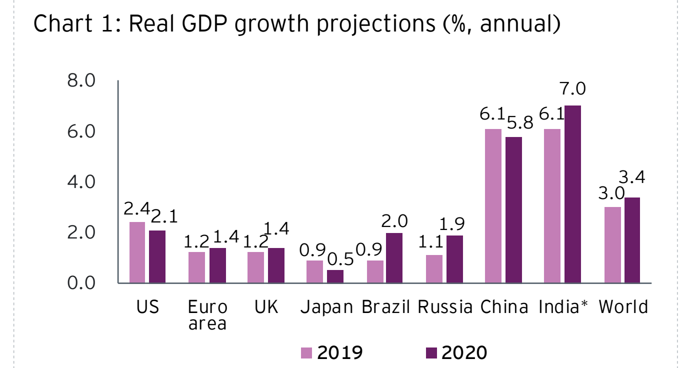
EconoMeter

macro-fiscal trends

1 IMF projected global growth at 3% in 2019, weakest since 2009. India's growth projection was revised down by 1.2% points to 6.1% in 2019.

- As per the IMF (World Economic Outlook, October 2019), global growth is projected at 3% for 2019, a downward revision of 0.2% points. It is expected to improve to 3.4% in 2020.
- India's growth is projected at 6.1% in 2019 (2019-20) due to a weaker than expected outlook for domestic demand. Growth is expected to increase to 7% in 2020 (2020-21) supported largely by lagged effects of monetary policy easing and the recent fiscal initiatives such as a reduction in Corporate Income Tax rates and introduction of export incentives.

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



Source: World Economic Outlook, IMF, October 2019

**Pertains to fiscal year, for e.g., 2019 indicates FY2019-20*

2 Real GDP growth fell to a 26-quarter low of 5% in 1QFY20. The RBI, in its October 2019 monetary policy review, projected the real GDP growth at 6.1% in FY20.

- As per the data released by Ministry of Statistics and Programme Implementation (MoSPI) on 30 August 2019, real GDP growth decelerated to a 26-quarter low of 5.0% in 1QFY20 from 5.8% in 4QFY19, its fifth consecutive fall since 4QFY18.
- From the demand side, the growth slowdown was mainly driven by a sharp fall in the growth of PFCE from 7.2% in 4QFY19 to an 18-quarter low of 3.1% in 1QFY20.
- Reflecting lower growth in governments' revenue expenditures, GFCE grew at a relatively slow pace of 8.8% in 1QFY20 as compared to 13.1% in 4QFY19.
- Investment demand continued to remain subdued for the second consecutive quarter as shown by a low growth of 4.0% in GFCF in 1QFY20, that was only marginally higher than 3.6% in 4QFY19.
- Indicative of a weakness in external demand, exports of goods and services grew by 5.7% in 1QFY20 as compared to 10.6% in 4QFY19. With growth of imports at a slower pace than exports at 4.2% in 1QFY20, the contribution of net exports to growth turned positive at 0.1% points after remaining negative for 10 successive quarters.

Table 1: Real GDP growth (%)

Aggregate demand	4Q FY18	1Q FY19	2Q FY19	3Q FY19	4Q FY19	1Q FY20	FY18	FY19
PFCE	8.8	7.3	9.8	8.1	7.2	3.1	7.4	8.1
GFCE	21.1	6.6	10.9	6.5	13.1	8.8	15.0	9.2
GFCF	11.8	13.3	11.8	11.7	3.6	4.0	9.3	10.0
EXP	2.8	10.2	12.7	16.7	10.6	5.7	4.7	12.5
IMP	16.2	11.0	22.9	14.5	13.3	4.2	17.6	15.4
GDP	8.1	8.0	7.0	6.6	5.8	5.0	7.2	6.8
Net Exp. Contrib. to growth (% points)	-2.7	-0.7	-2.8	-0.2	-0.9	0.1	-2.8	-1.1

Source: Central Statistical Organization (CSO) MoSPI, Government of India, 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 slowed to a 21-quarter low of 4.9% in 1QFY20.

- On the output side, GVA growth fell to a 21-quarter low of 4.9% in 1QFY20 as compared to 5.7% in 4QFY19 due to a deceleration in five key sectors of the economy, namely manufacturing, financial real estate and professional services, public administration and defence, construction and mining.
- As reflected in the growth trends of a few selected high frequency indicators such as Index of Industrial Production (IIP), Purchasing Managers Index(PMI) and motor vehicle production, GVA growth in manufacturing decelerated from 3.1% in 4QFY19 to 0.6% in 1QFY20, its weakest performance since 1QFY18.
- Growth in the output of construction and financial, real estate and professional services was lower at 5.7% and 5.9%, respectively in 1QFY20. Growth in mining sector has remained volatile in the last few quarters. It fell to 2.7% in 1QFY20 from 4.2% in 4QFY19.
- Growth in public administration and defence also slowed to 8.5% in 1QFY20 from 10.7% in 4QFY19.
- GVA growth in agricultural sector was at 2.0% in 1QFY20 as compared to a contraction of (-) 0.1% in 4QFY19. Sustained lower growth in agricultural sector may constrain rural demand.

Table 2: Sectoral real GVA growth (%)

Aggregate demand	4Q FY18	1Q FY19	2Q FY19	3Q FY19	4Q FY19	1Q FY20	FY18	FY19
Agr.	6.5	5.1	4.9	2.8	-0.1	2.0	5.0	2.9
Ming.	3.8	0.4	-2.2	1.8	4.2	2.7	5.1	1.3
Mfg.	9.5	12.1	6.9	6.4	3.1	0.6	5.9	6.9
Elec.	9.2	6.7	8.7	8.3	4.3	8.6	8.6	7.0
Cons.	6.4	9.6	8.5	9.7	7.1	5.7	5.6	8.7
Trans.	6.4	7.8	6.9	6.9	6.0	7.1	7.8	6.9
Fin.	5.5	6.5	7.0	7.2	9.5	5.9	6.2	7.4
Publ.	15.2	7.5	8.6	7.5	10.7	8.5	11.9	8.6
GVA	7.9	7.7	6.9	6.3	5.7	4.9	6.9	6.6

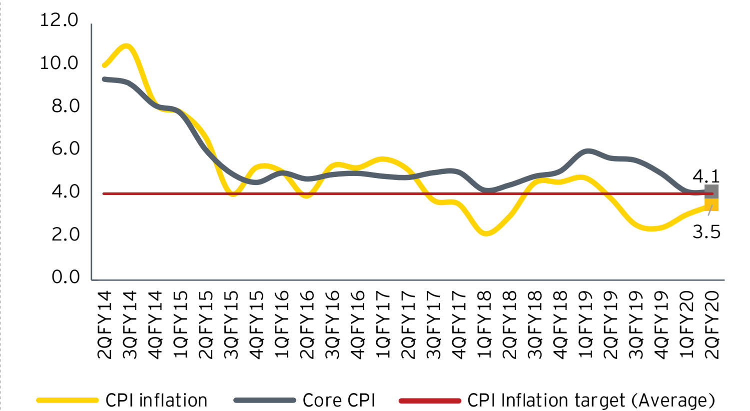
Source (Basic data): MoSPI

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; Publ: Public Administration, defence and other services

4 The Reserve Bank of India (RBI) lowered the repo rate to 5.15% in October 2019 from 5.40% in August 2019, its fifth consecutive rate reduction since January 2019 thereby taking the cumulated rate reduction to 135 basis points during this calendar year.

- Consumer Price Index (CPI) inflation increased to 3.5% in 2QFY20 from 3.1% in 1QFY20 mainly due to rising food inflation.
- Core CPI inflation[23] remained stable at an all-time low (2011-12 series) of 4.1% in 2QFY20, the same level seen in 1QFY20.
- The RBI expects CPI inflation to average at 3.5% in 3QFY20 and at 3.7% in 4QFY20.
- In the RBI's assessment, outlook for headline CPI inflation is likely to be shaped by limited pressure on prices of food and pulses, likely moderation in vegetable prices and expected softer output prices due to persistent weak demand conditions.

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

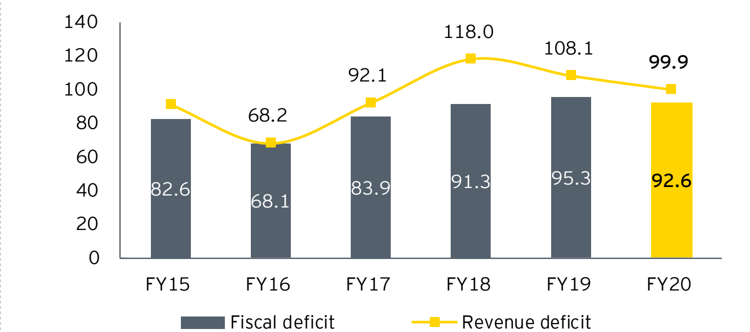


Source: MoSPI; Note: CPI stands for Consumer Price Index

5 Center's fiscal deficit during 1HFY20 stood at 92.6% of the budgeted target.

- The center's fiscal deficit during April-September FY20 stood at 92.6% of the FY20 budgeted target as compared to 95.3% during the corresponding period of FY19.
- The center's revenue deficit during 1HFY20 stood at 99.9% of the budgeted target as compared to the corresponding figure of 108.1% in FY19.

Chart 3: Fiscal and revenue deficit as a % of annual budgeted target



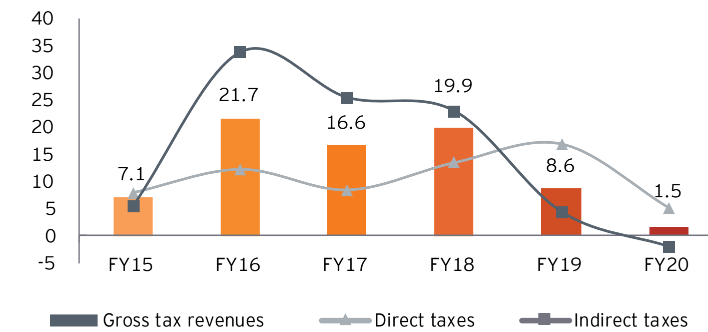
Source: Monthly Accounts, Controller General of Accounts, Government of India; Union Budget documents of various years

23 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.

6 Growth in gross central taxes at 1.5% during 1HFY20 was the lowest since FY10.

- Gross central taxes during the first six months of FY20 grew by 1.5% as compared to 8.6% during the corresponding period of FY19.
- The cumulated growth in gross central taxes during 1HFY20 was the lowest since FY10.
- Direct taxes grew by 5.2% during April-September FY20 as compared to 16.9% during the same period in FY19.
- Indirect taxes contracted by (-) 2.0% during 1HFY20 as compared to a growth of 4.4% during 1HFY19.

Chart 4: Growth in central tax revenues during April-September (in %, y-o-y)



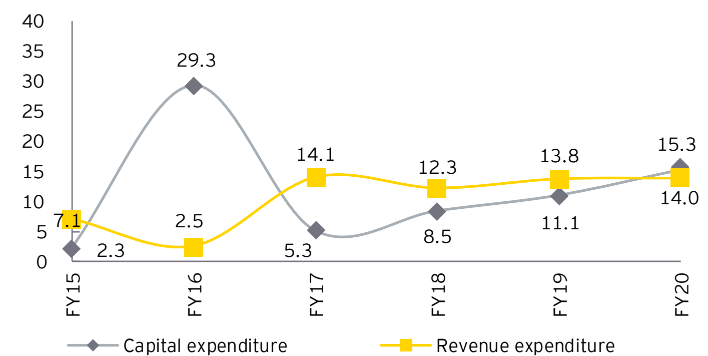
Source: Monthly Accounts, Controller General of Accounts (CGA), Government of India

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; (4) Collections under customs for July 2017 also include INR21,377 crore on account of IGST on import/exports and compensation cess on imports/exports of INR609 crore for 2017-18.

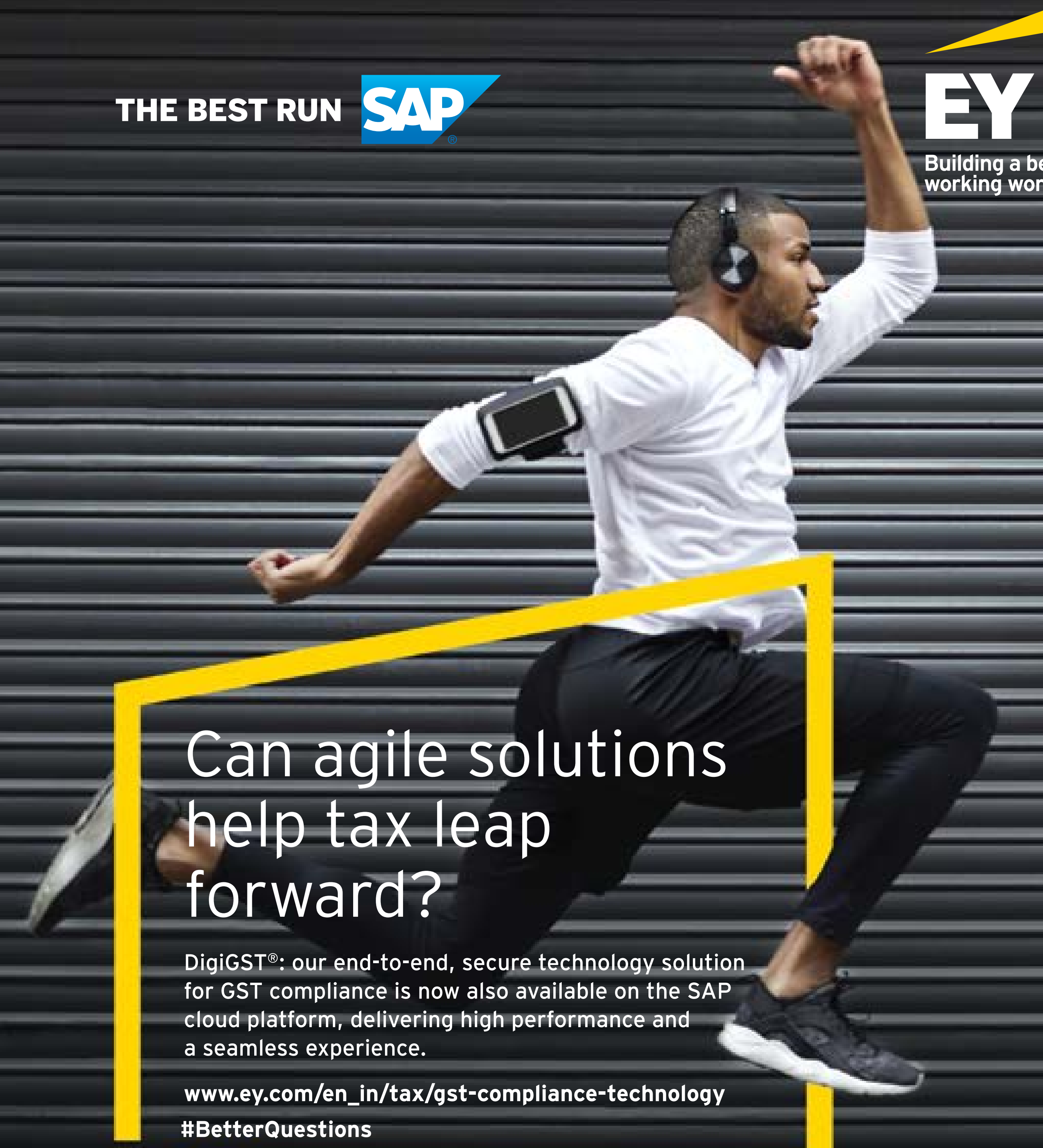
7 Growth in center's expenditure picked up during 1HFY20 primarily due to an increase in the growth of its capital expenditure.

- Growth in center's total expenditure during April-September FY20 picked up to 14.1% as compared to 13.5% during April-September FY19.
- Growth in revenue expenditure was at 14% during 1HFY20, marginally higher than 13.8% during 1HFY19.
- Growth in center's capital expenditure, which remained subdued at 3% until August 2019, increased to 15.3% during April-September FY20, higher than 11.1% during April-September FY19.

Chart 5: Growth in central expenditures during April-September (in %, y-o-y)



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



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EYIN1912-018
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