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Building a better working world

Foreword

As we know well, the world of tax, both from a policy and administrative perspective, is changing across the globe. The presidency of G20 to India has come at a very pivotal point of time and the recent G20 discussions under India's leadership underscored the need to implement strategies for overhauling global tax norms. The focus is on measures to check tax evasion, enhance tax transparency, and on capacity building to support the OECD BEPS Pillar One and Pillar Two solutions. Besides tax, climate change and the progress towards Sustainable Development Goals remain high on the agenda for G20 discussions. This issue of 'EY Tax Insights' covers the above themes, and more.

The OECD / G20 Inclusive Framework's work on Pillars One and Two has seen progress, but work is still ongoing in significant areas. Negotiations are still on for Pillar One and countries are at different stages of implementing Pillar Two provisions as a part of their tax laws. Among the most recent Inclusive Framework deliverables, 'Amount B' is a critical component of the broader agreement on Pillar One. Similarly, Subject To Tax Rules is an integral part of the consensus on Pillar Two for developing countries in the Inclusive Framework. With this backdrop, the article 'Navigating BEPS Pillar Two Reforms' discusses how countries are embracing the new tax provisions and the ways in which MNEs can be better prepared for GloBE implementation to be able to adapt quickly. The features on 'Amount B under Pillar One' and 'Model treaty provision of the Subject to Tax Rule' highlight the important design elements and implications of the proposed provisions for businesses.

Shifting to the 'green agenda', the feature on 'tax policy as a catalyst for sustainable decarbonization' brings out how, in line with global practices, India is crafting its decarbonization strategy to reduce emissions and drive investments. It highlights the need for businesses to stay updated and prepared for the emerging developments, as fiscal tools are increasingly being used to drive the sustainability agenda globally. A case in example is the EU Carbon Border Adjustment Mechanism (CBAM) which is due to be implemented on 1 October 2023. India is reviewing its trade strategies and preparing to discuss the concerns of the developing world. Separately, India is offering fiscal benefits for the production of Green Hydrogen and the manufacturing of electrolysers through strategic Interventions for the Green Hydrogen Transition (SIGHT) program, which is akin to a Production Linked Incentive scheme for the Green Hydrogen sector.

India has taken many strategic measures to position GIFT IFSC as a preferred destination for investments, both inbound and outbound. The magazine includes a feature on the GIFT City which offers a conducive and attractive landscape to attract domestic and foreign financial institutions, banks, insurance companies, and other financial service providers.

Last, but not the least, is the new face of India's cutting-edge tech-enabled tax administration that has improved efficiency and accuracy in monitoring and collection of data, and enhanced taxpayers' experience. In response, businesses should prioritize their focus on process improvements across different functions more than ever.

We hope you find the articles and features in this issue insightful. As always, we look forward to your feedback and suggestions.

Sameer Gupta
Tax Leader, EY India

Team

Publisher
Ground Floor
67, Institutional Area
Sector 44, Gurugram - 122 003
Haryana

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


In this issue

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Tax policy as a catalyst for sustainable decarbonization

Rajnish Gupta
Partner, Tax and Economic Policy Group, EY India

Shalini Mathur
Director, Business Tax Services and Economic Policy Group, EY India

Enabling policies have effectively slashed costs, lowered tariffs, and facilitated the extensive incorporation of clean energy into the grid.

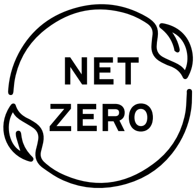
Governments also acknowledge that decarbonization presents economic prospects, including the creation of new markets, employment opportunities, and industries in the shift towards sustainability.

Decarbonization and transition towards new energy along with digitalization are the two most important drivers of economic growth and transformation globally. While new innovations in digitalization have been driven by private players, it is the governments that have an important role in driving decarbonization. Large-scale government support is required in early-stage clean technology development and integrating it into the overall energy system. Supportive policy has helped reduce costs and tariffs and made large-scale deployment of clean power and its integration into the grid possible.

Governments are particularly leveraging indirect tax or similar policies to encourage decarbonization through the use of renewable energy sources and infrastructure, greener and more efficient production processes, electric vehicles, and green building practices to name a few. The use of carbon levies, excise duties/VAT /GST and other pollution-linked fees to deter carbon emissions is gaining ground, as is the handing out of multiple incentives to attract green technologies and businesses.

Governments also recognize that decarbonization throws up economic opportunities and benefits of creating new markets, jobs, and industries in the green transition. For instance, effective January 2023, United States' Inflation Reduction Act offers large subsidies and tax credits to companies investing in electric vehicles and renewable energy technologies (such as batteries, solar panels, and wind turbines) if the products and parts are manufactured in the US. The Investment Tax Credit (30%)[1] and Production Tax Credit (US$ 0.0275/kWh, 2023 value)[2] allow eligible taxpayers to deduct a percentage of the cost of renewable energy systems from their federal taxes. According to some press reports, tax credits may be a better tool than subsidies[3]. Similarly, the European Commission's proposal for a

"Green deal industrial plan for the net-zero age"



presented in February this year, recommends EU Member States to introduce tax breaks either as tax credit or accelerated depreciation, among other initiatives. Simplification of subsidies for batteries, solar panels, wind turbines, heat pumps, electrolyzers, and carbon capture technology is also proposed.

On the other hand, the EU's Carbon Border Adjustment Mechanism (CBAM), due to enter the transition phase in October 2023 and be effective in 2026 will put a fair price on the carbon emitted during the production of carbon intensive goods that enter the EU. The idea is to ensure that the carbon price of imports is equivalent to the carbon price of domestic production.

Initially, CBAM will cover carbon-intensive imports in six sectors:

- Aluminum
- Cement
- Electricity
- Fertilizers
- Iron and steel
- Hydrogen

1. https://www.epa.gov/green-power-markets/summary-inflation-reduction-act-provisions-related-renewable-energy#:~:text=The%20Inflation%20Reduction%20Act%20of,of%20new%20clean%20electricity%20resources (Accessed on 4 August 2023)
2. Ibid
3. US Top Destination for Indian Solar Module Exports in 2022 (mercomindia.com)

imposing reporting requirements on the importers.

In line with global practices, India is crafting its decarbonization strategy to reduce emissions and drive investments. One of the initiatives in this direction is the production linked incentives (PLIs) that offer financial incentives (tax rebates / import and export duty concessions/ other incentives) to manufacturers for meeting specific milestones in sales, linked indirectly to capacity creation. The PLI schemes for Advanced Chemistry Cell (ACC) (INR 181 billion), automotive sector (INR 259.38 billion) and Faster Adoption of Manufacturing of Electric Vehicles (FAME) (INR 100 billion) will enable India to shift from traditional fossil fuel-based automobile transportation system to environmentally cleaner, sustainable, advanced and more efficient Electric Vehicles (EV) based system. Similarly, the Government has allocated a total domestic manufacturing capacity of

48,337 MW

with a cumulative support of more than

INR
185 billion

under the PLI Scheme for High Efficiency Solar PV Modules.

The government has also been using specific tax incentives such as lower taxes on environmentally friendly products such as EVs and ethanol. As an example, EVs attract a GST of 5% against 28% and even more for ICE engine-based vehicles. Similarly,

Ethanol for blending with petrol attracts a GST of

5% against **18%**

for industrial alcohol.

More recently, to promote green mobility, excise duty on GST-paid compressed bio-gas was given

tax exemption in the Finance Act, of 2023.

India does not have an explicit carbon tax, even though it can be effective in reducing emissions and be a source of additional revenues. However, the coal cess of INR400[4] per ton and the high level of taxation on petrol and diesel are examples of an implicit carbon tax. The effective tax on petrol and diesel can be more than 100% in contrast to the general 18% tax on most fuels subject to GST. As an anomaly, clean fuels like natural gas continue to be outside the ambit of GST, thereby impacting its competitiveness as a fuel and India's ability to reduce emissions.

The Indian government has been using other regulatory measures towards decarbonization. For instance, the Energy Conservation (Amendment) Act, of 2022 has introduced concepts such as carbon trading and mandates the use of non-fossil fuels and energy efficient standards to ensure faster decarbonization and achievement of sustainable development goals.

Going forward, businesses will need to be mindful of the impact of the increasing use of fiscal tools for decarbonization. Besides the potential exposure and tax burden, these tools may involve increased compliances and reporting obligations.

India's initiatives to move towards developing a carbon pricing mechanism, promoting renewable energy infrastructure and explore carbon capture technology would encourage companies to reduce their emissions and align India's policies with the global policies.

4. The Goods and Services Tax (Compensation to States) Act, 2017


NET ZERO
EMISSIONS

2

Green energy trade shift: implications of the new EU CBAM norms

Agneshwar Sen
Associate Partner,
International Trade, EY India

The EU's carbon adjustment mechanism will initially cover in its ambit certain goods whose production is carbon intensive and is at high risk of carbon leakage: cement, iron and steel, aluminium, fertilisers, electricity and hydrogen

With the CBAM's enforcement on the horizon and regulatory requirements set to kick in from October 1, 2023, it is important for India to evaluate its trade approaches and make necessary preparations

In the quest to plug carbon emissions leakage, the European Union's (EU) carbon border adjustment mechanism (CBAM) is the latest addition to the green energy practices adopted around the world. Essentially, the benefit of this measure is to encourage green energy imports. The CBAM came into force on 17 May 2023.[1] A transitional period of the CBAM will commence from 1 October 2023 and last through the year 2025.[2] The first reporting period for importers will end on 31 January 2024.[3] The obligation for importers under CBAM, which is being referred to as the world's first carbon border tax, to pay a charge in respect of their imports will enter into force on 1 January 2026.[4]

1. https://taxation-customs.ec.europa.eu/carbon-border-adjustment-mechanism_en#:~:text=The%20CBAM%20regulation%20officially%20entered,importers%20ending%2031%20January%202024
2. https://www.whitecase.com/insight-alert/eu-agreement-carbon-border-adjustment-mechanism
3. https://taxation-customs.ec.europa.eu/carbon-border-adjustment-mechanism_en#:~:text=The%20CBAM%20regulation%20officially%20entered,importers%20ending%2031%20January%202024
4. https://www.whitecase.com/insight-alert/eu-agreement-carbon-border-adjustment-mechanism

As part of EU's trade policy for green energy, the CBAM seeks to strike a balance between the carbon pricing norms that apply to goods imported into EU and the goods produced domestically in EU. While the latter are subjected to the existing EU Emissions Trading System (ETS), in the former category the importers will be required to pay for the greenhouse gas (GHG) emissions embedded in certain carbon-intensive products by purchasing CBAM certificates. The price of CBAM certificates will be pegged to the price of emission allowances (European Union Allowances / EUA) auctioned under the ETS,[5] calculated based on the weekly average auction price of EUA expressed in €/tonne of CO_2 emitted.[6]

CBAM will be phased in between 2026 to 2034 while the EU ETS free allowances (cap) will be gradually reduced.[7] During this period of 2026-2034, CBAM will apply only to the proportion of emissions that does not benefit from free allowances under the EU ETS.[8]

5. https://euindiachambers.com/wp-content/uploads/2022/02/The-EU-Carbon-Border-Adjustment-Mechanism-Implications-for-India.pdf
6. https://taxation-customs.ec.europa.eu/carbon-border-adjustment-mechanism_en
7. https://taxation-customs.ec.europa.eu/system/files/2023-07/20230714%20Q%26A%20CBAM_0.pdf
8. https://taxation-customs.ec.europa.eu/system/files/2023-07/20230714%20Q%26A%20CBAM_0.pdf

The CBAM system will mirror the EU ETS and will work as follows

1. CBAM will be applied on the **actual declared carbon content embedded in the goods imported** in the EU, according to a formula that will reflect the effects of the EU ETS on the production of similar goods in the EU.[9]

2. From 2026 EU importers will **buy CBAM certificates** corresponding to the carbon price that would have been paid had the goods been produced under the EU's carbon pricing rules.[10]

3. Conversely, if a non-EU producer has already paid a carbon price in a third country on the embedded emissions for the production of the imported goods, the **corresponding cost can be fully deducted** from the CBAM obligation.[11]

Scope of the CBAM

The CBAM aims to level the playing field for EU's domestic as well as imported products by ensuring that the imported products also incur comparable CO2 costs and prevent domestic businesses from shifting their production plants / operations to non-EU countries.[12]

The EU's carbon adjustment mechanism will initially cover in its ambit certain goods whose production is carbon intensive and is at high risk of carbon leakage: cement, iron and steel, aluminium, fertilisers, electricity and hydrogen.[13] By the end of the transition phase, a review report will be prepared of the CBAM's functioning.[14] The report will also assess the inclusion of other goods produced in sectors covered by the EU ETS in the scope of the CBAM mechanism, such as certain downstream products,[15] which will be included by 2030.[16]

CBAM and trade policy issues

The EU has claimed that the CBAM has been designed to be compatible with the World Trade Organization (WTO) WTO and its other international obligations and simply seeks to place EU based producers at par with the non-EU producers in terms of the carbon cost embedded in the covered products. At a preliminary level this seems questionable due to the trade implications of CBAM. Hitherto, border measures allowed under the WTO have been agnostic of the production process or method (PPM) adopted in its manufacture. For example, whether cotton is grown organically or using chemical fertilisers, the customs duty is the same. With CBAM this long held principle is being changed as the same product depending on the production process (i.e., its carbon intensity) will face differential taxation.

Another often repeated complaint about CBAM from the developing countries is that it overlooks the concept of 'Common but Differentiated Responsibilities'[17] enshrined as Principle 7 of the Rio Declaration at the first Rio Earth Summit in 1992. The declaration states: "In view of the different contributions to global environmental degradation, States have common but differentiated responsibilities". Through CBAM, the EU is arguably equalizing the responsibilities by imposing the same carbon cost wherever the exporter may be located and whatever the carbon reduction commitment of that country may be. Further, the revenues from CBAM will contribute to the EU's budget. Thus, instead of aiding developing countries to meet their carbon reduction objectives, the developing countries exporting to the EU will be contributing to the EU's ambitious carbon reduction commitments.

9. https://taxation-customs.ec.europa.eu/system/files/2023-07/20230714%20Q%26A%20CBAM_0.pdf
10. https://taxation-customs.ec.europa.eu/system/files/2023-07/20230714%20Q%26A%20CBAM_0.pdf
11. https://taxation-customs.ec.europa.eu/system/files/2023-07/20230714%20Q%26A%20CBAM_0.pdf
12. https://euindiachambers.com/wp-content/uploads/2022/02/The-EU-Carbon-Border-Adjustment-Mechanism-Implications-for-India.pdf
13. https://taxation-customs.ec.europa.eu/carbon-border-adjustment-mechanism_en
14. https://taxation-customs.ec.europa.eu/system/files/2023-07/20230714%20Q%26A%20CBAM_0.pdf
15. https://taxation-customs.ec.europa.eu/system/files/2023-07/20230714%20Q%26A%20CBAM_0.pdf
16. https://taxation-customs.ec.europa.eu/system/files/2023-07/20230714%20Q%26A%20CBAM_0.pdf
17. https://documents-dds-ny.un.org/doc/UNDOC/GEN/N92/836/55/PDF/N9283655.pdf?OpenElement

Way forward

the road ahead

While international obligations will be debated and settled in appropriate forums, climate policies such as EU's approach to green energy trade are here to stay. The coming into force of the CBAM is around the corner with its regulatory compliances starting from 1 October 2023. Countries, such as India, need to take stock of their trade strategies and prepare themselves.

India has recently launched its Carbon Credit Trading Scheme (CCTS) in the pursuit of its NetZero goals and of promoting green energy. The CCTS will aid the institutionalization and performance of the Indian Carbon Market (ICM) by laying down a process for compliance in which emission goals will be formulated for specific industries and organisations, upon meeting which they will receive credit certificates. Implementing the CCTS in a robust and effective way will help Indian businesses to demonstrate that their goods are manufactured through low-carbon processes using green technology, thereby, attracting lower CBAM charges and enhancing green energy export opportunities in EU.

Manufacturers in India would need to focus on smart manufacturing by investing in energy-efficient technologies to reduce carbon emissions and adopt sustainable trade practices. Furthermore, while India has been beefing up its green energy initiatives, there is an urgent need for creating complementary green infrastructure that will expedite the transition to clean energy for businesses.

India is at advanced stages of negotiating trade and investment agreements with the EU. This provides India with a platform to put forth its concerns with respect to the CBAM implications. The country must explore negotiating an exemption or a reduced rate of CBAM for the Indian manufacturers. It is well-accepted that the historical burden of global GHG emissions lies with the developed world. In this context, EU's goals for promoting green energy through trade policy should take into account the concerns of the developing world.

Also contributed by

Esha Sandhu

Senior Manager, International Trade,
EY India

3

SIGHT Program: the new PLI avatar for the green hydrogen ecosystem

Saurabh Agarwal
Partner, Indirect Tax,
EY India

The Strategic Interventions for Green Hydrogen Transition (SIGHT program) is akin to a Production Linked Incentive scheme for the Green Hydrogen sector and it offers fiscal benefits for a duration of three and five years for production of Green Hydrogen and manufacturing of Electrolysers respectively

The recent announcement by Finance Minister with respect to extension of PLI benefits to Chemicals and Petrochemicals sector, have created positive ripples in the global manufacturing ecosystem

Firm clean energy transition commitments made by Government of India in COP 26 at Glasgow in Nov 2021, affirmed that a long-term roadmap would be laid for successful implementation and achievement of these targets. One of the key instruments of this strategy was ensuring replacement of fossil energy by renewable energy, including creating capacities for production and export of Green Hydrogen ('GH') in India.

The National Green Hydrogen Mission released in early 2023 was the first such tangible step in this direction. The Mission introduced the Strategic Interventions for Green Hydrogen Transition ('SIGHT') program which provided for a financial incentive budgetary outlay of

INR 17,490 crore

wherein

INR13,050 crore

was allocated for Green Hydrogen production and

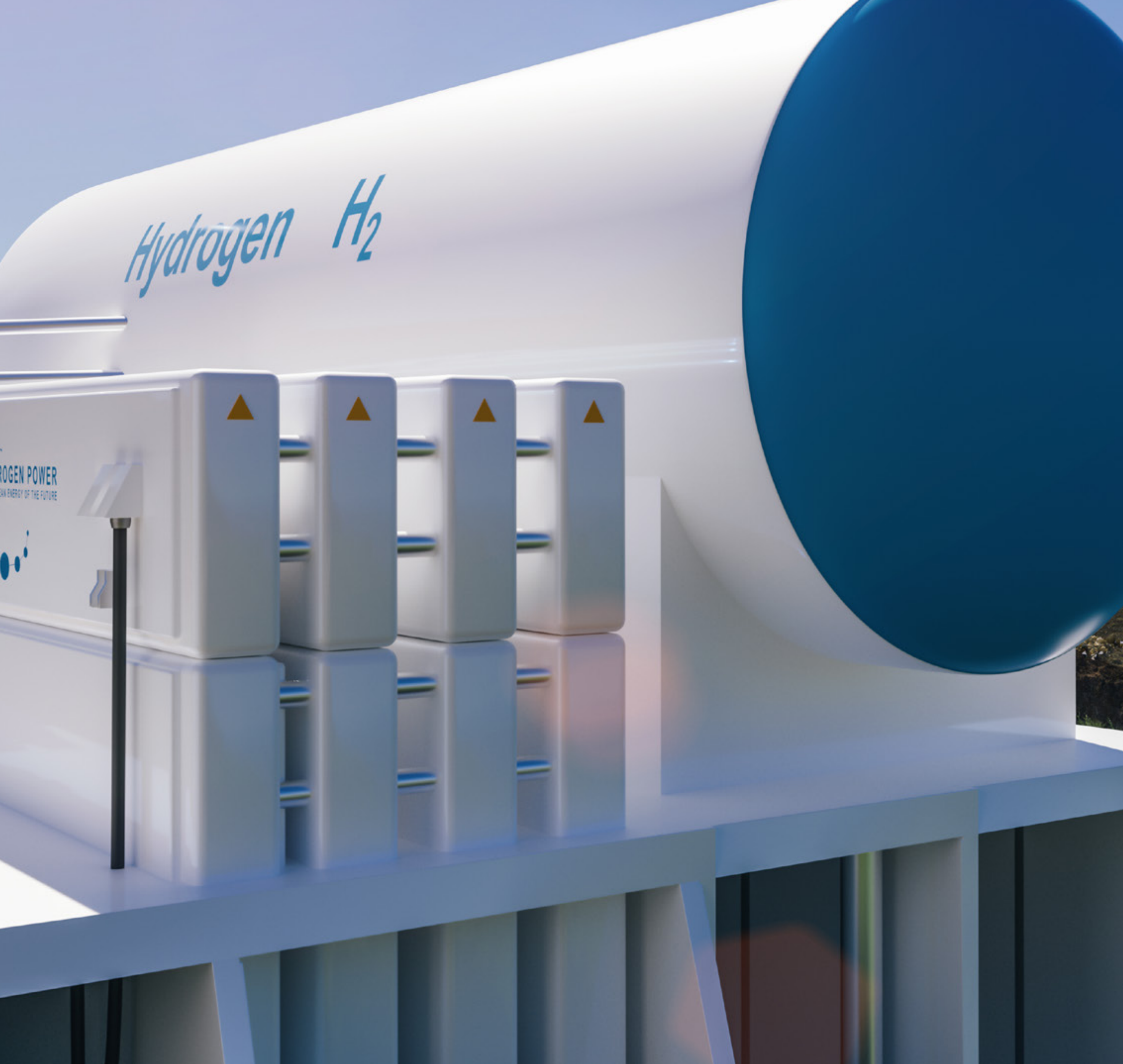
INR4,440 crore

were allocated for electrolyser manufacturing.

The SIGHT program is akin to a Production Linked Incentive scheme for the Green Hydrogen sector and it offers fiscal benefits for a duration of three and five years for production of Green Hydrogen (GH) and manufacturing of electrolysers respectively. Selection criteria of successful applicants would be done on a competitive bidding basis, wherein the GH tender would prioritize bidders quoting the least amount of average incentives over a three-year duration, and the electrolyser tender is focusing on critical aspects of energy efficiency parameters and localization commitments over the five-year time frame.

The program envisages allotment of incentives through multiple tranches and this is the first tranche interalia. Special capacities have been earmarked for GH produced through biomass-based pathways and for indigenously developed technologies as well. This broad-based approach by policy makers is applaudable as it would be instrumental in laying strong foundations for this nascent sector and help the emerging startups and technologies in this space.

While the program is largely inclusive, there are several areas that lack detail and require more clarity like definition of term 'Green Hydrogen', guidelines for monitoring the 60,000 hours performance guarantee of manufactured electrolysers, and guidelines that are to be followed for verifying the localized content of the manufactured product.Whilst it is expected that most of these concerns would be addressed by the regulators in due course of time, some key parameters/ guidelines pertaining to product quality standards, etc should be clarified beforehand as it would enable companies to assess their investment commitments in more realistic terms.



Genuine concerns are also raised by electrolyser manufacturers with respect to the

50%

local sales condition, as it is believed that such stringent criteria may desist the Indian players from getting better bargain for their products in global markets.

Further, given the competitive nature of bidding mechanism, it becomes imperative that the bidders assess the whole landscape of incentives available in the country, whether from Central government or from different State government schemes/ policies. Ensuring better ROI for the projects would be crucial for delivering optimum Levelized Cost of Hydrogen (LCOH) in the long term and for ensuring competitiveness of the sector vis-a-vis Blue or Grey Hydrogen.

In addition to the direct form of fiscal benefits, additional measures like competitive bidding for aggregated demand as well as certain mandatory purchase obligations for select consumption sectors are also under the anvil and could be expected to be released soon. Whilst all these measures shall provide the required impetus to this sector at initial stages, its long-term success would depend on development of novel technologies and on establishment of projects that could achieve true economies of scale.

While the spotlight presently is on the Green Hydrogen space, it is also pertinent to observe the latest happenings in related manufacturing sectors. The recent announcement by Finance Minister with respect to extension of PLI benefits to Chemicals and Petrochemicals sector, and the latest held industry-wide consultation by the Ministry of Heavy Industries for Advance Chemistry Cell manufacturers, have created positive ripples in the global manufacturing ecosystem and has again indicated GOIs seriousness towards its clean energy commitments. The recent projections on India's GDP upwards of 6% growth target as well as upgrade of India's ranking to 'overweight' by global brokerage firms, is yet another reflection of faith in the Indian growth story.

The current scheme of measures introduced by Government of India shall go a long way in strengthening the core of Indian manufacturing ecosystem and shall position India suitably to become the third largest economy in the coming decade, all this while ensuring ethos of clean and sustainable development as envisioned by our Hon'ble Prime Minister for an Atmanirbhar Bharat.

Also contributed by

Mohit K Sharma

Senior Manager, Indirect Tax,
EY India

4

Navigating BEPS Pillar 2 reforms: are MNEs prepared?

Paresh Parekh
Partner and Leader, Consumer Products and Retail Sector - Tax, EY India

Mansi Agarwal
Director, International Tax and Transaction Services, EY India

OECD's BEPS 2.0 Pillar 2 project has progressed well, with OECD offering comprehensive guidance on various aspects of pillar 2 to be incorporated into domestic legislation of countries within agreed timelines

Due to a clear political will, numerous countries have either started implementing pillar 2 or have expressed their intent for the near future

With the Global Minimum Tax now a reality, multinational enterprises (MNEs) must evaluate the impact and be well-prepared to adapt

Journey so far

The Organisation for Economic Co-operation and Development ('OECD')/G20 Inclusive Framework ('IF') on Base Erosion and Profit Shifting ('BEPS') had agreed a two-pillar solution in October 2021. This initiative aimed to address tax challenges brought about by the digitalization of the economy and has made significant progress so far. While Pillar 1 mainly focuses on the re-allocation of profits to market jurisdictions, Pillar 2 is designed to ensure that large MNEs pay a minimum 15% of tax on their income arising in every jurisdiction where they operate.

Since such agreement, OECD till date has released a series of agreed documents including Model Global Anti-Base Erosion ('GloBE') Rules, Commentary to the Model GloBE Rules, guidance on GloBE Safe Harbours, two sets of Administrative Guidance, a standardized GloBE Information Return ('GIR'), etc. These documents serve as templates for jurisdictions to incorporate pillar 2 into their domestic laws for its coordinated implementation within the agreed timeframe.

Another core element of the Pillar 2 is Subject to Tax Rule ('STTR') which is a treaty-based rule that gives taxing right to source countries (which are considered as developing countries) on certain payments to connected parties if such stream of income is subject to tax rates below 9% in the payee's jurisdiction of residence. A document released in July 2023, contains the model treaty provision to be applied to such defined payments. It has been agreed that a multilateral instrument to facilitate implementation of STTR will be open for signature from 2 October 2023.[1]

It is very evident from the outcome statement, delivered in July 2023, that there is a political will of the IF members to implement the Two pillar approach. However, the stringent timelines may pose a challenge for its smooth implementation. A chart depicting progress made till date and way forward is provided below:

1. Action 1 - OECD BEPS

Pillar Two - Timelines

8 October 2021

IF Statement on agreement of Two Pillar Solution

20 December 2021

Release of OECD Model Rules for Global anti-Base Erosion (GloBE), including IIR and UTPR

14 March 2022

Release of Commentary to Model Rules and announcement of public consultation on administrative / compliance matters

December 2022

Release of safe harbour guidance and consultation documents on information return and tax certainty for GloBE

How are countries embracing Pillar 2

The global minimum tax is already a reality where several jurisdictions have either issued final/ draft legislations or have set clear intentions of enacting such measures. Talking about key jurisdictions, all European Union ('EU') members have accepted to implement pillar 2 measures. Basis the EU directives, countries like Germany and Netherlands have already issued draft regulations. United Kingdom in July 2023 has enacted the legislation to bring in effect Qualified Domestic Minimum Top-Up Tax ('QDMTT') and Income Inclusion Rule ('IIR') for fiscal years starting on or after 31 December 2023 and Undertaxed Payments Rule ('UTPR') from 31 December 2024. For India headquartered MNE Groups having parent entities in EU or United Kingdom, the relevant fiscal year from which GloBE rules would become applicable would be from 1 April 2024. Moving towards East, Japan, South Korea have already enacted legislation wherein both these countries would be implementing IIR beginning 2024. Now, drawing our attention to some of the common holding jurisdictions, Mauritius has introduced QDMTT, however, its expected date of implementation is yet unclear. Singapore and Hong Kong in its budget had announced its plan to implement GloBE (IIR and UTPR) and Domestic Top-up Tax effective for fiscal years starting on or after 1 January 2025.[2] Besides these, numerous other IF members have expressed their intention to adopt the GloBE Rules through official channels. Yet, noticeably absent among them are United States ('US') and China. However, it is critical to note that the GloBE rules are not considered as minimum standard, however their implementation would happen under a 'common approach'. A 'common approach' means a jurisdiction must follow Model Rules if implemented, however, if not implemented, it has to accept the implementation by others in a coordinated and consistent manner.

How much time to get ready for Indian MNEs?

NOW: August 2023 | **1 April 2024** | **31 March 2025**

Stakeholders buy-in

Data management

Impact Assessment

Incentives/ structuring opportunities

8 months

System changes

Process changes

Data collection

New processes

IAS 12 disclosure[3]

Year-end tax provision

Year-end audit

GloBE Information Return filing

+15 or 18 months

Change Management

Start of FY for which GloBE rules apply

2. ey-beps-2-0-pillar-two-developments-tracker.pd
3. IFRS - IASB amends tax accounting requirements to help companies respond to international tax reform

February 2023	July 2023	July 2023	October 2023
Release of GloBE administrative guidance	Outcome statement delivered to G20 Finance Ministers and Central bank. Release of 2nd Administrative guidance, GloBE information return	STTR Model Treaty provisions and commentary released	MLI implementing STTR will be open for signatures

What MNEs need to know

MNEs need to keep pace with the continuous changes that are unfolding to be able to adapt quickly. Below are some of the aspects to be considered to ensure better preparedness for GloBE implementation:

Educating relevant stakeholders

These rules will have a comprehensive impact, not solely on the tax teams but also on Finance and Information Technology teams. It is essential to educate the senior management on the evolving regulations, emphasizing the risks associated with potential additional tax outflows. It would be equally important to engage with auditors for appropriate provisioning and disclosure to be made in books of accounts.

Assessing the impact

As a start, MNEs need to evaluate the Effective Tax Rates ('ETRs') as per the GloBE Rules for each jurisdiction and assess any additional tax liability, which will help them to identify risk areas which needs attention. MNE groups to review their operating/ business/ holding structures in lieu of the changing regulations.

Be compliance ready with technology support

The changing landscape is giving rise to new set of compliances. Considering the mammoth data requirements, leveraging on advanced technology becomes imperative to efficiently collate, analyze, and ensure data is audit-ready and consistently aligned with other filings.

Also contributed by

Akshay Nayak

Manager, International Tax and Transaction Services, EY India

5

Simplifying transfer pricing: exploring Amount B for routine distributors

Shweta Pai
Partner, International Tax and Transaction Services, EY India

Unlike Amount A of Pillar One and the global minimum tax rules under Pillar 2, there are no monetary thresholds (e.g., minimum global revenue) for Multinational Enterprise (MNE) Groups to be within the scope of Amount B

One vital area on which input is sought is whether the scope determination for Amount B should include an additional qualitative threshold

Application of Amount B in the India is not going to be straightforward

The Organisation for Economic Co-operation and Development (OECD), on 17 July 2023, as part of the ongoing OECD/G20 project on addressing the tax challenges of the digitalization of the economy (the Base Erosion and Profit Shifting or BEPS 2.0 project) issued a public Consultation Document on Amount B of Pillar One (Consultation Document). Amount B provides for fixed returns for in-scope in-country baseline marketing and distribution activities. The Amount B approach is meant to be a simplified and streamlined approach to reduce administrative challenges for tax administrations and compliance burden for taxpayers.

The Consultation Document does not yet represent consensus of the Inclusive Framework on BEPS and requests stakeholder input by 1 September 2023. Upon finalization by the year-end, Amount B will be incorporated into the OECD Transfer Pricing Guidelines (OECD TPG) by January 2024.

The Consultation Document

The scope of Amount B covers both buy-sell and agency arrangements including the wholesale distribution of digital goods. It excludes substantial retail sales, distribution of digital services and the trading, marketing or distribution of commodities.

The Consultation Document proposes two alternatives (A and B) to the scoping criteria. Alternative A proposes no additional qualitative scoping exclusions. Alternative B proposes the scope of Amount B would only include distributors that fit within a definition of "baseline" distributor and that do not make "non-baseline contributions" that cannot be reliably priced under the proposed pricing method.

For pricing under Amount B, the Transactional Net Margin Method (TNMM) is viewed as the most appropriate method (moderated by the Berry ratio), but tax authorities and taxpayers may under specified circumstances assert the applicability of the comparable uncontrolled price (CUP) method.

The Consultation Document contains a pricing matrix of arm's-length results based in part on financial information from a global dataset of companies involved in baseline marketing and distribution activities. Jurisdictions with local market comparables will matrix to apply it as part of Amount B. The arm's-length range derived from the pricing matrix is based on three industry groups and five categories of operating assets and operating expense intensities (providing for 15 different potential operating margins). The range of arm's-length results is between 1.50% and 5.50%. If the taxpayer applying Amount B reports a margin that is outside the identified range, the tax administration should adjust the result to the midpoint of the Amount B range. Agreements reached under mutual agreement procedures (MAPs) and advance pricing agreements (APAs) will be respected over Amount B.

The Consultation Document provides that the documentation requirements under Amount B will build on the existing documentation requirements included in the OECD TPG.

India perspective

Transfer Pricing aspects of marketing and buy-sell arrangements has been the focus of the tax authorities and the key dispute between the taxpayers and the tax authorities has generally been whether the India operations qualify as "baseline" or not. The allegation of the Indian tax authorities is that the Indian distributors make more than baseline contributions such that the activities benefit the owner of the trademark. The tax authorities have generally been carving out these activities and benchmarking them separately. The position of the taxpayers has been that the Indian operations are routine and therefore "baseline" and the return on sales earned by the Indian entity subsumes the remuneration, if any required for the additional activities. This matter is currently pending review by the Supreme Court of India.

Also, India operations of several MNE Groups are organized as "sales and marketing service support" entities which appear to be out of scope of Amount B whereas arrangements which are much wider in scope such as "sales agents" find a place. However, it is not clear as to how "sales agents" would be distinguished from marketing service providers from an India standpoint.

Implications

Unlike other BEPS measures, Amount B would be widely applicable as it is not subject to any revenue thresholds. It is presently unclear as to how Amount B will be implemented (eg: as a safe harbor, prescriptive etc). If implemented well, most countries and taxpayers will benefit from reduction in disputes and streamlining the transfer pricing for selling arrangements given that this will represent a consensus measure. Irrespective of the implementation mechanism, Amount B is expected to result in reduction of compliance burden as well as provide tax certainty in a manner which may not be as cumbersome as other processes like APA and MAP. Therefore, businesses also should evaluate the potential impact of these changes on their business models and consider adoption.

Given the lack of consensus in the scoping criteria and the two alternatives proposed (A&B), it is unclear whether the Indian tax authorities would accept the inclusion of Indian buy-sell structures within the scope of Amount B until there is clarity on the issue by the Supreme Court. Businesses may want to consider taking the opportunity to engage with the OECD and country policymakers through the consultation process. Until then it appears that APAs and MAPs may provide a better alternative to seek upfront certainty on transfer pricing aspects relating to India buy-sell structures.

6

What are the implications of OECD's STTR on the business landscape?

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

The STTR allows source countries to impose an additional tax liability on certain payments

Multilateral Instrument will facilitate the implementation of STTR and is expected to open on 2 October 2023

Alternatively, the STTR can be implemented into relevant tax treaties individually via bilateral negotiations

Among the series of documents that the Organisation for Economic Co-operation and Development (OECD)/G20 Inclusive Framework (IF) released on 17 July 2023 on the Base Erosion and Profit Shifting (BEPS) 2.0 project, is a document under Pillar 2 containing the model treaty provision of the Subject to Tax Rule (STTR), together with an accompanying commentary explaining the purpose and operation of the STTR. The STTR which is an integral part of Pillar 2 is a treaty-based rule that specifically targets risks to source jurisdictions posed by intragroup payments which take advantage of low nominal rates of taxation in the jurisdiction of the payee. The STTR allows source countries to impose an additional tax liability on certain payments.

STTR Design Elements

The STTR covers payments between "connected persons." The STTR includes a "targeted anti-avoidance rule (TAAR)" intended to prevent the use of intermediaries to avoid the STTR, such as interposing an unconnected person between two connected persons or routing a payment through a high-tax connected person.

The STTR applies to "Covered Income" such as interest, royalties, any income received in consideration for services etc. which is subject to a nominal tax rate of less than 9%. Nominal rate of tax will generally be the statutory tax rate applicable to the type of income. However, the nominal tax rate is lowered if the statutory rate is subject to a 'preferential adjustment'. A preferential adjustment is a permanent reduction in the amount of the covered income subject to tax or the tax payable on that income in the form of a full or partial exemption or exclusion from income or a deduction from the tax base or a tax credit (excluding a credit for foreign taxes paid).

The STTR applies to Covered Income (other than interest and royalties) where the amount of Covered Income exceeds the costs incurred in earning that income plus a mark-up of 8.5%[1]. The STTR applies if the aggregate sum of Covered Income paid in a fiscal year exceeds EUR 1 million (or EUR 250,000 for jurisdictions with GDP below EUR 40 billion). Taxes imposed under the STTR are levied after the end of the fiscal year in which they arise and not as a withholding tax. The recipient jurisdiction is neither required to exempt the Covered Income nor to provide a tax credit for tax payable under the STTR. A multilateral instrument will facilitate the implementation of the STTR. The same is expected to be open for signature from 2 Oct 2023 onwards. Alternatively, the STTR can be implemented into relevant tax treaties individually via bilateral negotiations.

1. https://www.oecd.org/tax/beps/pillar-2-subject-to-tax-rule-in-a-nutshell.pdf

India Implications

India has extensive taxing rights under its domestic tax law on income arising to non-residents by virtue of concepts such as business connection/ significant economic presence (SEP) as a nexus for determining taxable presence. In addition, royalty, interest and technical service fees that arise in India to a non-resident is also taxed on a gross basis at 20%. Further, under India's extensive tax treaty network,

India has generally retained a right to tax royalty, interest and technical service fees on gross basis at

10% / 15%.

However, given the variations in the definition of technical service fees in tax treaties certain categories of technical service fees could fall outside the ambit of taxation in the absence of a permanent establishment (PE). Interpretative issues also arise on the definition of technical service fees on applicability to certain digital/ technology transactions. Transactions that do not involve "human intervention" or relate to the use of a "standard facility" maybe outside scope.

In this context, it would be useful to see the likely impact inclusion of STTR in India's tax treaties could have on cross-border payments. A couple of illustrations would help understand this.

Example 1

A Ltd, a company resident in India, makes management service fees payment to a connected person (S Ltd), a company resident in State S. Under its domestic tax law India can tax the payment at 20%. However, under India-State S tax treaty, the fee is not taxable in India in the absence of a PE of S Ltd. While S Ltd is taxed in State S at a nominal tax rate of 17%, State S exempts income from taxation that is not received in State S. Since S Ltd receives this income in a bank account outside State S, the management service fee is not taxed in State S.

If STTR is included in India-State S tax treaty, the following could be the consequence: Management service fee paid to S Ltd is a covered income for purpose of STTR. The nominal rate of tax would be regarded as 0% since preferential adjustment applies. Hence, India would get a right to tax back up to 9% under STTR, subject to the monetary and mark-up thresholds being satisfied.

Example 2

I Co, a company resident in India and member of X Co group, functions as a re-seller of cloud computing services to customers in India. S Co, a company resident in State S and a member of X Co group, is a regional distributor of the services. I Co makes an arm's length payment to S Co for cost of services purchased. S Co in-turn makes a tax-deductible payment of 95% of the consideration received from I Co to X Co, the group's intangible property (IP) owner resident in State X, as consideration for obtaining regional distribution rights. S Co is taxed at 17% on its net income while X Co has a preferential regime under which it is taxed at 5% on IP income. Under the Indian domestic tax law S Co has a taxable nexus in India by virtue of SEP; but not taxable under India-State S tax treaty in the absence of a PE.

If STTR is included in India-State S tax treaty, the following could be the consequence: Income from cloud services could be covered income for purpose of STTR. The term "services" for purpose of STTR would generally be interpreted to mean an action performed for the benefit of another person. The method of delivery is not relevant to the determination. Even though S Co is taxed in State S at a nominal tax rate higher than 9%, the TAAR could potentially apply which allows the intermediary (S Co) to be disregarded in the transaction flow for determining the tax rate for purposes of STTR. The effect of the TAAR would be to treat the original payment by I Co to S Co as a payment of covered income to a connected person in State X and substitute the tax rate to which X Co is subject in State X in respect of the related payments from S Co, resulting in STTR applying.

If S Co is an e-commerce operator and subject to equalisation levy on the amount received from I Co, S Co could be exempt from income-tax by virtue of Section 10(50) of the Income-tax Act, 1961, regardless of STTR.

The STTR is a core element of Pillar 2 and, where applicable, the STTR would apply before the Global Minimum Tax Rules. While members of the IF have committed to implement the STTR into their bilateral treaties with members of the IF that are developing countries when requested to do so, the actual timeline for treaty changes to come into force remains uncertain. Companies should evaluate the potential implications of the STTR for their businesses and monitor STTR developments in relevant jurisdictions.

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7

Modernizing India's corporate tax compliances: **automation, AI and beyond**

Rahul Patni
Digital Tax Leader,
EY india

Manoj Rathi
Partner, Global Compliance and Reporting,
EY India

The paradigm shift in technology has not only improved accuracy in terms of data collection and reporting but has also enhanced taxpayers' experience

The Indian government has bolstered its focus on reconciliations like Clause 34(a) and 44 of Tax Audit Report and Form 26AS reconciliation which is just the first step towards a more comprehensive reconciliation with multiple data sources as envisioned in AIS

The use of technology in corporate tax processes has become a necessity for businesses in India

Over the years, there has been continuous and sustained efforts to digitize the entire interface between taxpayers and the administration. This is evident from the recent changes in form of e-invoicing, New Income Tax portal, Faceless assessment/ appeals, Annual Information Statement (AIS)/ Taxpayer Information Summary (TIS), Invoice Registration Portal (IRP) and the list goes on. This paradigm shift has not only improved accuracy in terms of data collection and reporting but has also enhanced taxpayers' experience.

On the flipside, cross legislation reconciliations have become part of the new order helping the tax administration to ensure consistency in cross legislation filings. Notably, the government has bolstered its focus on reconciliations like Clause 34(a) and 44 of Tax Audit Report and Form 26AS reconciliation which is just the first step towards a more comprehensive reconciliation with multiple data sources as envisioned in AIS.

Clearly, the administration has leapfrogged in its digital adoption over past few years and seems on course to be a new-age tax administration focused on achieving its larger objective of taxpayer service where:

Real time access to transaction data, GST and Income-tax system integration and insightful data analytics may help in improving the compliance index

Clear visibility on outstanding demands and refunds across tax legislations may help faster disposal of matters and enhance taxpayer experience

Tech adoption may result into only few but meaningful enquiries from the tax office and reduce the pie of tax disputes in the country

1. https://www.oecd.org/tax/beps/pillar-2-subject-to-tax-rule-in-a-nutshell.pdf

In terms of technology adoption, GST has seen the highest uptick followed by TDS and TCS processes. However, it is time for India Inc to reimagine its corporate tax compliance and reporting lifecycle, which has thus far operated manually with significant people dependency. Some of the operational challenges which surround a typical corporate tax compliance lifecycle include:

Integration and data extraction

Complex businesses face challenges while integrating new technology with their existing systems and processes. Further, the ability to pull data from ERPs in the reporting format expected by the authorities is a problem which generally remains unsolved.

Complex laws and data sources

Generally, compliances around Tax audit and tax return filing involve fair bit of interpretation of tax positions and adjusting which require user discretion at multiple instances. These also include screening through various data sources, applying tax logics which at times cannot be standardized for a solution to automate.

Legislative changes

Keeping up with rapidly evolving tax regulations and ensuring technology compliance can be a daunting task.

To sum up, use of technology in corporate tax processes is no more a matter of choice; on the contrary, it has become a necessity for businesses in India. The ever-changing regulatory landscape demands more efficient, accurate, and streamlined processes.

The above sentiment is also reciprocated in one of the EY survey done with 100+ companies in 2022 on key challenges faced by them in tax compliances and reporting.

90% ERPs have very limited configuration to fetch ready-to-use data

94% Void in using tech-based solutions and reliance on spreadsheets or offline modes of working

90% Struggle to retrieve data for tax assessments and strong data repository is needed to enable retrieval within shortened timelines

88% Significant time is consumed in coordination with multiple teams and consolidating data

As evident, around 90% of the senior leadership is looking at full scale automation of tax function and compliance processes. Businesses need an enterprise level solution architecture, which can help not only meet their compliance requirements effectively but also gain a competitive advantage in the market.

Today, businesses could aim at enterprise level technological enablement for not only transforming their corporate tax compliance and reporting lifecycle but also for adopting a comprehensive and integrated approach to facilitate reconciliations. It could also help ensure consistency across different tax filings covering all tax processes such as GST, TDS, TCS, faceless assessments and litigation management.

With the advent of Generative AI, the corporate tax compliance lifecycle is set to get revolutionized. Through robust data processing and reconciliation technologies and capabilities of AI, organizations can look at interpretation of complex tax rules and logics by swiftly analyzing vast volumes of data and providing accurate insights. A sophisticated data extraction and mapping strategy can help in significantly reducing the manual effort required for data massaging, research and analysis. By automating rule-based processes, AI can not only enhance accuracy but also free up significant time and resources which can be directed towards strategic tax planning and decision-making.

Also contributed by

Mohit Agrawal

Manager, Global Compliance and Reporting, EY India

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IFSC at GIFT City: unpacking key factors driving investor attraction

Jaiman Patel
Partner - International Tax and Financial services sector, EY india

Recognized as a crucial component in India's pursuit of a $5 trillion economy, GIFT IFSC has garnered interest from notable Indian and global corporations

The tax holiday of 10 years for banks in GIFT IFSC translates to reduced borrowing costs for Indian borrowers.

GIFT City is India's first operational greenfield smart city, focusing specifically on financial services.

It aims to offer ease of doing business through simplified regulations, tax concessions, and a conducive landscape to attract domestic and foreign financial institutions, banks, insurance companies, and other financial service providers. HDFC Bank, HSBC, and SBI, among others, have established operations within GIFT IFSC. Google and Capgemini announced their intentions to operate from GIFT IFSC. GIFT IFSC houses 545+[1] registered entities as of July 2023.

1. www.business-standard.com

Key features of GIFT IFSC include

1 Dedicated financial services zone within India (capital convertibility)

2 Limited applicability of exchange control provisions

3 Lower cost of operations

4 Progressive tax regime

Recent developments and growing popularity in GIFT IFSC

GIFT NIFTY

onshoring the offshore

The trading of SGX Nifty, previously on the Singapore Exchange's platform, has shifted to NSE's International Exchange (NSE IX) within GIFT IFSC w. e. f. 03 July 2023. This creates a gateway for more global securities to be listed on GIFT-NIFTY. The current daily turnover is $10 billion. Capital gains from derivatives listed on NSE IX are exempt from Indian income tax. As the platform grows, its influence on global and local markets will shape financial activities in and beyond India.

Banks

matured lending platforms

The original IFSC banking framework, which only permitted branches to be set up, has expanded to include subsidiaries (i.e., a company). Recently in July and August 2023, a few banks have obtained a license to undertake banking operations; 5 of the top 10 global banks and all top 10 Indian banks operate in GIFT IFSC. As of July 2023, the total banking asset size is US$41.20 billion[2] and a cumulative value of banking transactions is US$508 billion.

Indian Income-tax law provides for a concessional tax regime of 5% on interest on external commercial borrowing (ECB) by Indian borrowers. Post 1 July 2023, the tax rate applicable is 20% or as per tax treaties, whichever is lower. Reduced tax holiday of 10 years for banks in GIFT IFSC translates to reduced borrowing costs, which may attract additional business for banks in GIFT IFSC given that borrowers will always tend to reduce borrowing cost and therefore borrow from banks in GIFT IFSC.

Importantly, foreign banks are now allowed to undertake acquisition financing and issue P-notes basis underling Indian securities. This could create new opportunities for foreign banks and help Indian companies get funding for local acquisitions.

Family investment funds (FIF)

emerging area of interest

GIFT IFSC houses over 50 Alternate Investment Funds (AIFs) with a corpus exceeding US $17.8 Billion. A framework under the fund regime has been enabled for Family Investment Funds (FIFs), which allows Indian residents to set up overseas investment vehicles, with specific conditions as mentioned below.

Obtain a license from IFSCA

Minimum corpus – US$10 million over a period of three years

Minimum one Principal Officer is required

Considering that the revised RBI overseas investment regulations carve out specific relaxation to IFSC investment vehicles, this IFSC framework can be evaluated by Indian family offices that intend to make overseas investments. While currently, there are certain clarifications sought from IFSCA and RBI, looking ahead, the realm of FIFs is poised to emerge as a compelling area of interest within the financial landscape of GIFT IFSC

2. www.business-standard.com

Finance companies/ corporate treasury activities

GIFT IFSC facilitates the setup of Finance companies for borrowing, lending, and corporate treasury operations. Within the Finance company framework, one of the permitted activities is corporate treasury, which authorizes set up of units in GIFT IFSC by global players (i.e., entities outside India) and Indian players with global operations.

The key benefits of treasury centers are:

Dealing in foreign currency without applicability of FEMA for transactions undertaken outside India

10-year tax holiday for business income

Interest payments to lenders of financial institutions outside India are exempt from tax

Non-financial services entities can also set up corporate treasury units. Setting up of corporate treasury centers in the GIFT IFSC may create plenty of opportunities for Indian and global MNCs to centralize treasury operations and effectively manage liquidity, along with tax benefits and reduced operational costs, which are added advantage.

Aircraft leasing

India's aviation sector is thriving, leading to higher demand for aircraft. Previously, Indian firms leased from jurisdictions with tax advantages. With favorable regulations and taxes, GIFT IFSC offers a lucrative aircraft leasing opportunity. Presently there are 15+ aircraft leasing entities registered in GIFT IFSC. Basis public information, around 25+ assets such as fixed-wing aircraft, helicopters, engines, and ground support equipment are leased from GIFT IFSC. Air India has set up an entity in GIFT IFSC for leasing aircraft. Considering the boom in market and favorable regime in GIFT IFSC, this may be the right time for aircraft leasing entities to capitalize on this opportunity.

Listing on international exchanges in GIFT IFSC

The Finance Ministry announced for allowing Indian entities to list on international exchanges, including IFSC exchanges. The formal notification is still awaited. Once notified, the unlisted companies including Indian start-ups shall be able to list on IFSC exchanges. Presently, Indian companies have done secondary listing of bonds of over US$52 billion on the IFSC Exchanges. As regulations evolve, IFSC exchanges are ready to be dynamic hubs for capital raising, global investment, and strategic growth across diverse companies.

The Government of India recognizes that in a globalized world, global capital will act as an important driver of economic growth and a strong financial sector would be a key constituent in India's growth story. GIFT IFSC is expected to play a pivotal role in this journey by tapping global capital flows to meet India's development needs and provide a globally competitive financial platform for the full range of international financial services. Recent developments only seek to reinforce the enormous potential and opportunities that GIFT IFSC offers for investors.

Also contributed by

Cheryl Jagtap
Senior Manager, Global Compliance and Reporting

Anvesh Desai
Senior, Indirect Tax, EY India

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