India Tax Insights

Issue 6

October 2015

India on BEPS

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Role of emerging economies

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Bridging the gap between BEPS and GAAR

EY

Building a better working world

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Team

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Welcome

Sudhir Kapadia
National Tax Leader, EY India

We are happy to present the sixth edition of our magazine – *India Tax Insights*.

A rise in activism, media scrutiny and public interest about how businesses pay taxes has galvanized policymakers to action. In February 2013, the Organization for Economic Cooperation and Development (OECD) released its report on Base Erosion and Profit Shifting (BEPS). The report reflected the view that current international tax standards have not have kept pace with changes in global business practices. The report was published shortly after the publication of the BEPS Action Plan. It points out gaps in the interaction of domestic tax rules of various countries, the application of bilateral tax treaties to multijurisdictional arrangements and the rise of the digital economy have led to weaknesses in the international tax system. On 5 October 2015, the OECD released final reports on all 15 focus areas in its Action Plan on BEPS. These reports include recommendations for significant changes in key elements of the international tax architecture. International tax changes stemming from the OECD BEPS project will transform the global tax environment in which MNEs operate. This issue of Tax Insights therefore, focuses on BEPS and what it means for the future of international taxation.

Jeffrey Owens, Senior Tax Policy Advisor to EY and formerly Director of the OECD's Center for Tax Policy and Administration, explains the pivotal role of OECD BEPS project in world taxation and how emerging countries have contributed to this initiative on an equal footing with the developed countries. While there will be follow-up work by the OECD continuing into 2016 and beyond, attention will turn to countries as they decide whether and how to implement OECD recommendations. Chris Sanger, Global Head of Tax Policy at EY, shares his views on what lies ahead for BEPS.

OECD has extensively engaged with the developing countries through the BEPS project. India, as a G20 member country, has contributed significantly to the BEPS initiative. In a candid interview, Mr. Akhilesh Ranjan, Joint Secretary in the Ministry of Finance, Government of India, shares his perspective on the relevance of BEPS for India.

As identified by the BEPS Action Plan, the existing international standards for transfer pricing rules can be misapplied so that they result in outcomes in which the allocation of profits is not aligned with the economic activity that produced the profits. A holistic approach to deal with BEPS also calls for improved transparency. While Rajendra Nayak, Partner, EY India, comments on the impact of BEPS on India's transfer pricing landscape, Vijay Iyer, transfer pricing leader, EY India, comments on how transfer pricing documentation practices will change as a result of BEPS.

Preventing tax treaty abuse is a minimum standard that has been agreed as a result of the BEPS project. In this context, Jayesh Sanghvi, International tax leader, EY India explains the implications of this BEPS action from an Indian perspective. While countries embark on implementing BEPS, a question arises on the interplay of BEPS actions with the impending general anti avoidance rule (GAAR) in the Indian tax law. Will GAAR complement BEPS or will it cause more uncertainty? Pinakin Desai, Partner in EY India's Tax Knowledge & Solutions group, along with James C Wilson, Tax Controversy Leader, EY UK, share their thoughts.

In addition, our regular features, GlobalNews and EconoMeter, present a snapshot of key global tax developments and economic indicators, respectively.

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

In this iss

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Are we ready?

Focus

Even with these differences, the agreed actions represent a considerable step toward alignment of the international tax systems of individual sovereign nations. The success of the project however, will depend on how countries implement these recommendations.

BEPS:
What lies ahead?

Christopher Sanger
Global Head of Tax Policy,
EY

Introduction

The first major challenge of the G20/OECD Project on Base Erosion and Profit Shifting (BEPS) has been met, with the publication of the 15 Action items and the agreement at the G20 Finance Ministers meeting. This was a significant task, bringing together many countries and perspectives in an effort to forge consensus on how businesses should be taxed. That consensus was important in the 1920s when the network of double tax treaties was in its infancy. It is even more essential now, as the extent of global trade has increased to unimaginable levels at that time, driven by advances in technology and communications.

Stumbling blocks and future challenges

This has not been easy and reaching this stage has involved a significant level of compromise. Indeed, the fact that this has been achieved is testament to the impact of combining tax technical firepower with political will. While this was the first challenge, there are many to follow if the objectives are to be realized.

What has been produced so far is a blueprint for change and the outcomes span from minimum standards to reinforced standards and finally to best practices. The impact of each of these will be different, depending on how (or whether) the recommendations of the G20/OECD are implemented. The nature of compromise is that most countries will not have achieved all that they want from this process, but it nevertheless represents the largest example of policy cooperation in a generation.

There are several immediate challenges facing the BEPS process:

- **Risk of disparate implementation worldwide**
  Even with these differences, the agreed actions represent a considerable step toward alignment of the international tax systems of individual sovereign nations. The success of the project however, will depend on how countries implement these recommendations.

> *For businesses, the inability of governments to secure broad consensus on mandatory, binding arbitration is a real disappointment that will inevitably prolong controversy and potentially weaken the case for investment in some countries.*

Strong political leadership will again be required if consensus is to be retained and not diluted by different interpretations of how each Action might be construed. Without clarity and consistency regarding implementation, we are likely to experience further disparities and conflicts between tax systems, which in turn, will increase costs of investment, undermine certainty and potentially damage both businesses and countries.

- **Protracted periods of dispute**

  One of the areas where alignment has been most problematic has been in the systems for resolving numerous tax disputes that are likely to arise, as businesses and countries adjust to both new rules and an expanded volume and transparency of information. For businesses, the inability of governments to secure broad consensus on mandatory, binding arbitration is a real disappointment that will inevitably prolong controversy and potentially weaken the case for investment in some countries.

Businesses want certainty about the taxes they pay; this ability to achieve certainty is ideally required at the time of sanctioning investment, or through established procedures to avoid protracted discussions and cost for many years.

- **Lack of overall coherence**

  Each of the BEPS proposals has been developed in isolation, which is understandable given the aggressive timetable. However, the interaction among the recommendations must be considered, particularly since some of the Actions address similar risks. As important, countries must consider how various recommendations are likely to mesh with their existing rules in these areas. Countries will need to adapt the rules to fit their circumstances, but alignment with the objectives of the BEPS project should be maintained.

Recommendations

Given these three key risks, governments need to play a strong rule to build from the political consensus and there are three things that governments should be asking from the BEPS Project at this juncture:

- Firstly, the G20/OECD should continue to reflect on how these proposals interact and what combination of minimum standards, with best practices, will address particular challenges. While this remains a question for each country, work to demonstrate what combinations are coherent will be helpful in maintaining alignment.
- Secondly, the implementation and administration of the recommended measures is every bit as important as their policy design. Countries will need to ensure that they are deploying the necessary resources in this area. Sharing experiences through the G20 and the OECD's Forum on Tax Administration will help any painful lessons learned by some countries to mean that others can avoid similar adverse experiences.
- Finally, but perhaps most crucially, effective mechanisms for dispute resolution will be more important than ever. Given the failure to deliver on global mandatory binding

arbitration, other forms of dispute resolution will be under further increased pressure. The political consensus should be extended to include monitoring of the level and nature of disputes that arise around the globe, with a focus on countries where there is a clear divergence from the coherence intended by the BEPS Project. This peer-led review should be active and transparent if we are to avoid disputes that lead to an erosion of the BEPS Project's objectives.

Of course, many of the activities now fall directly to the countries themselves. Critical in this will be to maintain the communication and transparency between tax administrators and tax policy makers to make sure that good policy design is not frustrated by poor implementation. This is not an easy task as policy designed in compromise will necessarily fit somewhat awkwardly in practice in many regimes.

Nevertheless, the overall direction of policy at the heart of the G20/OECD process needs to be retained if the system is not to, once again, revert back to different approaches.

How companies should prepare

This all adds up to a very vibrant environment for companies. The outcome of the next stage of the BEPS program will have a global impact. Whether it is the immediate impact of changes in the OECD transfer pricing guidelines, which are inherent in the approach of the tax systems of many countries, or the domestic legislative changes to implement chosen best practices, the tax system is changing and changing in many countries all at the same time.

Keeping track of the changes in each jurisdiction will be a challenge, and it will be particularly tempting to assume that implementation of the same Action in different jurisdictions results in the same outcome. In practice, this is unlikely to be the case and there will at least be timing differences. It will be important for groups to consider how each country's actions are affecting them.

More widely the increased sharing of information between tax administrations increases the likelihood of disputes, as descriptions written for one audience are read by another, potentially after translation by someone unfamiliar with the original facts and circumstances. This is a recipe for increased controversy in areas where this is not warranted and there is a clear benefit to engaging with tax administrations in advance to address any misunderstandings rapidly.

The EY Tax Risk and Controversy Survey 2014 showed that only one third of companies had experienced tax administrators seeking to develop a more open and collaborative relationship, down from more than half. However, with the challenges that BEPS implementation will create, this is precisely the time when such cooperative compliance approaches are needed most.

Conclusion

The real challenge of BEPS is starting now — the delivery of changes in a coherent manner. This is not easy and will take several years, with many pitfalls facing the unwary. Ideally we will see an open approach between governments and taxpayers as both adapt to the new environment. Only through such cooperation can the aspirations of the BEPS policy makers be delivered. The focus on improving dispute resolution mechanisms must continue and the objective of eliminating double taxation must be given renewed emphasis. Increased cost of controversy and increased double taxation are not outcomes that policy makers should accept.

BEPS Project **Journey so far**

February 2013

- OECD delivers its initial Report on Base Erosion and Profit Shifting (BEPS)

July 2013

- OECD delivers its Report on BEPS and identifies 15 Action Points
- Revised Discussion Draft on transfer pricing for Intangibles released (Action 8)
- White paper published on transfer pricing documentation (Action 13)

September 2013

- St. Pertersburg Summit: G20 leader's declaration endorses the BEPS project, making it a joint project between the OECD and G20

January 2014

- Discussion Draft on TP Documentation and Country-by-Country (CbC) Reporting (Action 13)

February 2015

- Guidance on Harmful Tax Practices (Action 5), CbC Reporting (Action 13) and Multilateral Instrument (Action 15)

March 2015

- Discussion Draft on Disclosure of Aggressive Tax Planning (Action 12)

April 2015

- Discussion draft on CFC Rules (Action 3), Data and Analysis (Action 11), transfer pricing (Actions 8-10)

May 2015

- Ad-hoc Group formed to work on Multilateral Instrument to implement BEPS Action recommendations

October 2015

- OECD releases Final reports on all 15 Actions of BEPS Action Plan
- Final reports presented at G20 Finance Ministers' meeting in Lima, Peru on 8 October 2015

Way Forward

November 2015

- BEPS package to be presented to the G20 leaders for their approval at the summit meeting scheduled for 15-16 November in Antalya, Turkey.
- Inaugural meeting of ad-hoc Group for developing multilateral instrument to modify existing treaties

March 2014

- Discussion draft on Treaty abuse (Action 6), Hybrid mismatch agreement (Action 2), Digital economy (Action 1) released

September 2014

- OECD publishes reports/ recommendations on Digital Economy (Action 1), Hybrid Mismatch Arrangements (Action 2), Harmful Tax Practices (Action 5), Treaty Abuse (Action 6), transfer pricing for Intangibles (Action 8), TP Doc and CbC Reporting (Action 13), Multilateral Instrument (Action 15)

October 2014

- OECD issues revised calendar for stakeholder consultation
- OECD releases Discussion Draft on Permanent Establishment (PE) (Action 7)

November 2014

- Brisbane Summit: G20 Leaders endorsed the first 7 of the 15 actions on BEPS, delivered in the context of the G20/OECD BEPS project
- Discussion Draft on Low Value-Adding Services (Action 10) and Follow-Up Work on Treaty Abuse (Action 6) released

December 2014

- Discussion Draft on Profit Splits (Action 10), Commodity Transactions (Action 10), VAT/ GST Guidelines (Action 1), Interest (Action 4), Dispute Resolution (Action 14), Risk, Recharacterization (Actions 8-10) released

February 2016 and rest of 2016

- OECD to develop 2016 "a more inclusive framework to support and monitor the implementation of the BEPS package."
- Further work on certain areas is planned to be completed by 2016 such as, applying the limitations on net interest expense to banks and insurance companies, final versions of the LOB rule and Commentary (post finalization of US model), treaty entitlement of non-collective investment vehicles (non-CIVs) and pension funds, etc

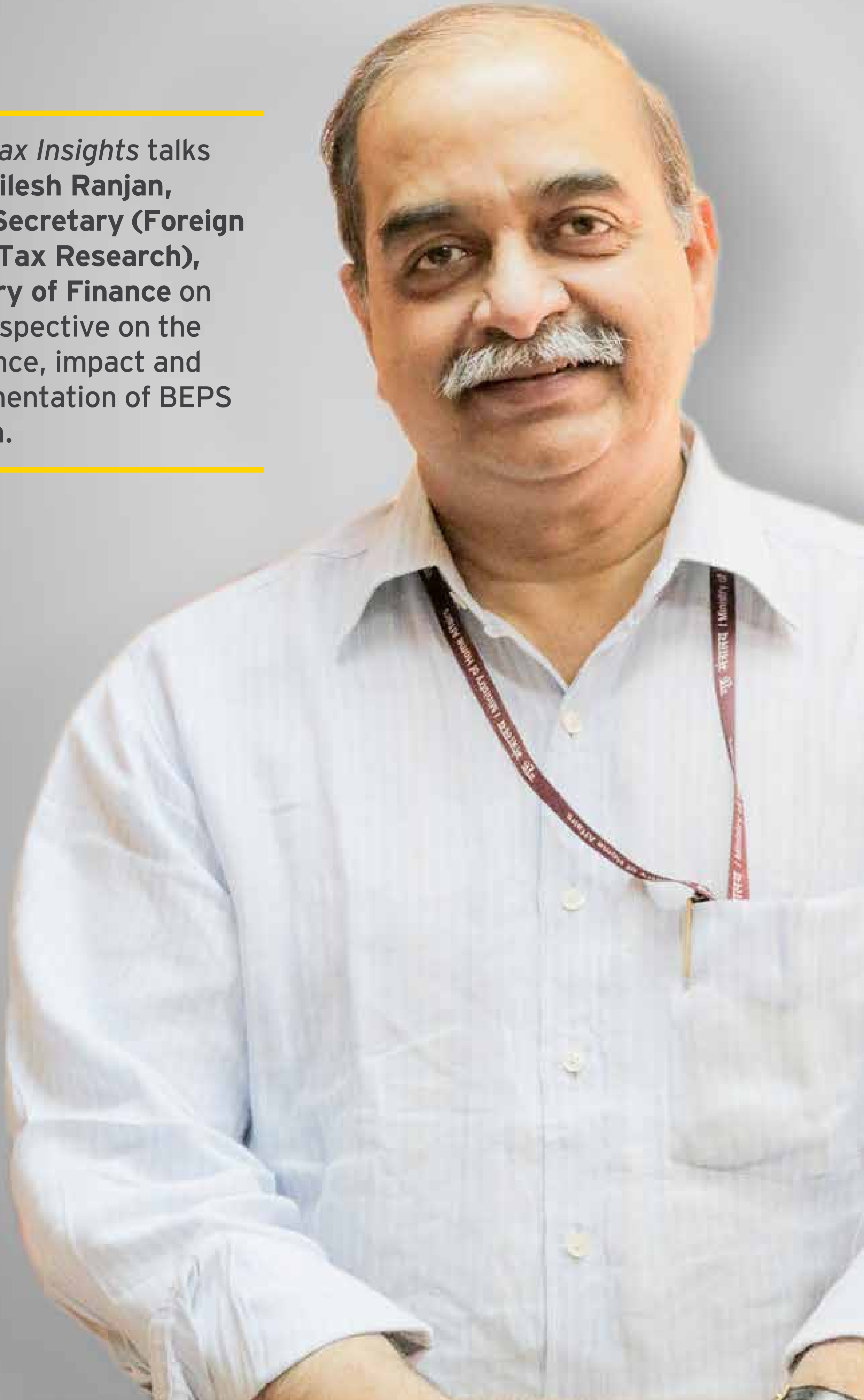
December 2016

- Ad Hoc group to complete its work on Multilateral Instrument such that it can be open for signature by 31 December 2016.

2020

- Supplementary report reflecting the outcome of continued work on the overall taxation of the digital economy to be released

India Tax Insights talks to **Akhilesh Ranjan, Joint Secretary (Foreign Tax & Tax Research), Ministry of Finance** on his perspective on the relevance, impact and implementation of BEPS in India.

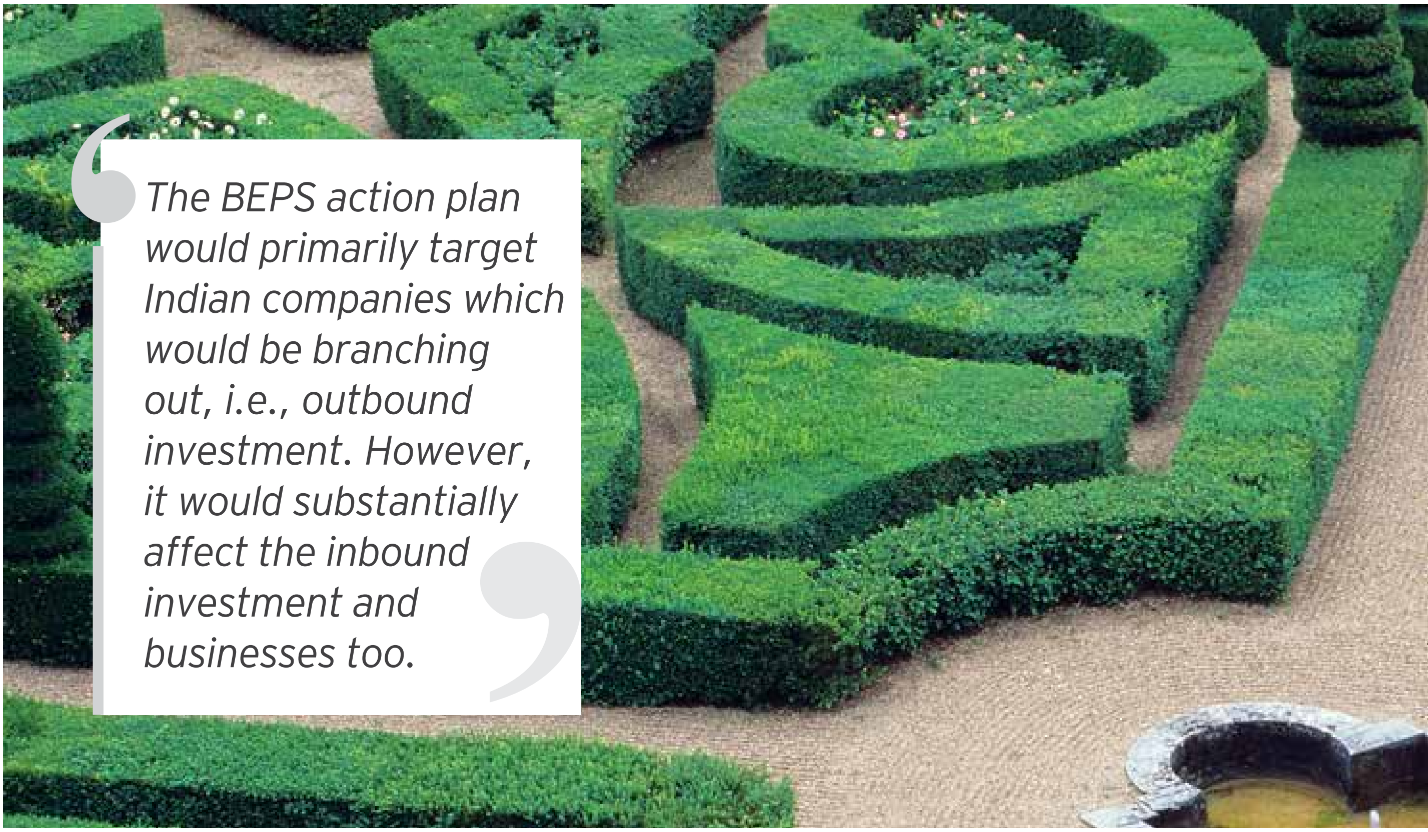


In conversation with Akhilesh Ranjan

Background

The Base Erosion and Profit Shifting (BEPS) project of the OECD- G20 countries has been in the spotlight of the international tax community for two years, since the release of an Action Plan in July 2013. The BEPS project aims to address governments' concerns on the flaws in the current international tax rules that allow the multi-national enterprises (MNEs) to artificially shift profits where they are subject to a more favourable tax treatment. The OECD is developing recommendations for changes in international tax laws, tax treaties and even domestic tax laws to increase transparency and reduce the potential for BEPS activity.

India, too, has been actively participating in the BEPS discussions and will initiate action in line with the final BEPS recommendations. The Ministry of Finance is in the process of formulating its policy response to the BEPS agenda and the next few months will see changes to substantive law, rules and even bilateral tax treaties.



> *The BEPS action plan would primarily target Indian companies which would be branching out, i.e., outbound investment. However, it would substantially affect the inbound investment and businesses too.*

Q

How has India contributed to the BEPS action plan? What are the main obstacles encountered by the Indian tax administration in assessing BEPS?

ANS: Being an emerging economy and part of G20, we have been participating in the BEPS right from the inception stage, when the plan was endorsed by the G20, and from the formulation of the action plans. Our businesses are branching out all over the world and a substantial amount of business is coming to India. So, the issues surrounding BEPS were there on our horizon and we wanted to be a part of any initiative which could tackle the avoidance mechanisms. There are several issues in the BEPS action plan, which are of great interest to us. For instance, anti-abuse provisions in treaties - there are a lot of other ways, besides abuse through certain jurisdictions, in which treaties can be misused to get benefits which are not intended. Similarly, the work related to action plan on transfer pricing (TP) promised to be far reaching and which will change the concepts of TP, especially in the area of valuation of intangibles and allocation of income on the basis of intangibles. So, all the action points are areas of concern for us and therefore the whole project is very relevant for us.

Q

What does the BEPS debate mean for India? Which of the 15 BEPS Actions are most important for India and may have the biggest impact?

ANS: The BEPS action plan would primarily target Indian companies which would be branching out, i.e., outbound investment. However, it would substantially affect the inbound investment and businesses too. Of particular interest to us are issues such as Action7 which covers artificial avoidance of permanent establishment status. We have for long been holding the view, which is also shared by many other countries, that the exemptions called 'preparatory and auxiliary functions' are not to be taken in literal sense. These functions have to be evaluated to see whether they are actually preparatory or auxiliary. A number of attempts to tax PE have not been successful only because of the way in which the clauses are worded in the treaties, giving rise to different interpretations. So, we wanted to make it clear that countries cannot avoid PE by ways such as fragmenting their business into different entities in India. The work on TP, like I said earlier, is of great importance to us. We are facing challenges in this area almost every day. We have always believed in the idea of allocating income not strictly in accordance with the contract wordings or the way in which things are written down, but in accordance with the conduct of the business and how the functions actually interplay.

Q

How does India plan to implement the recommendations of the BEPS action plan?

ANS: As you are aware, there are three types of recommendations in the BEPS reports. There are some minimum standards which countries are committed to follow, and, as India is a part of the BEPS project, we will implement those measures. Some of them are treaty related measures which are proposed to be implemented through a multilateral instrument. This instrument is in the process of being drafted and India is a part of the drafting group. We expect the instrument to be ready by the end of 2016. Once that happens, we are sure that sufficient number of countries will be joining the multilateral instrument and through that mechanism we will be able to implement the treaty recommendations, without having to renegotiate bilaterally with different countries.

There are certain other minimum standards which we are committed to such as dispute resolution. We shall put in place procedures and practices which will enable a speedy resolution of tax disputes through the MAP route. If some legislative or administrative changes or instructions are needed to achieve speedy dispute resolution, such measures will be implemented in a suitable manner.

Presently, we are examining all the action plans to see what is required to be done now (in the next few months) and what needs to be staggered, say, for gathering more information on the action plans where recommendations are just best practices and not common approaches or minimum standards. We will need to take a view whether India really needs to enact a legislation at this point of time or wait for businesses to develop and see if the situation demands that we put in place those mechanisms. So, the process of analysing what needs to be done has already begun and we would be firming up our views very shortly.

Q

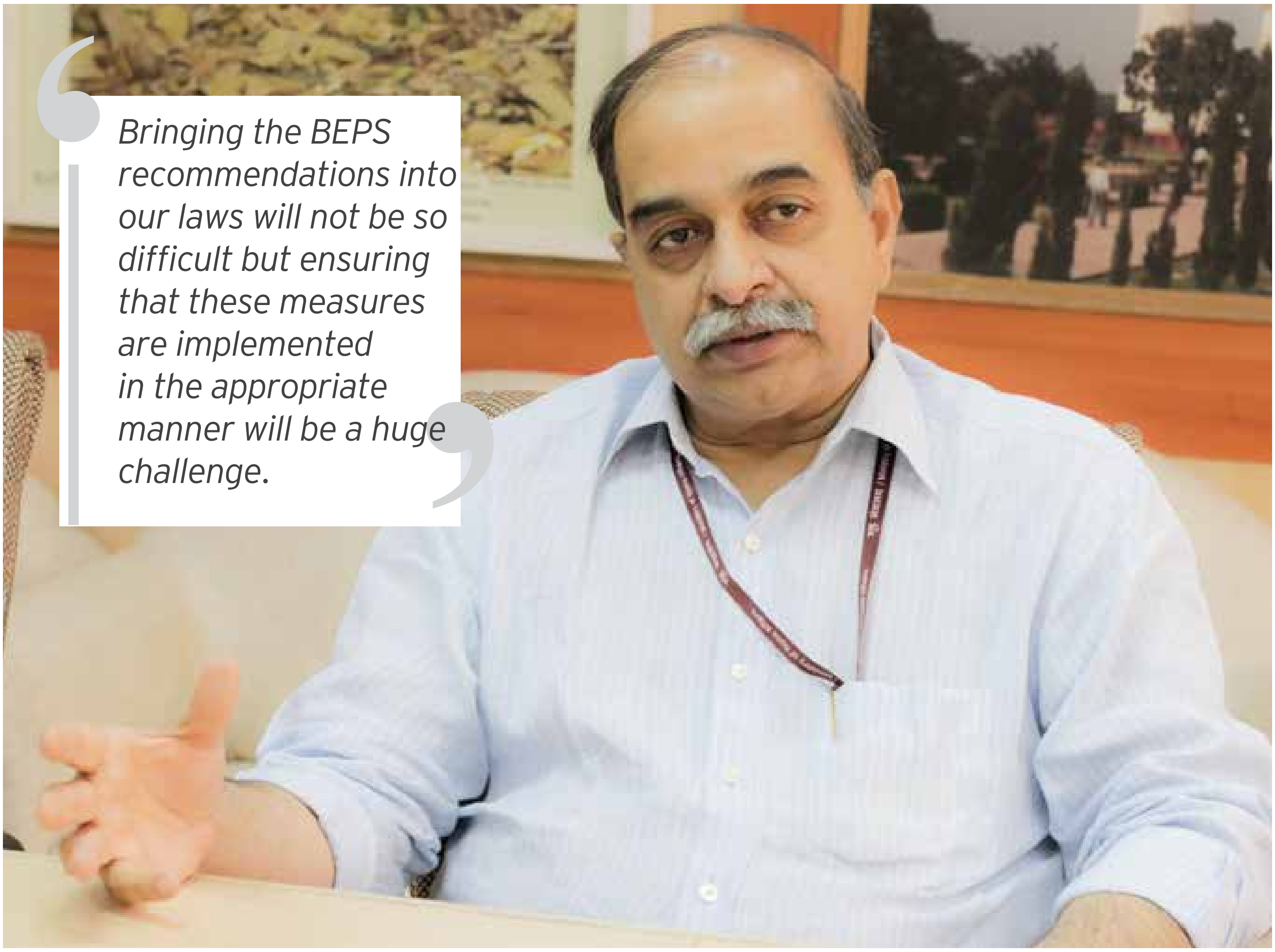
Do you see a shift in the borderlines between source and residence taxation due to the BEPS process?

ANS: The BEPS project is not really about source and residence taxation. In fact, in many places it has been stated categorically that is not an attempt to change the taxation rules in that regard. However, the fundamental principle of BEPS is to tax income in the place where the economic activities are performed and where value is created and this principle does move towards the source concept. So, if the solutions being recommended rely more on the above factors, then we are moving towards a greater reliance on the source taxation principle, which is something India always wanted to have. In the near future, it may not lead to a dramatic change in the taxation rules but certainly, it represents a change in a way of thinking around the world and we are happy with that.

Q

Would you expect India's current treaty renegotiations (e.g. with Mauritius, Cyprus) to take a back seat in light of the proposed Multilateral Instrument?

ANS: I do not think there is any conflict between these multilateral and bilateral arrangements and the bilateral discussions will continue. What ultimately comes through in the multilateral instrument will have precedence as and when the countries join these instruments and it only supplements the bilateral process, so our treaty negotiations with these countries will go on.



> *Bringing the BEPS recommendations into our laws will not be so difficult but ensuring that these measures are implemented in the appropriate manner will be a huge challenge.*

Q

What procedures are being put in place to assure taxpayers that efforts to protect against the grant of treaty benefits in inappropriate circumstances do not create greater hardship for grant of treaty benefits in appropriate circumstances?

ANS: There are three alternatives for preventing unintended treaty benefits - limitation of benefits (LOB), principle purpose test (PPT) and combination of the two. India has supported the combination of the two approaches. We believe that we should first attempt to apply the more objective LOB rule and many arrangements do get caught in these rules. The PPT will be applied only where an arrangement is not getting caught in the LOB rules but still there is a clear evidence of an unintended benefit. If we take this approach of a combined LOB and PPT in the treaties, then there may not be many instances of genuine arrangements being hit by these measures.

Q

Action 6 suggests invoking domestic anti-abuse rules to prevent treaty abuse in certain cases. Does this suggest that, going forward, treaty dispute resolution would have a greater role to play?

ANS: There is a possibility that the number of tax disputes may rise on implementing the BEPS measures. But, as a solace, there will be greater clarity in the articles that will finally come out in the multilateral instruments. They will be less susceptible to different interpretations. Though there is always a possibility of misinterpretation and there will be certain disputes, these will have to be handled through MAP process. But, as long as we are able to come up with rules that are as clear as possible, I think we should be able to tackle this challenge.

Q

The stated objective of the BEPS actions on transfer pricing is to "align taxation with value creation". Is there currently a mismatch between taxation and value creation and if so, in which areas? How do you see this objective affecting transfer pricing enforcement and APA/ MAP negotiations in India?

ANS: The main area where alignment of taxation with value creation will be of great use is transfer pricing. We have been facing challenges because a large amount of investment into India into subsidiary companies is categorised as a mere contract activity with no risk or low risk profile and not anything which should be compensated at more than a normal cost plus or such margin. We have always believed that in many of these cases substantial work was done in India, especially in the field of information technology (IT). India makes a huge contribution in the development of intangibles and in ensuring their proper implementation and exploitation within India and worldwide. It is here that we feel that more income should be allocated towards these functions in India where there is concrete development, enhancement or exploitation of the intangibles.

So, we have been facing a lot of TP challenges because of the concept that all residual income must flow back to the legal owner of the intangible. Now the BEPS reports hold that mere legal ownership of the intangible may not be enough to allocate the entire residual income to that entity. The functions to be carried out will have great importance for the purpose of income allocation. Thus, TP will be one of the major areas where we will benefit. Most of the TP matters deal with service arrangements not just in IT but in also other high-value services. In all these areas where we can show that a substantial value creation has occurred in India, a greater allocation could be justified rather than a mere cost plus normal return which is associated with a typically low risk profile.

Q

The output from the substantive TP related BEPS actions (Actions 8-10) are expected to lead to immediate changes to the OECD TP guidelines. Do you see India formally recognizing the OECD TP guidelines?

ANS: I do not think that is really necessary. The TP guidelines are almost a law as far as the OECD countries are concerned. The guidelines do have a very persuasive influence on all the countries in the world because that is the only major work that is available internationally for TP. Our TP law is also based on the same principles and same methodology and we do draw guidance and substance from the OECD TP guidelines. We do not need to join them but can incorporate those guidelines into our own law and rules in the manner that is best suited for Indian conditions. Considering that the TP guidelines would also undergo a change after BEPS, largely those changes would have to be brought into the Indian TP context.

Q

What is India's view on the need for (controlled foreign company) CFC legislation given that it is not a minimum requirement under the OECD BEPS Action plan?

ANS: Yes, CFC is one of the best practice recommendations. The BEPS report only outlines what CFC legislation should look like. So, we have to take a call on this. CFC provisions were envisaged under Direct Tax Code (DTC) too. While India agrees with the CFC rules in the BEPS report, with so many action plans to be implemented, we will have to tread carefully and see if and when the CFC rules are needed. Moreover, considering the impact the CFC rules could have on outbound investment, we would not wish to carry out any policy changes that would drastically affect Indian companies.

Q

Action 4 lays out different options to limit interest deductibility. Is there any preferred option for India?

ANS: We have supported the fixed ratio based earnings so that a major part of the earnings do not get drained out by interest payments. Of course, at the same time we realise that a large amount of investment in India is in the form of debt. Many companies in need of capital are unable to get equity have to rely on debt. We will examine this recommendation very cautiously before taking a final view on this aspect.

Q

What is India doing towards capacity building in the tax administration for implementing BEPS?

ANS: It is an extremely important aspect and one of the biggest challenges for us. Bringing the BEPS recommendations into our laws will not be so difficult but ensuring that these measures are implemented in the appropriate manner will be a huge challenge. We intend to bring the BEPS reports to the knowledge of all our tax officers in the quickest possible time. We will impress upon them that with the changes in law the administration will have a greater responsibility to gather facts and base their actions on the facts of the case which cannot be disputed and are verifiable. We will be spending major resources in the next year or so towards educating our own officers and seeing that the BEPS measures are appreciated in the right spirit.

We are also aware of the concerns of the industry or businesses and will be engaging with them. I hope they are studying the BEPS reports to understand how they would affect the industry. We want to know how the Indian industry perceives the BEPS action plan. We aim to make implementation of BEPS action plan a participative process and will act only after knowing well how these measures will impact the industry.

Q

With emphasis on transparency, confidentiality of data becomes a concern. What steps are being taken by India to ensure data confidentiality?

ANS: One of the principal themes of the BEPS Reports is transparency. However, the BEPS recommendations also have many in-built safeguards, e.g., the country by country report and transfer pricing is supposed to be transmitted through tax treaty route and not directly through tax administration. These measures would by themselves help in maintaining the confidentiality of this data.

We, in India, have already started serious work on confidentiality and data security. Besides the BEPS project, India is taking a lead in the field of automatic exchange of information. We have also signed FATCA agreement with USA. All these agreements require a strict adherence to the confidentiality and data security. So, we are revamping our own systems. We have e-safe guidelines and have appointed our chief security officers. We are issuing guidelines on how the data safeguard measures are to be taken. So, a lot work is being done domestically in making data safeguard a more important part of the life.

Secondly, internationally there is a peer review process in the context of automatic exchange. The global forum on transparency and information process exchange monitors the implementation of automatic exchange under the Common Reporting Standard (CRS), has set up a peer review mechanism where each country's systems, laws, procedures, guidelines etc are up for international review. India has already offered itself for review and a report on India's system is in progress. So, both nationally and internationally, there are monitoring processes in place, and therefore I can assure Indian industry of data security and transparency.

Q

With India not in favour of mandatory arbitration, what other alternative instruments or mechanism does India suggest for resolving disputes in an effective and timely manner?

ANS: We are opposed to arbitration as we do not think that it is a very good way of solving tax disputes, as tax is a sovereign function. Particularly when we have the MAP mechanism in tax treaties, though we are aware that the MAP resolutions have not really kept pace with the creation of disputes, the effort should be more towards revitalising the MAP process rather than on thinking of any new ideas which are contrary to our principles. In fact, India is amongst the few countries which have been resolving disputes through MAP. We support the minimum standards in the Action14 Report on dispute resolution and fully intend to implement these measures and ensure a very speedy resolution.

Q

Do we envisage major changes in the Indian GAAR provisions? Given that GAAR will be applicable from 1 April 2017, when do you think we can have clarity around GAAR implementation and the detailed rules for the purpose?

ANS: In the last Budget, the Finance Minister had said that the only reason to defer GAAR for another year is that it can be brought along with the implementation of BEPS outcomes. It may not be necessary to bring any change in the GAAR provisions. Even the BEPS reports do not cite anything against the GAAR provisions in the Indian law. In fact, the BEPS recommendations go further, as the Action 6 talks about GAAR as one of the main purposes. So, already the international thinking or rules are more in favour of generalised anti-tax avoidance rules. The BEPS outcomes will complement the domestic GAAR legislation.

Personally, I do not see any change in GAAR or the date of its implementation.

Q

Would existing structures be grandfathered or, alternatively, time be provided for Indian MNEs to restructure their operations once India firms up its view on how it would implement the BEPS recommendations?

ANS: The implementation timeline for the BEPS measures, once we put them into law, will depend on the specifics of the action /measure. In many of the BEPS reports the time limits are inherent. For example, in the country-by-country reporting although the information should be furnished for FY 2016-17 for us, there will be time for enterprises to report by March 2018. We understand the industry concerns and that they may require sometime. We need industry's feedback here and their views will certainly be kept in mind while deciding the date of applicability of these measures.

BEPS establishes the importance of emerging economies in the new world tax order

Jeffrey Owens
Senior Tax Policy Advisor to the Global Vice Chair of Tax, EY

"The BEPS project has reinforced the reach of the OECD and has shown that it is able and willing to give a real role to big emerging economies such as India."

For more than fifty years, the OECD had a monopoly of setting international tax rules. Its Model Convention, transfer pricing Guidelines and best practices influenced not only what OECD countries did but also the approach of non-OECD countries. However, with the emergence of the BRICS and other economies in transition, the OECD recognized in the 1990s that it must reach out to non OECD economies. This process began by bringing in the BRICS countries (with the exception of Brazil) as observers into the OECD and the development an outreach program .These developments were given a new political momentum when the G20 gave the OECD a mandate to deal with bank secrecy and tax havens and in 2009 endorsed the creation of the global forum on tax transparency, which today includes more than 120 jurisdictions. The BEPS project has reinforced the reach of the Organisation and has shown that it is able and willing to give a real role to big emerging economies such as India.

The BEPS project was launched in 2013 with an ambitious 15 point action plan and a two-year deadline. Few thought that the OECD will be able to meet this timetable and that it will be able to carry all the G20 with its recommendations. Criticism came from various sources. The NGOs felt that the OECD was the wrong organization to take on this issue, since it was not inclusive enough, preferring the UN tax committee. Business was concerned that the agenda was far too wide, that there was a lack of balance between the need to avoid double taxation and double non taxation and that not enough attention was paid to the compliance burdens that may be placed on them and on how to achieve a consistent implementation of any new rules. It was initially unclear whether all OECD countries will be prepared to sign up to new rules and there was — and remains — tension between predominately source countries and resident countries (although the broad issue of source versus residence was quickly taken off the agenda).

This was the environment in which the OECD needed to deliver its recommendations to the G20 and in carrying out this mandate it needs to be congratulated, both on meeting its commitment toward the G20 and the quality of the technical work it has undertaken within very tight timelines. Achieving a broad consensus on the process between OECD countries and participating non-OECD countries is no mean achievement.

> The ease and attractiveness of using low tax jurisdictions - what the OECD in 2009 referred to as tax havens - is significantly reduced and we can expect that in some ways these will be the biggest losers from BEPS.

With all the actions now on the table it is also easier to see how they are mutually supportive – this is the advantage of the package approach and a top down-driven project.

The OECD has also been pragmatic in accepting that since different countries start from different positions it was unrealistic to expect a "one size fits all" approach. This is why most of the recommendations provide options or identify best practice or minimum standards rather than being over prescriptive. However, this is likely to give rise to more cross-border disputes but one has to recognize political realities when trying to get a consensus among such a diverse group of countries.

Perhaps the biggest disappointment is that apart from the proposal for a monitoring of MAP practice (most of the detailed changes proposed to MAP are already in the MEMAP) little progress is made on the issue of arbitration. Again not surprising, in so far as the OECD stayed within the existing institutional framework for arbitration and many developing countries, including India, were wary of their experience with mandatory arbitration under bilateral investment agreements. The "coalition of the willing" is fine; but we need the "unwilling" at the table. Here there may be a role for the UN Tax Committee to explore alternative approaches to mandatory dispute resolution mechanisms, recognizing that it took five years to convince major OECD countries such as the UK and the US that mandatory arbitration could work in favor of the tax administration. Similarly, we need to be patient with non-OECD countries and design a process, which they consider to be fair, unbiased, timely and not too expensive.

Throughout the last two years, the OECD has done a good job in reaching out to non-OECD beyond the G20. While developing countries are not at the center of the decision-making process, at least they had an opportunity to put forward their views, although in some case these were ignored (e.g., the high threshold on the country-by-country reporting).

What some commentators have ignored is that the main aim of the BEPS project is to change behavior, both on the part of governments and MNEs. This project has been a resounding success. Even before the release of the reports, MNEs have began to reassess their approach to tax planning and some governments such as Ireland, Luxembourg and the Netherlands have reviewed the rules, which permit MNEs to use them to shift profits into low tax jurisdictions. These behavioral affects are far more important than the detailed rules coming out of BEPS.

Moreover, the ease and attractiveness of using low tax jurisdictions – what the OECD in 2009 referred to as tax havens – is significantly reduced and we can expect that in some ways these will be the biggest losers from BEPS .

As regards tax competition one of the unanticipated outcomes of BEPS will be that tax competition for "real" activities will become increasingly fierce. Countries will be forced to further reduce their corporate tax rates. The race to the bottom will intensify and the winners will be countries such as the UK, the Netherlands, Switzerland, Singapore and Ireland, which are able to attract not just the tax base but the underlying activities. So long as a regime is able to align value creation with the tax base and is transparent and subject to exchange of information, then anything goes! In this context it will be interesting to see what progress is made on the issue of tax incentives and whether the G20, or more likely regional groupings such as ASEAN, can make progress in setting a framework, which promotes increased transparency and accountability of incentives.

Looking forward it is clear that there remains much to be done, both in working out some of the technical details, but more importantly in putting forward an effective and robust peer review process and one that gives a role to business. Therefore, I see this as another step in the long road to establish international tax arrangements, which are robust, consistently applied, and which get the right balance between protecting the tax base and stimulating investment .

A bigger question is whether the OECD can maintain the engagement of the BRICS and other large emerging economies so that it continues to be the main rule setting body in the tax world? As these countries become both capital exporters and capital importers so there should be a gradual convergence of interest, with countries such as China having to consider not only how their tax systems affects FDI but also how it affects the competitiveness of Chinese MNEs operating abroad. Moreover, as their MNES face cross-border tax disputes and double taxation, we may see an alignment of interests in having more effective dispute settlement mechanisms.

If this alignment of interests does take place, it will raise the question of where do real developing countries take their tax issues and how can their voice be heard. Clearly the answer should be to reinforce the UN Tax Committee, providing it with more resource, broadening its mandate so that it covers a wide range of issues and changing the composition of the group so that it includes officials with a broad-based experience. In this post-BEPS environment, with a real risk that the OECD plus group will dominate the international tax debate, the OECD countries need to review their traditional reluctance to seeing the UN as a countervailing force. To conclude, the OECD will continue to dominate the international tax debate but hopefully with the UN as a more effective counterweight.

India's major concerns in the BEPS arena are identified as excess payments for interest, service charges, management and technical fees and royalties, which end up causing base erosion due to supernormal deductions.

BEPS
Preventing tax treaty abuse

Jayesh Sanghvi
Partner & National Leader
International Tax Services, EY India

"Treaty abuse is one of the most important sources of BEPS concerns" – this statement in the Action Plan on base erosion and profit shifting (BEPS) emphasizes its importance. The multilateral instrument being negotiated[1] to amend bilateral tax treaties under Action 15 has also identified focus on other BEPS actions including avoidance of Permanent Establishment (PE), hybrid mismatches and dispute resolution. This focused call to action reiterates the importance of treaty related concerns on BEPS. Action 6 on "Preventing the Granting of Treaty Benefits in Inappropriate Circumstances" takes center stage on treaty concerns on BEPS and recommendations given in the final OECD report will pave the way forward for curbing treaty abuse.

India's major concerns[2] in the BEPS arena are identified as excess payments for interest, service charges, management and technical fees and royalties, which end up causing base erosion due to supernormal deductions. Furthermore, higher threshold for PEs, including that in the digital economy, results in avoidance of PE status and leads to elimination of source taxation, affecting capital importers such as India. Therefore, the OECD's reports, touching on preventing treaty abuse, find significant resonance with the Indian tax policy agenda.

OECD recommendations

While the report of the OECD on Action 6 covers various aspects, the core of the proposal is the amendment of the OECD Model Tax Convention and the commentary to include specific and general anti-abuse rule in the form of a limitation-on-benefits (LOB) rule and the principal purpose test (PPT), respectively.

The LOB are objective rule-based conditions that seek to secure a "sufficient link" between the enterprise and the state of its residence, depending on the legal nature, ownership and general activities of the entity. This helps in establishing the eligibility for treaty benefits based on the *bona fide* of the taxpayer and the transaction.

The PPT is in the nature of a more general anti-abuse rule based on the principal purpose of the transaction or arrangement.

The report acknowledges the relative strengths and weaknesses of both the LOB and PPT rule as well as the fact that the state of domestic law, judge made law, administrative capacity and treaty policy of each country may necessitate a more flexible approach to adoption of both or either, with or without modifications.

1. OECD Focus Group tasked with developing a Multilateral Instrument as envisaged under Action 15 by December 2016
2. Indian Revenue response to the UN questionnaire on country experience regarding BEPS issues

An Indian response has to be a fine balance between preventing tax avoidance and promoting tax certainty while safeguarding tax competitiveness. If India has to adopt certain subjective measures such as GAAR and PPT rules to deny treaty benefits, the same should be done only after taking stock of its administrative capacity to issue detailed guidelines, exemplifying common situations and also available to issue private rulings, at the speed of business.

Although allowing flexibility, the OECD does extract a "minimum standard" commitment and this is significant. This commitment requires all countries to introduce an express statement of intention in the treaties to the effect that the objective of the treaty is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation. This intent needs to be imbibed in the treaties via the following options:

i. A combined approach with both the LOB and PPT rule; or
ii. Only the PPT rule; or
iii. LOB supplemented by anti-conduit financing rules

Historically, the US has the most experience in the use of LOB to prevent treaty shopping, whereas anti-abuse provisions in the OECD model were initially known only in the form of "beneficial owner" concept. A comprehensive LOB based on 1996 US model and UK-based PPT model was introduced in the OECD model commentary only in 2003.

The proposal to introduce the LOB in the body of the model treaty now will give it much more prominence and likely more widespread adoption. Various aspects of the LOB include, similar to the US model, a qualified person test, active business test, equivalent/derivative benefits test and discretionary relief provision. Detailed commentary has been introduced for each clause, with suggestions for customization/modification as the situation may justify. Relevant to note in the Indian context is that the activity to make or manage investments is not to be considered "active business", which is one of the exceptions to application of the LOB. The commentary also clarifies that companies functioning solely as a headquarter company would also not qualify the "active business" test. The "active business" test applied in the context of holding or headquarter company "resident" in treaty countries providing source country capital gains exemption on share transfers will squarely come under doubt, requiring remediation. The "active business" test also rests significantly on the principle of "complementarity" and "substantiality" as regards the business conducted in the resident vis-à-vis the source states. These are likely to act as significant deterrents to attempts at "de minimis" activities with intent of qualifying the "active business" tests.

Although we have mentioned the experience of US in LOB treaty clauses, the US LOB has come to be extremely complex, with a significant number of exceptions introduced, making its underlying objectives and policies uncertain. The US has thus released a new draft of the LOB for its model. OECD's recommendation under Action 6 with regard to LOB is thus *ad interim* and will be finalized consistent with the final US recommendations, expected early 2016.

The UK style PPT rule is proposed in the recommendations to operate "notwithstanding the other provisions of the convention". Therefore, PPT may be applied to deny treaty benefits even if all of the objective LOB tests are met. The interplay of the LOB and the PPT rule are likely to create a degree of uncertainty, as is prone in the application of subjective tests. The success of a subjective test, in striking a right balance between restricting and permitting, resides in the administrative capacity of the Revenue in issuing clarifications, guidance and private rulings with speed and clarity.

India's stance

India's domestic legislative responses to treaty shopping in recent times include the requirements of a tax residency certificate, prescribed self-certified information filing, reporting requirement for foreign payments and the presence of a general anti avoidance rules (GAAR) in the rule book slated to be effective shortly. Almost all of India's bilateral treaties (probably the solitary exception being the Indo-Russia treaty) include a preamble and a title akin to the OECD's recommendations on prevention of fiscal evasion. India has adopted anti-abuse provisions in its treaties in more recent times. Nearly 40 Indian treaties contain anti-abuse provisions in the form of a LOB article, with varied application of the US-styled LOB rule and UK-styled PPT rule.

However, Indian judicial thinking in the matter of treaty shopping, barring a few exceptions, has been consistent that the rule of law has to prevail and unless addressed through renegotiation or anti-abuse provisions, the benefits cannot be limited.

Concluding thoughts

While there is a call for consistency in action as countries adopt recommended measures, the initial set of actions will be driven by individual countries' political expediency and commitments. India should actively participate in the development of the multilateral instrument and also wait for the final recommendations of the revised US LOB draft. India's response to treaty abuse has to squarely address situations of conflict and overlap such as the interplay of domestic GAAR and the PPT rule in the treaty, interplay of the objective LOB with the PPT rule, grandfathering or remediation options, commitments under economic cooperation agreements, among other considerations.

An Indian response has to be a fine balance between preventing tax avoidance and promoting tax certainty while safeguarding tax competitiveness. If India has to adopt certain subjective measures such as GAAR and PPT rules to deny treaty benefits, the same should be done only after taking stock of its administrative capacity to issue detailed guidelines, exemplifying common situations and also available to issue private rulings, at the speed of business.

BEPS and the shifting sands of transfer pricing

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Background

Over several decades and in step with the globalization of the economy, world-wide intra-group trade has grown exponentially. Transfer pricing rules, which are used for tax purposes, are concerned with determining the conditions, including the price, for transactions within a multi-national enterprise (MNE) group resulting in the allocation of profits to group companies in different countries. The impact of these rules has become more significant for business and tax administrations with growth in the volume and value of intra-group trade. As the Action Plan on Base Erosion and Profit Shifting (BEPS Action Plan, OECD, 2013) identified, the existing international standards for transfer pricing rules can be misapplied so that they result in outcomes in which the allocation of profits is not aligned with the economic activity that produced profits. The work under Actions 8-10 of the BEPS Action Plan has targeted this issue, to ensure that transfer pricing outcomes are aligned to value creation.

OECD's revised guidance

BEPS Actions 8–10 has resulted in revised OECD guidance on the arm's length principle to ensure the following:

- Actual business transactions undertaken by associated enterprises (AEs) are identified, and transfer pricing is not based on contractual arrangements that do not reflect economic reality
- Contractual allocations of risk are respected only when they are supported by actual decision-making
- Capital without functionality will generate no more than a risk-free return
- AEs performing important value-creating functions related to the development, enhancement, maintenance, protection and exploitation (DEMPE) of the intangibles can expect appropriate remuneration
- AE assuming risk related to the DEMPE of the intangibles must exercise control over the risks and have the financial capacity to assume risks
- Clarity on transfer pricing treatment of synergies, location-savings and assembled workforce

The above changes make a key contribution to aligning transfer pricing outcomes with the value creating activities performed by the members of an MNE group.

Key role of functional substance

In identifying arm's length prices for transactions among AEs, the contributions of members of the group related to the creation of intangible value should be considered and appropriately rewarded. It is therefore necessary to determine, by means of a functional analysis, which member perform and exercise control over DEMPE functions.

Transfer pricing issues relating to provision of R&D services has created significant controversy in India. Generally, the Indian affiliates providing services operate as "contract service providers" where the assumption is that the services provided are routine and the Indian entity does not bear significant risks. As a result, the Indian affiliate is typically remunerated using traditional TP approaches such as a mark-up on total costs and the foreign AE is entitled to the intangible-related returns.

It may be recalled that the Indian Tax Administration has issued Circular 6/ 2013 to provide guidance on classification of development centers for transfer pricing purposes. The Circular provides that for an intra-group R&D arrangement to be regarded as provision of contract R&D services with insignificant risks the foreign principal needs to perform and control economically significant functions and bear and control risks

> *A possible impact of the OECD guidance arises in a case where there is a separation between functions that contribute to value creation and the functions that exploit the value drivers. In such cases groups may need to tear apart the contributions of each entity in order to support the transfer pricing model.*

and R&D costs. The Circular further states that the satisfaction of these conditions will be determined primarily by analyzing whether the conduct of the parties is consistent with the purported contractual allocation of risks. The Circular is largely consistent with the principles outlined in the OECD's guidance on performance of DEMPE functions, control over risks and actual conduct.

R&D activity can involve highly skilled personnel and vary considerably both in its nature and in its importance to the success of the group. The actual arrangements can take a variety of forms from the undertaking of detailed programs laid down by the principal, extending to agreements where the research company has discretion to work within broadly defined categories. In the latter instance, the additional functions of identifying commercially valuable areas and assessing the risk of unsuccessful research can be a critical factor in the performance of the group as a whole. Applying the OECD guidance (as well as the Circular) requires a detailed functional analysis and obtaining a clear understanding of the precise nature of the research, and of how the activities are being carried out by the company. It is also interesting to note that in the revised OECD guidance does not conclude that a cost-plus method may always be appropriate for such activities (as is indicated in the current OECD Guidelines). Instead, the OECD suggests the need for a

detailed functional analysis prior to determining the appropriate transfer pricing methodology, including the consideration of options realistically available to parties.

A possible impact of the OECD guidance arises in a case where there is a separation between functions that contribute to value creation and the functions that exploit the value drivers. In such cases groups may need to tear apart the contributions of each entity in order to support the transfer pricing model. In a centralized operating model, where there is a residual profit taker in the supply chain, with other entities receiving only routine rewards under the transfer pricing model, groups will need to demonstrate that effectively all the important functions involved in managing risk and associated with asset ownership are performed by the residual profit taker. Otherwise, the new OECD principles are likely to push MNEs away from cost-plus type routine returns and toward increased sharing of the residual profit.

Location savings

Features of the geographic market in which business operations occur can affect comparability and arm's length prices. Such issues may arise in connection with the consideration of cost savings attributable to operating in a particular market. Such savings are referred to as location savings. According to the OECD guidance, where the functional analysis shows where comparable entities and transactions in the local market can be identified, those local market comparables will provide the most reliable indication regarding how the net location savings should be allocated among two or more AEs.

While there is no formal articulation on the position of the Indian tax administration on location savings, India has provided its comments on several emerging transfer pricing issues, including on location savings, in the UN Transfer Pricing Manual. India is of the view that price determined on the basis of local comparables does not adequately allocate location savings and it is possible to use profit-split method to determine arm's length allocation

of location savings where comparable uncontrolled transactions are not available.

India's comments outlined in the UN Manual does not appear to be fully aligned with the OECD guidance on the impact of local comparables on allocation of location savings and reflects the tension that often dominates transfer pricing issues between developing countries and developed countries.

Assembled workforce

Some businesses are successful in assembling a uniquely qualified or experienced cadre of employees. The existence of such an employee group may affect the arm's length price for services provided by the employee group. While the Indian transfer pricing law includes "trained and organized workforce" in the definition of "intangible," the OECD guidance considers it as a factor that should ordinarily be taken into account in a transfer pricing comparability analysis. Regardless of this difference, where the benefits of a unique assembled workforce vis-à-vis the workforce of enterprises engaging in potentially comparable transactions are similar, the need for comparability adjustments may not arise.

It should, however, be noted that access to an assembled workforce may, in some circumstances, impact transfer pricing, even where the employees making up the workforce are not transferred. Such a situation may arise, for instance, in an acquisition where the price paid may include the value of technology intangibles as well as the value of the R&D function. If in a post-acquisition restructuring the target entity functions as a R&D service provider, the entity in such a case may be entitled to compensation for such value, either as part of the price paid for the transferred technology intangibles, or through the compensation paid in years following the restructuring of R&D services of its workforce. It should generally be assumed that value does not disappear, nor is it destroyed, as part of an internal business restructuring.

MNE groups will need to evaluate whether their existing transfer pricing policy is aligned with the broad definition of intangibles and the guidance on allocation of intangible-related returns within a MNE group.

Concluding thoughts

In light of the BEPS actions on transfer pricing, MNE groups will need to further substantiate the activities conducted and value created by the group entities in various countries to support their transfer pricing. A more thorough functional analysis may be needed to reflect the "control over risks" framework, regarding the managerial or operational control exercised over risks. It is of critical importance to identify the functional ownership of risks and intangibles, besides the legal ownership thereof. Transfer pricing policies merely based on contractual arrangements and legal ownership will need review. MNE groups will need to evaluate whether their existing transfer pricing policy is aligned with the broad definition of intangibles and the guidance on allocation of intangible-related returns within a MNE group. Furthermore, they should establish whether their policy correctly reflects comparability factors such as location savings, market-specific characteristics and synergies.

Why are the BEPS recommendations important?

The output from the BEPS project is largely in the form of recommendations for the design of countries' domestic laws, as well as proposed changes to tax treaties. Broadly, the OECD's recommendations include changes that would:

- Limit interest deductions
- Eliminate the benefits of hybrid financing arrangements
- Lower the permanent establishment standards for taxable presence in a country
- Place new restrictions on access to benefits of tax treaties
- Create new transfer pricing rules for intangible property
- Recharacterize taxpayers' transactions through new approaches to transfer pricing
- Require more robust transfer pricing documentation
- Require new country-by-country reporting

Long-term, as a result of the global focus on BEPS, MNCs can expect to face:

- Increased reporting obligations
- More scrutiny of intangible property ownership and financing structures
- A greater focus on the substance of a transaction and its alignment with the business
- Increased complexity in transfer pricing
- Further limitations on access to treaty benefits
- More (and more complex) controversy
- A need for more proactive engagement with tax authorities to gain certainty and avoid or resolve disputes

How should companies prepare?

Some specific steps companies can take to respond to BEPS-related developments include:

- Build consideration of potential BEPS impacts into current tax planning
- Re-examine supply chains
- Analyze current and future financing arrangements
- Consider APAs and other early engagement with tax authorities
- Share updates on the changing global tax environment frequently with management, the audit committee and other affected stakeholders

The international tax changes stemming from the OECD BEPS project will transform the global tax environment in which MNCs operate. Businesses that do not attempt to anticipate the impact of these changes may struggle to adapt to new approaches and comply with new rules. Now is the time to evaluate the potential BEPS pressure points for your business and develop plans for ensuring that your business models and structures are aligned with the new global tax mindset.

"BEPS is a laudable initiative by OECD aimed at increasing transparency and ensuring that MNEs pay their fair share of taxes in the countries where they operate. It will bring about a paradigm shift in the way tax planning is understood currently.

In the long run this project is expected to bring about a consistency in tax rules amongst the participating nations in the areas of transfer pricing, CFC regulations, PE, tax treaty abuse, dispute resolution etc. However, in the short term this also has the potential of causing confusion and increasing disputes on account of deluge of information shared under automatic exchange of information on CbCR, rulings etc. How the various tax jurisdictions handle this aspect remains to be seen. MNE's will have to invest significantly in people and technology to ensure that they stay on top of the onerous reporting requirements envisaged under BEPS action plans."

Vikas Aggarwal, Head of Region Taxes, Nokia.

"One must appreciate the backdrop in which the BEPS project was initiated. Economies of most developed countries were strained and were in the brink of kissing recession even while the pressure on social spending continued.

BEPS thus aimed at bringing about certain level of transparency in tax compliance and reporting so that each country can get its fair share of taxes. While the objective of the project itself is laudable, the caution from the industry is always on the reasonable and responsible implementation of the tax policy around BEPS. Indian tax administration is prone to certain level of adventurism in applying international principles in the past few decades. From double non taxation, it should not lead to multiple taxation model thus burdening the already ailing industry at large. From erosion of tax base, country must not be forced into erosion of investment base itself thus endangering economic activity, growth and development.

More elaborate guidance and uniformity in application of tax policies coupled with robust alternate dispute resolution mechanisms would make the tax compliance experience less burdensome thus improving ease of doing business in India. With mature, reasonable and responsible tax administration, industry would welcome and cooperate with the administration on any number of international projects around tax reforms."

Bala Subramanian, Global Head – Tax, Wipro Ltd

"The estimate of BEPS as 4 to 10% of global corporate tax revenue is not as large as thought to be. Changing tax laws globally and digressing from the fundamental principles of taxation including transfer pricing based on some perceptions instead of sound analytical studies may not be a good policy. Further, the perceived BEPS risks may not be wide spread and may be confined to some large MNEs only after introduction of GAAR and substance over form principles in many jurisdictions. Moreover, it is an ambitious project to make a large number of countries to agree on a universal broad framework.

While certain MNEs might have resorted to aggressive tax planning, at the same time many MNEs face problems of double or multiple taxation, uncertainty in tax laws, increased compliance burden and adversarial tax regime, which also need to be addressed. Strengthening of alternate dispute resolution mechanism is a good measure.

There is a need to have balanced approach whereby all nations adopt a clear and definite tax policy, low tax rates without excessive deductions and exemptions, adopt international best practices and have effective co-ordination amongst all including an automatic common reporting system. More certainty and transparency in tax systems would lead to more economic activity resulting in increased tax revenue."

Sunil Gupta, Direct Tax Consultant

The effects of BEPS on Transfer Pricing documentation

Vijay Iyer
Partner & National Leader
Transfer Pricing, EY India

On 5 October, the OECD issued the Final Reports on the 15 Action points announced under Base Erosion and Profit Shifting (BEPS) Project. The final deliverables of BEPS Project by OECD provides governments with much needed ammunition to close the gaps in the existing international rules that allow corporate profits to "disappear" or be artificially shifted to low/no tax environments, where little or no economic activity takes place and rules that could lead to "fair" share of tax for each tax jurisdiction where multinational enterprise (MNE) operates.

This holistic approach to tackling BEPS behavior is supported by transparency requirements agreed under Action 13. In a major step toward improved transparency on MNE operations, the requirements for transfer pricing (TP) documentation have been substantially revised (Action 13). MNEs will be required to submit information regarding their global business operations and TP policies in a "Master File," as well as more detailed information regarding relevant related party transactions and the amounts involved in such operations in a "Local File." Country-by-country reporting (CbCR) will provide a clear overview of where profits, sales, employees and assets are located and where taxes are paid and accrued. Guidance and tools to ensure a swift and consistent implementation of CbCR across countries have been developed, to ensure the widest possible dissemination of information among tax administrations, while respecting agreed safeguards on confidentiality, appropriate use and consistency.

TP analysis depends on access to relevant information. The access to the TP documentation provided by Action 13 will enable the TP guidance to be applied in practice, based on the relevant information on global and local operations in the master file and local file. In addition, the CbCR will enable better risk assessment practices by providing information about the global allocation of the MNE group's revenues, profits, taxes, and economic activity. CbCR is a "minimum standard" that has been agreed upon by participating countries and reflects a commitment to implement the common template for CbCR in a consistent manner.

Taken together, these three documents (CbCR, master file and local file) makes it easier for tax administrations to identify whether MNEs have engaged in TP and other practices that have the effect of artificially shifting substantial profits into tax-advantaged environments. The reporting guidelines also contain three Model Competent Authority Agreements to facilitate the exchange of CbCR among tax administration. These are based on the Multilateral Convention on Administrative Assistance in Tax Matters, bilateral tax conventions and Tax Information Exchange Agreements (TIEAs).

Implementation of Action 13 on TP documentation

Several countries have already discussed, adopted or amended local TP documentation requirements, and some of them have introduced the master file/local file approach. With regard to CbCR, some countries have either implemented or implementation is in progress. However, several countries are expected to implement CbCR as it represents a "minimum standard" of BEPS.

It may be noted that in September 2015, China issued consultation draft to update TP rules in a post-BEPS environment. The draft will replace the main body of rules governing TP in China. The consultation draft seeks to implement Action 13's three-fold approach to documentation, comprising the master file, the local file and the CbCR. The consultation draft will also require companies to prepare so-called Special Files for intra-group services, cost sharing arrangements and thin capitalization.

The three-tier disclosure requirement recommended by OECD significantly enhances the information required to be disclosed by MNEs vis-à-vis current disclosure requirements.

Given the enforcement environment in India, the master file/local file may still be called for by tax authorities, as necessary or relevant, for the determination of the arm's length price (ALP) of the international transactions of taxpayer during the course of TP audits. According to the OECD guidance, the master file and local file are to be delivered to the local tax administration, while the CbCR may be shared only through government-to-government exchanges.

Possible approach for India

There are material gaps between OECD's prescribed TP documentation under the master file/local file approach, as compared to what is currently prescribed in Rule 10D of the Income-tax Rules, 1962 (the Rules). Some of the significant gaps (i.e., information required according to master file/ local file but not according to Rule 10D) are as follows:

1. **Master file:** Global organization structure, key profit drivers, description of main geographic markets, global supply chain, business changes, IP strategy, listing of IP, TP policy regarding IP, group financing policies and TP relating to the same, unilateral APAs and tax rulings
2. **Local file:** Detailed business strategy, competitors, inter-company agreements, reasons for performing multi-year analysis, APAs and tax rulings

Since the BEPS package on Action 13 requires master file/local file to be delivered directly to the local tax administration, Indian TP documentation rules is likely to require amendments to enable the Indian tax administration to request taxpayers to file documentation in accordance with the master file/local file.

It is recommended that the Indian tax administration follow the OECD's model legislation and guidance (to the extent relevant) while implementing CbCR. The key features of the OECD guidance are:

1. As a general rule, CbCR will need to be filed by the ultimate parent of a MNE group with the tax administration of the jurisdiction where the ultimate parent is based. There may, however, be exceptions to this general rule in certain circumstances, which the OECD recognizes.
2. CbCR should be a separate template and not part of TPD.
3. CbCR sharing should be only through government-to-government exchanges.
4. CbCR to apply where consolidated turnover of MNE group is > €750 million (approx. INR5,500 crores).
5. The template should be in accordance with that prescribed by OECD without any country-specific modifications.

One may expect that with substantial information available at the disposal, both with the taxpayers as well as with the tax authorities, the intensity of TP audits and the approach of dealing with TP of inter-company transactions are bound to be affected.

Best practices that taxpayers may need to consider while implementing the Action Plan 13.

With new OECD Guidance indicating that the first required CbCR is to cover financial year starting April 2016 to March 2017, it is important that MNEs begin to prepare for the same proactively and implement necessary changes in their IT systems to capture information required for reporting.

Taxpayers will need to be prepared to explain and support both sides of a transaction, even if they have applied a one-sided TP method. Otherwise, with increased visibility into profits earned by an MNE in different jurisdictions, tax authorities may be encouraged to split profit between entities using a factor of the tax authority's choice. In order to avoid such a result, taxpayers should make sure that the result from any one-sided analysis is consistent with the value creation by respective entities involved in the transaction. In essence, the taxpayers are advised to consider the following in light of the final report on Action 13:

- Revisit and review operations and business structures to identify areas of potential TP risks;
- Review existing TP documentation and judiciously assess gaps vis-à-vis recommended guidelines;
- Keep the impact of BEPS project in mind whenever businesses are undergoing change;
- Proactively evaluate option of entering into an Advance Pricing Agreement (APA) with tax administration to gain certainty around the TP arrangement of inter-company transactions at the right time.

Concluding thoughts

The impact of the BEPS project is expected to be far-reaching and profound, triggering changes to domestic laws and regulations in India. There is a significant opportunity for the Government of India as well to align some of its existing documentation rules to bring it at par with global standards. On the other hand, the pressure on tax authorities is likely to increase significantly in order to judiciously analyze the additional details disclosed by taxpayers and form conclusions. One may expect that with substantial information available at the disposal, both with the taxpayers as well as with the tax authorities, the intensity of TP audits and the approach of dealing with TP of inter-company transactions are bound to be affected.

BEPS and GAAR: the gap needs to be bridged

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The measures proposed in the final OECD reports on base erosion and profit shifting (BEPS) are designed to address perceived weaknesses in international tax rules, which can allow profits not to be taxed where the relevant economic activities are taking place. The focus on tackling "tax avoidance" has therefore, a similar aim to general anti-avoidance rules (GAAR) that have already been introduced in several territories in that both the GAAR and a number of the BEPS Actions are anti-avoidance provisions aimed at discouraging impermissible tax avoidance.

The BEPS Actions and domestic GAAR provisions will have some overlap, the extent of which will depend on the depth of the domestic GAAR and the way in which relevant BEPS Actions are implemented by particular countries.

Key principles underpinning BEPS Actions are:

- A reinforcement of the substance requirements in the existing international standards to ensure that profits are taxed where economic activity takes place and value is created.
- Coherence in the domestic rules that affect cross-border activities. This includes proposals to address abuse of provisions in tax treaties, best practice guidance on controlled foreign companies and rules on hybrids.
- Improved transparency and certainty. The Actions call for automatic exchange of information across jurisdictions and the introduction of possible requirements to disclose aggressive tax planning scheme.

Given this "substantial renovation of the international tax rules" will there still be a need for a GAAR to supplement or complement the new rules that will be brought in?

In India, there are reasons why GOI may like to persist with GAAR as a supplement or complement, instead of shelving the same with outcome of BEPS:

i. With the introduction of GAAR in India domestic law, the courts in India may apply the law subject to implicit legislative intent to justify commercial purpose in scrutiny of all tax matters, which has tax aggression. The Courts may now adopt doctrine of substance over form or "look through" approach of interpretation and the emphasis on form or "look at" approach of interpretation may be subordinated.

ii. Whereas BEPS may largely address concerns on cross border transactions, the scope of GAAR extends as well to purely domestic transactions.

> *It is advisable that prior to GAAR's introduction, it is reviewed in the light of BEPS implementation plan. Taxpayers will need time to absorb the impact of BEPS and GAAR. It will be a relief if GAAR is deferred and there is reasonable spacing between BEPS and GAAR.*

iii. GAAR provides tax authorities with wider powers — say, including power of re-characterizing income. For example, royalty payment, which is in excess of ALP may be re-characterized as dividend income, but for GAAR.

iv. While BEPS implementation will operate as a SAAR, GAAR is meant to be applied in cases of exception.

v. Mandatory disclosure of aggressive tax planning scheme may serve the purpose of receiving information, but, mere collection of information may not empower tax authority with powers, which form part of GAAR regime.

A similar position exists in the UK, where the rule is a general anti-abuse rule, rather than strictly a general anti-avoidance rule, aimed at counteracting the tax advantages obtained from abusive tax arrangements. Tax arrangements are "abusive" if they are arrangements, the entering into or carrying out of which, cannot reasonably be regarded as a reasonable course of action in relation to relevant tax provisions , with regard to all the circumstances. This is the so-called double-reasonableness test.

As with India, the UK tax authorities see the UK GAAR as an important tool in combatting unacceptable tax avoidance at all levels (domestic and cross border). It was introduced, after much debate, to tackle what was seen as unacceptable tax avoidance in situations in which existing case law principles is not likely to apply. Published guidance notes provide detail as to the types of transactions that may be caught, as well as further explanations as to when the legislation might apply and the UK tax authorities believe that this guidance is useful in driving taxpayer's behavior. The UK Government is consulting on strengthening sanctions for tax avoidance (in the form of penalties) and it clearly sees the UK GAAR as necessary legislation in ensuring tax is paid.

As with India, the UK tax authorities see the UK GAAR as an important tool in combating unacceptable tax avoidance at all levels (domestic and cross border).

Even the OECD in its Action Points recognizes the need for a form of GAAR within its proposals for tackling tax treaty abuse (Action 6). That Action calls for a principal purposes test or "PPT" rule to be included in the OECD Model Tax Convention. Under that rule, if one of the principal purposes of transactions or arrangements is to obtain treaty benefits, these benefits will be denied unless it is established that granting these benefits will be in accordance with the object and purpose of the provisions of the treaty. A domestic GAAR may not then be able to over-ride what has been agreed in a relevant treaty but Action 6 does address two specific issues related to the interaction between treaties and domestic anti-abuse rules to ensure countries retain certain taxing rights.

More generally, the Action 6 report recognizes that the adoption of anti-abuse rules in tax treaties is not sufficient to address tax avoidance strategies that seek to circumvent provisions of domestic tax laws; noting that these must be addressed through domestic anti-abuse rules, including thorough rules that will result from the work on other parts of the Action Plan.

The simultaneous application of both the new BEPS proposals and a GAAR may have some interesting angles. For example, in India, GAAR needs to be applied subject to certain checks and balances. A special purpose committee has to approve an action before GAAR can apply. In a situation, which is covered by GAAR as well as BEPS, question may arise whether taxpayer protection remedy, in the form of pre-audit verification by special purpose committee, will become an obligation of minimum threshold on the part of tax authority. To address this dilemma, it may need to be clarified that GAAR will not apply in cases where there is SAAR, including provision introduced to implement BEPS action.

While there can be no complaint against a law, which seeks to address tax evasion or highly aggressive tax avoidance, governments may need to ensure that they do not tread into the limits of over-legislation. The objective of revenue collection should be balanced against support for the business environment. Over-legislation, which impairs the ease of doing business and spurs litigation, complexity and uncertainty may be counter-productive.

In India, GAAR is to take effect from financial year 2017–18. It is advisable that prior to its introduction, it is reviewed in the light of BEPS implementation plan. Taxpayers will need time to absorb the impact of BEPS and GAAR. It will be a relief if GAAR is deferred and there is reasonable spacing between BEPS and GAAR.

Global news

01

International decisions on tax treatment of hybrid entities

Taxation of hybrid entities has been a perplexing issue, which may result in substantial erosion of tax bases of the countries concerned. However, with the recommendation in the final report by OECD on hybrid mismatch arrangement (BEPS Action 2) once translated into the domestic and treaty law it may neutralize the mismatch in tax outcomes. The following are the decisions taken by the apex court of respective countries on hybrid entities:

UK SC's landmark ruling on taxation of income from Delaware LLCs

In the case of Anson v. HMRC[1], the SC held that taxpayer, a UK resident and a member of a Delaware limited liability company (LLC) was eligible for double tax relief for US taxes paid on his share of the LLC profits as compared to UK income tax.

In the facts of the case, Mr. Anson (Taxpayer) was resident for UK tax purposes. He was liable to UK income tax on his UK-sourced income and on foreign income remitted to the UK. Mr. Anson was a member of a Delaware LLC, which was classified as a partnership for US tax purposes. As a non-US resident and as a member of an entity classified as a partnership, the Taxpayer was liable to US taxes on his share of profits. These profits were distributed and remitted to the UK, causing a UK income tax charge under the UK laws.

Issue under consideration was whether credit can be claimed for taxes paid in the US against the UK tax liability, under Article 23(2)(a) of the US-UK tax treaty?

The UK SC held as below:

- According to the Vienna Convention, treaty provisions should be interpreted considering the ordinary meaning of the terms of the treaty in their context and in the light of the treaty's object and purpose. The purpose of Article 23(2)(a) of the US-UK DTAA is to avoid double taxation.
- In light of the LLC Agreement and the governing laws of Delaware, the members automatically become entitled to their share of profits generated by the business carried on by the LLC as they arose, independently of, any subsequent distribution.
- The Taxpayer had been found to be entitled to the share of profits allocated to him, rather than receiving a transfer of profits "previously vested in the LLC." Hence, both under the US and the UK tax law, his measure of income was his share of profits of the LLC.
- The Taxpayer's liability toward UK tax was, therefore, computed with reference to the same income as was taxed in the US and he qualified for double tax relief.

1. *Anson v. HMRC [2015] UKSC 44*

Japanese SC rules that Delaware limited partnership (LPS) is a "corporation" for Japanese tax purposes[2]

In this case, the SC laid down the following two steps to determine whether a foreign entity is a corporation for Japanese tax purpose:

- **Step 1**- Whether legal status equivalent to a Japanese corporation is granted to the foreign entity under the laws of the country in which it is established?

  In case Step 1 cannot be demonstrated beyond doubt, Step 2 may be used.
- **Step 2**- Whether foreign entity assumes rights and obligations on its own account?

Judgment of Supreme Court in case of a Delaware Limited Partnership (LP)

Step 1:

- The Delaware Revised Uniform Partnership Act (the Act) states that a limited partnership (LP) will have a separate legal entity.
- However, on the basis of the Act, it cannot be said that the LP has legal status equivalent to Japanese Corporation

Step 2:

- Under the Act, an LP is granted rights to conduct legal actions under its own name.
- The partnership interest is a property right of the LP and the partner has no interest in the specific LP property.

In light of the provisions of the Act, since a Delaware LP can itself be a party to legal acts and since such legal effects can be attributed to itself, the Delaware LP qualifies as a "corporation" for Japanese law purposes.

Japanese SC rules that Bermuda LP is not a "corporation" LP for Japanese tax law purposes

According to facts of the case, Taxpayer was a LP registered and exempted from tax under the Bermuda Law (Bermuda LP). It had a Delaware LLC and two Cayman corporations as its partners. Delaware LLC sells its partnership interest to an Irish Corporation. Subsequently, Bermuda LP and the Irish corporation entered a swap contract under which business profits of the Cayman Corporation (sourced from Japan) were distributed to the Irish corporation and, in turn, to the Bermuda LP.

Issue under consideration was whether the Bermuda LP was taxable in Japan on the profits received from Irish Corporation under the Japanese tax law (i.e., if the Bermuda LP qualifies as a "corporation").

Japanese SC ruled that,

On whether Bermuda LP is a corporation?

- Whether a business entity is a "foreign corporation" is determined with reference to the relevant foreign law governing the corporate legal personality of the business entity in question.
- Since, Bermuda law did not provide the taxpayer with a corporate legal personality, the taxpayer was also not a "foreign corporation" under the Japanese Law.

Whether a non-judicial association is a corporation?

- For a non-judicial association to be a corporation under the Corporate tax act (CTA) it must have (1) organization as a body, (2) decision by majority, (3) perpetual succession (4) defined rules concerning representation, general meetings, etc.
- In this case, the BLP did not fulfil conditions (1), (2) and (4); accordingly, it was not a corporation under Japanese law.

Source- EY Alert titled Supreme Court rules that Delaware Limited Partnership are corporations under Japanese tax laws dated 30 July 2015; IBFD

Global news

02 Developments in the field of digital economy

While OECD delivered its final report on digital economy (BEPS Action 1) on 5 October 2015, globally countries have been attempting to reform their tax rules in order to be able to tax part of the profits of digital companies. After amendments to tax laws by the UK, Austria and Israel, the following countries have taken a step forward to tackle tax challenges of the digital economy:

Tax authorities of Saudi Arabia and Kuwait adopted "Virtual Service PE" concept[1]

Tax authorities of Saudi Arabia and Kuwait have introduced a concept of "Virtual Service PE" by way of internal guidelines. This may result in the denial of income tax relief claimed by non-residents (NRs) under applicable double tax treaties of Saudi Arabia and Kuwait.

According to the "Virtual Service PE" concept, an NR is deemed to have a PE in the source state (i.e., Saudi Arabia or Kuwait) if the following conditions are met:

- NR furnishes services to a person in connection with the latter's activity in the source state;
- The period during which such services are rendered according to the contract (and not the actual physical presence of employees or contractors of a NR service provider), exceeds the threshold period under the applicable tax treaty;

As a result of the above, any work or services performed under cross-border agreements by NR in source state for a period longer than the tax treaty threshold (e.g., 183 days) will, prima facie, create a Service PE for the NR, even if employees/contractors of the former are not physically present in the source state for such period and perform their activities entirely offshore.

This new approach is not in line with the PE concept outlined in the double tax treaties concluded by source states, which are in accordance with OECD/UN MCs. Therefore, concerns are raised if such approach is likely to amount to "treaty override" through unilateral interpretation of tax treaty terms. This development is likely to affect most MNEs, which have concluded or plan to conclude service arrangements with customers in Saudi Arabia or Kuwait.

1. *EY Global Tax Alert "Saudi Arabian tax authorities introduce Virtual Service PE concept" dated 30 July 2015 and EY Global Tax Alert "Kuwait Tax Authorities adopt "Virtual Service PE" concept," 21 September 2015*

Turkey considers corporate income tax on electronic services supplied by NR in Turkey[2]

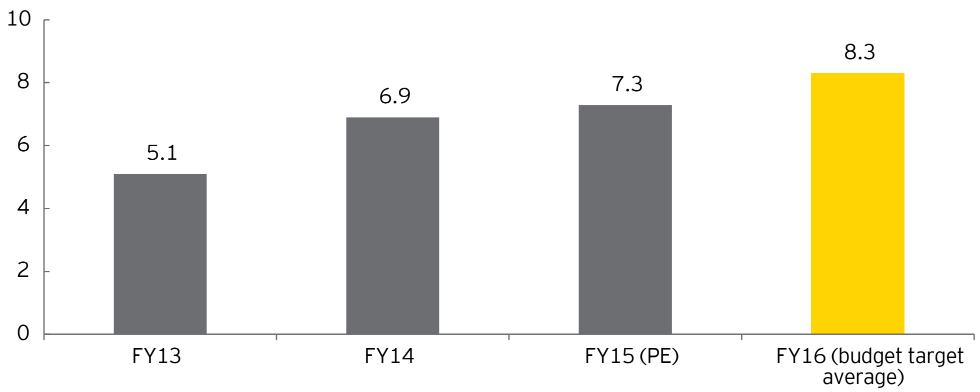
The Turkish Government is reported to be considering a range of proposals, which will enable the Turkish Revenue Administration to collect both direct and indirect taxes on the sales and revenue-generating online activities earned by NR businesses. A specific primary objective of the proposals will be to collect taxes from social network platforms and from NR entities generating income from online advertisements targeted at Turkish consumers.

The proposal intends to introduce the concepts of “electronic taxpayer” and “electronic place of business“ in Turkish tax law, by virtue of which NR enterprises may in the future be liable for tax on their advertisement income, even if they are not incorporated in Turkey. Currently, there has not been any formal legislative action on the amendment of key

2. *EY Global Tax Alert “Turkey considers corporate income tax, VAT on electronic services supplied by non-resident businesses to Turkish customers,” 14 July 2015*

EconoMeter

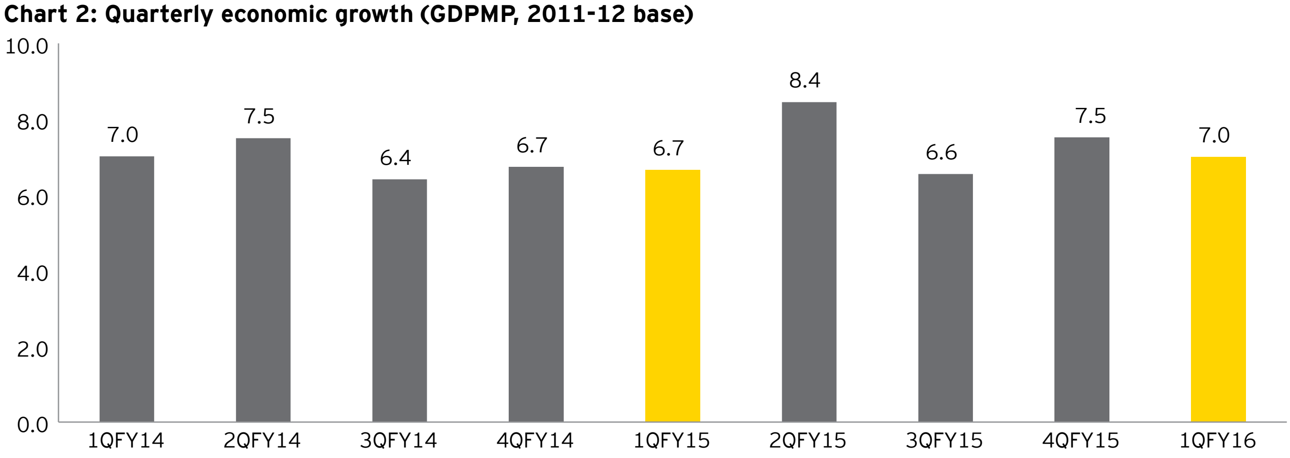
Chart 1: Economic growth (Gross Domestic Product at Market Prices (GDPMP), 2011-12 prices



Source: CSO, Ministry of Statistics and Plan Implementation, Government of India and Union Budget FY16
PE - Provisional Estimates

The Indian economy grew at 7.3% (2011-12 prices) in FY15, compared with 6.9% in FY14, as both domestic and external demand remained weak. Real GDP growth for FY15 has been revised downwards from 7.5% [based on Advance Estimates (AE)] to 7.3% [Provisional Estimates (PE)].

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



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

India's real GDP (2011-12 prices) growth moderated to 7.0% (y-o-y) during 1QFY16 as compared to a 7.5% in 4QFY15 led by continued weakness in domestic and external demand

Table 1: Growth in components of aggregate demand (2011-12 base, % y-o-y)

	Private final consumption expenditure	Government final consumption expenditure	Gross capital formation	Exports	Imports	GDP at market prices
FY13	5.5	1.7	-0.3	6.7	6.0	5.1
FY14	6.2	8.2	3.0	7.3	-8.4	6.9
FY15	6.3	6.6	4.6	-0.8	-2.1	7.3
1Q14	7.7	27.3	2.3	2.6	-3.5	7.0
2Q14	5.6	5.3	6.3	-1.6	-8.4	7.5
3Q14	4.6	11.0	5.3	15.7	-14.2	6.4
4Q14	7.0	-7.2	-1.4	14.1	-7.0	6.7
1Q15	6.2	1.6	8.7	9.1	-3.6	6.7
2Q15	7.1	8.9	3.8	-2.0	1.1	8.4
3Q15	4.2	27.6	2.4	-0.3	2.8	6.6
4Q15	7.9	-7.9	4.1	-8.2	-8.7	7.5
1Q16	**7.4**	**1.2**	**4.9**	**-6.5**	**-5.4**	**7.0**

Source: CSO, Ministry of Statistics and Plan Implementation, Government of India
*Data for 4QFY14 is derived based on the AE published by the CSO.

Growth in private final consumption expenditure (PFCE), the key driver of domestic demand, slowed to 7.4% (y-o y) in 1QFY16 while growth in investment recovered to 4.9%. India's GDP growth in FY16 is expected to be largely driven by growth in PFCE supported by declining inflation while external demand is set to remain subdued.

Table 2: Sectoral output growth at 2011-12 prices (% y-o-y)

	FY13	FY14	FY15	FY15 1Q	FY15 2Q	FY15 3Q	FY15 4Q	FY16 1Q
Agriculture and allied activities	1.2	3.7	0.2	2.6	2.1	-1.1	-1.4	1.9
Industry	2.3	4.5	6.1	7.7	7.6	3.6	5.6	7.7
Mining and quarrying	-0.2	5.4	2.4	4.3	1.4	1.5	2.3	4.0
Manufacturing	6.2	5.3	7.1	8.4	7.9	3.6	8.4	7.2
Electricity, gas and water supply*	4.0	4.8	7.9	10.1	8.7	8.7	4.2	3.2
Construction	-4.3	2.5	4.8	6.5	8.7	3.1	1.4	6.9
Services	8.0	9.1	10.2	8.7	10.4	12.5	9.2	8.7
Trade, transport and communications**	9.6	11.1	10.7	12.1	8.9	7.4	14.1	12.8
Finance, insurance, real estate and professional services	8.8	7.9	11.5	9.3	13.5	13.3	10.2	8.9
Public administration and defense	4.7	7.9	7.2	2.8	7.1	19.7	0.1	2.7
Total Gross Value Added (GVA) at basic prices	4.9	6.6	7.2	7.4	8.4	6.8	6.1	7.1

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

The real Gross Value Added (GVA) at basic prices grew by 7.1% during 1QFY16, up from 6.1% growth in 4QFY15. Apart from mining (4.0%) and construction (6.9%), output from all the other major sectors including services sector moderated during the quarter.

Table 3: Inflation based on Consumer Price Index (new series): combined index for rural and urban areas (month over corresponding month of previous year: % change)

	General	Food, beverage	Pan, tobacco and intoxicants	Fuel and lighting	Housing	Clothing, bedding and footwear	Miscellaneous
FY13	10.3	11.7	11.1	11.1	11.0	8.5	7.6
FY14	10.0	11.4	9.5	9.6	11.6	7.3	7.3
FY15	5.9	6.5	8.1	7.3	6.9	4.2	4.6
May 2014	8.3	8.9	7.6	8.4	13.7	4.7	6.7
Jun 2014	6.8	7.3	7.6	8.2	6.8	4.5	6.1
Jul 2014	7.4	8.7	7.7	8.3	6.6	4.3	6.0
Aug 2014	7.0	8.6	7.8	8.0	6.1	3.9	5.4
Sep 2014	5.6	6.3	7.9	7.3	5.8	3.4	4.3
Oct 2014	4.6	4.3	7.6	7.3	5.6	3.4	4.3
Nov 2014	3.3	2.0	8.0	6.9	5.4	3.5	3.7
Dec 2014	4.3	4.4	7.9	6.3	5.2	3.4	3.5
Jan 2015	5.2	6.3	8.3	6.2	5.1	3.8	3.1
Feb 2015	5.4	6.8	9.2	6.4	5.0	4.7	2.9
Mar 2015	5.2	6.2	9.2	6.3	4.8	5.1	3.0
Apr 2015	4.9	5.4	9.4	6.1	4.7	5.5	3.2
May 2015	5.0	5.1	9.5	6.1	4.6	6.0	3.8
Jun 2015	5.4	5.7	9.8	6.3	4.5	5.9	4.2
Jul 2015	3.8	2.9	9.8	5.4	4.4	5.9	3.4
Aug 2015	3.7	2.9	9.4	5.8	4.7	5.9	3.1
Sep 2015	4.4	4.3	9.4	5.4	4.7	6.0	3.3

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

CPI inflation eased marginally to 3.7% (y-o-y) in August 2015, down from 3.8% in July 2015. Declining inflation led to a policy rate (repo rate) cut of 50 basis points during the policy meet held on 29 September 2015.

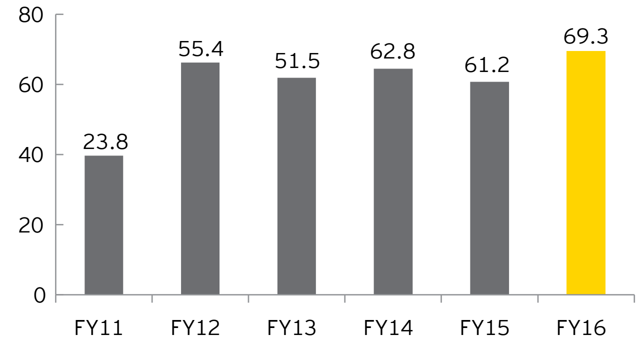
Table 4: Growth in Index of Industrial Production (major industries) (month over corresponding month of previous year: % change)

	General Index	Mining	Manufacturing	Electricity
FY12	2.9	-2.0	3.0	8.2
FY13	1.1	-2.3	1.3	4.0
FY14	-0.1	-0.6	-0.8	6.1
FY15	2.8	1.4	2.3	8.4
Sep 2014	2.6	0.1	2.7	3.9
Oct 2014	-2.7	4.5	-5.6	13.7
Nov 2014	5.2	4.0	4.7	10.0
Dec2014	3.6	-1.7	4.1	4.8
Jan 2015	2.8	-1.8	3.4	3.3
Feb 2015	4.8	1.6	5.1	5.9
Mar2015	2.5	1.1	2.8	2.0
Apr 2015	3.4	0.2	4.2	-0.5
May 2015	2.5	2.3	2.0	6.0
Jun 2015	4.4	-0.5	5.4	1.3
Jul 2015	4.1	0.9	4.6	3.5
Aug 2015	6.4	3.8	6.9	5.6

Source: Office of Economic Advisor, Government of India

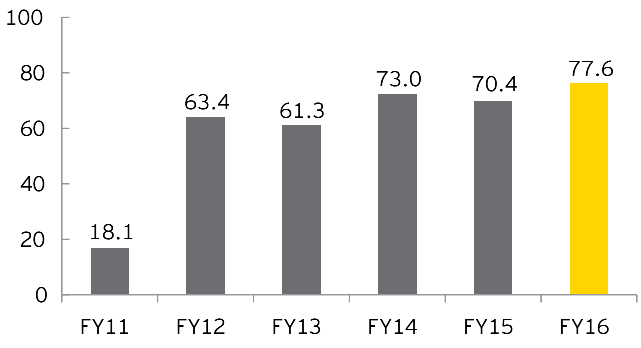
The industrial sector output growth remained above 4% for the second consecutive month. However, growth in core sector output, with a weight of close to 38% in the overall IIP, has moderated during the last two months suggesting continued weakness in the industrial sector.

Chart 4: Cumulated Fiscal Deficit up to August 2015 as % of Annual Budgeted target for FY2016



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

Chart 5: Cumulated Revenue Deficit up to August 2015 as % of Annual Budgeted target for FY2016



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

Centre's capital expenditure growth remained robust during April-July FY16. Meanwhile, the revenue expenditure growth has continued to keep pace as its share in total expenditure stood at 86%. In line with increasing revenue expenditure, the revenue deficit rose to 77.6% of the annual budgeted target in the first four months of FY16, its worst performance since FY09. Centre's cumulated fiscal deficit reached 69.3% of the annual budgeted target during the first four months of FY16.

Table 5: Major heads of Central Government revenue (INR billion)

Revenue heads	FY14 actual	FY15 (PE)	FY16 (BE)	% change in FY15 PE over FY14 actual	% change in FY16 BE over FY15 PE
Gross revenue receipts	13,376	14,420	16,712	7.8	15.9
Tax revenue (including States' share)	11,387	12,450	14,495	9.3	16.4
Corporation tax	3,947	4,289	4,706	8.7	9.7
Taxes on income	2,429	2,584	3,274	6.4	26.7
Customs	1,721	1,880	2,083	9.3	10.8
Union excise duties	1,702	1,891	2,298	11.1	21.5
Service tax	1,548	1,680	2,098	8.5	24.9
Non-tax revenue	13,376	14,420	16,712	-1.0	12.6

Source: Union Budget, Controller General of Accounts
PE – Provisional Estimates, BE – Budget estimates

Central taxes are budgeted to grow at a much higher rate in FY16 compared with the growth in FY15.

Table 6: Major heads of Central Government expenditure (INR billion, %)

Expenditure heads	FY14	FY15 (PE)	FY16 (BE)	% change in FY15 PE over FY14 actual	% change in FY16 BE over FY15 PR
Total expenditure	**15,594**	**16,448**	**17,775**	5.5	8.1
Non-plan	**11,061**	**11,911**	**13,122**	7.7	10.2
Plan	**4,533**	**4,536**	**4,653**	0.1	2.6
Revenue	**13,718**	**14,577**	**15,360**	6.3	5.4
Capital	**1,877**	**1,870**	**2,414**	-0.4	29.1

Source: Union Budget

The total Central Government expenditure budgeted at 12.6% of GDP for FY16 is at a historical low because of resource crunch. In its attempt to revive investment demand in the economy, the Government has budgeted to increase capital spending by 29.1% in FY16 relative to spending growth of just 5.4% in FY15.

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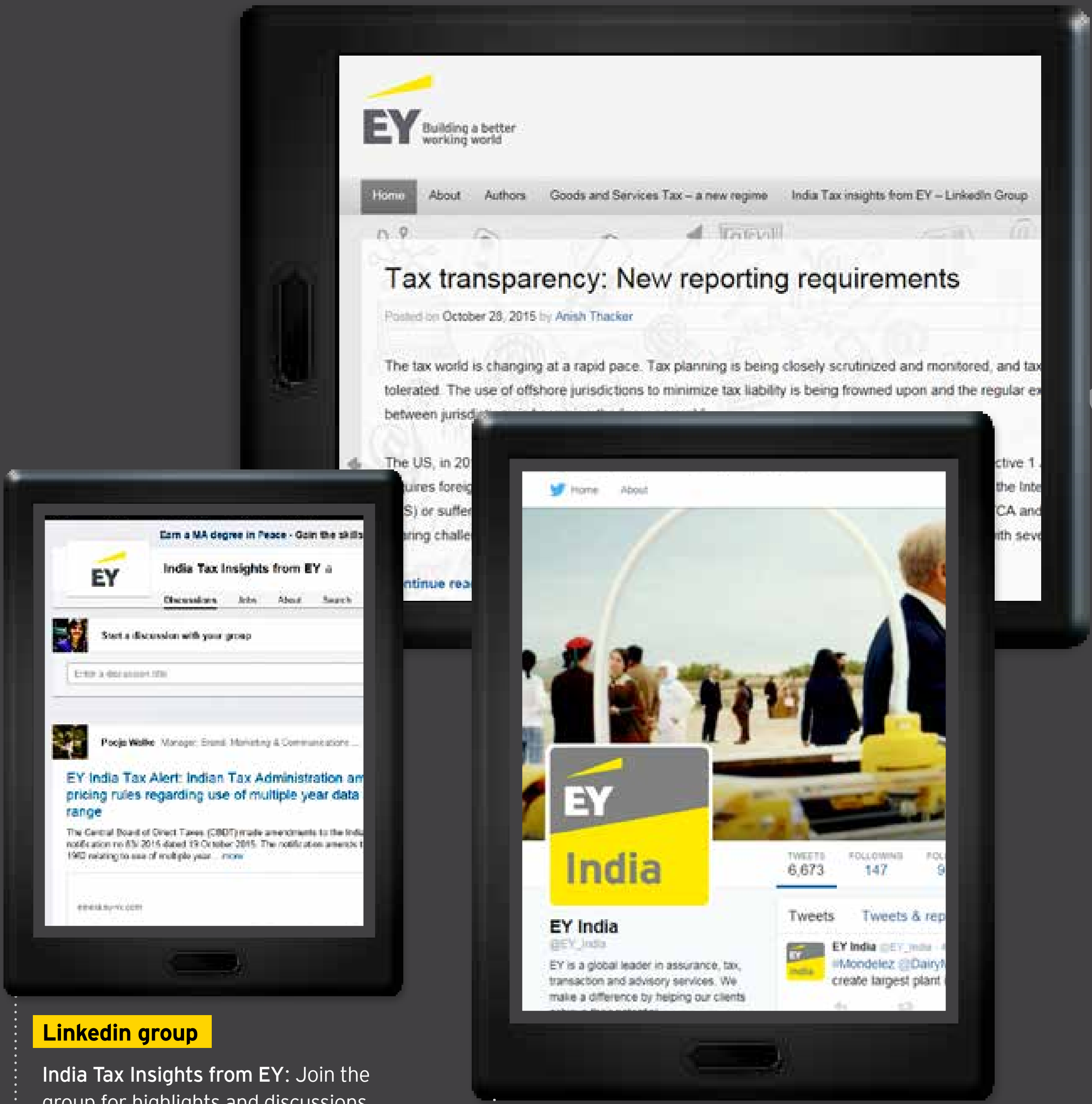

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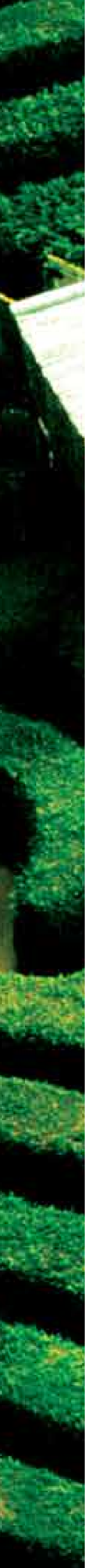

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