Enabling ‘Make in India’ through effective tax reforms
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India stands out as a country with immense potential and opportunity given the current global environment. It is once again creating an interest and excitement in the global arena as hopes build for its reforms agenda to be carried forward. Industry expects tax reforms to be at a priority position in this agenda.

Around the world, the discussions on tax policy have become centric to checking tax base erosion and enhancing transparency in terms of exchange of information. India’s tax policy is no exception and is changing in response to the global developments. However, India needs to strike the right balance between checking tax avoidance and making the tax environment more facilitative compared to other jurisdictions competing for investments. More than low rates of tax or tax incentives, the investors look for a responsive tax administration that provides certainty and consistency in tax treatment.

The Government has already embarked on the journey to deliver a litigation-free and a certain tax environment. It has taken positive steps to correct some of the policy and administrative decisions taken by the tax department in the last couple of years which resulted in immense uncertainty and angst among the taxpayers. The Budget 2014 also announced measures to improve the existing disputes minimisation and resolution mechanisms.

The focus now needs to be on an effective implementation of these measures and building trust between the tax administrators and taxpayers. A facilitative tax environment is crucial to creating a more positive image for India as an investment destination and to make the Prime Minister’s mission for ‘Make in India’ a success.

With the various action items on the OECD BEPS Action plan gathering momentum, it is also seen that the policy responses are varying across the globe. The Government should engage with the industry actively on all the BEPS Action items to develop a coordinated response. The risk of unilateral policy, legislative or enforcement response could compound the pre-existing backlog of tax litigation and further damage the investment climate.

At present, the most awaited tax reform in India is the Goods and Services Tax. While the Centre and the States are still engaged in discussions on the design of the tax system, the industry hopes for an early consensus for a comprehensive GST that will put the economy on the high growth trajectory.

This Paper explores the emerging tax trends across the globe. It also discusses the policy and administrative reform measures needed for a stable, certain, less litigious and facilitative tax environment in India that supports investments and growth.
Chapter 1
1 Promoting “MAKE IN INDIA” – Tax incentives to rejuvenate the manufacturing sector

1.1 Direct Tax

On 25 September 2014 the Indian Prime Minister, Narendra Modi unveiled the ambitious “Make in India” campaign with an aim to turn India into a global manufacturing hub. The campaign, “Make in India” is a major national program designed to facilitate investment, foster innovation, enhance skill development, protect intellectual property and build best-in-class manufacturing infrastructure.

The PM, Narendra Modi said, “The world is looking at Asia. I do not have to waste time to invite ….. I need to give the address............. I want to appeal all the people world over......Come, Make In India. Sell anywhere but manufacture here......”

Given the above and in order to resonate well with the “Make in India” program, it is imperative that certain tax incentives are offered to investors, which will go a long way in providing a much-needed impetus to the manufacturing sector. Given the same, we have listed below some of the key incentives, which are already provided in the Income tax Act, 1961 (the Act) along with our humble recommendations and a wish list for the future.

Toll manufacturing

In order to encourage the growth of India as a manufacturing hub, the domestic tax provisions should exempt foreign principals from creating a taxable presence in India in case of toll manufacturing arrangement with Indian manufacturers.

A reasonable cost plus margin should be prescribed for toll manufacturing/contract manufacturing arrangements by MNCs with its Indian manufacturing units under transfer pricing regulations.

Profit-linked incentives vis-à-vis investment-linked incentives

Profit-linked incentives, currently given for infrastructure and crucial sectors, should be continued till the end of the Twelfth Five Year Plan, i.e., till 2017 to encourage investment and growth of India’s infrastructure sector. It should also be considered to do away with MAT for the infrastructure industry as levy of the same defeats the very purpose of extending tax incentives to the industry, especially given the high rate of MAT.

Minimum Alternate Tax (MAT) on SEZ profits

At the time of instituting the SEZ Act, the Government had promised investors that MAT would not be applicable on SEZ units. However, the exemption on payment of MAT is no longer available to SEZ units. Further, post withdrawal, activities in development of SEZ and units in SEZ has considerably slowed down. Recently the Government has expressed its desire to make India a manufacturing hub by launching the “Make in India” campaign. Reinstating the exemption will immensely boost non-resident investors in manufacturing goods in an SEZ providing fillip to the “Make in India” campaign. It may also be noted that according to the Press Release dated 13 August 2014 issued by the Ministry of Commerce and Industry (Department of Commerce), the Ministry has already recommended the restoration of the original exemption of DDT and MAT.
Foreign technology and relaxation in tax compliances/litigation procedure

Foreign technology plays a very vital role in overall development of a developing country such as India. However, the cost of using the said technology is very high, in view of which, the same is not effectively used in India.

Therefore, in order to reduce cost of technology, the rate of withholding tax on royalty payments should be reduced to zero. This would reduce cost to the Indian arm and also eliminate hassles in compliances faced by foreign technology providers.

Controversy created by conflicting judicial precedents on creation of permanent establishment on deputation of expatriates to the Indian subsidiary should be clarified, which would, in return, help in transfer of technology to the Indian arm.

According to Indian tax laws, any non-resident who earns any income, which is sourced from India is required to file a return of income in India. In order to make the Indian economy more investor-friendly, the Government can provide relief to the foreign investor by classifying return filing not compulsory for foreign companies receiving royalty and interest income from India, in case they have no presence in India.

In the existing system litigation cases take years to get resolved due to which many foreign investors avoid investment in India. Therefore, it is recommended that litigation cases where revenue has not been successful in appellate proceedings should not be pursued further.

Interest on foreign borrowings

Finance Act 2014 came with a sweetener for taxpayers who intended to borrow monies in foreign currency from a non-resident. The Act provided for a reduced withholding tax rate of 5%, subject to satisfaction of certain conditions, one of which being that borrowings should be made vide a loan agreement within the window period of 1 July 2012 to 1 July 2017.

In order to encourage fresh capital flow into the country, nil withholding tax regime should be introduced on loan granted for a period exceeding three years. This will also reduce borrowing cost for the Indian industry and improve the return on investments for foreign lenders.

In order to further encourage the development of the Indian debt market and to accelerate the pace of growth of the Indian economy, it is recommended that the condition of borrowings within a specified window period should be done away with.

Scope of section 80-IA

Currently, eligible industrial undertakings engaged in infrastructure development are eligible for deduction under section 80-IA of the Act. In order to attract more investment in business of manufacturing defence and aerospace equipment, the scope of units eligible for deduction under section 80-IA should also be extended to units engaged in business of manufacturing defence and aerospace equipment. Furthermore, it would also make India self-sustained in terms of defence equipment, for which it mainly depends upon other developed economies.

Depreciation on leasing transactions

Currently, provisions of section 32 read section 43(1) and 43(6) is not clear as regards the person who is entitled to claim depreciation in a leasing transaction. The said entitlement for claim of depreciation is a subject matter of dispute between the revenue and the assessee. In order to avoid litigation on the issue, it is recommended that provisions should clearly spell out the allowance of depreciation at prescribed rates and subject to fulfilment of certain conditions, in respect of leased assets.
Additional depreciation

Additional depreciation @ 20%\(^1\) is admissible when new machinery or plant is acquired and installed by the assessee who is engaged in manufacture or production of any article or thing. In order to further stimulate investments in the manufacturing sector, the rate of additional depreciation could be increased.

Expenditure on scientific research

Currently, as per the provisions of the Act, weighted deduction of 200% is available for expenditure incurred for scientific research on in-house R&D facility approved by DSIR. In order to remove any unintended ambiguity and to expand the scope of the present provision, the following issues need to be considered:

- To boost the overall manufacturing sector, the benefit of weighted deduction should also be extended to expenditure incurred on “building and infrastructure” exclusively used for R&D.
- It is recommended that to encourage increased in-house R&D activity, the ambit of eligible revenue expenses should also be increased to include:
  - Expenditure on outsourced R&D activities including clinical/trial field
  - Lease rent paid for research farms or research labs

Investment allowances

The Finance Act 2013 has introduced a provision\(^2\) to incentivize substantial investments in plant and machinery by providing a deduction of 15% of the actual cost of plant or machinery acquired and installed between 1 April 2013 and 31 March 2015 by a company engaged in the business of manufacture or production of any article or thing provided the value of plant and machinery exceeds INR 1 billion. The Finance Act 2014 extended the benefit of this provision for companies, which acquire and install new plant and machinery during any financial year (FY14-15 to 2016-17) for amount exceeding INR 250 million.

While the above is a welcome provision, the following issues need consideration:

- Benefit of investment allowance should be extended to total investments made to build additional capacity and should not be restricted to investment made in plant and machineries.
- The limit of INR 1 billion is too high, and only a few large projects would be able to avail the benefit. In order to truly incentivise businesses, particularly small and medium businesses, the limit should be reduced to INR 10 million, if not altogether done away with.
- With respect to projects, which take more than a year to commence operation, provision should clarify that incentive will be available if new assets are acquired and installed in different financial years.
- Benefit of investment allowance should not be restricted to companies engaged in the business of manufacturing or production of specified activities but should be extended to all sectors of the economy. This will truly provide a fillip to the economy and will meet with the true intent of the provisions.
- Deduction should also be available in respect of assets on which 100% depreciation is applicable.

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\(^1\) Section 32(1)(iia) of the Act
\(^2\) Section 32AC of the Act
Deduction in respect of employment of new workmen

The current provision\(^3\), as amended by the Finance Act 2013, provides incentives to an Indian company, which derives profits from an industrial undertaking engaged in manufacture and production of goods in a factory provided requisite number of workmen are employed by them in a given year. The scope of this section is now restricted only to a taxpayer, who manufactures goods in a factory – erstwhile, the section covered taxpayers who are in the business of “manufacture or production of article or thing”.

In the current global environment, service industries, e.g., software, logistic, business process outsourcing, tourism etc., are the most vibrant and is also expected to provide significant employment opportunities to the skilled and qualified youth of the country. In view of the same, expanding the provisions to incentivise employment in general will be highly recommended.

Promoting the “Made in India” brand

Currently for R&D, deduction is allowed at 200% under section 35(2AB). In our country, we lack export of branded products. Actually as a country, we need to add more value to branding that would help promote “Made in India” for which various marketing activities such as TV advertisement, radio advertisement, exhibitions etc. are required to be done abroad and the cost of the same is very high.

It is recommended that to encourage such activities for brand-building exercises abroad, weighted deduction should be allowed on expenditure incurred for brand building abroad at par with R&D, i.e., 200%.

Needless to say, a favourable investment regime coupled with tax certainty will definitely go a long way to boost the economy of the country. One hopes that the recommendations, as far as possible, are duly considered and implemented in letter and spirit, which undoubtedly will pave a way for “ache din”, which all of us are eagerly waiting for!

1.2 Indirect tax

The National Manufacturing Policy (NMP) targets an ambitious 25% contribution to GDP by 2022, from the current average of 15%. This initiative requires support of a conducive fiscal and administrative setup where both the Central and State Governments need to work in tandem for effective implementation. India, after a long gap, is again on the radar of global investments and it is important that we leverage this opportunity to attract investments for manufacture and transfer of technology.

Incentives to rejuvenate manufacturing can be achieved both by providing targeted sector-specific fiscal incentives and by ensuring an environment that provides for ease of business.

For example, the National Policy of Electronics (NPE) in 2012 unveiled the vision for making India a global hub for electronics systems and design engineering.

The NPE’s overall goals for 2020 were:

- Attract investments of US$100 billion
- Increase exports from US$8 billion to 80 billion
- Generate employment of 28 million

The Modified Special Incentive Package Scheme (MSIPS) for electronics systems and design engineering designed for units that manufacture specified electronic goods in identified area clusters is one such scheme introduced by the Department of Electronics and Information Technology (DEITY).

\(^3\) Section 80JJAA of the Act
MSIPS envisages the following:

- Capex subsidy of 25% for units outside a Special Economic Zone (SEZ) and 20% for units in SEZ
- Reimbursement of Additional duty of Customs (AD)/Excise duty on capital equipment for units outside SEZ
- Reimbursement of central taxes and duties for 10 years in select high-tech units such as fabs, semiconductor logic and memory chips, LCD fabrication:
  - Customs duty
  - Excise duty
  - Service tax

Incentives are available for a period of 10 years from date of approval of project by DEITY. It is important to note that State Government incentives are over and above the aforesaid incentives. Incentives will be released after the end of the financial year in which the investment exceeds a minimum prescribed threshold.

In recent months, with improvement in sentiments and launch of the “Make in India” campaign, the scheme has witnessed very good response from companies intending to manufacture in India.

Several States in tandem have equally formulated their electronic policies in recent months to attract investments for their states. States including the newly formed Telangana, erstwhile Andhra Pradesh, Madhya Pradesh as well as Gujarat, Maharashtra etc. have also been very active in announcing State and sector-specific incentives around State taxes to attract large manufacturing investments.

**Inverted duty structure across the supply chain is a dampener**

Another area that needs constant scrutiny is the problem of inverted duty structure across the supply chain. The inverted structure arises due to the following factors:

- Output Excise duty on finished goods lower than Excise duty on inputs and input services
- Inability to fully utilise Cenvat credit of AD and Special Additional Duty of Customs (SAD) against output Excise duty

Though the first issue is sector specific and may need close examination for corrections, the second issue in recent years has become more skewed across the industry.

The second issue arises from the fact that that for a company to offset 12% AD and 4% SAD, it requires substantial value addition. AD and SAD together with cesses form an effective duty of 18% plus. To fully utilise this, one requires a value addition of 40% plus, which is a challenge in several sectors leading to significant accumulation of credits besides accumulation on account of capital goods and input services. In the absence of full utilisation of these duties, such accumulated credits lead to costs.

This needs close examination and resolution either in the form of refunds or exemptions from SAD. In case of traders such SAD paid on imports are refunded, for manufacturers the assumption is that credit is available but it is far from the truth.

**Need to simplify Cenvat credits**

Another area that requires simplification is Cenvat Credit. There are far too many restrictions and complexities in availing credits across capital goods, inputs and input services. With the GST on the anvil, as a precursor, there is an urgent need to simplify and allow credits in the chain without restrictions. This will avoid unnecessary disputes and cascading for the industry.

Certainty of tax is an important fact for many wanting to invest in India and manufacture. This Government is acutely aware of this situation and had ushered in changes in the last Budget by expanding the Authority of Advance Rulings (AAR) with regional benches. They also have appointed
the Chairman of AAR and we hope the authority commences functioning in right earnest to dispose the huge pendency.

The recent appointment of the High Level Committee to interact with trade and industry on tax laws is another step in that direction to provide clarity and certainty.

**Onerous process of realising export-led incentives**

India is emerging as a key automotive market and global small car hub. Several multinational companies manufacture small cars in India for local consumption and for exports. Automotive manufacturing generates direct/indirect employment and requires considerable investments. Duty drawback and Excise duty rebate arises on export of cars, both of which are significant. The process of realising both these export-led incentives is extremely onerous and time consuming, leading to significant cash flow issues for this sector, which then affects the competitiveness of exported products. It is important that such processes/documentation for claiming these benefits are simple and time bound to ensure no taxes/ duties are embedded in the export products.

**Control litigation**

The recently tabled Tax Administration and Reform Commission (TARC) reports have several valuable suggestions, which will go a long way to create the right administrative tax environment to incentivise investment and manufacturing. It is important that the implementation of these suggestions is quick and sincere.

To put this in perspective, almost 90,000 cases were pending before various benches of the Customs, Excise and Service Tax Appellate Tribunals (CESTAT) across the country as on April 2014. Furthermore, according to the TARC report, amounts for which cases were pending as on March 2013 were INR 185.76 billion in Excise, INR 218.8 billion in Customs and INR 577 billion in Service tax, cumulatively adding to approximately INR 980 billion locked in litigation.

Going forward, there is a serious need to control unnecessary litigation at low levels and also dispose cases at an increased pace at appellate levels including CESTAT. In future, issues should be raised purely on merits of law instead of routine challenges for revenue considerations. The recently introduced mandatory pre-deposits with automatic stay will in some way reduce the pendency at appellate levels to the extent of stay matters.

**Implementation of GST**

The much awaited introduction of Goods and Services Tax (GST) is another key indirect tax reform that would go a long way in promoting the “Make in India” vision. This reform will incentivise Indian manufacturing through removal of cascading and simplifying the current complex indirect tax structure.

“Make in India” is an important initiative to promote manufacturing and generate employment, but its successful implementation will require a stable fiscal setup both at the Centre and State besides an industry friendly environment.
Chapter 2
2 GST: how can we make “good” better?

The Goods and Services Tax (GST) is a significant step in indirect tax reforms, eagerly awaited by the industry. The initiatives being taken by the Centre to forge a consensus with the States on various issues surrounding the Constitutional amendment, required for implementation of the GST, are commendable. The industry hopes that the discussions with the States will culminate into a good and progressive tax system for the country.

All the issues currently under debate, including the amendments to the Constitution, the design of GST, the GST rate and the rules for implementation of the GST are very significant and need a thorough debate and consideration before they are finalised and implemented. Without a good design and structure, the GST will not be the “positive sum game” for stakeholders as it was envisaged to be. Furthermore, it will not be able to achieve its fundamental objectives, such as simplification of the tax system, improvement in tax compliance, enhancement in industrial productivity and competitiveness and a 1.5%-2% increase in the economic growth of the country. To the contrary, a partial or a “compromised” GST will bring more pain for the industry and will not be in the best interests of the country.

2.1 Treatment of petroleum and alcohol under GST

The States continue to oppose the inclusion of petroleum products (petroleum crude, high speed diesel, motor spirit, natural gas and aviation turbine fuel) and alcohol for human consumption in the GST purview.

The proposal to exempt any product is against the interests of the industry and the economy. The suppliers of exempted goods and services are not eligible to claim a credit for the tax on inputs. Non-recovery of input taxes results in substantial tax cascading, adding to the cost of production and distribution. Moreover, the burden of blocked input taxes falls entirely on domestic manufacturers – foreign manufacturers acquire their inputs abroad, free from Indian taxes. The substantial burden of cascading taxes increases the cost of doing business, discourages investment in the sector, and creates a bias in favour of imports. This will be contrary to the basic objective of GST of minimizing tax cascading.

Petroleum sector

The petroleum sector includes oil exploration and production, refining, transportation and pipelines, distribution and marketing. At all these stages, substantial inputs of goods and services are acquired, for instance, survey and exploration of mineral oil or gas service, cargo handling service, transportation of goods by road service etc. All such inputs will be taxable under the GST, but the tax paid would be non-recoverable if the petroleum products are excluded from GST. According to estimates, the quantum of blocked input credit for the petroleum sector could be as high as INR 300 billion per annum, depending on the quantum of investment in the sector in a given year.

Keeping the petroleum sector out of the GST regime is likely to raise many consequential issues for the industry and the government. New layers of complexities will also arise, followed by increased litigation, relating to apportionment of credits for inputs used in common for taxable and excluded items.

Differential treatment of petroleum and other products may render the IGST model for taxation of inter-state sales unworkable or inordinately complex in this sector. The taxation of inter-state supplies of services provided to the excluded sector would also involve significant complexities to determine the place of supply. For instance, services such as advertising acquired by petroleum companies have

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no unique place of supply or consumption. It will be a challenge to decide which State would collect tax on them.

B2B supplies should be taxable in the State of the recipient. However, the “place of supply” rules for B2B services are not exact, with the result that it can be difficult to apply the GST to such supplies at the State level. Pan-India companies providing services have no unique place of supply. They may have offices/carry on businesses in multiple places. Application of State GST to inputs may not matter as they would be fully creditable. However, if the recipient of services is an excluded sector such as the petroleum company, the taxes paid will not be creditable and they will accrue to the State where the company is located. This is expected to lead to distortions, conflicts and arbitrariness in determining the place of supply.

The decision to exclude the petroleum sector from GST is apparently based on the concern that its inclusion will lead to revenue losses for States. The revenue objective of the States, however, could be readily achieved through a supplementary excise or sales tax on petroleum products, as is the practice in many international jurisdictions. Even now, with the exception of a few States such as Assam and Tamil Nadu, almost all States levy VAT on petroleum. The VAT applied by these States is at an increased rate, which is akin to a supplementary rate over and above the standard rate.

Therefore, the fear of the States about revenue loss is really unfounded. The revenue would be determined by the level of tax rates and not by the structure of the GST. The supplementary tax can be levied by the Centre as well as the States and allow them full flexibility to raise additional revenues from petroleum products, while freeing up the petroleum sector from the distorting effects of tax cascading through denial of credits for the GST on products and distribution inputs of the sector.

While applying supplementary taxes in case of petroleum products, it may be kept in mind that currently crude is subject to octroi or state purchase taxes in certain States. These taxes are not creditable for the refineries and get embedded in the cost of refined petroleum products, which again become subject to State VAT and other taxes. This pattern of taxation results in cascading in the sector. It is also contrary to the principle of destination in the sense that tax on crude should accrue in the State where it is refined and not where it is consumed. As discussed below in suggestions, the application of supplementary taxes should be at the point of destination of the final product.

Alcohol

Like any other industry the alcohol industry, if excluded from GST, will face similar challenges and problems as mentioned above.

Under the current Constitution, the power to levy excise on alcohol is exclusively with the States. Cenvat does not apply to the production/manufacture of alcohol. Therefore, no credit is allowed for the Cenvat and the Service Tax paid on inputs used in the production and distribution of alcohol.

At the State level, the alcohol industry is subject to sales tax or VAT (as well as excise and other levies), but generally no credit is given for taxes paid by the industry on its inputs. Therefore, there is significant amount of tax cascading resulting in increased costs for the industry. The alcohol sector faces additional complexities due to the significant diversity and variation in the taxes across States.

The exclusion of alcohol from GST will perpetuate these complexities, and pose serious collateral problems for other allied sectors too. The hotels, restaurants and other outlets serving alcohol, which sell both GST and non-GST items will be the worst affected in terms of administrative complexities.

Administrative issues will also arise for both the industry and the government in terms of assessment and compliance, which will add to the compliance costs and disputes.

On the other hand, the inclusion of alcohol sector in the ambit of GST is likely to give more revenues to State governments as they will continue to have the power to levy supplementary excises and other levies over and above the GST on alcohol. The jurisdictional control of the States over this sector will not be undermined in any way.
Most importantly, GST will allow a better audit trail for inputs and outputs of the industry, allowing the governments a better control over the alcohol sector and bring in better transparency. It will help in freeing up the industry from the menace of harmful cartels that peddle illegal and spurious products to consumers, posing a health hazard to consumers in low-income brackets.

If GST applies to alcohol, it will significantly reduce tax evasion and give more revenues to States due to improved enforcement and compliance. Since the Centre will also be involved in the administration of GST there will be an opportunity for the States to have an automatic mechanism to cross-verify the sales declared for the GST with those declared for the income tax. The improved intelligence and monitoring under the GST would minimize any leakages and positively impact government revenues. Seamless coordination between Centre and State administrations will provide audit trail and plug revenue leakages.

States continue to have concerns about the loss of fiscal autonomy if alcohol were included in the GST. Under the current Constitution, the States have exclusive powers to legislate in respect of matters relating to the “production, manufacture, possession, transport, purchase and sale of intoxicating liquors”. They also have the exclusive power to levy excise duties on the manufacture/production of alcoholic liquors for human consumption and countervailing duties at the same or reduced rates on similar goods manufactured or produced elsewhere in India.

If alcohol is included under GST, the States will retain the exclusive power to levy excise duties. Therefore, to protect their revenues, the States could levy supplementary excises and other levies over and above the GST on the alcohol products. This is also the practice in most international jurisdictions where the alcohol industry is covered under the GST at par with other sectors and supplementary duties are imposed to raise revenues or to discourage consumption of alcohol.

The supplementary excise duty and other levies can be increased or lowered to suit revenue demands of the States. Unlike the petroleum sector, where both the Centre and the States can levy supplementary taxes, the power to levy excises on alcohol will continue to be vested exclusively in the States. In other words, the current constitutional provision giving the States the exclusive power to levy excise on alcohol will remain unaltered. The States will also be able to continue the levy of their fees and charges under the regulatory powers granted to them.

The tax treatment of petroleum and alcohol should be guided by the following broad principles:

► These products should not be excluded from the GST base. If at all they have to be excluded, the exclusion should not be under the Constitution.

In this context, even the erstwhile Chairman of the Empowered Committee of State Finance Ministers, Shri Sushil Modi, in his statement before the Parliamentary Standing Committee on Finance, stated “The said goods may be kept under GST and the revenue shortfall (on account of their being taxed at the standard rate, which is expected to be lower than the current tax rate on such goods, and also on account of providing input tax credit on these goods) can be made good by having recourse to additional non-creditable levies, in line with the best practices being followed internationally vis a vis such goods. Excluding goods from the Constitutional definition of goods and service tax would call for another Constitutional amendment, if, at some time in the future, a consensus emerges to bring these goods in the GST fold, and we are all aware that a Constitutional amendment may be a difficult proposition.”

This is also a view supported by the Parliamentary Standing Committee on Finance, which stated in its Report on the Constitution (A) Bill, “The Committee believes that such specific exclusions need not be provided in a Constitution (Amendment) Bill, as this will needlessly make the GST regime very rigid. Since the ultimate goal is to have an integrated, comprehensive and seamless GST regime subsuming various Central and State indirect taxes and levies, the Committee recommends that the above mentioned exclusion provision may be omitted from the Constitution (Amendment) Bill.”

► The concerns of the States about any revenue losses arising on account of inclusion of petroleum and alcohol products under the GST can be addressed through the supplementary levy. The States’ existing powers to levy supplementary levies on these products, over and above the GST, will continue. The supplementary tax can be levied by the States to allow them full flexibility to
raise additional revenues from products, while freeing up these sectors from the distorting effects of tax cascading through denial of credits for the GST on products and distribution inputs of the sector.

For imposing the supplementary levy, the following aspects need to be considered:

► Supplementary levy should be imposed at the point of destination and not at the point of production or other intermediate points in the supply chain.
► It could be a single point levy and non-creditable.
► No intermediate product in the supply chain of excisable goods (e.g., crude) should be subject to supplementary levy. Since no credit will be provided for this levy, its cost should not be embedded in the cost of production of final products.

These aspects are summarised in the table given below:

<table>
<thead>
<tr>
<th>Product</th>
<th>Petroleum</th>
<th>Alcohol</th>
</tr>
</thead>
<tbody>
<tr>
<td>Within GST under the Constitution</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Subject to supplementary taxes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Point of levy of supplementary taxes</td>
<td>Destination State</td>
<td>Destination State</td>
</tr>
<tr>
<td>Whether supplementary taxes at single/multiple point</td>
<td>Single</td>
<td>Single</td>
</tr>
<tr>
<td>Supplementary tax on intermediate products</td>
<td>Exempt</td>
<td>Exempt</td>
</tr>
</tbody>
</table>

2.2 Treatment of tobacco and tobacco products under GST

We understand that according to the current Constitutional draft, tobacco is proposed to be included in the GST base along with levy of Central Excise duty by the Centre. We also understand that the States have been asking for the power to levy supplementary duty on tobacco. However, the main difficulty in applying a supplementary duty is monitoring and control. The supply chain of the tobacco sector is very fragmented and the point of consumption can be far off from the point of production. A substantial part of tobacco is distributed by the unorganised sector. As a result, for better monitoring and control purposes, the supplementary duty can be levied by the Centre only at the point of production and not consumption.

2.3 Revenue neutral rate (RNR)

An ideal GST should have a single GST rate, kept at a reasonable level to make it socially and politically acceptable, minimise classification disputes and to facilitate voluntary compliance.

However, if at all the government has to apply tax at two rates, the following guidelines should be kept in mind:

► Goods of the same nature (e.g., all food items) should be kept in the same rate basket to avoid classification disputes.
► Competing goods should also be kept in the same rate basket to avoid any classification disputes.
► Essential goods should attract the lower of the two rates.
► All goods sold by a general store should attract the same rate so that traders, particularly small traders, are not burdened with the compliance complexities.
► Services should attract the lower of the two rates.
2.4 GST Council

The role of the GST Council for a dual GST, as proposed to be introduced, cannot be over-emphasised. It will be a forum where the Centre and the States can discuss and jointly decide upon critical parameters such as GST rates, exemptions, thresholds and other key parameters such as the place of supply rules. A forum of this nature will be fundamental to achieving harmonisation, essential for GST implementation.

The role of the GST Council has been contentious and the Centre and the States have had divergent views on the issue of the degree of harmonization and the States’ fiscal autonomy. The States have expressed concerns about the supremacy of the Council over the legislature, if its decisions were to be binding on the States. Therefore, according to the Constitution (A) Bill, the Council’s powers have been made only recommendatory though they will be guided by the need for a harmonised structure of GST.

While it is expected that the GST Council’s recommendations will be respected and abided by the Centre and the States, for structural features of the GST such as the determination of place of supply, the recommendations of the Council should be binding on all States. This will be essential to ensure that there is no double taxation of any supply of goods or services or cascading impact of any taxes.

2.5 Place of supply rules

Determination of the place of supply will be fundamental to determining the State where tax is to be paid and therefore, deciding on the application of SGST or IGST.

We understand that the Government of India has already prepared the Draft Place of Supply Rules. **Before finalising the Rules, the industry must be provided an opportunity to work closely with the government in further developing these Rules after considering the intricacies of the businesses.**

The rules should not be simply an adaptation of those that apply at the Centre level. Under the rules prescribed by the Centre, place of supply or point of taxation is generally defined to be the place where the recipient or customer is located. Where the place of buyer and seller is the same, SGST could apply. Where the buyer and the seller are located at different places, IGST would apply. The main difficulty with these rules is that while at the national level the place of buyer/supplier is readily identifiable, this will not be the case at the State or sub-national level. Many suppliers have a pan-India presence and operate from many States. Similarly, many recipients/customers have a pan-India presence.

In such cases, neither the place of supplier nor the place of buyer is unique. Ad-hoc or arbitrary rules are needed in such cases to define their location, which in turn impacts whether they are subject to SGST or IGST and if it is SGST, in which state it would apply.

Another point to note is that in case of B2C supplies, the place of buyer is not known to the supplier at the time of transaction. As a result, the supplier will be at a loss to determine which State’s law he should apply. For example, a digital product supplied online through e-commerce. In such cases, the place of supply can be defined for goods but for intangible services, the supplier has no verifiable information on the place where the recipient customer is located. He can place the order electronically from any place in India or abroad. In fact, the location of the supplier itself is indeterminate. To add to the complexity, the buyer’s/seller’s location may change. For instance, there may be a change of residence of the policyholder in the case of life insurance policies.

This problem is faced by all international jurisdictions applying VAT/GST, but they have not been able to find a workable solution.

The following aspects must be considered while finalising the Place of Supply Rules:

- The Rules should follow the consumption-destination principle, i.e., the supply of goods or services should be taxed in the State where it is consumed.
- The destination must be unique among the States.
Place of supply should not impact in any way input tax credit entitlement of the supplier or the recipient.

As far as possible, the rules should apply uniformly to goods and services. Where they differ, clear guidelines must be provided for treatment of composite supplies consisting of both goods and services.

Where the State tax rates differ, the Rules should minimise any incentives to divert supplies to low rate jurisdictions.

Matters relating to the place of supply may be considered by the GST Council. However, as observed in the previous section, the Constitution (A) Bill requires the Council’s powers to be only recommendatory. For structural features of the GST such as the place of supply, the recommendations of the Council should be binding on all States. Therefore, the Place of Supply Rules must be uniform and binding for all States. This will be essential to ensure that there is no double taxation of any supply of goods or services.

Tax should be creditable for both local sales and inter-state sales. Inter-state sales will attract CGST and IGST but not SGST (effectively, inter-state sales will be zero-rated under SGST). Any input tax under SGST could be offset against IGST.

In the case of services such as telecom services and e-commerce supplies, there is no fixed place of performance or use of the service. Therefore, special rules need to be framed keeping in mind the basic destination principle.

A clear definition of what constitutes “goods” and “services” should be provided under the Constitution (A) Bill.

2.6 Entry tax

The Constitution (A) Bill proposes to amend the Seventh Schedule to the Constitution and substitute a new entry 52 for the current entry 52, to retain the States’ power to levy taxes on the entry of goods into a local area for consumption, use or sale therein to the extent levied and collected by a Panchayat or a Municipality.

Entry tax imposes a major cost burden on the industry and is a deterrent for its operations and expansion plans. The problems get compounded when entry taxes are levied on industrial inputs and on transit sales. Such taxes go against the concept of the common market.

Further, entry tax has been a subject of protracted litigation at all levels. Article 301 of the Constitution provides for freedom of trade and commerce throughout the territory of India and precludes the States from taxing inter-state transactions to prevent/minimize barriers to inter-state trade. On the other hand, Article 304 of the Constitution allows the legislature of the State to impose tax on goods imported from other States or the Union Territories, in line with the tax imposed on similar goods produced in that State, to avoid any discrimination between imported goods and locally manufactured goods.

The Task Force on GST constituted by the Thirteenth Finance Commission had recommended that all entry and octroi duties levied by the third-tier of Government must be abolished. We understand that the Centre also considered the option of fully subsuming entry tax in GST, but, at the insistence of Maharashtra, made an exception for entry taxes levied and collected by local bodies (i.e., an octroi). Now that Maharashtra itself is proposing that local body taxes will be totally overhauled under the GST, there should be no exclusion for any entry tax, regardless of whether it is levied by the State or a local body.

Continuation of entry tax outside the GST will perpetuate the current complexities and litigation and impose barriers to trade. It is, therefore, suggested that entry tax should be fully subsumed in the GST.
2.7 Entertainment tax

The Constitution (A) Bill empowers the District Councils and Regional Councils to levy tax on entertainment and amusement. Furthermore, the Bill proposes to amend the Seventh Schedule to the Constitution and substitute a new entry 62 for the current entry 62, to retain the States’ power to levy taxes on entertainments and amusements to the extent levied and collected by a Panchayat or a Municipality or a Regional Council or a District Council.

One of the basic objectives of the GST is to replace the current multiplicity of taxes with a single, comprehensive tax. Continuation of levies such as the entertainment tax levied by local bodies will defeat this objective. Such specific taxes balkanize the common market and give rise to significant controversies about the scope of taxes.

The current entertainment tax structure is a patchwork of many taxes and the entertainment tax rates are abnormally high. The impact of cascading taxes on the industry is significant. Exclusion of entertainment tax from GST will lead to cascading in many instances and impose a serious burden on the industry.

Supplementary levies in addition to the GST are warranted only for products that are harmful to health (e.g., alcohol) or give rise to negative externalities (e.g., petroleum products). However, there are no negative externalities associated with entertainment and it deserves to be treated at par with other goods and services.

Imposing a separate tax on entertainment outside GST would pose serious practical difficulties. Entertainment is not well defined and includes a large variety of activities. With the advent of modern technology, entertainment has assumed many diverse forms and has become highly mobile. Already several disputes have arisen about the scope of entertainment tax.

An example is that of the entertainment tax levied by Madhya Pradesh that covers a wide range of telecom and other activities. The provisions of the MP Entertainment tax Act could be interpreted to include even the non-entertainment value added services offered by telecom operators such as news updates, messenger/email services, money transfers and bill payment services to name a few. Moreover, the entire telecom business is structured based on the telecom circle jurisdictions and not for individual States within the circle. Therefore, the jurisdiction of levy (only Madhya Pradesh) does not coincide with the telecom jurisdiction (both Madhya Pradesh and Chhattisgarh) thereby raising serious compliance issues.

A separate tax at the national or state level is bad enough, it will be worse at the local or municipal level, as evident from the above example. Businesses do not maintain records/books of accounts that identify transactions at the local level.

Moreover, the quantum of revenues earned by States from entertainment tax is not significant and constitutes less than 1% of their total revenue from indirect taxes. The revenue apportioned to/collected by local bodies is an even smaller proportion. It is expected that the States’ revenue would witness an overall increase. The States would have enough scope to provide funds to local/municipal bodies.

Therefore, entertainment tax, including tax imposed by local bodies, should be fully subsumed in the GST.

**Conclusion**

While bringing in a reform of this magnitude, the Government must provide adequate opportunity to the industry to regularly interact with the officials dealing with these aspects. This is crucial to be able to understand the issues and complexities involved and arrive at mutually acceptable outcomes.
Chapter 3
3 Global tax trends: how is India responding?

3.1 Transparency and Exchange of Information (EOI)

With increased technology advances, there is enhanced focus on transparency. Ease of doing business index of World Bank and norms for the World Economic Forum's Global Competitiveness ranking take transparency into consideration for their calculations.

Initiatives seeking increased transparency in tax matters derive momentum from several factors that include development issues; idea of fairness of tax including fair share of tax, government crackdown on tax avoidance; advances in technology that have made these efforts feasible, coupled with public perception about the corporates obligation to pay a fair share of tax.

An OECD project targeting harmful tax practices that commenced in 1998 was refocused in 2001 to expand and improve the exchange of tax-related information between jurisdictions. One outcome of this project was the 2002 OECD model agreement on Exchange of Information on Tax Matters (TIEA).

Following a push by the G20 in 2009, when the global economy was suffering from the effects of the global financial crisis and governments sought additional tax revenues, the number of TIEAs around the world increased markedly, including in cases where comprehensive bilateral treaty was unlikely.

The other two major developments, which gave a push to transparency are, Savings Taxation Directive of EU, which requires EU member States to share information to ensure that cross border financial income is taxed effectively and no EU member State is allowed to refuse request for information solely on the grounds of banking secrecy. The other development is Foreign Account Tax Compliance Act (FATCA) enacted in the US in 2010 to target non-compliance by US taxpayers using foreign accounts. These measures have sought to enhance inter-governmental information exchange.

Legal construct for exchanging information

The legal basis for exchange of information internationally is found in Article 26 of the OECD MC and UN MC. This article facilitates EOI through various mechanisms – on request, spontaneous and automatic, between tax treaty partners.

Apart from the above bilateral measures, a multi-lateral tool titled the Convention on Mutual Administrative Assistance in Tax Matters (MAAT) was developed by the Global Forum\(^5\) to effectively exchange information. MAAT provides for a legal basis for multi-country co-operation to facilitate EOI and assistance in recovery of taxes.

Exchanging information on an "automatic" basis

As a sequel to MAAT, on 21 July 2014, the OECD released the full version of the “Standard for Automatic Exchange of Financial Account Information in Tax Matters” (Standard) in response to G20’s call for automatic exchange to become the new international standard for EOI. The Standard consists of the (i) Model Competent Authority Agreement (Model CAA), intended as a template for intergovernmental agreements, and (ii) a Common Reporting Standard (CRS) that contains the reporting and due diligence standard that underpins the automatic EOI. The OECD has modelled the CRS on the intergovernmental approach to the Foreign Tax Account Compliance Act (FATCA).

A major breakthrough in this regard was achieved on 29 October 2014 when finance ministers from 51 jurisdictions signed a multilateral CAA at Berlin. Another 30 have pledged to join by 2018. The signatories have agreed to start sharing information from 2017 or 2018.

\(^5\) The Global Forum currently has 123 members on equal footing and is the premier international body for ensuring the implementation of internationally agreed standards of transparency and EOI in tax matters. Through an in-depth peer review process, the Global Forum monitors that its members fully implement the agreed standards of transparency and EOI.
Focus of BEPS project on transparency

OECD’s proposal for country by country reporting (CbCR), proposed as part of BEPS Action Plan 13, called for a review of existing transfer pricing documentation rules and emphasised sharing of information for transfer pricing audits. The CbCR template as evolved requires all multi national enterprises (MNEs) to report on an annual basis, information country wise (not entity wise). The template covers information about revenue, earnings before tax, current tax, stated capital and accumulated earnings, employee headcount, tangible assets, a list of group entities by country and business activity code for each entity’s major activities. The CbCR is intended to aid tax authorities in a “transfer pricing risk evaluation” and together with related TP documents (i.e., the master files and local files) are intended to provide tax authorities with information to evaluate whether profits are being taxed in accordance to the functional profile of the company.

Action Plan 5 of BEPS viz. “Countering harmful tax practices” also emphasises on transparency by way of compulsory spontaneous EOI of taxpayer specific rulings related to preferential regimes. The report also provides for a detailed framework for such spontaneous EOI by defining circumstances in which information is to be shared with the counterpart country.

India's position on transparency and EOI

India has been a strong proponent of transparency and EOI for tax purposes and has pushed the G20 forum to exert pressures on countries that do not conform to international standards of transparency. India is already a signatory to MAAT and has agreed to be an early adopter of the Standard on automatic information exchange. In a Press Note issued by Government of India (GOI) in September 2014, the Government has reiterated the importance of sharing information about taxpayers hiding money in tax havens. The hon'ble Prime Minister Narendra Modi at the G20 session on “Delivering Global Economic Resilience” in Brisbane on 16 November 2014 echoed similar views.

Despite all its commitment, India missed to sign the multilateral CAA in October 2014 at Berlin. This is reportedly in the wake of ongoing proceedings before the Supreme Court (SC) pursuant to the case of Ram Jethmalani. The SC required the GOI to share certain information with a Special Investigation Team (SIT). While the GOI was duty bound to comply with the direction of SC, there is apprehension on whether the treaty country may perceive such sharing to be against international standards of confidentiality covenant agreed to in a treaty. The GOI has petitioned to the SC to guide on whether it would be appropriate for the GOI to sign any treaty requiring a certain level of confidentiality desired by other countries, within the framework of Indian law, without having to violate the Indian law or the treaty. Pending clarity on this, signing CAA has also been deferred.

This uncertainty is likely to impact India’s ability to sign FATCA, and also proceeding to initiate an agreement to exchange information on an “automatic” basis with Switzerland.

Legislative and administrative measures in India to facilitate EOI

India has made certain changes relevant to facilitate effective EOI by way of amendments to the Indian income Tax Act (ITA). For instance, S. 285BA, which has been amended, making it necessary for financial institutions to furnish prescribed information to tax authority on annual basis. S.94A was inserted in the ITA to empower the GOI to insist on certain additional reporting and compliance requirements where a transaction is with a country notified as a non-cooperative Jurisdictional Area (NJA). Cyprus was notified as a NJA on 1 November 2013. The Press Release issued by the Ministry of Finance in this regard suggests that this step was needed because Cyprus has not been providing the information requested by Indian tax authorities under the EOI provisions of the India-Cyprus DTAA.

The GOI has since set up an EOI Cell in the Foreign Tax and Tax Research (FT&TR) Division of the CBDT to facilitate EOI. India has a strong network of around 80 plus DTAA’s containing the EOI article and

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6 India has signed MAAT on 26 January 2012. It is effective in India from 1 June 2012.
7 Early adopters are expected to start the exchange process from September 2017, while others join in 2018.
8 339 ITR 107 (2011)
Enabling ‘Make in India’ through effective tax reforms

TIEAs with more than 16 jurisdictions. Additionally, more than 10 other TIEAs are under different stages of negotiation.

Apart from MAAT, India also has a multilateral agreement with the South Asian Association for Regional Cooperation (SAARC)\(^9\), which has a specific provision for EOI.

Concluding thoughts

While transparency is certainly desirable, the exercise needs to be handled pragmatically by balancing with the corresponding cost of compliance and the burden on time and resources of national talent. Moreover, the information – in particular, the bulk raw data, needs to be captured, classified, analysed and interpreted intelligently, and in good time, by using the state of art “e-technology.” Unless this is done, the wild collection of data may not only confuse tax administrators, but can also result in undue demand on the resources of MNEs by multiple countries. It is apprehended that unless exchanged information is understood in its proper context, there is a risk of adverse, unintended and incorrect interpretation. There is an apprehension that the raw data is likely to be used by tax administrators for adoption of formulary apportionment rather than using arm’s length transfer pricing principles. There is also a concern on confidentiality. Unless proper safeguards and appropriate legal system is in place, information may slip into the hands of competitors through some weak jurisdictions. Unfair publication of unanalysed data may also harm reputation of MNEs. Allegation of misconduct in proceedings initiated by activists in some jurisdictions is further likely to drag the MNEs to litigation. One hopes, that the policy makers, legislators and administrators will reap the benefits of EOI by exercising their discretion and judgment in fixing the scope of uniformly designed templates and in analysing or using protected information.

3.2 Tax base erosion

BEPS: OECD/G20 project: overview and current status

The 2008 financial crisis had put Government budgets under strain and MNEs were criticised for failing to pay their “fair share of tax”. In June 2012, the G20 released a statement calling for “the need to prevent base erosion and profit shifting (BEPS)”. The OECD responded to this call by releasing an initial report on BEPS in February 2013. The initial report contained studies and data available regarding perceived magnitude of BEPS and provided an overview of global developments, which affected corporate tax matters. The report primarily echoed the view that BEPS concerns were aggravated because current international tax standards failed to keep pace with changes in global practices, particularly in the area of intangibles and the development of e-Commerce/digital economy.

The initial report was followed up by a comprehensive 15 Action Plan report released in July 2013. The Action Plan report recommended consensus-based changes needed to address risk of double non-taxation or cases of no or low taxation arising primarily due to artificial separation of activities from the jurisdiction in which the value was created.

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\(^9\) Illustratively with Barbados, Costa Rica, Cook Island, etc.

\(^{10}\) The agreement with SAARC is effective in India from 1 April 2011.
Three pillars of BEPS

13 out of 15 actions are classified under three pillars viz. coherence, substance and transparency. Action Plan 1 (Digital Economy) is an industry-specific report likely to be affected by other actions, while Action Plan 15 focuses on swiftly implementing the results of the Action Plan by way of a multilateral instrument. The following table provides a broad overview of various action plans, which form part of the 3 pillars:

<table>
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<tr>
<th>Coherence</th>
<th>Substance</th>
<th>Transparency</th>
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<td>Hybrid mismatch arrangements (2)</td>
<td>Preventing tax treaty abuse (6)</td>
<td>Methodologies &amp; data analysis (11)</td>
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<td>Interest deductions (4)</td>
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<td>CFC Rules (3)</td>
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<td>TP/High risk transactions (10)</td>
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<td>Digital Economy (1)</td>
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<td></td>
<td>Multilateral instruments (15)</td>
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Action plans under the “coherence” pillar aim to ensure that there is consistency and fairness in tax treatment across jurisdictions to check cases of double non-taxation arising from differing or preferential tax treatments under domestic laws of various countries or due to differing treaty rules.

Action plans under the “substance” pillar aim to ensure that income is offered for taxation in the jurisdiction in which value creation functions take place. These emphasize transfer pricing apart from checking treaty abuse (including treaty shopping).

Action plans coming under the “transparency” pillar encourage exchange of information and aim to provide certainty and predictability to taxpayers through a dispute-resolution mechanism.

Actions so far

The OECD has differing timelines stretched over 2014 and 2015 under each of the above Action Plans. The results of these actions are expected to provide countries the tools they need to ensure that profits are taxed where economic activities generating profits are performed and where value is created. With respect to 7 out of 15 actions, the reports (aggregating to more than 700 pages) came to be made public in mid-September 2014. Among them are key recommendations for CbCR and a proposal for a new multilateral instrument designed to provide an innovative approach to achieve automatic amendment to treaties across the globe to ensure that recommendations emerging from different action plans are implemented swiftly.

BEPS and developing countries

In view of a specific direction from G20, OECD also undertook an exercise to develop an exclusive report to identify BEPS’ challenges peculiar to developing countries. The report released by the OECD in August 2014 asserts that BEPS reduces resources available to developing countries especially if they rely disproportionally on tax revenue from MNEs. The report reiterates that BEPS undermines the effectiveness and credibility of tax systems of these countries. It identifies different peculiar challenges of developing countries such as inadequate legislation, lack of trained administrators, inadequate reporting rules, poor compliance, poor enforcement and ineffective processing systems for capturing information, etc.
India's Response to BEPS

In response to the BEPS questionnaire dated 8 August 2014 issued by the UN, India has also highlighted that like any other developing economy, BEPS is a concern for India in view of the fact that Indian economy is also reliant on corporate tax from MNEs. India has identified certain major BEPS challenges such as – excessive payments towards finance and service charges to overseas affiliates; inappropriate (mispricing) of business functions actually conducted in India; ability of a digital economy player to have significant virtual presence without paying any source country tax; ability of MNEs to artificially avoid PE trigger and engage in treaty shopping. As part of its response, India highlighted significance of effective EOI among jurisdictions.

While India continues to express strong commitment on the BEPS initiative, the response states that India strongly believes that BEPS issues must be addressed in a manner that result in breaking down all such structures or practices that promote or protect base erosion and profit shifting. For example, if the problem is a leaking bucket then steps must be taken to swiftly plug that leak or replace the bucket instead of debating how to calibrate the speed of inflow of water into the leaking bucket.

Global trends

While OECD actions are likely to be finalised by end of 2015, significant unilateral actions are seen in various countries, which touch upon many of the aspects identified in BEPS action plans. To illustrate:

- Many countries have strengthened SAARs to deal with targeted/identified anti-avoidance measures apart from introducing GAAR (e.g., Finland, France and Norway).
- Certain countries have taken positions to tax internet activities even in the absence of a fixed place of business (such as, Taiwan and Vietnam) – [e.g., proposed introduction of a special tax in the UK to primarily target technology companies having economic activity in the UK].
- With a view to counter hybrid mismatch, significant action has been seen in the form of comprehensive anti-hybrid rules (in the UK, Denmark and South Africa), taxing dividends where they are deducted by the payer (in Germany, Hungary and Poland), limiting the deductibility of an expense where the recipient is subject to no or low tax (in Austria, France, Mexico).
- A few countries currently have disclosure rules targeted at aggressive tax planning (e.g., the UK, Canada, Ireland, Israel, South Africa and the US). The scope of these rules is defined either by reference to features of the transaction (in Ireland, South Africa, Israel) or by the commercial arrangement with the advisor/promoter (in Canada) or by both (in the UK, the US).

India trends

Globally, India was one of the early proponents of BEPS concerns. The following legislative provisions or approach illustrate this:

- Though no specific domestic tax provisions concerning digital economy are present, definition of royalty/fees for technical services under the domestic law is perceived to be wide enough to capture many technology/digital economy transactions. As part of its response to BEPS Action Plan on Digital Economy, India has reiterated that, in the e-commerce era, the current PE concept based on physical presence may lead to serious disequilibrium in sharing of tax between country of source and country of residence.
- India’s tax treaties are characterised by a reduced threshold for PE definition, inclusion of a provision on service PE, etc.
- Though there are no specific rules currently, CFC rules are contemplated in the proposed Direct Tax Code (DTC). It also specifically provides for override of tax treaties for CFC application.
- GAAR provisions and LOB clause in many of India’s tax treaties seek to prevent abuse of treaty benefits under inappropriate circumstances.
- While Indian tax authorities do, in general, follow the OECD TP Guidelines, the following aspects concerning TP may merit attention:
Definition of the term “intangible property” for TP purposes is wide enough to include human capital-related IP such as trained and organized workforce and employment agreements.

The Indian TP administration does not agree with the position that risk can be controlled remotely by the parent company and that Indian entities engaged in core functions, such as carrying out R&D activities or providing services can be risk mitigated entities.

According to India, apart from location savings, profit from location-specific advantages (referred to as “location rent”) such as skilled manpower, access to market, large customer base, superior information and distribution network should also be allocated between associated enterprises.

What India needs to do/concluding thoughts:

The importance of equity, certainty and fairness are essential attributes for an effective and efficient tax system and they should be given due consideration in the making, administration and enforcement of tax laws. Unfortunately though, in recent years, a perception has been formed that India is not a very friendly place to do business. What startled people the most was retrospective amendment in 2012 to virtually negate SC judgement in the Vodafone case. There is an urgent need to change this image and the current Government appears to be committed to act towards this to usher in non-adversarial tax regime.

India has set up a Tax Administration Reform Commission (TARC) comprising senior government officials and private sector tax professionals under the chairmanship of Dr. Parthasarathi Shome, with an objective of bringing in credibility among tax payers and streamlining income tax procedures. The first report of the TARC that was made available to the public in June 2014 expresses an overwhelming need for fundamental reform in tax administration and contains various recommendations to achieve desired tax reforms. The report contains refreshingly significant recommendations for a “comprehensive” transformation of tax administration founded on accountability and recognition of the taxpayer as a “customer”. The recently released guidelines direct field officers to implement a series of taxpayer-friendly measures. These guidelines consolidate some earlier instructions and are aimed to boost efforts in achieving the objective of furthering a non-adversarial and customer-friendly tax regime.

Moreover, in terms of TP assessment, Indian audits are perceived to be aggressive and have made various adjustments, which were seen to be inconsistent with the basic tenets of taxation. Introduction of APA and pragmatic response to the applicants will go a long way in controlling proliferation of tax litigation in the field of TP.

While there may be no objection to plugging the weakness created by e-commerce trading and while tax evasion and artifice can be dealt with sternly, discretion should be exercised in so implementing the law that there is no disincentive to invest in India. The growth of business brings many other economic advantages to the country. It becomes important to sustain the climate of confidence, clean environment and equitable approach in matters of tax administration.

3.3 Tax planning

Global trends in tax planning

“Avoidance of tax liability by so arranging commercial affairs that charge of tax is distributed is not prohibited. A tax payer may resort to a device to divert income before it accrues or arises to him. Effectiveness of the device depends not upon considerations of morality, but on the operation of the Income-tax Act. Legislative injunction in taxing statutes may not, except on peril of penalty, be violated, but it may be lawfully be circumvented”, exhorted Justice Shah in CIT v Raman & Co. As can be seen from Justice Shah’s remarks in 1967, and evidenced in many judgements later, the
dilemma of addressing questions of morality in matters of tax planning has more often than not surfaced for consideration of the judiciary.

Every form of tax planning results in reduction or avoidance of tax. In many cases, such reduction is tolerated by the legislature because they achieve an economic or social objective. Illustratively, incentive provisions on export realisation, enhanced deductions on investment in plant and machinery, deductions to set up facilities in remote places, investment in certain priority sector, etc. This kind of tax planning is regarded as acceptable. Where reduction in tax liability is in total disregard of the spirit of the legislation, it is termed as aggressive or unacceptable tax planning. This form of aggressive tax avoidance may be compliant with the letter of law but violates its spirit.

Governments have been spurred to act by multilateral organizations, including the G20, the OECD and the European Commission. Tax activist groups have turned a spotlight on tax havens, high-net-worth individuals, and now, the seemingly low effective tax rates reported by some MNCs. A series of steps, including increased information exchange, expanded disclosure requirements, have also been put in place to address what countries view as unacceptably aggressive tax planning.

As early as in 1998, the OECD released a report **Harmful Tax Practices - An Emerging Global Issue**. The report notes that tax planning through use of tax havens and preferential regimes resulted in tax base erosion of other countries and distortion of trade and investment patterns. The focus of the report was on location of geographically mobile services, such as financial and other services, including provision of intangibles. The ongoing BEPS Project is a comprehensive leap forward in this direction with increased participation from developing countries and other stakeholders. As part of BEPS project, the OECD has identified certain structures, practices and strategies used by MNCs to reduce taxable profits in the jurisdictions in which they operate and ways to address them. Once implemented, they will have a significant impact on tax planning structures going forward.

**Anti-avoidance measures**

Anti-avoidance rules can broadly be divided into two main categories: “general” and “specific.” A general anti-avoidance rule (GAAR) is a set of broad principles-based rules within a country’s tax code designed to counteract the perceived avoidance of tax. GAAR is a concept within law that provides the taxing authority a mechanism to deny tax benefits of transactions or arrangements believed not to have any commercial substance or purpose other than to generate the tax benefit(s) obtained. A tax law designed to deal with particular transactions of concern are termed as specific anti-avoidance rules (SAARs).

While judges in several GAAR cases have defended businesses against overly broad application of the rule, some countries that lose in court have responded by proposing new laws to make their GAAR stringent. In countries without a GAAR, tax authorities are increasingly challenging business arrangements on the grounds that they lack substance, even if such arrangements comply with the applicable law. While Australia implemented GAAR nearly a century back in 1915, China has introduced GAAR incorporating substance over form principle into its tax laws in 2009. UK GAAR came into force from July 2013 whereas US does not have GAAR but has adopted a general statutory rule codifying economic substance over form principle into its tax laws in 2009. UK GAAR came into force from July 2013 whereas US does not have GAAR but has adopted a general statutory rule codifying economic substance over form principle into its tax laws in 2009. UK GAAR came into force from July 2013 whereas US does not have GAAR but has adopted a general statutory rule codifying economic substance over form principle into its tax laws in 2009. UK GAAR came into force from July 2013 whereas US does not have GAAR but has adopted a general statutory rule codifying economic substance over form principle into its tax laws in 2009. When compared with GAAR, SAAR fares better in tackling specific cases of abuse.

One area of SAAR that has generated significant global attention in the last few years is the practice in some countries, such as India, China, Chile, of looking through holding company structures and attempting to tax indirect transfer of assets. This trend began with the position taken by India in the Vodafone case, a position that was ultimately rejected by the highest Indian court. This resulted in introduction of SAAR in 2012, that too with retroactive effect dating back to introduction of Income Tax Act in 1961. The move has not gone too well with investors.
India's response to tax planning

Courts in India have respected the taxpayers' right to legitimately plan their affairs to minimise their tax liability. In Vodafone International Services the SC held that all tax planning is not illegal, illegitimate or impermissible. However, at the same time the courts have not hesitated to strike down blatantly artificial or colourable devices. In the case of Vodafone, the SC spell out a word of caution that a TRC may not by itself be considered as conclusive proof of residency and the Tax Authority will not be precluded from denying DTAA benefits, if it is established, on facts, that the Mauritius company has been interposed as the owner of the shares in India, solely with a view to avoid tax without any commercial substance. In such cases, the tax authority is entitled to look at the entire transaction as a whole and if it is established that the Mauritian company has been interposed as a device. In other words, TRC does not prevent enquiry into a tax fraud, for round-tripping or any other illegal activities.

From time to time, specific amendments have also been brought into the Income Tax Act (ITA), to address unacceptable tax avoidance strategies of taxpayers. Illustratively, some prominent Specific Anti Avoidance Rules (SAAR) under ITA are listed below:

<table>
<thead>
<tr>
<th>Section</th>
<th>Purpose</th>
</tr>
</thead>
<tbody>
<tr>
<td>Section 2(22)(e)</td>
<td>Deems loans granted by closely held company to shareholder or a concern in which shareholder is interested as dividend</td>
</tr>
<tr>
<td>Section 9(1)(i)</td>
<td>Deems shares of a foreign company to be situated in India if it derives its value substantially from assets located in India – provision to tax indirect transfer of Indian assets</td>
</tr>
<tr>
<td>Section 40A(2)</td>
<td>Denies deduction for excessive payments to related parties</td>
</tr>
<tr>
<td>Section 56(2)(vii), (viia)</td>
<td>If some property is received at less than its fair market value, the difference is treated as income of recipient</td>
</tr>
<tr>
<td>Section 56(2)(viib)</td>
<td>Taxes share premium received by closely held company in excess of fair value of share in the hands of the company</td>
</tr>
<tr>
<td>Section 115JB</td>
<td>Levies taxes on book profits where tax on income computed according to ITA is lower than tax on book profit</td>
</tr>
<tr>
<td>Section 115QA</td>
<td>Levies distribution tax on buy back of shares and plugs the loophole through which profits were repatriated in a tax-free manner</td>
</tr>
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</table>

In addition to SAAR, GAAR was formally introduced as part of ITA in 2012. Considering comments from various stakeholders, a modified version of GAAR was introduced by the Finance Act 2013 with certain changes and its application was deferred to tax year 2015-16. Once GAAR applies, the Tax Authority would have wide powers to disregard, re-characterise step or part of arrangement, reallocate income or expenditure among parties, disregard any accommodating party, deem connected persons as a single person, treat residence or situs of parties or assets or transaction as different from the one actually entered into as part of the transaction, re-characterise equity, debt, capital and revenue items etc. GAAR provisions also override tax treaty provisions.

GAAR Rules were notified in September 2013, which limited application of GAAR to arrangements in which aggregate tax benefit involved is more than INR30 million. A carve out from GAAR is also provided for Foreign Institutional Investors (FII) and investors in FII under certain conditions. Income from transfer of investments made prior to 30 August 2010 is grandfathered.

In addition to the above, the DTAs entered into by India also contain several specific anti avoidance provisions such as limitation of benefits, inclusion of “beneficial ownership” criteria to avail concessional withholding tax rate in the source country, inclusion of article on fees for technical service, trigger of services PE where services furnished in the source country exceed a certain specified threshold number of days.

13 [(2012) 342 ITR 1 (SC)]
What India should do

While SAAR as a means to address tax abuse is welcomed, its application would be less litigious when it is as a rule made prospective in its application. As stated earlier, when compared with GAAR, SAAR fares better in tackling specific cases of abuse. SAAR tends to be more efficient, since it is less subjective and procedurally more efficient.

However, where GAAR is to be implemented, the Government needs to step in and reassure the taxpayers that as recommended by the Shome Committee, GAAR will be applied only in case of abusive, contrived and artificial arrangements. As part of ensuring clarity and certainty to investors, the business choices made (illustratively decisions such as raising funds through debt v. equity, using LLP form of organisation as compared to a company, leasing assets instead of outright purchase, etc.) should not be questioned under GAAR on the premise that there was an incidental tax benefit attached to it. Appropriate compensatory/secondary/consequential relief should be provided to the affected party on application of GAAR. It would also go a long way forward in building and boosting confidence of investors if it is clarified that GAAR and SAAR will not apply simultaneously and that once an arrangement is tested for SAAR, GAAR will not be applied on the same arrangement. On the implementation side, India needs to have a team of specialised trained tax officers who will oversee the enforcement of GAAR with regular clarifications and instructions, which will bridge the trust deficit between taxpayers and tax authorities. A generic rule of GAAR provisions with an overriding effect over tax treaties in all situations should be withdrawn. Many of the LOB clauses present in a tax treaty, contains a subjective test, according to which treaty benefits will be denied if the “main purpose” of the transaction/ arrangement is to obtain treaty entitlement. The Tax Authority is likely to invoke this provision even in respect of bonafide transactions. Therefore, domestic guidelines with examples should be issued to guide taxpayers on situations where such test and GAAR conditions are regarded as met.
Chapter 4
Part 1- ASEAN
4 Making tax environment more facilitative: lessons from other jurisdictions

Base erosion and profit shifting (BEPS) is a ubiquitous word in today’s global tax environment. It essentially refers to alleged shifting of profits by multinational corporations (MNCs) from high tax jurisdictions to no or low tax jurisdictions, albeit all within existing international and domestic legal frameworks. It will not be an exaggeration to state that this has led to a global awakening and resultant concern among governments all around the world, who are struggling to protect their tax revenues to tide over the global economic downturn. This has led to concerted efforts globally by governments to make MNCs pay their “fair share” of taxes in their respective countries. The Organization for Economic Cooperation and Development (OECD) has also spearheaded a BEPS Action Plan to propose ways domestic and international tax legislation should adapt to combat BEPS. Given this, governments, particularly in developing countries, now have an uphill task of treading a fine line between implementing measures to protect their tax base, while at the same time maintaining a domestic environment conducive to foreign investment.

This balancing act for now, in certain countries, seems more skewed towards protecting the tax base resulting in certain unilateral tax measures not going down well with foreign investors.

4.1 China

China has generally not been known for the friendliest environment for foreign investment with a rank of 90 (out of 189) on the World Bank’s 2014 Ease of Doing Business (“EDB”) index. China’s State Administration of Taxation (SAT) has also long been aggressively focusing on cross-border tax leakage, independent of the OECD’s BEPS Action Plan.

For example, the Guoshuihan [2009] No. 698 (“Circular 698”) was released back in 2009. Circular 698 aims to tax gains derived by non-residents from an indirect transfer of shares in a Chinese company where the seller is unable to substantiate the objective behind the adopted reorganization model resulting in avoidance of China taxation.

More recently in 2014, the SAT issued a notice directing local tax bureaus to investigate outbound intercompany royalty and service payments to assess if these payments have real business purpose and commercial substance. In case it is lacking, anti-avoidance investigation procedures are to be launched.

China has also jumped on the anti-BEPS wagon, closely following releases of OECD’s BEPS Action Plan and focusing internal efforts against items of concern highlighted and discussed by the OECD.

China still does not appear to be relaxing its stance against alleged tax avoidance. However, with a domestic population of more than 1.3 billion people and the commercial potential that comes with it, China perhaps may not need to rely as heavily on being an “easy” place to do business to attract foreign investment as other developing countries may need to.

4.2 The Philippines

The Philippines hovers at around the same level of “easiness” of doing business as China, at number 95 on the World Bank’s EDB index. Similar to China, the Philippine tax authorities are also fairly aggressive in their fight against BEPS. However, based on recent developments, it does appear that the Philippines is moving towards a more sophisticated approach in the application of its rulings.

For example, a revenue memorandum order was issued in 2000 by the authorities, which requires taxpayers to submit a tax treaty relief application (“TTRA”) at least 15 days prior to the income actually being paid to non-resident, in order to apply treaty relief (e.g., reduced rate of withholding tax). This administrative issuance was repealed and superseded by Revenue Memorandum Order No.

14 http://data.worldbank.org/indicator/IC.BUS.EASE.XQ
72-2010, which has been strictly followed by the Philippine tax authorities and treaty relief has generally denied where a TTRA is not filed.

However, in a landmark case in 2013, the Philippine Supreme Court ruled in favour of the taxpayer (who did not submit the TTRA within the requisite time frame), stating the principle that a TTRA should merely act as a confirmation that the treaty relief is applicable, and non-submission should not act to deny a treaty relief where the taxpayers have satisfied conditions to qualify for treaty relief as stipulated in tax treaties. This decision was reiterated in a Court of Tax Appeals case in 2014.

Lawmakers in the Philippines have also recently proposed a reduction in the headline corporate income tax rate to 25% from 30% currently to be more competitive in the region.

As such, while the Philippines may not be an easy place to do business according to the World Bank, from a federal level tax perspective, it does seem that the Philippines is striving to create an economy more open to cross-border transactions. However, it is yet to be seen whether or not the direction at the top filters down to local tax officers in conducting their tax audits.

4.3 Indonesia

As MNCs expanding into Indonesia have realised, it is not easy to set up a foreign business in Indonesia. It is therefore, no surprise that Indonesia ranks at number 114 on the World Bank's 2014 EDB index.

Indonesia has also been experiencing a slowdown in its economy due to recent presidential elections and low commodity prices on minerals, which of course, has detrimentally affected tax collection. Furthermore, based on statistics, the Indonesian tax authorities have failed to meet their tax revenue budget since 2009.

In the last few years, the Indonesian tax authorities have therefore, been intensifying their tax audit efforts, particularly with respect to transfer pricing, and making tax adjustments. Indonesia's new president, Joko Widodo, has also stated his mission of raising tax revenues by increasing the number of tax officers and ramping up tax collection efforts. Furthermore, with the OECD BEPS Action Plan promulgating transparency of taxpayers' operations and the exchange of information between tax authorities, the Indonesian Director General of Taxation (DGT) has also embarked on developing a tax database through data collection and information exchange. As such, it can only be expected that the Indonesia tax scene will be heating up even more in the near future in terms of tax controversy.

While the above seems to paint a gloomy picture for foreign investors, there has been some positive headway. Earlier in 2014, there were some changes made to the “negative list” for foreign investment, with some sectors now open more to foreign investment. In addition, a tax holiday facility, which was due to expire in August 2014, was also extended to 15 August 2015.

However, for now at least, Indonesia still seems to be concentrating more on increasing tax revenues than on inviting foreign investment.

4.4 Singapore

At the other end of the spectrum is Singapore, which is ranked number 1 on the World Bank’s 2014 EDB index. Singapore does not have any natural resources and hence, its economy is heavily reliant on foreign investment. As such, Singapore’s tax environment is generally more friendly to taxpayers, with a comparatively competitive corporate income tax rate, and a plethora of tax incentives for operations/activities in Singapore.

In addition to tax practices being relatively straightforward, to provide an even increased level of tax certainty, Singapore tax authorities are proactive in issuing technical guidance on the interpretation of tax legislation. For example, when many countries struggle on the subject of taxation of “royalties” and resultant withholding tax in the hands of the payer, Singapore authorities have issued detailed guidance on how to interpret what a “royalty” is for the purposes of Singapore withholding tax, as well as guidance on the application of the foreign-sourced income exemption. These initiatives help to avoid protracted litigation, and make the tax process smooth and easy to comply with.
However, in the context of today’s globalised world and particularly in view of the Singapore economy’s dependence on foreign investment, Singapore is also careful to ensure that its tax policies are in compliance with generally accepted international tax practices to avoid being viewed/and/or alleged as a “tax haven”. In 2014, Singapore has voiced its support for the OECD’s BEPS Action Plan, issued guidance on the tax treatment of hybrid instruments and has also issued a Public Consultation on making its transfer pricing documentation policies more stringent. Singapore has always imposed substance requirements for the granting of tax incentives, to ensure that only serious businesses with the ability to bring in substantive business operations to Singapore and contribute to the economy will qualify for tax incentives.

Lessons may be learnt from all the above countries, whether in terms of implementing measures to protect government tax revenues, or to facilitate foreign investment. The key takeaway is that countries need to implement the policies best suited to the development of their own economies. This, in most cases, would necessitate an economy, which is fairly open to foreign investment, not only to bring in foreign funding, but also to learn skills and best practices from more developed nations.

It is therefore heartening to see India’s new government take steps towards creating a more open and friendly tax environment. Historically, India’s tax regime has been viewed as extremely aggressive with fairly unreasonable positions adopted by tax authorities. However, the Central Board of Direct Taxes (CBDT) in November 2014 issued internal guidelines to local tax bureaus with a view of adopting “a less adversarial” approach towards taxpayers. Furthermore, the Finance Minister has also made good on his promise in the 2014-15 Budget speech and set up a High Level Committee (HLC) tasked with the objective of restoring investor confidence, partly by providing a stable and predictable tax regime.

We will, of course, have to wait and see how these new directives will be followed through on the ground, but they have definitely set tracks in a positive direction.

In summary, the 3 C’s imperative for any country to create a favourable, friendly and welcoming tax environment are - Clarity in tax laws; Consistency in their application and above all Certainty of treatment.
Chapter 4
Part 2- UK
4.5 The UK is open for business

The UK raises its game

EY’s 2014 UK attractiveness survey report finds the UK tops all European countries in terms of foreign direct investment (FDI) for the 12th year running. Our survey showed four key drivers of the UK’s performance:

- The strength and consistency of the UK's appeal across a wide range of attributes important to investors.
- The strength of the UK's attractiveness to existing investors
- The work that has been undertaken to improve the UK's offer to potential investors. Our survey respondents highlight financing, support for SMEs, taxation and support for key industries as areas in which the UK has advanced over the last year
- The draw of London

When all these factors come together -- as they did in 2013 -- the UK is able to attract the leading share of investments from major markets like the US, Japan and India, leading Europe in key sectors such as software and business services, as well as in R&D and HQ investments.

Many of the recent changes to the UK corporate tax regime mean that it is now seen as a facilitator, rather than a barrier, to groups achieving their commercial goals. A key tax factor is the 20% corporation tax rate due to come into effect in April 2015. Evidence for the success of this policy is very clear. Outward migrations of UK companies overseas have largely ceased. A number of high-profile multinationals have relocated to the UK with some groundbreaking moves announced very recently including, notably, from Switzerland, Italy, the Netherlands and Ireland extending the range of redomestications from the first wave of US transactions. And for every HQ transaction that requires public disclosures under relevant stock exchange rules, there are many more regional HQ and other business reorganizations into the UK without publicity. We are advising many groups that are considering moving HQs and operations to the UK.

The UK tax regime today

The UK tax regime has changed significantly in recent months. It is now attractive to business from both a commercial and corporation tax perspective, and features:

- A low headline rate of corporation tax reducing to 20% by 2015
- Competitive reliefs for innovative and high-tech industries, including an “above the line” research and development credit and a 10% rate of corporation tax on profits from the development and use of patents and certain other intellectual property in the UK
- Competitive rules for taxing the profits of a parent or regional holding company, with new, largely territorial, controlled foreign company rules, a broad-based dividend exemption, a foreign branch exemption, a substantial shareholding exemption (applying, broadly, to disposals of shares in trading companies by trading groups) and an extensive network of double taxation conventions
- Favorable interest deductibility with no territorial limitation, although with comprehensive anti-avoidance to protect from abuse
- A robust and highly respected tax authority, which is keen to engage with groups that wish to gain certainty on opportunities presented by these changes to the UK tax regime and a Treasury department that consistently demonstrates commitment to early and transparent consultation on tax law change.
Other trends to highlights

A positive trend relates to certainty, which businesses making significant investments require. In our experience, the UK Government is committed to giving certainty to business in relation to the taxation consequences of UK investment plans. In practice, this is typically through clearances agreed with HMRC. We believe that, surprisingly, many established UK HQ multinationals were slower to adapt their investment decisions to the changed UK environment than some non-UK HQ groups. We are now seeing more UK HQ groups reshaping their global business models and working with HMRC to obtain certainty and reduce tax risk. UK investment is now coming from UK HQ as well as non-UK HQ groups.

The level of interest in UK inward investment transactions has led to the creation of a specific team within HMRC dedicated to supporting such transactions. The Inward Investment Support team effectively fulfils the role that the Customer Relationship Manager would play for an established UK business. Many inward investment transactions change the footprint of people, functions and risks across countries within a global group. This means that certainty around transfer pricing treatment is a key part of many transactions. HMRC has also been investing additional resource into its existing APA team.

In an increasingly complex world, with high levels of controversy and comprehensive fiscal authority reviews occurring all across the globe, we believe that APAs fundamentally reduce corporation tax risk and are a key part of international tax risk management. The UK has bilateral APA and MAP experience across a broader range of countries than we see in the vast majority of other fiscal authorities around the world. We see this as a major differentiator for the UK as a country in which to locate business activity, because of the combination of a competitive tax regime with a sophisticated and respected tax authority that can work bilaterally to reduce global tax risks.

A second positive change to highlight is around wider government commitment to maximize the benefits to the UK of a competitive tax policy. This has been particularly visible in the trade missions of Members of Government, including the December trade mission to China which EY attended as advisers to Government. It is also visible in high-quality, such as The UK – number one for European headquarters and Guide to UK tax, both published in 2013.

The global tax landscape is evolving

A detailed summary of the various workstreams and action plans that will follow from the base erosion and profit shifting (BEPS) report is outside the scope of this report. However, some very clear, and we believe irreversible, themes are emerging from the OECD project on this topic, which include:

▶ More information will be available to more fiscal authorities to allow them to target their resources better to respond to what are perceived as higher-risk areas of international corporate tax.
▶ The broad trend, which has existed for many years, towards an increased alignment of commercial and global tax planning strategies with economic substance will continue and accelerate.
▶ Global corporate tax, and especially transfer pricing, risks will continue to increase.

In our view, all of these themes reinforce and support the impact of the UK’s competitive tax policy. The likelihood of high levels of substance in the UK, the breadth of the treaty network, the competitive tax regime and the bilateral experience of HMRC in agreeing APAs and MAPs mean the UK should continue to be a beneficiary of global investment flows.
The specific focus on innovation

A key part of the current UK Government’s aim for the UK to be the most competitive tax regime is to encourage the holding of innovative activities in the UK and to encourage foreign investors to move innovation to the UK.

The UK Government’s new patent box regime that enables patent box profits to be taxed at 10% is a key part of this. The regime is potentially relevant to all businesses involved in innovation and to a wide range of businesses across all segments. The added benefit of research and development “above the line” tax incentives are available where the research and development itself is performed in the UK.

The key question we are often asked is whether the regime is making a difference to behaviors and, therefore, ultimately whether it will deliver on its policy objectives of making the UK a global innovation center. While it is still early days, in our experience the outlook is very positive:

- For groups that already have significant innovation hubs in the UK, the regime has been very well received and many corporates are positive about using the UK for innovation in the medium-term.
- Many outbound investors have gone further and have, or are in the process of, consolidating the ownership of their intellectual property (IP) back in the UK, moving it away from their other traditional innovation centers of the US, Japan and Germany.
- For inbound investors, the fact that the UK tax rate is now so favorable means that other advantages can be brought into the decision-making process: in particular, the UK’s attractiveness to foreign nationals, availability of skilled labor and access to capital markets.

Overall, the trends are indicating that the UK is becoming the center of choice for UK-headed groups and many IP-rich inbound investors. Crucial to this is the fact that HMRC continues to demonstrate that it is keen to engage with groups wishing to obtain more certainty on opportunities presented by recent changes to the UK tax system, and on what the new rules actually mean in practice.

The UK, and Cyprus, Patent Box rules have been considered by the EU Code of Conduct Group and referred to the Council of Economics and Finance Ministers who decided in December 2013 that it would be appropriate to review all existing preferential intellectual property regimes in Europe. The key area of focus is whether these regimes support economic substance or whether they facilitate profit shifting, and the expectation is that this review will be completed in mid-2014.

The UK is clearly open for business

Our UK attractiveness survey showed that the six aspects of the UK that foreign-based companies consider most attractive from an investment location perspective are:

- Quality of life, diversity, culture and language
- Technology, and telecommunications infrastructure
- Stability and transparency of the political, legal and regulatory environment
- Entrepreneurial culture and entrepreneurship
- Stability of the social climate
- Education in trade and academic disciplines

The combination of these strengths with a competitive tax regime makes the UK an attractive place for business. The fact that the UK also has a globally respected tax authority could be a powerful asset in an environment of increasing global tax risk. However, this is not a time for the UK to rest on its laurels.
The challenge for the UK now is to build on its strengths, to define a long-term growth strategy by sector, function and region, and continue to position the UK positively with investors. However, it will be important for the UK to continue to provide certainty around the tax regime in the mid- to long-term and support businesses as they consider their options for undertaking more business activities in the UK.

**The UK's evolving corporate tax system**

Since 2010, the UK Government has undertaken a comprehensive review of the UK tax system, consulting with business on the direction and design of its reforms. It has sought to make tax policy simpler, more transparent and, therefore, better suited to a globalized trading world and to modern business practice.

The UK Government believes that the corporate tax system can and should be an asset for the UK, complimenting the UK’s attributes as one of the most open economies globally with a highly skilled workforce, access to capital markets and first-class infrastructure. Accordingly, it is committed to creating the most competitive tax regime in the G20.

From April 2015, the UK corporation tax rate will be reduced to 20 per cent – the lowest it has ever been in the UK. There are competitive rules for taxing the profits of multinationals – including a modernized Controlled Foreign Company (CFC) regime – as well as an extensive treaty network, making the UK an attractive location for headquarters, regional holding companies and global or regional business hubs.

At the same time, there are highly competitive reliefs for innovative and high-tech industries, including:

- The Government’s commitment to a ‘Patent Box’ regime. This regime is being amended in line with the UK’s participation in the OECD Base Erosion and Profit Shifting project but the UK Government is confident it will be able continue to offer a competitive Patent Box which incentivizes innovation and growth
- An internationally competitive ‘above the line’ R&D (research and development) credit with the rate of the credit being increased to 11% from April 2015.
- Generous tax reliefs for the creative sectors in the form of animation, high-end television producers and video games.

More detail on the role the UK’s corporate tax system plays in the UK being ‘Open for Business’ is set out in the accompanying pages.
Enabling ‘Make in India’ through effective tax reforms

The Confederation of Indian Industry (CII) works to create and sustain an environment conducive to the development of India, partnering industry, Government, and civil society, through advisory and consultative processes.

CII is a non-government, not-for-profit, industry-led and industry-managed organization, playing a proactive role in India's development process. Founded in 1895, India's premier business association has over 7200 members, from the private as well as public sectors, including SMEs and MNCs, and an indirect membership of over 100,000 enterprises from around 242 national and regional sectoral industry bodies.

CII charts change by working closely with Government on policy issues, interfacing with thought leaders, and enhancing efficiency, competitiveness and business opportunities for industry through a range of specialized services and strategic global linkages. It also provides a platform for consensus-building and networking on key issues.

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With 64 offices, including 9 Centres of Excellence, in India, and 7 overseas offices in Australia, China, Egypt, France, Singapore, UK, and USA, as well as institutional partnerships with 312 counterpart organizations in 106 countries, CII serves as a reference point for Indian industry and the international business community.

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