Tax & Regulatory Insights

July 2018

AMCHAM INDIA

EY

Building a better working world

Contents

Foreword

Garima Pande

Chairperson, Tax & Tariff Committee, AMCHAM

Dear Member,

The Tax & Tariff Committee of AMCHAM is pleased to present the inaugural edition of **'Tax & Regulatory Insights'** – a quarterly newsletter aimed at providing business leaders with insights on recent developments impacting the economic, tax and regulatory landscape. The newsletter covers updates on the Indian Economy, tax policy, Income-tax judicial rulings, Goods and Services Tax (GST) and other policy matters, along-with a summary of the likely impact on businesses. In the international tax domain, the subject of taxation of digital businesses appears to be garnering a high-level of attention with multilateral organizations like the Organisation for Economic Co-operation and Development (OECD) and the European Commission (EC) actively working towards formalising guidance on this subject. The newsletter also discusses some of the significant income-tax judicial rulings in the recent months, which underline a continued tax rigour on foreign enterprises doing business in India. The upcoming first anniversary of the GST regime in India is marked by important amendments from a compliance perspective, namely the Electronic way bill (E-way bill) system.

We hope you find the Newsletter useful and look forward to your feedback and suggestions.

American Chamber of Commerce in India

Established in 1992, the American Chamber of Commerce in India (AMCHAM), is the apex Chamber of U.S. companies in India. Since inception, it has provided a platform for networking and created opportunities to engage with the U.S. and Indian policy-makers.

AMCHAM is headquartered in New Delhi and has offices in Bengaluru, Chennai, Hyderabad, Kolkata and Mumbai. The Chamber has over 400 members engaged in diverse sectors in its membership.

The U.S. Ambassador in India is the Honorary President of the Chamber. The Chairman and members of the National Executive Board govern the affairs of the Chamber. The Chamber's mission is to assist its members succeed in India through advocacy, information, networking and business support services.

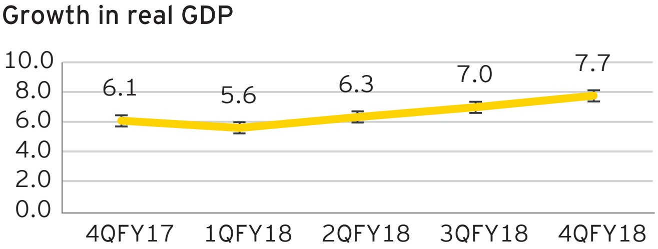
AMCHAM promotes activities that encourage and stimulate bilateral trade between India and the U.S. It organizes meetings regularly with U.S. Embassy, visiting U.S. delegations and Government of India officials.

01 Economy Watch

Overall, India's growth prospects continue to be robust, as evidenced by the recently released National Income Estimates (Provisional)[1] (Chart 1 and 2). The Asian Development Bank also estimates that India's Gross Domestic Product (GDP) will continue to grow in the near future, aided by measures to spur rural income and a modest pickup in investment[2].

Chart 1: Real GDP Growth[3]

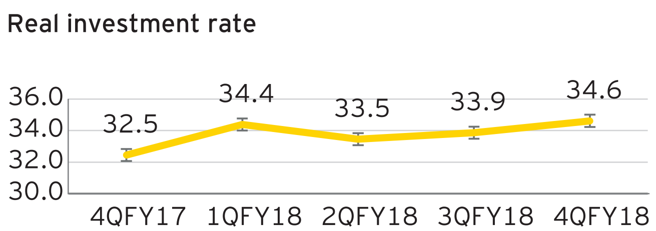
After declining for nine consecutive quarters since January 2016, the real GDP growth has steadily recovered from 5.6% in Q1 of Financial year (FY) 2018 to 7.7% in Q4 of FY 2018



From demand side, this upsurge in growth has been largely driven by domestic consumption, particularly government consumption expenditure and overall investment expenditure. From the output side, the growth in Q4 of FY 2018 was led by manufacturing, construction, financial services and trade sectors.

Chart 2: Real investment rate[3]

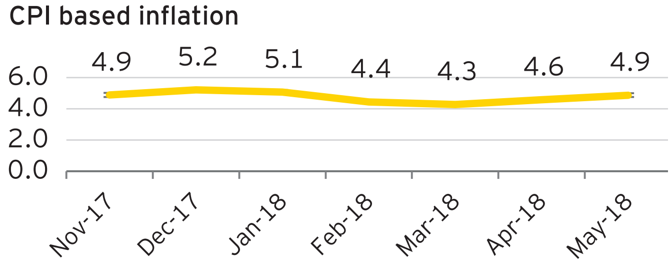
The real investment rate has increased from 32.5% in Q4 of FY 2017 to 34.6% in Q4 of FY 2018



Since the contribution of net exports to GDP growth has remained zero or negative for past six quarters[3], it is clearly the domestic demand that has driven the growth recovery. Further, rising crude oil prices have adversely affected most indicators of India's macro balance, including fiscal deficit and inflation (Chart 3). Due to rising inflation, the Reserve Bank of India (RBI) has recently increased the repo rate to 6.25%.

Chart 3: Inflation[1]

Consumer Price Index (CPI) based inflation has reversed its downward trend since December 2017, and has increased to 4.9% in May from 4.6% in April 2018



02 Tax Policy Updates

Interim report of the OECD on tax challenges arising from digitalization[4]

As a follow up to Action 1 of the Base Erosion and Profit Shifting (BEPS) project, the OECD released its Interim Report titled "Tax Challenges Arising from Digitalisation" on 16 March 2018 (the Report). The Report provides an in-depth analysis of the main features commonly found in certain highly-digitalized business models and value creation in the digitalized age, but does not make any specific recommendations to countries. The Report also provides an overview of unilateral measures that have been introduced by various countries in this area.

India has been actively pursuing the BEPS agenda and has formally recognized the need for its tax laws to move towards taxation based on "economic allegiance" as against "physical location". India has, therefore, introduced "Equalisation Levy" (EL) and concept of

*Content sourced from EY Economy Watch May 2018 issue and June 2018 issue
1 Central Statistical Organization, MOSPI, Government of India
2 Asian Development Outlook, April 2018
3 National Accounts, Central Statistical Organization, MOSPI, GoI
4 https://read.oecd-ilibrary.org/taxation/tax-challenges-arising-from-digitalisation-interim-report_9789264293083-en#page1

"Significant Economic Presence" (SEP), that attempts to establish India's taxation rights on income derived by non-resident enterprises from transactions or activities carried out in India without any physical presence in India if the revenue or user threshold is met.

EC proposals on new digital taxation rules[5]

On 21 March 2018, the EC issued two new proposals for taxation of digital businesses activities (applicable subject to compliance with prescribed thresholds).

In the interim phase, Digital Services Tax (DST) is proposed to be levied at the rate of 3% on revenues derived from digital activities such as sale of online advertising space, digital intermediary activities and sale of data generated from user-provided information. In the following phase, it is proposed to implement the Significant Digital Presence (SDP) solution (intended to serve as a long-term solution), whereby the meaning of Permanent Establishment (PE) shall be extended to cover specified digital transactions. It is further proposed that principles for profit attribution to a SDP shall be aligned to the OECD approach for profit attribution and European Union (EU) Member states shall be required to apply respective corporate tax rules in order to tax such profits. While there is no consensus on the effective timeline for DST levy, SDP is proposed to be implemented w.e.f. 1 January 2020.

In order for the above rules to apply vis-à-vis non-EU countries, the EC has suggested that EU Member States should renegotiate their existing Double Taxation Avoidance Agreement (DTAAs) with non-EU countries to incorporate taxation based on SDP and related profit attribution rules.

The proposed DST and SDP appear similar to the concepts of EL and SEP, both of which are already introduced under Indian domestic tax law. With two multilateral organizations i.e., the EC and the OECD, actively working towards implementation of digital taxation measures, it would be important to monitor developments around this evolving landscape and continue to assess the emerging digital taxation issues as businesses continue to build their digital footprints across the globe.

Milestone in BEPS Implementation: Multilateral Convention to enter into force on 1 July 2018 for first five jurisdictions

On 22 March 2018, Slovenia became the fifth jurisdiction (after the Republic of Austria, the Isle of Man, Jersey and Poland) to deposit its instrument of ratification of Multilateral Instrument (MLI). As a result, MLI would now enter into force w.e.f. 1 July 2018 for these five jurisdictions.

For India, the MLI will enter into force after submission of India's instrument of ratification of MLI with the OECD.

In the backdrop of imminent amendments to India's bilateral tax treaties once the MLI becomes effective, it is imperative for businesses to assess the impact of these amendments on their global operations and regularly monitor the MLI positions of relevant operating jurisdictions.

United Nations Model Convention (UN MC) Update 2017[6]

With the objective of aligning the UN MC to amendments under OECD BEPS regime, the UN released its updated UN MC 2017 on 18 May 2018. Key amendments, *inter alia,* include:

- Inclusion of new clause in Article 1 (Persons covered) to allow DTAA benefits to fiscally transparent entities
- Inclusion of "tie breaker" rule for determining the treaty residence of dual-resident persons other than individuals in Article 4 (Resident)
- Modification of Article 5 (PE) to prevent the avoidance of PE (such as, change in scope of agency PE, introduction of anti-fragmentation rule in relation to preparatory/ auxiliary exemption, etc.)
- Modification in Article 10 (Dividends) to add condition of 365 day holding period to avail benefit of lower tax rate where beneficial owner directly owns shares above 25% threshold
- A new Article 12A to provide for source taxation of fees for technical services
- A new Article 29 that contains provisions relating to entitlement to DTAA benefits. These include limitation on benefits and general anti-abuse rules

The UN MC has a significant influence on many DTAAs of India and other developing nations. The updated UN MC 2017 is expected to provide useful guidance to India for negotiating/ re-negotiating its DTAAs. It will also be interesting to see incorporation of certain provisions in Indian DTAAs (for instance, DTAA eligibility of fiscally transparent entities).

5 http://europa.eu/rapid/press-release_IP-18-2041_en.htm
6 http://www.un.org/esa/ffd/wp-content/uploads/2018/05/MDT_2017.pdf

Tax e-assessments

In line with the Indian Government's resolve to digitally transform the Indian tax administration and conduct faceless, nameless, paperless and jurisdiction less[7] assessments under Indian tax laws, the Central Board of Direct Taxes (CBDT) has issued instructions[8] directing Income-tax authorities to conduct all pending scrutiny assessment cases only through "e-proceedings" functionality. This is subject to specified exceptions (such as, examination of books, etc.). While this is a significant step in the path towards digitization of income-tax proceedings, greater clarity is needed for effective implementation of various aspects of this scheme.

India Hong Kong DTAA[9]

India and Hong Kong signed their first comprehensive DTAA on 19 March 2018. The DTAA will enter into force after the completion of ratification procedures by both countries.

The provisions of the India Hong Kong DTAA are largely based on the OECD Model Treaty 2017 and United Nations Model Treaty 2011, providing greater taxation rights for the source country. Significant provisions of the DTAA include source country taxation of capital gains from transfer of shares and beneficial rates of tax on dividends, royalty and fees for technical services. Further, certain provisions are influenced by the OECD's MLI on BEPS, such as the principal purpose test (PPT), Competent Authority rule as tie-breaker test for dual resident entities, Mutual Agreement Procedure provisions and corresponding adjustment in transfer pricing cases. However, the DTAA does not include any of the MLI proposals on PE. It is also interesting to note the liberal use of PPT in the articles governing taxation of passive income streams (such as, dividend, interest and capital gains).

India's DTAA with Hong Kong is a long anticipated and welcome step. The DTAA is expected to stimulate flow of investment, technology and personnel between India and Hong Kong, prevent double taxation and facilitate the exchange of information between the two countries.

03 Income-tax Judicial and Administrative Updates

Hon'ble Supreme Court of India (SC) upholds applicability of expenditure disallowance provisions [u/s 14A of the Income-tax Act, 1961 (Act)] in case of strategic investments

In its recent ruling in *Maxopp Investment Ltd. v. CIT*[10], the SC has upheld that an expenditure incurred for/ attributable to earning exempt income, has to be necessarily disallowed under section 14A of the Act, regardless of the fact that "dominant purpose" of making such investment was not to earn dividend income. (i.e., even where the purpose of making the investment was strategic in nature and not to earn dividend income).

While the issue of disallowance of expenditure related to earning exempt income continues to remain litigative, this ruling seeks to settle one of the contentions adopted by taxpayers arguing against such expenditure disallowance.

Given that rulings of the SC represent the law of the land (unless contrary provisions are introduced in the tax law), this ruling could adversely impact Indian corporate taxpayers holding strategic investments in group companies.

Income-tax Appellate Tribunal (ITAT) (Special Bench) rules on Indian subsidiary constituting a PE of foreign company in India

Special Bench of the Delhi ITAT in the case of *Nokia Networks OY (taxpayer) vs JCIT*[11], in a majority view, ruled that mere allegation that the Indian subsidiary (ICo) is a "virtual projection" of its overseas parent entity cannot be sufficient reason to conclude that the parent has a PE in India.

The ITAT noted that there was no evidence on record to indicate that premises of ICo were at the disposal of the Taxpayer. Further, it was noted that the activities carried on in India were the business activities of ICo and not the Taxpayer, and, hence, the business activity test was not met qua the premises of ICo. If, based on facts, there is no establishment of a fixed place and disposal test (or other parameters, as envisaged in Article 5 of the DTAA), then

7 Jurisdiction less assessment scheme is proposed by Finance Act 2018. However, the scheme u/s 143(3A) of the Act is yet to be notified.
8 Instruction No 1 of 2018 dated 12 February 2018
9 https://www.ird.gov.hk/eng/pdf/Agreement_India_HongKong.pdf (India-Hong Kong DTAA currently available only on the website of Hong Kong Government)
10 Civil Appeal Nos. 104-109 OF 2015
11 I.T.As. No.1963 & 1964/DEL/2001

the "virtual projection" argument itself cannot result in creation of a PE. The ITAT also held that the activities of negotiation of off-shore contract, network planning and signing of contracts are preparatory and auxiliary in nature, and therefore, cannot result in constitution of a PE in India. Further, since all the offshore supply was carried outside India and no activities in relation to such supply were carried on in India, The Taxpayer did not have a business connection in India.

On Dependent Agent PE (DAPE), the ITAT observed that ICo was an independent party carrying onshore activities of installation and technical support on principal-to-principal basis and in absence of any evidence that ICo concluded any contracts in India, ICo did not create DAPE of the Taxpayer in India.

The majority ruling in the above case is broadly in line with internationally accepted principles on creation of PE. This ruling is expected to provide useful guidance and set a precedence for various multinationals engaged in off-shore sale of goods and having subsidiary/affiliates in India engaged in marketing and other business support services. In such cases, Indian tax authorities often allege that Indian subsidiaries constitute PE of such foreign companies in India and proceed with attributing income to such Indian PEs.

While minority bench ruled against the Taxpayer, the said view is not binding. However, the possible alternate view highlights the need to critically evaluate PE risks under similar facts and contractual arrangements.

SC rules waiver of loan is not taxable as business income

In its recent ruling in the case of *Mahindra and Mahindra Ltd*[12], the Hon'ble SC held that a benefit is taxable as business perquisite (under section 28 of the Act) only if it is received in a form other than money. Since waiver of loan by a creditor gives rise to cash benefit in the hands of the debtor, the amount of loan waived cannot be taxed as a business perquisite.

Further, the SC also ruled that the benefit of waiver of loan is not taxable as remission of trading liability (under section 41 of the Act) since a loan represents a liability other than trading liability.

The taxability of benefit obtained on waiver of loan has been a subject matter of litigation in past. The present SC ruling is a welcome decision as it settles the controversy on taxation of waiver of loan. More importantly, the SC's conclusion in the said ruling applies to waiver of all loans – whether used for acquiring capital asset or for working capital purposes. However, this ruling is in the context of normal computation of business income and does not deal with the controversy of taxability of waiver of loan under Minimum Alternate Tax provisions of the Act.

Authority for Advance Ruling (AAR) ruling on PE constitution, royalty and fees for technical services

In its recent ruling in the case of *Mastercard Asia Pacific Pte. Ltd. (MAPPL)*[13], the AAR held as follows:

- The equipment, network, customer premises and subsidiary premises qualify as fixed place PE of MAPPL in India under India-Singapore DTAA. The AAR upheld a PE on the basis that Mastercard Interface Processors (MIP) (which connected the financial institution to the Mastercard network and were core to the business of MAPPL in India) were at the disposal of MAPPL, since all material decisions relating to the operation and maintenance of MIPs were made by MAPPL (even though MAAPL was not the legal owner of MIPs in India). Additionally, the AAR observed that since a sister company of MAPPL was responsible for management and maintenance of the Mastercard Network (comprising of MIPs and Mastercard's application software owned and controlled by MAPPL, as well as transmission towers, leased lines, fibre optic cables and transmission nodes owned by third parties), Mastercard network was at the disposal of MAPPL and therefore constituted a fixed place PE of MAPPL in India. Space occupied by the employees of Bank of India at the office facilities of Bank of India (a third party financial institution) was also observed to be at the disposal of MAPPL and held to constitute a fixed place PE, since the employees of Bank of India carried out their functions and operated under the control and supervision of MAPPL
- MAPPL's employees visiting India for the purpose of rendering services in India exceeded the threshold prescribed under India-Singapore DTAA and thereby held to constitute service PE of MAPPL in India
- MAPPL's Indian subsidiary was legally and economically dependent on MAPPL and therefore constituted DAPE in India, since employees of the Indian subsidiary habitually secured orders for MAPPL in India

12 Civil Appeal Nos. 6949-6950 OF 2004
13 AAR No 1573 of 2014

This ruling continues to highlight the critical need for international businesses to continuously monitor the PE exposure arising from undertaking business operations in India.

Draft notification on capital gains u/s 112A of the Act[14]

Section 112A of the Act prescribes a beneficial tax rate of 10% (vis-à-vis otherwise applicable tax rate of 20%) on long-term capital gains arising on transfer of equity shares, units of equity oriented funds and units of business trusts, subject to payment of Securities Transaction Tax (STT). Further, in case of equity shares, STT is required to be paid both on acquisition and transfer of such capital asset, but this condition can be relaxed by the Central Government in notified cases. Accordingly, the CBDT has issued a draft notification carving out some exceptions to the above requirement for STT payment for certain acquisitions of equity shares [in such cases long-term gains shall continue to be eligible for the lower tax rate of 10% (plus applicable surcharge and cess), despite non-payment of STT at the time of acquisition of the equity shares].

The draft notification is identically worded to Notification no. 43/ 2017 (dated 5 June 2017), which extended the benefit of erstwhile long term capital gains exemption u/s 10(38) of the Act to certain acquisitions made without the payment of STT. The exemption list broadly covers various off-market transactions (such as, ESOPs, mergers, demergers, etc.) and, inter alia, provides relief in case of acquisition of shares by a non-resident in accordance with foreign direct investment guidelines.

04 Goods and Services Tax Updates

E-way bill implementation

For Inter-state movement of goods, the E-way bill system has been introduced from 1 April 2018. Now E-way bill is required for inter-state and intra-state movement of goods for all states subject to various provisions of the Central and the State GST Rules.

The E-way bill system acts as an anti-evasion measure/ deterrence against illicit movement of goods and also facilitates online tracking of goods dispatched/ received. However, it has resulted in increase in compliance for businesses.

GST mismatch notices to taxpayers

With an aim to detect tax evasion and unwarranted credit claims, the GST department has begun issuing notices to taxpayers demanding explanations for, inter alia, following mismatches:

- Mismatch in details filed in summary returns in GSTR-3B vis-à-vis corresponding details reported by suppliers in GSTR-2A
- Mismatch in details between GSTR-3B and GSTR-1 to verify payment of taxes against outward supplies

It is therefore important for all registered persons to reconcile their returns with the suppliers' data available online on GST portal and identify errors/ gaps on timely basis to avoid interest implications.

Annual return under GST

Under GST, all registered persons with turnover exceeding INR 20 Million in a FY are required to get their accounts audited either by a chartered accountant or by a cost accountant and furnish an annual GST return within the prescribed timeline. The annual GST return is required to be accompanied by a statement of reconciliation (duly certified by a chartered accountant or a cost accountant), between the audited annual accounts and GST returns.

Currently, Finance Ministry is working on the format for the annual return which is expected to be introduced in the upcoming GST Council meet. The annual return will seek all details to help the government in maintaining the invoice-wise database, cross-checking of returns to avoid tax evasion and checking any erroneous claims of credit and refunds.

This may impact businesses, since they will now be required to maintain a detailed reconciliation between financial statements and the data considered for GST return purposes. It is also likely that GST authorities may issue notices to taxpayers on the basis of the annual return filings, requiring them to provide reason(s) for differences (if any) arising out of such reconciliation.

14 Draft notification dated 24 April 2018

Other key policy updates

Proposed amendments in Special Economic Zone (SEZ) Rules 2006[15]

A committee was set-up by the Ministry of Commerce to review and propose amendments to the SEZ Rules 2006, with the objectives of aligning these with the GST law and removing procedural difficulties. Some of the important recommendations of the committee are outlined below:

- Comprehensive changes are suggested in the existing formula for computation of Net Foreign Exchange Earning (NFE) to, inter alia, exclude the following:
  - Free on Board (FOB) value of trading income
  - Foreign currency payment received for supply made to bonded warehouse or Free trade and warehousing zones
  - Foreign currency payment received on account of supply of goods and services to Domestic Tariff Area (DTA), etc
  - Trading activities would be severely impacted by the proposed recommendations
- In case of default in achieving the minimum prescribed NFE, a penalty equal to 1% of shortfall of FOB value has been proposed
- It is proposed to provide Board of Approval with additional decision-making power with respect to extension of the letter of approval for Developer. While such a recommendation is a welcome step, the minimum period for which such extension can be provided would need to be specified
- A provision for merger of two or more units of the same company falling within the same SEZ is proposed. While this is a positive step towards ease of doing business in SEZs, industry stakeholders may require this provision to be further liberalized and permit merger of SEZ units that are housed in different SEZ units falling under the same jurisdictional Development Commissioner
- It is proposed to permit SEZ units to sub-contract upto 15% of FOB value of export

Considering that SEZ policy is intended to make SEZs an engine for economic growth, the implementation of recommendations should be undertaken in such a manner that the business of existing SEZ units is not adversely impacted.

Draft amendments to the Defence Offset Guidelines[16]

The Ministry of Defence (MoD) has proposed draft amendments to Defence Offset Guidelines, including three additional avenues for discharge of offset obligations (viz., investment in specified projects, equity investment in defence manufacturing unit and investment in specified Securities and Exchange Board of India (SEBI) regulated funds for defence, aerospace and internal security). The draft is likely to be finalised by end of June 2018.

These guidelines are expected to have, *inter alia,* following key impact:

- Since investment in SEBI regulated funds is now permissible, it is likely that Private Equity players may play a significant role in the Defence Sector through investment in specified SEBI regulated Funds for Defence, Aerospace and Internal Security
- In addition to the three additional avenues, the proposed multipliers for computation of offset discharge are also fairly attractive (ranging from 2 to 5). This provides tremendous flexibility to the Original Equipment Manufacturers to come forward and make investments in the three additional avenues

Key amendments under Foreign Exchange ManagementAct, 1999 (FEMA)

RBI has, *inter alia,* issued various circulars/ notifications under FEMA with the intent to further liberalize or provide further clarity in the existing FEMA provisions:

- RBI vide Notification No. 389/2018-RB dated 20 March 2018 has issued the Foreign Exchange Management (Cross Border Merger) Regulations, 2018 which will be applicable to all cross border mergers pending before the competent authorities as on the date of commencement of these regulations
- The RBI has notified amendments to the Foreign Direct Investment policy (as announced vide Press Note 1 of 2018) vide Notification No. FEMA 20(R)(1)/2018-RB dated 26 March 2018. The amendments to various sectors including single brand retail trading, airlines, real estate broking, etc. will now be effective from immediate effect
- A.P. (DIR Series) Circular No.25 dated 27 April 2018 has been issued to liberalise the existing External Commercial Borrowing (ECB) regulations to provide for a uniform all in cost ceiling, increase in ECB liability to equity ratio for ECB raised from direct foreign equity holder under automatic route, expansion of the list of eligible borrowers and introduction of a negative list for all 3 tracks of ECBs
- A.P. (DIR Series) Circular No. 31 dated 15 June 2018 outlines revisions to the existing guidelines governing Foreign Portfolio Investment in debt securities, with the objective of providing operational flexibility to FPIs. Key amendments cover criteria relating to minimum residual maturity period, investment limits in central government securities and introduction of investor-wise limits in corporate bonds.

15 http://sezindia.nic.in/upload/uploadfiles/files/CIRCULARforwebsiteregardingRulescommitteerecommendation.pdf
16 http://ddpmod.gov.in/sites/default/files/OFFSET%20GUIDELINES.pdf

Prepared by AMCHAM and EY

Ernst & Young LLP
EY | Assurance | Tax | Transactions | Advisory

EYIN1806-016
ED None

JJ

American Chamber of Commerce in India

PHD House, 4th Floor, 4/2, Siri Institutional Area, August Kranti Marg, New Delhi - 110 016

Tel : +91-11-2652 5201/02 | Mob: +91-9810202213
Fax: +91-11-2652 5203

E-mail: madhvi.kataria@amchamindia.com
Website: www.amchamindia.com