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Taxation and Investment in India

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ABSTRACT/RÉSUMÉ

Taxation and Investment in India

Business taxation in India is characterised by high effective tax rates, a narrow tax base, and an uncertain tax environment for potential investors. However, India has now begun a process of significant business tax reform, including a staged reduction of the corporate income tax rate and removal of a range of business tax concessions. This paper sets the scene for these (and further) reforms by examining the taxation of business income in India with a particular focus on its impact on the investment climate. The paper calculates corporate effective tax rates to highlight the impact of the tax system on investment incentives, investigates the narrowness of the current tax base and the proposed base-broadening reforms, and examines the degree of investor certainty as to the tax rules and their application.

This Working Paper relates to the 2017 *OECD Economic Survey of India* (www.oecd.org/eco/surveys/economic-survey-india.htm)

JEL classification codes: H2

Keywords: taxation, investment, India

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Fiscalité et investissement en Inde

En Inde, la fiscalité des entreprises se caractérise par des taux effectifs d'imposition élevés, une base d'imposition étroite et un climat d'incertitude pour les investisseurs potentiels. Néanmoins, l'Inde s'est aujourd'hui engagée dans un vaste programme de réforme de la fiscalité des entreprises, qui passe par la réduction progressive du taux de l'impôt sur les bénéfices des sociétés et par la suppression d'un certain nombre d'avantages fiscaux accordés aux entreprises. Ce document présente le cadre dans lequel s'inscrivent ces réformes (et celles à venir) en examinant le régime indien d'imposition des sociétés, en particulier sous l'angle de l'impact que celui-ci peut avoir sur le climat de l'investissement. Les auteurs calculent les taux effectifs de l'impôt sur les bénéfices des sociétés afin de mettre en lumière l'incidence du régime fiscal sur les incitations à investir ; examinent la question de l'étroitesse de la base d'imposition actuelle et les propositions de réformes visant à l'élargir ; et évaluent la prévisibilité des règles fiscales et de leur application pour les investisseurs.

Ce document de travail fait référence à l'édition 2017 de la publication *Étude économique de l'OCDE : Inde* (www.oecd.org/fr/eco/etudes/etude-economique-inde.htm)

Classification JEL : H2

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TABLE OF CONTENTS

1. Introduction....6
2. The corporate income tax and its impact on investment incentives....7
2.1. CIT revenue....7
2.2. Tax rates....7
2.3. Tax base....9
2.4. Corporate effective tax rates....10
3. The tax base is narrow....15
3.1. Corporate tax concessions....15
3.2. Addressing base erosion and profit shifting....22
3.3. Taxation of small businesses....30
3.4. Efficiency and effectiveness of tax administration....37
4. Investors face significant uncertainty regarding the tax rules and their application....40
4.1. Tax disputes are high....41
4.2. Audit processes....42
4.3. Transfer pricing rules....43
4.4. Use of mutual agreement procedures (MAP)....44
4.5. Taxation of indirect transfers of assets located in India....45
4.6. Application of the minimum alternate tax to non-resident investors....45
REFERENCES....47
ANNEX....50

Tables

1. ETRs under the current CIT system....10
2. ETRs before and after the proposed CIT rate reduction....12
3. ETRs before and after the proposed CIT rate + depreciation cap reform....12
4. Main tax expenditures in India's corporate income tax....16
5. Indian FDI Positions, 2010-2014 , Main tax expenditures in India's corporate income tax....22
6. Combined Statutory Tax Rates on International Dividend Payments....23
7. India inbound FDI positions....26
8. Statutory personal income tax rate schedule in India....31
9. Unfinalised tax disputes in India by length of dispute....41
10. Transfer Pricing Audits and Adjustments in India by Fiscal Year....43
A1. ETRs on equity-financed investment, with tax depreciation equal to economic depreciation....50
A2. ETRs on debt-financed investment, with and without a 20% withholding tax....50
A3. ETRs on equity-financed investment with 5% inflation....51
A4. ETRs on debt-financed investment with 5% inflation....51

Figures

1. Tax revenue as a percentage of GDP in India, BRIICS and OECD countries 7
2. Statutory corporate income tax rates in India, BRIICS and OECD.....8
3. Corporate income tax paid as a percentage of profits before tax.....15
4. Tax administration capacity in India is comparatively low 39
5. Unfinalised tax disputes in India, BRIICS and OECD countries, 2012/13 41

Boxes

1. Tax rate calculations for resident and non-resident corporations, 2016 9
2. Methods for calculating ETRs 14
3. A Comprehensive Package of Measures to Address BEPS 24
4. Simplified tax regimes – good practice in OECD and G20 countries 32
5. "Tax Compliance by Design": technology and compliance 36
6. Key recommendations of the Tax Administration Reform Commission.....38
7. Approaches to taxing indirect transfers 46

TAXATION AND INVESTMENT IN INDIA

By Alastair Thomas, Isabelle Joumard, Tibor Hanappi and Michelle Harding[1]

1. Introduction[2]

Business tax reform is high on the Indian government's agenda as it looks to encourage foreign investment and growth. In 2015, the government announced its intention to gradually lower the corporate income tax rate for resident corporations from 30% to 25% and to rationalise a range of corporate tax concessions. At the same time, India is also strengthening its international tax rules as part of the OECD/G20 base erosion and profit shifting (BEPS) project. This working paper examines the taxation of business income in India, with a particular focus on its impact on the investment climate. It calculates corporate effective tax rates to highlight the impact of the tax system on investment incentives, investigates the narrowness of the current tax base and the proposed base-broadening reforms, and examines the degree of investor certainty as to the tax rules and their application. This paper has been prepared as an input into the 2017 *OECD Economic Survey of India*. Policy recommendations are presented in the *Economic Survey* itself, rather than in this paper. The rationale and options for reforming income and property taxes are also discussed in Joumard *et al.* (2017).

The corporate income tax (CIT) system in India is characterised by high effective tax rates and a narrow tax base. High effective tax rates result from the imposition of several charges on top of an already significant statutory CIT rate, together with a corporate-level tax on distributed dividends (the dividend distribution tax). Even after the proposed reduction in the statutory CIT rate, effective tax rates for equity-financed investment will remain high, discouraging investment. For example, average effective tax rates calculated in this paper for an equity-financed investment range from 37.8% to 44.8% depending on asset type, while marginal effective tax rates range from 24.3% to 52.7%.

The corporate tax base is narrow due to a wide range of tax concessions, while multinational enterprises are also able to minimise their tax liability in India through BEPS techniques. However, the announced reforms can be expected to significantly broaden the corporate tax base. The overall business tax base is narrowed by a high degree of informality amongst small businesses. Meanwhile, the investment climate is significantly affected by a lack of clarity in various areas of tax law, an aggressive audit process, and the use of retrospective legislation which has created significant tax uncertainty for investors, and resulted in India leading the world in numbers of tax disputes.

The paper is structured as follows. Section 2 provides a brief introduction to India's corporate income tax and presents corporate effective tax rates. Section 3 discusses the business tax base. Section 4 examines the impact of the tax system on tax certainty and hence investor confidence.

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1 . Alastair Thomas is a Senior Economist at the OECD Centre for Tax Policy and Administration, Isabelle Joumard is a Senior Economist in charge of the India desk at the OECD Economics Department, Tibor Hanappi is an Economist at the OECD Centre for Tax Policy and Administration and Michelle Harding is Head of Tax Data and Statistical Analysis at the OECD Centre for Tax Policy and Administration. The authors thank Indian officials, members of the Economic and Development Review Committee, and colleagues from the OECD Economics Department and Centre for Tax Policy and Administration; Edward Barret, Piet Battiau, Monica Bhatia, David Bradbury, Melinda Brown, Manuel De Los Santos, Jesse Eggert, Maikel Evers, Robert Ford, Andrew Heckman, Mark Johnson, Korstiaan Kool, Siva Pattanam, Michael Hewitson, Thomas Neubig, David Partington, Alvaro Pereira, Grace Perez-Navarro, Pascal Saint-Amans, Jacques Sasseville and Piritta Sorsa for helpful comments and suggestions. The authors would like to particularly acknowledge the guidance provided by Bert Brys in the development of the paper. Thanks also to Emmanuelle Modica, Hermes Morgavi and Michel Lahittete for statistical assistance, and Anthony Bolton for editorial assistance.

2 . Unless otherwise specified, this paper reflects the Indian tax system as of 1 July 2016.

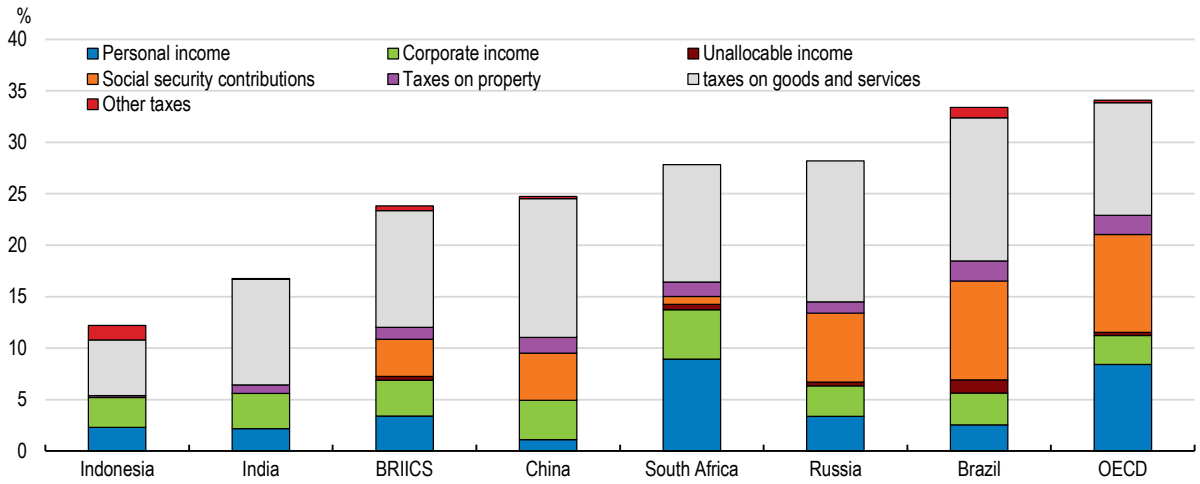
2. The corporate income tax and its impact on investment incentives

India operates a worldwide CIT system. As such, resident corporations are subject to CIT on their domestic and foreign sourced income, including capital gains. A corporation is resident in India if: (1) it is incorporated in India; or (2) the management and control of the corporation is wholly exercised in India. Non-resident corporations are also liable to tax in India if they have a permanent establishment (PE) in India (for corporations resident in a treaty partner) or have a business connection with India (for corporations not resident in a treaty partner).[3] The non-resident corporation is then subject to CIT on ordinary income attributed to the PE or the business connection. Income is attributed to the PE or business connection on an arm's length basis, drawing on transfer pricing principles.

2.1. CIT revenue

As with most emerging economies, the CIT is a particularly important source of tax revenue in India. Figure 1 presents a decomposition of India's tax-to-GDP ratio as compared to other BRIICS and OECD countries. While India's overall tax-to-GDP ratio is low at 16.6%, the CIT contributes 3.4% of GDP (20.3% of total tax revenue). In comparison, the OECD average tax-to-GDP ratio is 34.2%, but CIT contributes just 2.8% of GDP (8.2% of total tax revenue).

Figure 1. **Tax revenue as a percentage of GDP in India, BRIICS and OECD countries, 2014**



Note: Data for China is for 2013.

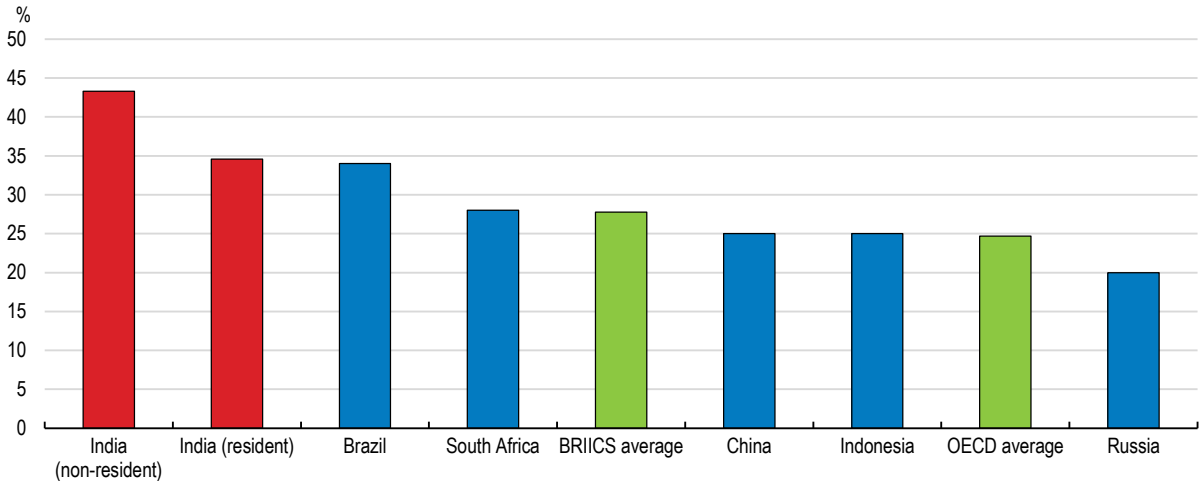
Source: OECD Revenue Statistics database, IMF and Ministry of Finance of India.

2.2. Tax rates

Resident and non-resident corporations are subject to different CIT rates. For resident corporations, the statutory CIT rate is 30%. In addition, there are surcharges imposed at high income levels as follows: a 7% surcharge on the total tax liability if taxable income exceeds INR 10 million (approx. EUR 140 000) but is less than INR 100 million (approx. EUR 1.4 million); or a 12% surcharge on the total tax liability if taxable income exceeds INR 100 million. All taxpayers are also subject to a 2% education "cess" and a 1% secondary and higher education "cess" payable on the total tax liability (including surcharge, if applicable). In total, this results in an effective statutory tax rate of 33.1% (if the 7% surcharge is applicable) or 34.6% (if the 12% surcharge is applicable) – which is relatively high compared to other BRIICS and OECD countries (see Figure 2).

3 . The concept of a business connection is wider than a PE. It includes, for example, the granting to a resident of a license to exploit an asset belonging to a non-resident (IBFD, 2016).

Figure 2. **Statutory corporate income tax rates in India, BRIICS and OECD countries, 2016**



Note: Maximum statutory tax rates are shown in each country. Lower rates may apply for some taxpayers subject to certain conditions in some countries. For India, rates include both the (highest) surcharge and education cesses as detailed in the text. The BRIICS average uses India's resident company rate.

Source: OECD Tax Database and PwC (2016)

A dividend distribution tax (DDT) is applied to all dividends distributed by resident corporations. The DDT tax is paid by the corporation, with the distributed dividends exempt in the hands of the shareholder.[4] The DDT rate is 15%, with surcharges and education cesses also applying on the DDT amount, as above. In total this results in an effective tax rate on distributed dividends of 16.5% (if the 7% surcharge is applicable) or 17.3% (if the 12% surcharge is applicable).

For non-resident corporations, the CIT rate is 40%. In addition, there are similar surcharges imposed at high income levels as follows: a 2% surcharge on the total tax liability if taxable income exceeds INR 10 million but is less than INR 100 million; or a 5% surcharge on the total tax liability if taxable income exceeds INR 100 million. Additionally, the same 2% and 1% education cesses as above apply. In total this results in an effective tax rate of 42% (if the 2% surcharge is applicable) or 43.3% (if the 5% surcharge is applicable). The higher non-resident CIT rate was introduced when India moved from an imputation system to the current DDT system. It was designed to reduce the difference between the taxation of distributed profits of an Indian resident corporation to a non-resident owner (subject to the resident CIT rate and the DDT) and an Indian Permanent Establishment (PE) of a non-resident corporation (subject to the non-resident CIT rate).[5] That said, the recent increases in the surcharge on the CIT and DDT for resident corporations has increased this differential.[6] Box 1 compares tax rates for resident and non-resident corporations.

Capital gains earned by corporations are taxed separately from ordinary corporate income. Short-term capital gains (held for less than three years) are taxed at 30% (plus surcharges, if applicable, and education cesses resulting in an effective tax rate of 33.1% or 34.6%). A concessionary rate of 15% (plus surcharges and education cesses) applies to short-term capital gains from the sale of shares, units of equity-oriented mutual funds or units of a business trust on which securities transaction tax has been paid. Long-term

4 . As of 1 April 2017, an additional dividend tax of 10% will apply to excess dividend income above a threshold of INR 1 million received by any person in a year.

5 . There may be additional taxation imposed in the home country.

6 . The lower surcharge for resident corporations increased from five to seven percent and the higher surcharge increased from 10 to 12% as of 1 April 2016.

capital gains (held for three years or more) are taxed at 20% (plus surcharges, if applicable, and education cesses resulting in an effective tax rate of 22% or 23.1%). However, long-term capital gains tax is not payable on certain securities on which the securities transaction tax has been paid. Additionally, roll-over relief is available where proceeds are reinvested in certain assets or sectors. The cost of assets is indexed in accordance with the official inflation index.

Box 1. **Tax rate calculations for resident and non-resident corporations, 2016**

The table below presents a calculation of the tax due on INR 100 of profit earned by an Indian resident vs non-resident corporation. In both cases the corporation is assumed to have taxable income of more than INR 100 million (approximately EUR 1.4 million), so that the highest surcharge is applicable. For a resident corporation, the after corporate tax profit (INR 65.39) is assumed to be distributed to the shareholder(s) so that the DDT and associated surcharge and cesses are also payable by the corporation in India.

Resident corporation	*INR*	**Non-resident corporation**	*INR*
Corporate income	**100.00**	**Corporate income**	**100.00**
CIT at 30%	**30.00**	**CIT at 40%**	**40.00**
Surcharge on CIT at 12%	3.60	Surcharge on CIT at 5%	2.00
Education cess on CIT & surcharge at 2%	0.67	Education cess on CIT & surcharge at 2%	0.84
Higher education cess on CIT & surcharge at 1%	0.34	Higher education cess on CIT & surcharge at 1%	0.42
DDT at 15% on distributed dividend	**9.81**		
Surcharge on DDT at 12%	1.18		
Education cess on DDT & surcharge at 2%	0.22		
Higher education cess on DDT & surcharge at 1%	0.11		
Total tax paid	**45.92**	**Total tax paid**	**43.26**

2.3. Tax base

In general, expenses are deductible where they are incurred "wholly and exclusively" for the purposes of the business of the taxpayer. Tangible and intangible assets are depreciated using the declining balance method at specified rates ranging from 5% for certain types of buildings to 100% for environmental protection equipment, with tax depreciation rates often in excess of economic depreciation. Intangible assets are depreciated at 25%. Taxpayers engaged in the business of generation and distribution of power are eligible for an additional depreciation allowance of 20% on investments made in new plant and machinery.

Losses are first set off against the specific head of income – "business income", "capital gains" or "other income" (e.g. dividends and other passive income), and then against other heads if necessary. Losses in the "other income" category cannot be carried forward. Business losses and capital losses can be carried forward up to eight years, subject to a continuity of ownership test (51%) for closely-held corporations. Short-term capital losses can be offset against both short- and long-term gains in the same year. Long-term capital losses cannot be offset against short term gains. Losses cannot be carried back.

In addition to providing accelerated depreciation, India provides a wide range of other CIT concessions to promote, for example, exports, balanced regional development, creation of infrastructure facilities, employment, and scientific research. The extent of these targeted concessions is discussed in more detail in section 3.

2.4. Corporate effective tax rates

To provide a clearer picture of the overall investment incentives created by the CIT system in India, this section presents average and marginal effective tax rates (AETRs and METRs, respectively; ETRs collectively) for an equity-financed investment in India. Profits are assumed to be distributed as dividends. AETRs are calculated for an investment producing a 20% pre-tax return, while METRs are calculated for a marginal investment that just breaks even (in which case the post-tax rate of return equals the real interest rate). The real interest rate is assumed to be 3% and the inflation rate is set at zero in order to focus solely on the impact of taxation on the ETRs. Box 2 discusses the underlying methodology for these calculations in more detail.

Table 1 presents ETRs for the current CIT system, while tables 3 and 4 present ETRs under recent reform proposals. The ETRs incorporate the combined effect of the statutory CIT rate, surcharge, education and higher education cess, dividend distribution tax (DDT), and depreciation provisions. As depreciation provisions vary across asset types, separate ETRs are presented for investment in a range of assets.

The DDT, surcharge and cesses will act to increase the ETRs above the statutory CIT rate, as will tax depreciation rates if they are lower than the true economic depreciation of the asset. In contrast, tax depreciation rates that are higher than true economic depreciation will act to lower the ETRs. Some businesses can benefit from additional tax concessions (such as for certain infrastructure investments or on export profits of a corporation in a special economic zone) which will act to lower ETRs for eligible businesses. While not captured in the ETR calculations, these concessions are examined in section 3.

The current system

The first two columns in Table 1 compare tax and economic depreciation rates, while the last two columns present AETR and METR estimates. AETRs range from 41.9% for electrical equipment to 50.3% for pre-packaged software. METRs range from 26.2% to 58.1%, again for electrical equipment and pre-packaged software.

Table 1. **ETRs under the current CIT system**

	Tax Depreciation	Econ. Depreciation	CIT=30% AETR	CIT=30% METR
	(%)	(%)	(%)	(%)
Non-residential buildings	10.0	3.0	43.5	35.6
Commercial vehicles	50.0	21.6	43.2	33.8
Computers (servers and networks)	60.0	27.0	43.1	33.6
Computers (end-user devices)	60.0	72.8	46.3	47.1
Plant and machinery (general)	15.0	10.8	44.8	41.5
Electrical equipment	80.0	16.5	41.9	26.2
Plant and machinery (pharmaceuticals)	15.0	8.6	44.3	39.2
Plant and machinery (telecommunications)	15.0	12.7	45.2	43.3
Pre-packaged Software	25.0	55.0	50.3	58.1
Custom Software	25.0	33.0	46.9	49.3
R&D for motor vehicle manufacturing	25.0	31.0	46.6	48.3
R&D for electronic product manufacturing	25.0	40.0	48.0	52.5
Average			**45.3**	**42.4**

Note: True economic depreciation rates for each of the assets are estimated based on US empirical estimates of the declining balance rate provided by the US Bureau of Economic Analysis (Fraumeni, 1997, US Department of Commerce, 2003, and Li, 2012) adjusted for Indian Government estimates of asset-specific useful lives (as reported in India's Corporations Act 2013).

Source: Authors' calculations.

The lower ETRs for electrical equipment are driven by the accelerated tax depreciation rate – which is more than four times the estimated rate of true economic depreciation. Nevertheless, the AETR remains above the 30% statutory CIT rate due to the countering effect of the DDT, surcharges and cesses. In contrast, the impact of accelerated depreciation outweighs that of the DDT, surcharges and cesses on the METR which is now below the statutory CIT. The accelerated tax depreciation allowances have a larger impact on the METR than on the AETR because their relative value decreases as profitability increases. Accelerated depreciation also acts to lower the ETRs for non-residential buildings, commercial vehicles, computer servers and networks, and plant and machinery, though ETRs remain above the statutory CIT rate.

AETRs and METRs are higher for investment in the remaining asset types presented (pre-packaged and custom software, end-user computers, and R&D for motor vehicle and electric product manufacturing) as tax depreciation rates are lower than economic depreciation rates, and therefore act to increase ETRs.

Proposed reforms

In acknowledgement of its relatively high statutory CIT rate and narrow corporate tax base as compared to other major economies, the government announced in its 2015 budget that it would undertake a major structural CIT reform. Over four years from 2016, the government proposed to reduce India's statutory CIT rate (for resident corporations) from 30% to 25%. In addition, the government proposed the "rationalisation and removal of various kinds of tax exemptions and incentives for corporate taxpayers" (Jaitley, 2015).[7]

Table 2 presents ETRs prior to and after the proposed CIT rate reduction across a range of asset types. The reduction in the CIT rate lowers both AETRs and METRs, with AETRs typically falling to a greater extent than METRs. Since AETRs measure the effects of tax on location decisions (as well as other discrete investment decisions), these results suggest that the rate reduction can be an important policy tool to attract foreign investment into India. The 2016 and 2017 reforms reduced the CIT rate for resident corporations, including subsidiaries of multinational enterprises. The ETRs for non-resident corporations with a permanent establishment in India (who do not pay the DDT, but pay the higher 40% CIT rate instead), was unchanged after the reform, creating a bias against multinationals operating in India as a branch towards operating as a subsidiary.

As well as lowering the statutory CIT rate, the government's proposed reform package also includes the introduction of a cap on tax depreciation rates at a maximum of 40%. This cap would impact four of the asset categories presented in Tables 1 and 2 as they currently have tax depreciation rates above 40%: commercial vehicles, computer servers and networks, computer end-use devices and electrical equipment.

7 . In its FY 2016/17 budget, the government provided detail on the first elements of the CIT rate reduction and on the extent of the proposed base broadening. Rather than the anticipated gradual reduction of the CIT rate over four years, the government proposed in 2016 to reduce the rate in a phased manner. The statutory rate was reduced to 29% in 2016 for small businesses (with turnover not exceeding INR 50 million), and to 25% for new manufacturing corporations that do not claim any tax concessions (i.e. profit or investment linked deductions, investment allowance, or accelerated depreciation). The CIT rate remained unchanged in 2016 for all other corporations. Regarding base broadening, depreciation rates were proposed to be capped at 40% as of 1 April 2017. Multi-year tax exemptions on profits from different forms of infrastructure investments and for exporters in special economic zones (SEZs) were proposed to be eliminated over time via the non-extension of concessions that are the subject of sunset clauses, or the insertion of sunset clauses where they do not currently exist. The resulting sunset dates will range from 1 April 2017 to 1 April 2020. The enhanced deduction for scientific research expenditure was proposed to be reduced from 200% to 150% in 2017, and to 100% in 2020. A number of smaller concessions remains in place, including immediate deductibility of certain capital investment expenditures. It was proposed that infrastructure investment become eligible for this concession. The FY 2017/18 government budget included a cut in the corporate income tax rate from 30% to 25% for all companies with a turnover below INR 500 million. The government expected this measure to benefit 96% of Indian enterprises.

Table 2. **ETRs before and after the proposed CIT rate reduction from 30% to 25%**

	CIT=30%		CIT=25%			
	AETR	METR	AETR		METR	
	(%)	(%)	(rate, %)	(diff., pp)	(rate, %)	(diff., pp)
Non-residential buildings	43.5	35.6	39.1	-4.4	32.0	-3.5
Commercial vehicles	43.2	33.8	38.9	-4.3	30.5	-3.2
Computers (servers and networks)	43.1	33.6	38.8	-4.3	30.4	-3.2
Computers (end-user devices)	46.3	47.1	41.4	-4.8	42.2	-4.9
Plant and machinery (general)	44.8	41.5	40.2	-4.6	37.2	-4.3
Electrical equipment	41.9	26.2	37.8	-4.1	24.3	-1.9
Plant and machinery (pharmaceuticals)	44.3	39.2	39.8	-4.5	35.1	-4.0
Plant and machinery (telecommunications)	45.2	43.3	40.6	-4.7	38.8	-4.5
Pre-packaged Software	50.3	58.1	44.8	-5.5	52.7	-5.5
Custom Software	46.9	49.3	42.0	-4.9	44.3	-5.1
R&D for motor vehicle manufacturing	46.6	48.3	41.7	-4.9	43.3	-5.0
R&D for electronic product manufacturing	48.0	52.5	42.9	-5.1	47.2	-5.3
Average	**45.3**	**42.4**	**40.7**	**-4.7**	**38.2**	**-4.2**

Source: Authors' calculations.

Table 3 shows the additional impact of imposing the 40% cap on these four asset types, beyond the reduction in the statutory CIT rate. The cap on the tax depreciation rate increases the (post-CIT reform) AETRs by up to 7.4 percentage points, and METRs by as much as 12.5 percentage points. The effect is largest for end-user computer devices (where the tax depreciation rate was previously 60%, already below the estimated true economic depreciation rate of 72.8%). The smallest effect is for commercial vehicles (where the tax depreciation rate was previously 50%, compared to an economic rate of 21.6%). All ETRs are now above their pre-CIT reform level, as the impact of the CIT rate reduction is outweighed by the impact of the 40% cap on the tax depreciation rate.

In addition to the assets presented in table 3, a small number of other asset types currently have tax depreciation rates above 40% – e.g. investments in certain environmentally related assets such as air pollution control equipment or water supply and treatment systems are immediately deductible (i.e. a 100% tax depreciation rate). For an investment in such assets, the 40% cap would have a similar increasing effect on the ETRs as in table 3, countering the decreasing effect of the CIT rate reduction.

Table 3. **ETRs before and after the proposed CIT rate + depreciation cap reform**

	CIT=25%		CIT=25% / Cap on Acc. Depreciation			
	AETR	METR	AETR		METR	
	(%)	(%)	(rate, %)	(diff., pp)	(rate, %)	(diff., pp)
Commercial vehicles	38.9	30.5	43.7	4.9	36.6	6.1
Computers (servers and networks)	38.8	30.4	44.3	5.4	39.2	8.8
Computers (end-user devices)	41.4	42.2	48.8	7.4	54.7	12.5
Electrical equipment	37.8	24.3	43.2	5.4	34.0	9.7

Source: Authors' calculations

To provide a perspective on a larger base broadening reform than is currently proposed, ETRs have also been calculated for a reform that both reduces the CIT rate from 30% to 25% and removes all accelerated depreciation. In the absence of accelerated depreciation, AETRs and METRs for all asset types would be around 41% (results are presented in table A1 in the annex). These rates simply show the combined effect on investment incentives of the 25% statutory CIT rate, plus surcharges, cesses, and DDT. Comparing these rates to the pre-reform rates in Table 1 illustrates that such a "base broadening - rate reducing" reform would produce a lower AETR for investment in almost all assets. However, it would only lower METRs for 7 of the 12 assets presented.

Debt-financed investment

The above results focus on equity-financed investment, which constitutes the vast majority of FDI into India. ETR results for debt-financed investment (presented in table A2 in the annex) highlight the tax induced bias towards debt over equity financing which is driven by the deductibility of interest expenses. Results are presented for two scenarios – one where a withholding tax on outbound interest payments of 20% is imposed and one where no withholding tax is imposed – in order to illustrate two potential extreme cases. For a country that exempts foreign source income, the withholding tax will act as a final tax (as the DDT will for equity-financed investment). However, in countries that tax foreign source income, a credit may be given for any withholding tax paid. As the DDT is not a withholding tax and is therefore unlikely to gain relief in the home country, this is likely to exacerbate the debt bias created by the deductibility of interest for countries that tax foreign source income. This bias can be seen when comparing the zero withholding tax rate results with those for equity financing in table 1.

The impact of inflation

The above results have ignored the impact of inflation on ETRs in order to focus on the impact of the various different layers of taxation on the overall ETRs. However, in an inflationary environment, ETRs can vary significantly. This can be seen in the results in tables A3 and A4 in the annex which, under an assumption of 5% inflation, present substantially different ETRs than those presented in the main text. In the case of investments financed by new equity, inflation leads to higher ETRs due to two distinct factors. First, the inflationary component of income is taxed. Second, as tax depreciation allowances are not indexed for inflation in India, their real value falls over time. Both factors increase ETRs, potentially outweighing the impact of accelerated tax depreciation provisions. However, the effects of inflation are different in the case of debt-financed investments. Since nominal interest is tax deductible, higher inflation rates lead to larger interest deductions in subsequent periods, thus reducing the net cost of repaying debt and, consequently, ETRs on debt-financed investments. This effect generally counteracts the other two factors, leading, in a highly inflationary climate, to substantial reductions in ETRs compared to the zero inflation scenario.

Box 2. **Methods for calculating ETRs**

A well-established methodology exists for the calculation of forward-looking effective tax rates (ETRs). Early contributions developed the standard model of investment behaviour leading to the concept of the cost of capital which is defined as the minimum required rate of return on a marginal investment (Jorgenson, 1963; Jorgenson and Hall, 1967). King and Fullerton (1983) analysed the effects of tax on the cost of capital, introducing a methodology for calculating forward-looking marginal effective tax rates (METRs). OECD (1991) further extended the methodology to calculate METRs on domestic and international investment for the manufacturing industry in 24 OECD countries. Devereux and Griffith (1999, 2003) introduced the concept of average effective tax rates (AETRs) to study the effects of tax on infra-marginal investments earning more than just the cost of capital. Klemm (2008) further extended the Devereux-Griffith approach to account for time-variation in tax parameters.

The calculations presented in this report are based on the standard domestic investment model as described, for instance, by Devereux and Griffith (1999) or Klemm (2008).* To focus the discussion on the effects of the recent corporate tax reform in India, the ETR calculations do not account for personal income taxation; they include corporate income tax, business wealth taxation, 15% dividend distribution tax as well as 12% surcharge and 3% (education and higher education) cess. Indian tax depreciation rules are modelled as described in Appendix I of the Income Tax Act (1963).

To allow for comparison across different scenarios the approach builds on a set of additional economic parameters which are held constant throughout the analysis: the pre-tax rate of return on investment (*p*) is assumed to be 20%; the real interest rate (*r*) is 5% in all scenarios implying that, given the fact that personal income taxation is excluded, shareholders discount future income at this rate;** inflation is assumed to be zero. Economic depreciation rates for each of the assets are estimated based on empirical estimates of the declining balance rate provided by the US Bureau of Economic Analysis (Fraumeni, 1997, US Department of Commerce, 2003, and Li, 2012) adjusted for Indian Government estimates of asset-specific useful lives (as reported in India's Corporations Act 2013).

Based on these parameters and assumptions the AETR can be calculated as the pre-tax net present value (NPV) minus the post-tax NPV over the NPV of the net income stream in the absence of tax.

$$AETR = \frac{NPV_{cash-flow}^{pre-tax} - NPV_{cash-flow}^{post-tax}}{NPV_{income}^{pre-tax}}$$

The METR is derived based on the condition that no post-tax economic profit is earned; i.e. the rate of return on investment (*p*) is such that the post-tax NPV of the investment is zero. This condition determines the minimum required rate of return, i.e. the cost of capital ($\tilde{p}$). The METR is defined as the cost of capital minus the post-tax return to the shareholder over the cost of capital. If personal taxation is not accounted for the post-tax return to the shareholder is equal to the real interest rate (*r*).

$$METR = \frac{\tilde{p} - r}{\tilde{p}}$$

METRs thus measure the effects of tax on the cost of capital relative to a normal rate of return. They reflect the tax wedge on marginal investments that just break even and are used to assess scale decisions in competitive markets (i.e. decisions about the level of investment). AETRs measure the tax wedge on investments earning above-normal rates of return due to, for instance, patents, market power or location rents. They are used to assess tax effects on discrete investment choices (i.e. location decisions).

*The standard model developed by Devereux and Griffith (1999) analyses a one-period perturbation of the capital stock under pooled depreciation. Klemm (2008) analyses one-period investments under individual asset depreciation as well as the permanent investment case; however, under pooled depreciation (as is the case in India) the approaches are equivalent if personal income taxation is not accounted for (see Klemm, 2008, for a discussion).

**The effective tax rates presented in the international tax section do not take time-discounting into account.

3. The tax base is narrow

This section examines India's current business tax base as well as the proposed base-broadening reforms outlined in the 2016 budget. It considers, in turn: the tax concessions in the corporate tax base; India's international tax rules and efforts to prevent base erosion and profit shifting (BEPS); the taxation of small businesses; and the efficiency and effectiveness of the tax administration.

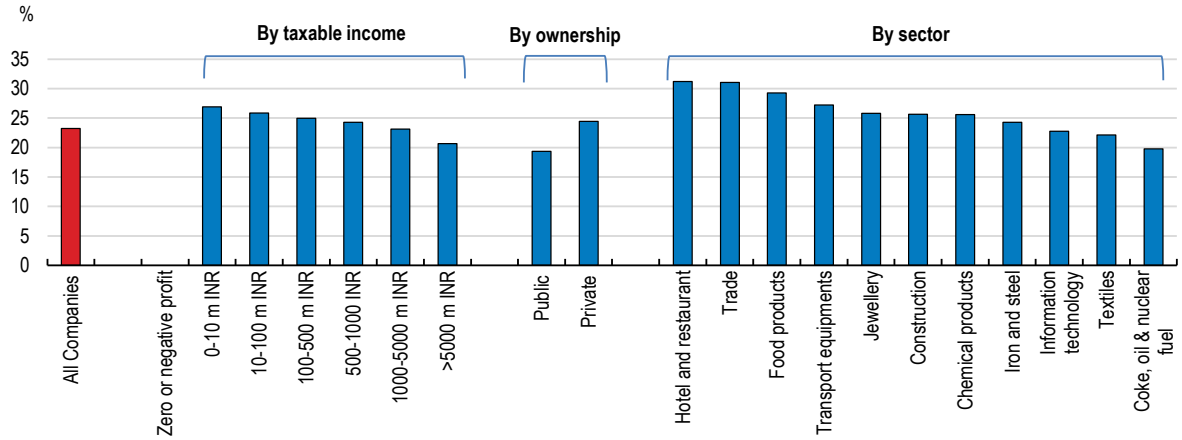
3.1. Corporate tax concessions

India has a narrow CIT base due to the presence of a range of tax concessions that have been introduced to promote, for example, capital investment, exports, balanced regional development, creation of infrastructure facilities, employment, and scientific research and development. These concessions result in some corporations paying significantly less tax than the high effective tax rates imply.

To illustrate the narrowness of the Indian CIT base we draw on India's annual *Statement of revenue impact of tax incentives* report. The 2016 report uses tax return data from the 2013-14 financial year to present average tax rates calculated as the actual tax paid by corporations as a percentage of their "profits before tax". A corporation's profits before tax include tax exempt income and exclude concessional deductions provided for tax purposes. As such, these "backward-looking" average effective tax rates take into account the wide range of tax concessions provided in India, whereas the "forward-looking" effective tax rates presented in section 2 only took account of accelerated tax depreciation provisions.

Figure 3 shows that the average tax rate paid by Indian corporations in 2013-14 was just 23.2% – far below the statutory CIT rate of 32.4% (with 5% surcharge) or 34% (with 10% surcharge) applicable in 2013-14. Average tax rates also varied by size of business (as measured by taxable income) and sector – with larger and more capital intensive businesses tending to face lower average tax rates.

Figure 3. **Corporate income tax paid as a percentage of profits before tax, 2013-14**



Note: Taxes paid include the 30% CIT rate, plus surcharge if applicable (5% of CIT paid for corporations with taxable income between INR 10 million and INR 100 million; 10% of CIT paid for corporations with taxable income above INR 100 million), education cess (2% of CIT and surcharge paid) and higher education cess (1% of CIT and surcharge paid). Profits before tax include tax exempt income and exclude concessional deductions provided for tax purposes. Calculations are based on a sample of 564 787 corporate tax returns from the 2013-14 financial year.

Source: Government of India (2016a) "Statement of revenue impact of tax incentives under the central tax system: financial year 2013-14 and 2014-15".

Table 4 examines the concessions that drive these low average effective tax rates in more detail. Accelerated tax depreciation allowances provide the largest tax expenditure – equating to just over 8% of CIT revenue and 0.3% of GDP in the 2014-15 financial year.[8] Area-based exemptions provide the next largest tax expenditure at 6.2% of CIT revenue. A range of concessions to encourage infrastructure investment (including electricity generation and distribution, telecommunications, oil and natural gas) result in a tax expenditure of 5% of CIT revenue. Corporate tax incentives for scientific research also result in a significant tax expenditure. An additional concession currently outside the benchmark tax base and hence not included in India's tax expenditure calculations is the exemption of income from agriculture from the tax base.

Table 4. **Main tax expenditures in India's corporate income tax, 2014-15**

	INR billion	% of CIT revenue	% of GDP
Accelerated depreciation	370	8.2%	0.3%
Area-based exemptions	281	6.2%	0.2%
Special economic zones	204		
Industrially under-developed areas	77		
Infrastructure	227	5.0%	0.2%
Electricity	107		
Oil and natural gas	67		
Telecommunications	15		
Other qualifying infrastructure facilities[1]	38		
Scientific research	82	1.8%	0.1%
Total gross corporate income tax concessions[2]	**984**	**21.8%**	**0.8%**
Recovered through Minimum Alternate Tax[3]	360	8.0%	0.3%
Net revenue foregone[2]	**624**	**13.8%**	**0.5%**

1. Other qualifying infrastructure facilities include: roads, bridges or rail systems; highway projects (including housing or other activities integral to the project); water supply projects, water treatment systems, irrigation projects, sanitation and sewerage systems or solid waste management systems; ports, airports, inland waterways, and inland ports or navigational channels.

2 The total gross corporate income tax concessions and net revenue forgone include other smaller concessions not shown above.

3 India operates a minimum alternate tax (MAT) to ensure that profitable corporations pay at least some tax. If a corporation's tax liability is below 18.5% of its book profits, the book profits are deemed to be taxable income and are subject to the MAT at a rate of 18.5%, plus surcharges and cesses.

Source: Government of India (2016a) "Statement of revenue impact of tax incentives under the central tax system: financial year 2013-14 and 2014-15".

Total tax expenditures in India's CIT are estimated at INR 984 billion. This equates to 21.8% of CIT revenue (0.8% of GDP) in 2014-15. In considering this figure (and to a lesser extent the semi-aggregated figures in Table 4), it should be emphasised that tax expenditures are estimated separately for each concession holding all other factors constant. Their aggregation is fraught with difficulty. In particular, behavioural responses to the removal of a concession – both on the particular investment or activity related to the concession, and on the take-up of other concessions – are not taken into account.

8 . Note though that these figures only account for the single year impact on tax revenue of higher depreciation deductions. They do not account for the corresponding reduction in depreciation deductions, and hence increased tax revenue, in future years.

This aggregate figure also does not take account of the impact of India's minimum alternate tax (MAT) which ensures that profitable corporations that benefit significantly from tax concessions still pay significant tax each year. The MAT was estimated to claw back INR 360 billion in 2014-15, reducing the total revenue forgone to INR 624 billion. That said, for profitable firms, the MAT acts as an advance payment of future tax liability.[9]

Not only do these concessions give away a very large amount of tax revenue, evidence of the effectiveness of such concessions at achieving their particular policy goal is often quite mixed (see, e.g, James, 2013; IMF/OECD/UN/World Bank, 2015). Furthermore, these concessions are often relatively complex leading to costly disputes over eligibility, as well as facilitating outright abuse.

These concerns have been acknowledged by the current government. The announced CIT base broadening reform – coupled with the proposed reduction in the CIT rate – is a positive step. Reducing the CIT rate will boost investment, but without creating the same distortions that the current concessions do. As such, moving to a system with a broader base and lower rate, even in a revenue neutral context, can be expected to produce a more efficient, as well as fairer, tax system. Further base broadening would increase such gains. The remainder of this section discusses, in turn, the major tax concessions in the Indian CIT.

Accelerated depreciation

As highlighted in section 2, India provides tax depreciation rates that are often significantly above rates of true economic depreciation for a wide range of assets. For example, non-residential buildings can be depreciated at a rate of 10% per year on a declining balance basis, whereas estimates of the actual economic life of non-residential buildings (as provided in the Corporations Act 2013) suggest a true economic depreciation rate of just 3%.

India's accelerated depreciation provisions encourage capital investment by businesses. However, this comes at substantial cost. First and foremost, it involves foregoing substantial tax revenue. It is by far the largest concession provided in the CIT base, accounting for 38% of all revenue forgone in the CIT in 2014-15. That said, these estimates somewhat overstate the true cost of accelerated depreciation as they only account for the single year impact on tax revenue of higher depreciation deductions, and not the corresponding reduction in depreciation deductions, and hence increased tax revenue, in future years. Furthermore, in the absence of inflation indexing, there is a case for providing some across-the-board acceleration to make up for the loss in value of depreciation deductions over time due to inflation.

Of potentially more importance than fiscal cost, is the distortionary impact of accelerated tax depreciation provisions on investment decisions. By providing a greater concession to investment in some assets over others they create the incentive to shift investment towards assets with the most favourable rates even if these are not the most profitable investments absent the tax considerations. Accelerated depreciation also favours capital intensive industries over labour intensive industries.

9 . If a corporation's tax liability is below 18.5% of its book profits, the book profits are deemed to be taxable income and are subject to the MAT at a rate of 18.5%, plus surcharge and cesses (leading to an effective tax rate of 20.01% or 20.96%). Book profits are profits before concessionary exemptions and deductions. The MAT paid is creditable against future ordinary tax liability for up to 10 years.

The government's proposal to cap rates at 40% is itself problematic. This will not eliminate the concession favouring investment in many assets (as their tax depreciation rates are already below 40%), but will create or exacerbate a tax bias against investment in some assets whose true economic depreciate rate is greater than 40% (e.g. end-user computer devices). Aligning tax depreciation rates with estimates of true economic depreciation would mitigate distortions.

Area-based concessions (special economic zones and industrially under-developed areas)

Special economic zones (SEZs) were introduced in India more than 50 years ago with the goal of generating additional economic activity, exports, investment and employment. Significant tax concessions are granted to businesses operating in SEZs. The most significant of these is the exemption of export profits. Businesses in a SEZ are 100% exempt from CIT on export profits for five years, and receive a 50% exemption for the following five years. A further 50% exemption is provided for another five years in relation to re-invested earnings derived from exports. In total, these exemptions are estimated to have cost INR 184 billion in the 2014-15 financial year. Businesses in an SEZ were also originally exempt from the MAT and the DDT. However, since 2012 they have been subject to both taxes, thereby reducing the extent of the tax concession. Businesses are also exempt from the central sales tax and service tax on all purchases. An SEZ is treated as if it were outside the customs territory of India. As such, there is duty free import of goods into an SEZ. Meanwhile, sales to the domestic market are treated as imports into India and subject to customs duty.

Developers of SEZs are also provided with a similar range of incentives. They receive a 100% tax exemption for any 10 consecutive years in the 15 years from beginning operation. They are also exempt from the central sales tax and the service tax, and are treated as being outside the customs territory of India.

International evidence on the effectiveness of SEZs is mixed. In particular, SEZs may not result in a significant increase in exports, employment or FDI (see, e.g., Zeng, 2015). Evidence also suggests that export-related concessions are more likely to be effective at increasing FDI than other types of concessions (Mutti and Grubert, 2004). Recent empirical analysis for India suggests that SEZs have had no clear impact on aggregate investment and exports (Rao et al., 2016).

Research on India's removal of export concessions in 2000 for businesses outside SEZs also suggests such concessions are open to abuse. James (2013) found that when these tax incentives were reduced, the declared income by firms losing the concession halved, but only due to under-reporting (i.e. audit determined pre-tax profit did not actually fall). James also found that investors with production units both inside and outside a SEZ had significantly higher pre-tax profits in the SEZ than outside, even for the same product – suggesting a diversion of profits from outside to inside the SEZ.[10]

It has also been argued that interest in investing in SEZs has fallen since the MAT was imposed, although this does not appear to have impacted on the number of SEZs or export figures (Mukherjee and Bhardwaj, 2016). The provision of export incentives to exporters outside SEZs in 2009 and signing free-trade agreements may also have reduced the relative incentive to operate in a SEZ (OECD, 2014a).

10 . Such leakage was also seen in Colombia, which recently introduced transfer pricing between domestic and zone corporations to try to avoid this. Business activities have also been artificially recharacterised as manufacturing to benefit from Colombia's SEZ tax incentives (Perret and Brys, 2015).

A major concern, particularly regarding the export profits exemption, is that it may be in breach of WTO rules. India has signed the WTO Agreement on Subsidies and Countervailing Measures. While this agreement does not have specific rules relating to SEZs, it does prohibit any subsidy that is contingent upon export performance. A tax exemption on export profits would therefore appear in breach of the agreement. Consequently, the government's proposal to place a sunset date of 1 April 2017 on the export profit exemption is another positive step. In the long term, the zones will then simply provide customs and indirect tax benefits to export-oriented businesses, which is in line with international best practice.

Generous tax relief is also granted to corporations operating in specified industrially under-developed regions or states so as to increase investment, employment and output in these areas. Corporations operating in these areas benefit from either a 100% deduction of profits for 10 years, or a 100% deduction for 5 years followed by a 30% deduction in subsequent years, depending on the state. Initially designed for North Eastern states, this tax relief was later extended to Jammu and Kashmir in 2002, and to Himachal Pradesh and Uttarakhand in 2003. Concessions are granted to a region or state for a 10 year period, and a corporation commencing operation within this 10-year window benefits from the tax concession for the subsequent 10 years. As of 2016, an additional depreciation allowance for new plant and machinery (on top of the tax depreciation deduction already allowed) and an investment allowance were granted to Andhra Pradesh and Bihar. Rao et al. (2016) found evidence that tax concessions for industrially under-developed states have increased investment, value added and employment in some states, but not in all. This suggests that the overall business environment, and in particular labour and product market regulations as well as infrastructure and human capital, play an important role in achieving balanced regional development.[11] As such, there is merit in making renewal of CIT concessions for industrially under-developed states by the central government conditional on states' action to improve the overall business environment.

Infrastructure incentives

India provides a wide range of tax incentives for the development and operation of infrastructure facilities. The most significant of these are for electricity and for oil and natural gas, as noted in table 4. The concession for electricity applies to businesses undertaking the generation, transmission and/or distribution of electricity. A deduction of 100% of profits is currently provided for any 10 consecutive years out of the 15 years from when the business started operating. A sunset clause is in place restricting eligibility to businesses beginning operations on or before 31 March 2017. The same 10-year 100% deduction of profits also applies for telecommunication infrastructure investments (but subject to an earlier sunset date, with operations needing to have commenced on or before 31 March 2005).

The concession for oil and natural gas provides a 100% deduction of profits for seven years from commencement of operations. It applies to the commercial production and refining of oil. Refining activities have a sunset date for commencement of operations of 31 March 2012, whereas there is currently no sunset date on commercial production. For natural gas, the concession applies to commercial natural gas production licensed under certain government exploration contracts. There is currently no sunset date.

11 . See OECD (2016) for further discussion of regional development in India.

The development, operation and/or maintenance of certain other infrastructure facilities also receive the 10-year 100% deduction of profits. Qualifying infrastructure facilities include: roads, bridges or rail systems; highway projects (including housing or other activities integral to the project); water supply projects, water treatment systems, irrigation projects, sanitation and sewerage systems or solid waste management systems; ports, airports, inland waterways, and inland ports or navigational channels. To qualify, the infrastructure facility must: be Indian owned; have entered into an agreement with Central, State or local government for the development, operation and/or maintenance of the infrastructure; and have started operation on or after 1 April 1995.

Another significant concession applies to profits from the development of housing projects approved by a local authority before 31 March 2008 which receive a 100% deduction of profits from the development, subject to certain conditions. Additionally, a new 100% profit deduction was announced in the 2016 budget that will apply to specified housing projects that are approved between June 2016 and March 2019 and are completed within three years.

In addition to the substantial fiscal cost, the wide range and complicated eligibility criteria make these concessions particularly open to both dispute and abuse. For example, size limits on apartments in housing projects have been misused through family members purchasing adjacent apartments to effectively form one large apartment (against the intent of the housing concession). This resulted in legislative change in 2009 to prevent such abuse.

Given the scope and complexity of the current range of concessions, the government's proposal to rationalise infrastructure concessions by removing many of the current multi-year profit concessions and allowing immediate deductibility instead (under the "investment linked deduction") is a positive step.[12] International best practice would be to regularly assess the remaining concessions to determine whether or not there is merit in their continuation in the longer term.

R&D

India provides enhanced deductions for R&D expenditure (more specifically "scientific research"). A 200% deduction for in-house R&D expenditure, including capital expenditure (other than land and buildings), is provided to any business engaged in the manufacture or production of any article or thing (subject to a list of excluded products).[13] To be eligible, the businesses' R&D activity has to be approved by the Department of Scientific and Industrial Research (DSIR). There is a sunset date on the 200% deduction of 31 March 2017. Capital expenditure (other than land) on R&D not eligible for the 200% deduction can be immediately deducted in the year incurred.

In addition, enhanced deductions are provided for payments made to certain entities for carrying out research and development in India as follows: 200% for payments to a National Laboratory or Indian Institute of Technology for scientific research; 175% for payments to an approved research association university, college or other institution for scientific research; and 125% for payments to an approved university, college or other institution for social science or statistical research.

12 . The elimination of concessions is proposed to occur via the non-extension of sunset dates or introduction of sunset dates where not currently present. Reforms will not, therefore, have effect until 31 March 2017, and current concessionary treatment will continue for several years under the current concessions given the multi-year nature of the exemptions they provide.

13. The negative list in schedule 11 of the Income Tax Act 1961 includes: alcoholic products, tobacco products, cosmetics, toothpaste, aerated waters using blended flavouring concentrates, confectionary, record players, photographic apparatus, projectors, office machines and apparatus, steel furniture, safes, latex foam, crown corks and caps for packaging.

The rationale for the introduction of R&D incentives is typically based on the existence of knowledge spillovers generated from R&D activity that are not captured by investors leading to a socially suboptimal level of investment in R&D. While R&D tax incentives are common amongst both developed and emerging countries, they suffer from a number of problems. Determining the socially optimal level of investment in R&D is fraught with difficulty. Furthermore, while empirical evidence tends to find that R&D concessions do increase reported R&D expenditure, estimates of the size of this effect differ markedly (CPB, et al., 2015). Indian research also raises doubts as to the Indian R&D tax incentive's effectiveness at increasing R&D expenditure (Mani, 2010). Even if a concession does result in increased R&D expenditure, accurately determining the responsiveness of businesses to the concession, and hence the necessary size of the concession to increase R&D to the socially optimal level (if it could be accurately determined), poses even further difficulty. This uncertainty suggests caution should be taken at least in relation to the overall generosity of a concession bearing in mind that overinvestment is also inefficient.

R&D concessions are also prone to abuse. They create an incentive to increase reported R&D, which is not necessarily the same thing as actual R&D. They are complex, and the definition of what constitutes R&D expenditure (and what does not) is inevitably grey and requires significant resources to police. Volume-based concessions, as in India, create large deadweight costs as they support R&D expenditure that would have occurred without the concession (while incremental R&D concessions are more complex to implement and administer and can create perverse incentives to cycle R&D expenditure, hence the international trend is away from them).

A final concern is that they tend to favour larger businesses over smaller businesses. This is because larger businesses tend to undertake most R&D, while smaller businesses are more likely to be in a loss position and thereby unable to take advantage of a tax deduction or credit. Given these various concerns, India has proposed the staged removal of the entire range of enhanced deductions for in-house research or payments to research entities. As capital R&D expenditure (other than land and buildings) will remain immediately deductible, there will still continue to be some degree of concessionary tax treatment for R&D expenditure.

Agriculture

Agricultural income is exempt from central government income tax in India whether derived by incorporated or unincorporated entities. This includes: any rent or revenue derived from land situated in India and used for agricultural purposes; any income from cultivation of that land, or from any process carried on to make the produce of the land fit for market, or from the sale of the produce; and income from renting a house on agricultural property. Broader farming activities (e.g. dairy or poultry farming) are not exempt.[14] The Constitution currently provide the right to tax agriculture solely to the states. However, most states do not exercise this right.

The non-taxation of agricultural income distorts investment away from non-agricultural activity that would be more profitable in the absence of the tax concession. It benefits middle and high income agricultural income earners (who avoid personal or corporate income taxes) relative to those earning similar levels of non-exempt incomes. Meanwhile it has no effect on low agricultural income earners who would not pay PIT in any case as they would fall below the generous level at which the PIT kicks in (approximately 250% of average earnings). Removing the exemption for agricultural income would require amendment of the constitution.

14 . Agricultural income does affect personal income tax (PIT) rates applicable to non-agricultural income. If agricultural income exceeds INR 5 000 and non-agricultural income exceeds the basic PIT exemption limit then agricultural and non-agricultural income are grouped together to determine marginal PIT rates to be applied to the non-agricultural income.

3.2. Addressing base erosion and profit shifting

In recent years India has seen significant increases in both inward and outward FDI (Table 5). The net inflow of investment has helped support the growth of the Indian economy. However, the increased openness of the Indian economy has also increased the risk of revenue losses through multinational enterprises (MNEs) exploiting mismatches in international tax rules to reduce the levels of tax they pay. While "base erosion and profit shifting" (BEPS) is a worldwide concern, it is of particular importance to emerging economies such as India, where CIT revenues account for a larger share of total revenues than in most developed countries. Furthermore, India's relatively high CIT rate places it at particular risk of revenue losses.

Table 5. **Indian FDI positions, 2010-2014 (USD million)**

	2010	2011	2012	2013	2014
Inward Direct Investment Positions	212,725	210,608	229,196	249,870	324,653
Equity	199,385	198,438	214,671	234,282	305,517
Debt	13,340	12,170	14,526	15,588	19,137
Outward Direct Investment Positions	71,315	78,541	93,413	90,163	92,430
Equity	56,804	58,095	78,689	71,083	73,047
Debt	14,512	20,446	14,724	19,080	19,383

Source: IMF Coordinated Direct Investment Survey (CDIS).

Table 6 presents combined statutory tax rates on international dividend payments. The first column shows the statutory CIT rate in each G20 country, including central and sub-central taxes on corporate income. For India, this figure is based on current law and includes the 15% dividend distribution tax (DDT) as well as the 12% surcharge and 3% education cesses.[15] The second column shows the withholding tax rate on equity-financed investment in each of the countries on the left hand side, computed as an unweighted average over the full set of potential investor countries in the OECD and G20. Since it levies the DDT, India does not levy a withholding tax on dividends. The third column shows the weighted average withholding tax rates, with the weights being constructed on the basis of bilateral dividend flows (where available) and FDI positions (see Hanappi, Lejour and Van't Riet, 2015, for a description).

The last column in Table 6 presents a combined tax rate on international dividend payments from a subsidiary located in one of the listed countries to a parent corporation in the wider group of G20 countries. The calculations are based on the weighted withholding tax rates and are equivalent to the approach outlined, for instance, by Barrios et al. (2012) or Van't Riet and Lejour (2014), assuming that ownership requirements are met and foreign source income is tax exempt in the residence country.[16]

15 . If a multinational enterprise has a permanent establishment in India the dividend payment to the parent company would be subject to a different effective tax rate (see Section 2).

16 . Foreign dividends are not tax exempt in all countries. Some countries that tax foreign dividends provide foreign tax credits or deductions. In some countries no foreign tax relief method is applied.

Table 6. **Combined statutory tax rates on international dividend payments, 2016**

	CIT Rate	Average Withholding Tax Rate on Outbound Dividends (to OECD and G20)		Combined Statutory Tax Rate (2) (3)
		(unweighted)	*(FDI weighted)*	*(FDI weighted)*
Brazil	34%	-	-	34%
China	25%	7%	8%	31%
India	**46%**	**-**	**-**	**46%**
Indonesia	25%	12%	11%	33%
Russia	20%	9%	7%	25%
South Africa	28%	7%	5%	32%
Argentina	35%	10%	10%	42%
Australia (4)	30%	0%	0%	30%
Canada	26% (1)	7%	6%	31%
France	34%	3%	1%	35%
Germany	30% (1)	4%	2%	31%
Italy	28%	4%	0%	28%
Japan	32% (1)	8%	4%	35%
Korea	24% (1)	9%	9%	31%
Mexico	30%	5%	1%	31%
Saudi Arabia	20%	5%	4%	23%
Turkey	20%	10%	11%	29%
UK	20%	0%	0%	20%
US	39% (1)	9%	6%	43%

Note: (1) Sub-central corporate tax rates have been accounted for (see OECD Tax Database); (2) foreign source income is assumed to be exempted in the residence countries; (3) ownership requirements as defined in the tax treaties are assumed to be fulfilled; (4) in the case of Australia it is assumed that dividends are fully franked and thus not subject to additional withholding tax; weights are constructed based on bilateral dividend flows and outward FDI positions as described in Hanappi, Lejour and Van't Riet (2015);

Source: OECD Tax Database, Indian Income Tax Department, IBFD and own calculations.

Comparing the combined statutory tax rates across the BRIICS economies shows that, under current law, international dividend payments from India are subject to the highest combined tax rates. Tax rate differentials range from around 12 percentage points (compared to Brazil) to 21 percentage points (compared to the Russian Federation).

Comparison within the full set of G20 economies shows that there are only a few other countries with comparably high combined tax rates. While the rates in the United States and Argentina are in the same range as India, the majority of countries are clustered between 31% and 35%. The Indian tax rate differentials can be as high as 23 percentage points compared to Saudi Arabia or 26 percentage points compared to the United Kingdom.

Although the calculations do not account for treaty shopping and/or the existence of low tax jurisdictions, they clearly indicate that the Indian tax rate differentials are considerable. As a result, in the absence of effective anti-avoidance measures, MNEs investing in India may be able to obtain substantial tax advantages by engaging in BEPS strategies to shift profits out of India.

The OECD/G20 BEPS project

Following the release of the report *Addressing Base Erosion and Profit Shifting* in February 2013, OECD and G20 countries, including India, adopted a 15-point Action Plan to address BEPS in September 2013. The Action Plan identified 15 actions along three key pillars: introducing coherence in the domestic rules that affect cross-border activities, reinforcing substance requirements in the existing international standards, and improving transparency as well as certainty.

The completed BEPS Package, which included final reports covering each of the 15 actions, was endorsed by G20 leaders in November 2015. It included recommendations on minimum standards, best practices, common approaches and new guidance in key policy areas (see Box 3).

Box 3. **A Comprehensive Package of Measures to Address BEPS**

The OECD/G20 BEPS project produced a comprehensive package of measures to address BEPS including minimum standards, common approaches, best practices and new guidance in the main policy areas.

- Minimum standards have been agreed upon in the areas of fighting harmful tax practices (Action 5), preventing treaty abuse (Action 6), Country-by-Country Reporting (Action 13) and improving dispute resolution (Action 14). All participating countries are expected to implement these minimum standards and implementation will be subject to peer review.

- A common approach, which will facilitate the convergence of national practices by interested countries, has been outlined to limit base erosion through interest expenses (Action 4) and to neutralise hybrid mismatches (Action 2). Best practices for countries which seek to strengthen their domestic legislation are provided on the building blocks for effective controlled foreign company (CFC) rules (Action 3) and mandatory disclosure by taxpayers of aggressive or abusive transactions, arrangements or structures (Action 12).

- The permanent establishment (PE) definition in the OECD Model Tax Convention has been changed to restrict inappropriate avoidance of tax nexus through commissionaire arrangements or exploitation of specific exceptions (Action 7). In terms of transfer pricing, important clarifications have been made with regard to delineating the actual transaction, and the treatment of risk and intangibles. More guidance has been provided on several other issues to ensure that transfer pricing outcomes are aligned with value creation (Actions 8-10).

- The changes to the PE definition, the clarifications on transfer pricing, and the guidance on CFC rules are expected to substantially address the BEPS risks exacerbated by the digital economy. Several other options, including a new nexus in the form of a significant economic presence, were considered, but not recommended at this stage given the other recommendations plus Value Added Taxes (VAT) will now be levied effectively in the market country facilitating VAT collection (Action 1).

- A multilateral instrument will be implemented to facilitate the modification of bilateral tax treaties (Action 15). The modifications made to existing treaties will address the minimum standards against treaty abuse as well as the updated PE definition. India participated in the ad-hoc group that developed the multilateral instrument in 2016.

Implementing the OECD/G20 BEPS minimum standards

To ensure a consistent global approach to the implementation of the BEPS package of reforms, OECD and G20 countries have developed an inclusive framework which allows interested countries and jurisdictions to work, on an equal footing, with OECD and G20 members on developing standards on BEPS related issues and reviewing and monitoring the implementation of the whole BEPS package. A particular focus of the inclusive framework will be ensuring implementation of the four minimum standards arising from the BEPS Project which will be subject to a peer review process, alongside ongoing monitoring of the other elements of the package. The first meeting of the inclusive framework took place on 30 June – 1 July 2016 in Kyoto, Japan.

India has supported and participated fully in the OECD/G20 BEPS project, and has agreed to implement all minimum standards. The four minimum standards relate to: harmful tax practices; tax treaty abuse; country-by-country reporting; and dispute resolution mechanisms.

Countering harmful tax practices (BEPS Project Action 5)

The OECD's 1998 work on harmful tax competition highlighted policy concerns about harmful tax practices with respect to geographically mobile activities, such as financial and other service activities, including the provision of intangibles. Those concerns are still relevant today, but current concerns are primarily about preferential regimes that risk being used for artificial profit shifting and a lack of transparency in connection with certain tax rulings. BEPS Project Action 5 revamped the work on harmful tax practices with a priority on improving transparency, including compulsory exchange of rulings related to preferential regimes, and by requiring substantial activity for preferential regimes.

Countries, including India, agreed that the substantial activity requirement used to assess preferential regimes should be strengthened in order to realign the taxation of profits with the substantial activities that generate them. A "nexus approach" was developed in the context of intellectual property (IP) regimes, which allows a taxpayer to benefit from the preferential tax treatment of an IP regime only to the extent that the taxpayer itself incurred qualifying research and development expenditures that gave rise to the IP income. The Forum on Harmful Tax Practices (FHTP) had previously concluded that four Indian non-IP regimes were not harmful (BEPS Project Action 5 report, p. 64), but the analysis of substantial activities has not been applied to these regimes. The FHTP will carry out further work to consider whether there are any instances where it may be necessary to revisit regimes in light of the agreed substantial activity factor as it applies to non-IP regimes.

Preventing Treaty Abuse (BEPS Project Action 6)

Tax treaties are intended to prevent double taxation by allocating taxing rights between two contracting states. Treaty benefits are granted on the basis of a bilateral agreement which typically entails the reduction or elimination of withholding taxes on dividends, interest or royalties in the country where the income arises.

In terms of its fiscal impact, treaty shopping is likely to be the most significant form of treaty abuse. It occurs when an entity that is not a resident of one of the two contracting states obtains treaty benefits through an intermediary in one of the contracting states. To address this concern, the BEPS Project Action 6 resulted in a commitment to ensure a minimum level of protection against treaty shopping (the BEPS Project Action 6 "minimum standard"). That commitment will require countries to include in the preamble to their tax treaties an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements. Countries will implement this common intention by including in their treaties: (i) the combined approach of a limitation-of-benefits (LOB) rule and a principal purposes test (PPT) rule; (ii) the PPT rule alone; or (iii) the LOB rule supplemented by a mechanism that would deal with certain treaty shopping transactions not dealt with by the LOB rule.

The LOB rule addresses treaty shopping through a set of provisions aimed at preventing persons (e.g. individuals, contracting states, corporations or other entities) who are not resident of the contracting states from accessing treaty benefits through the use of an entity that would otherwise qualify as a resident of one of these states. It restricts the number of persons that are entitled to treaty benefits by defining a set of 'qualified persons', and provides a set of conditions under which benefits may be granted with regard to a specific item of income, regardless of whether the person who derives that income is a 'qualified person'.

While the LOB rule provides a well-defined limitation of the set of persons entitled to treaty benefits, the PPT rule is more general. It states that treaty benefits shall not be granted in cases where specific arrangements or transactions have been undertaken with, as one of the principal purposes, obtaining benefits which would not have been granted otherwise. This rule seeks to distinguish between the legitimate exchange of goods and services as well as movements of capital and persons as opposed to arrangements which are primarily intended to obtain more favourable tax treatment. The application of this rule depends on the analysis and interpretation of all relevant facts and circumstances.

India currently has tax treaties with around 90 countries. However, many of these treaties were concluded more than a decade ago and less than one third include either a LOB rule or a PPT (Girish, 2016). India's effective implementation of the BEPS Project Action 6 "minimum standard" will therefore be crucial to preventing treaty abuse.

One major positive step in preventing treaty abuse has been the recent signing of a protocol to amend India's treaty with Mauritius. The amended treaty gives India the right to tax capital gains on investment via Mauritius in shares in Indian resident corporations. The previous treaty gave this taxing right to Mauritius – which does not impose a capital gains tax. This made foreign investment in India via Mauritius very attractive as is highlighted in table 7. Domestic investors could also benefit from similar arrangements provided they transferred investment funds to Mauritius before investing in Indian corporations (i.e. so-called 'round tripping'). The amendments to the treaty come into effect in April 2017.

Table 7. **India inbound FDI positions, 2014**

	FDI Positions (mn USD)	Equity Positions (net, mn USD)	Debt Positions (net, mn USD)
World	**324,653**	**305,517**	**19,137**
1 Mauritius	72,967	69,393	3,574
2 United States	53,343	53,164	179
3 United Kingdom	47,364	46,702	662
4 Singapore	32,325	27,508	4,817
5 Japan	26,386	24,443	1,943
6 Germany	25,294	23,922	1,372
7 Netherlands	16,248	14,817	1,431
8 Switzerland	16,119	15,791	328
9 Korea	5,440	3,547	1,893
10 France	4,893	4,560	334

Source: IMF Coordinated Direct Investment Survey (CDIS).

Country-by-Country reporting (BEPS Project Action 13)

Standardised country-by-country reports (CbCR) and other transfer pricing documentation (BEPS Project Action 13) will give tax administrations a global picture of where MNE profits, taxes and economic activities are reported, and relevant information on specific transactions subject to transfer pricing provisions, including the context in which they take place. This will help tax administrations to assess risks relating to transfer pricing and other BEPS issues.

India's effective implementation of the minimum standard on CbCR together with the other BEPS recommendations on transfer pricing documentation will assist its tax administration in its risk assessment processes to better target its enforcement resources to corporations that may be engaging in BEPS behaviours, and in the event audits in relation to transfer pricing are called for, provide information to commence and target audit enquiries. It is recognised that the need for more effective dispute resolution may increase as a result of the enhanced risk assessment capability following the adoption and implementation of the CbCR requirement.

Improving dispute resolution (BEPS Project Action 14)

Improved dispute resolution mechanisms, particularly the tax treaty mutual agreement procedure (MAP), are of fundamental importance to the proper application and interpretation of tax treaties. The MAP process provides the competent authorities of treaty partners with a mechanism to resolve differences regarding the interpretation or application of the tax treaty on a mutually-agreed basis.

The measures developed under BEPS Project Action 14 aim to strengthen the effectiveness and efficiency of the MAP process, by ensuring the consistent and proper implementation of tax treaties. The minimum standard will ensure that: treaty obligations related to the MAP are fully implemented in good faith and MAP cases are resolved in a timely manner; the implementation of administrative processes that promote the timely resolution of treaty-related disputes; and taxpayers can access the MAP when eligible. The minimum standard is complemented by a set of best practices, and an effective monitoring mechanism will be established to focus on the improvement of dispute resolution.

India's effective implementation of the minimum standard for improved dispute resolution will be a critical step forward in improving the business tax environment for international trade and investment. MAP is also discussed in section 4 below in the context of reducing disputes and improving taxpayer certainty.

Other BEPS Project Actions for consideration

A number of additional BEPS Project measures are also important for India to consider implementing to protect its tax base.

Hybrid mismatch arrangements

Hybrid mismatch arrangements are transactions which exploit cross-border differences in the treatment of instruments and entities to produce a mismatch in tax outcomes ultimately leading to double non-taxation. Such a mismatch can involve either two deductions of the same payment or a deductible payment that is not included as taxable income of the recipient. The BEPS Project Action 2 report recommends denying deductions in the payer jurisdiction in cases where the payment is not included as taxable income of the recipient in the other jurisdiction; in cases of double deductions it recommends denying deductions in parent jurisdictions. India currently has no specific tax rules targeting these types of arrangements. Introducing rules as recommended in the BEPS Project Action 2 report would help eliminate BEPS in India and abroad.

Controlled Foreign Company (CFC) Rules

Having a controlling interest in a foreign subsidiary may allow parent corporations, typically located in high-tax jurisdictions, to assign passive or mobile income, e.g. from intellectual property, services and digital transactions, to low-tax jurisdictions. Many countries already have in place CFC rules to prevent this form of profit shifting. In territorial tax systems foreign source income is tax exempt and CFC rules present a way to include this income in the domestic tax base. However, resident corporations in India, as well as foreign corporations effectively managed there, are subject to income tax on their worldwide income, at a high statutory tax rate, with deferral and foreign tax credits. In this case, CFC rules are important to deny the benefits from deferral of particular types of income. As such CFC rules also serve as an essential backstop to other avoidance strategies such as transfer mispricing.

India does not have CFC rules. The significant increase in outward FDI flows shows Indian MNEs increasing their investments abroad. The introduction of CFC rules would therefore help to protect India's tax base. The recommendations outlined in the report on BEPS Action 3 provide detailed guidance on the building blocks needed to design effective CFC rules given a particular country's economic structure. The main elements outlined include the definition of CFCs and relevant income, thresholds and exemptions as well as computation and attribution of income. The recommended approach also considers best practices used to avoid double taxation in this context.

Interest Limitations

The BEPS Project Action 11 report finds that the strategic location of debt is a significant tax avoidance strategy (OECD, 2015a). MNEs can minimise their worldwide tax liabilities by assigning debt to high-tax locations, such as India, in order to deduct interest payments from profits made in these locations. To address this issue, the BEPS Project Action 4 report recommends limiting debt shifting by imposing a fixed ratio rule above which interest deductions will be disallowed. Introducing such an interest limitation rule in India would limit BEPS through interest deductions.

Preventing the Artificial Avoidance of Permanent Establishment Status

Tax treaties generally provide that the business profits of a foreign enterprise are taxable in a State only to the extent that the enterprise has in that State a permanent establishment (PE) to which the profits are attributable. The definition of PE included in tax treaties is crucial in determining whether a non-resident enterprise must pay income tax with respect to its business income in another State. The BEPS Project Action 7 report calls for changes to the definition of PE in Article 5 of the OECD Model Tax Convention to prevent the use of certain common tax avoidance strategies and to prevent the exploitation of specific exceptions to the PE definition.

Together with the changes to tax treaties proposed in the BEPS Project Action 6 report, the changes to the definition of PE will restore taxation in a number of cases where cross-border income would otherwise go untaxed or would be taxed at very low rates as a result of the provisions of tax treaties. The changes to the definition of PE will be among the changes proposed for inclusion in the multilateral instrument that will implement the results of the work on treaty issues mandated by the BEPS Action Plan. Follow-up work on the attribution of profits issues related to Action 7 is being undertaken to provide additional guidance and greater certainty about the determination of profits to be attributed to the PEs resulting from the BEPS project Action 7 changes.

Aligning Transfer Pricing Outcomes with Value Creation

Mispricing of intra-firm trade in goods and services is another tax avoidance strategy which shifts profits out of high-tax locations. Worldwide intra-group trade has increased substantially in the last decades (OECD, 2015a; Lanz and Miroudot, 2011). Transfer pricing rules are used to determine the prices of transactions between related entities within a MNE group and are thus crucial for the allocation of profits to the affiliated entities in various countries. The BEPS Project Action Plan (OECD, 2013) concluded that the existing international standards can be misapplied such that the allocation of profits is not aligned with the economic activity that produced the profits.

BEPS Project Actions 8-10 provide additional guidance to ensure that transfer pricing outcomes will be better aligned with value creation of the MNE group. Action 8 clarifies that legal ownership of an intangible asset on its own does not give the owner the right to the returns that are generated by its exploitation. Instead, each entity will now be entitled to an appropriate return on the basis of its contribution to the creation of value. Action 9 emphasises the importance of accurately delineating the transaction, including addressing the contractual allocation of risks, strengthening the identification of risk

and ensuring that the assignment of risk to an entity is consistent with the entity's capability and authority to control and manage the risk, as well as its financial capacity to assume the risk. Action 9 also considers situations where capital-rich group members provide funding but perform few activities and, in substance, assume no risks. In this case, no more than a risk free return will be allocable to these entities. Action 10 provides further guidance on the allocation of synergistic benefits of operating as a group. Under these rules, benefits which arise purely as a result of group membership need not be specifically compensated, while those which result from deliberate action on the part of certain group members will be allocated to those members that contribute to them.

India's transfer pricing guidelines were introduced in 2001 and have been updated several times in the following years with the current transfer pricing rules showing broad similarity to OECD guidance. Further updating of these rules to include, in particular, the additional guidance regarding the accurate delineation of the transaction, and the treatment of risk and intangibles as provided by BEPS Actions 8-10, would further limit BEPS through mispricing of intra-firm trade.

Measuring and monitoring BEPS

Measuring the scale of BEPS has proven challenging given the complexity of BEPS and the serious data limitations, but estimates of the scale and economic impact of BEPS and the effects of BEPS countermeasures are helpful to policymakers. The BEPS Project Action 11 report recommends that governments report and analyse more corporate tax statistics, particularly for MNEs, and to work with the OECD to present them in an internationally consistent way. The Action 11 report provided a toolkit for estimating the country-specific fiscal effects of BEPS countermeasures, which Indian tax policy analysts could use to help estimate the effects of proposed countermeasures.

Mandatory disclosure rules

The lack of timely, comprehensive and relevant information on aggressive tax planning strategies is one of the main challenges faced by tax authorities worldwide. Early access to such information provides the opportunity to quickly respond to tax risks through informed risk assessment, audits, or changes to legislation or regulations. BEPS Project Action 12 provides a framework for countries without mandatory disclosure rules, such as India, to design a regime that fits their need to obtain early information on potentially aggressive or abusive tax planning schemes and the participants in such schemes.

Multilateral instrument to modify bilateral tax treaties

The countries participating in the BEPS Project agreed to establish an ad hoc Group to develop a multilateral instrument to modify existing bilateral tax treaties in order to swiftly implement the tax treatment measures developed in the course of the OECD/G20 BEPS Project. India is participating in the Group, and will be able to take advantage of the multilateral instrument to make needed tax changes to its tax treaties.

Addressing the tax challenges of the digital economy

As part of the OECD/G20 BEPS Project, tax challenges presented by the growth of the digital economy were considered in the BEPS Project Action 1 report. While the digital economy and its business models do not generate unique BEPS issues, some of its features exacerbate BEPS risks. These BEPS risks were identified and the work on the definition of PE, the revised transfer pricing guidance, and the design of effective CFC rules, along with other BEPS actions are expected to substantially address the BEPS issues exacerbated by the digital economy in both the market jurisdiction and the jurisdiction of the ultimate parent corporation. The report concluded that because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible to ring-fence the digital economy from the rest of the economy for tax purposes.

The digital economy also raises broader tax challenges than BEPS for policy makers, including in particular to nexus, data and characterisation for direct tax purposes. The report analysed several options, including an equalisation levy. While not making any recommendations, the report did note that countries could introduce an equalisation levy in their domestic law, provided that they respect existing treaty, and other international obligations, or they could introduce such a levy in their bilateral tax treaties. The report also highlighted potential trade issues with an equalisation levy. India has subsequently (as of 1 June 2016) introduced an equalisation levy of 6% of payments made by resident businesses for specified online advertising services provided by non-resident businesses without a taxable presence in India. It will be important for India to ensure that the equalisation levy is consistent with its tax treaty and international trade obligations.

The digital economy also creates challenges for value added tax (VAT) collection, particularly where goods, services and intangibles are acquired by private consumers from suppliers abroad. The BEPS Project Action 1 report recommends countries apply the principles of the International VAT/GST Guidelines and consider the introduction of the agreed collection mechanisms. On 1 December 2016, India introduced new rules targeting the cross-border supply of Business-to-Consumer (B2C) digital services. These rules require international suppliers of digital services to Indian customers to collect and remit India's service tax, following closely the advice in the International VAT/GST Guidelines.

Other anti-avoidance rules

In addition to international tax anti-avoidance rules, many countries have a General Anti-Avoidance Rule (GAAR) that is a set of broad principle-based rules designed to counteract tax avoidance. GAARs generally provide the tax administration a mechanism to deny the tax benefits of transactions or arrangements that do not have any commercial substance or purpose other than to generate tax benefits. India's 2015 budget announced that the application of India's recently legislated GAAR would be delayed until 1 April 2017.

3.3. Taxation of small businesses

Small and medium sized enterprises (SMEs) are a key part of the Indian economy. There were an estimated 48 million SMEs in India in 2013, that together accounted for approximately 40% of employment; 45% of manufacturing output; and 40% of exports; but only 17% of GDP (KPMG, 2015), due in part to the lower productivity of the SME sector (Goyal, 2013).[17]

17 . There is no single agreed definition of an SME and a variety of definitions are applied in OECD and G20 countries. In India, the definition of an SME is set by the Micro, Small and Medium Enterprises Development Act 2006 as follows: In the manufacturing sector, a business is defined as micro, small or medium when it has less than INR 2 500 000, INR 50 000 000 or INR 100 000 000 of plant and machinery. In the service sector, a business is defined as micro, small or medium when it has less than INR 1 000 000, INR 20 000 000 or INR 50 000 000 of equipment.

However, many of these SMEs operate outside of the tax and regulatory systems in the "underground economy".[18] The Central Board of Direct Taxes estimates that only around 2.9% of the Indian population pay personal income taxes, due in part to lower levels of income on which no tax is payable, but more significantly, to non-compliant businesses operating in the underground economy (Government of India, 2016b). This section first examines the current tax treatment of SMEs before discussing a number of potential reforms to improve tax compliance.[19]

Taxation of SMEs in India

Small and medium-sized enterprises in India are taxed under different regimes based on their legal form (i.e. whether they are incorporated or unincorporated) and whether they are subject to one of the two presumptive taxes.

Taxation under personal and corporate income taxes

Income from unincorporated SMEs is taxed only at the personal level. India operates a global personal income tax (PIT) system where all forms of income (labour, business and property income) are aggregated and the total is taxed according to a progressive marginal tax rate structure. This progressive rate structure is set out in Table 8. The 3% education cesses are applied to the PIT due – so that marginal statutory tax rates increase slightly to 10.3%, 20.6% and 30.9%, respectively. These figures exclude the surcharge of 12% of the personal income tax due (which only applies to income above INR 10 million), and excludes social security contributions (which are voluntary for self-employed individuals).

Table 8. Statutory personal income tax rate schedule in India, 2015/16

Residents < 60 years of age		Residents 60 – 79 years of age		Residents >79 years of age	
Threshold (INR)	Marginal rate (%)	Threshold (INR)	Marginal rate (%)	Threshold (INR)	Marginal rate (%)
0	0	0	0	0	0
250 000	10	300 000	10	500 000	20
500 000	20	500 000	20	1 000 000	30
1 000 000	30	1 000 000	30		

Source: IBFD (2016).

Incorporated SMEs are subject to double-level taxation, with income first taxed at the corporate level under the CIT, and then on distribution as a dividend (via the DDT), resulting in a combined statutory tax rate of at least 41.6%. This figure includes the 3% education cesses, but not the surcharge on high earning corporations.[20] If the income from an incorporated SME is distributed to the owner as payment for their labour, it is taxed under personal income tax rates, with a maximum statutory marginal tax rate of 30.9% (as above). In addition, social security contributions can apply, but only if the business employs more than 20 workers.

18 . There is also no single agreed definition of the "underground economy" (which, internationally, is often also referred to as the "informal economy"). However, it typically refers to economic activities and transactions that are sufficiently hidden so that they are unmeasured or untaxed, and where economic agents are at least passively aware that bringing these activities to the attention of authorities would result in tax or other legal consequences (Andrews, et al., 2011). It is in this sense that the term is used in this paper.

19 . In doing so, it is important to keep in mind that tax is only one of a range of complex and interacting factors that may lead to a business operating in the shadow economy. Other factors include burdensome regulations (e.g. strict labour regulations), low institutional quality (e.g. corruption, weak rule of law, lack of accountability), low human capital, high economic inequality, low trust in institutions, low quality of public services, lack of access to resources, low monitoring and enforcement, and cultural factors (Oviedo, 2009).

20 . High earning incorporated SMEs subject to either the 7% or 12% surcharge outlined in section 2 would face a combined statutory tax rate on distributed income of 44.13% or 45.92%, respectively.

These rules create a bias against incorporation for SMEs, particularly as a result of the generous zero income band in the PIT. For many SMEs this bias will be inconsequential as they will already prefer to operate in unincorporated form for non-tax reasons (e.g. fewer regulations). However, the bias against incorporation may discourage SME growth as incorporation typically provides greater access to finance (OECD, 2015b). In addition, it limits SMEs' ability to benefit from separate legal personality, limited liability, enhanced and increased flexibility in the distribution of income, perpetual life and succession (Chima Onuoha, 2013; Egger et al, 2009).

Presumptive taxation of SMEs in India

India also applies a presumptive tax regime for unincorporated businesses with an annual turnover of less than INR 20 million (EUR 248 000) that simplifies the calculation of the PIT base.[21] These businesses are able to calculate their taxable income as 8% of their turnover rather than to keep full books of account. A business operating under the presumptive tax may report taxable income below 8% of turnover, but must show books of accounts to demonstrate this (unless they fall below the minimum PIT threshold). PIT rates apply to the income calculated under the presumptive tax base, and advance payments of tax are not required. Similar presumptive or simplified regimes have been adopted in many countries in order to reduce compliance costs and encourage compliance (see Box 4).

Box 4. **Simplified tax regimes – good practice in OECD and G20 countries**

Simplified tax regimes are often used by countries to reduce compliance costs for and to encourage compliance of SMEs. They provide a simplified method of calculating taxable income for firms under a certain size threshold. One example used in many jurisdictions is a cash-flow tax which allows the calculation of income on a cash-flow rather than the more complex accrual basis. A popular alternative is a presumptive tax which uses a proxy for income in calculating tax liability. A range of proxies for income are used under presumptive tax schemes in OECD and G20 countries. These range from the most simple (a lump sum payment), to more complex presumptive bases based on an indicator (for example, floor area, or number of tables) or on the turnover of the business. Cash-flow or presumptive tax regimes are often accompanied by simplified reporting and filing requirements and may replace the income tax or other taxes, such as consumption taxes, social security contributions, and property taxes.

In designing simplified tax regimes, a number of competing priorities and challenges must be weighed. While simplified tax regimes, including both presumptive taxes and cash-flow tax regimes, offer a number of advantages in terms of simplicity and removing barriers to compliance, they can also introduce additional complexity, barriers to growth, horizontal inequities, and distortions. Careful design and targeting of simplified taxes is required to ensure that they deliver the simplifications sought while minimising these drawbacks.

The nature of the simplified tax regime sought will differ according to the objectives it is intended to address. Careful consideration of the entities to be targeted and the objectives of the scheme is required at the outset, and the nature of the simplification should be consistent with these. For example, where the simplified scheme is intended to increase formality among very small businesses, a simpler form of calculation such as a lump-sum tax or an indicator tax may be appropriate. For these very small SMEs, it may be useful to consider using the simplified tax regime to replace multiple taxes, including VAT, excise taxes, property taxes, PIT and social security contributions. Examples of very simple taxes on micro-businesses are seen in Brazil and Hungary. For example, in Brazil, the Microempreendedor Individual regime is a lump sum tax which applies to natural persons with 1 or less employees with annual revenue of less than BRL 60 000 (EUR 13 000). In Hungary, very small self-employed taxpayers are eligible for the KATA regime, which provides for lump sum taxation. Similarly, Poland allows SMEs with revenue of less than EUR 150 000 to be taxed under a lump-sum approach. Where very simple lump-sum or indicator taxes are used as a proxy for income, a challenge lies in setting the rate high enough to not discourage entry into the formal regime at the top of the turnover band, but low enough to entice informal operators into the net at the bottom end of the turnover band. This requires extensive consideration of the targeted businesses' profit margins.

(*Box 4 continued….)*

21 . A separate presumptive tax regime is applied to transport firms that own fewer than ten goods carriages. Taxable income is calculated based on an indicator – the number of goods carriages owned – at a rate of INR 7 500 per goods carriage per month. Normal PIT rates apply to the presumptive income base.

(*Box 4 continued….)*

Where the scheme is intended to reduce compliance costs for businesses already within the tax net, a more complex turnover-based presumptive tax is likely to be more appropriate. Such a tax more closely approximates taxable income than a lump-sum or indicator based tax and thus creates less disincentive to grow and join the full tax system once the turnover threshold is exceeded. However, a drawback of a presumptive tax based on turnover is that it taxes low-profit margin firms relatively more heavily than high profit margin firms. Examples of turnover taxes are seen in Brazil, Hungary, Italy and Slovenia. In Brazil, businesses with annual turnover of less than BRL 78 million (approx. EUR 17 million) can calculate their tax liability based on turnover, with different rates applying to different activities. In Hungary, businesses with annual turnover less than HUF 30 million (EUR 97 000) in the two preceding years can calculate taxable income as 37% of turnover. In Italy, a turnover tax replaces all other taxes for businesses with turnover up to between EUR 15 000 and 40 000 (depending on sector). Rates applied to calculate taxable income similarly vary from 40% to 86%. Meanwhile, in Slovenia, 80% of turnover is deductible for business expenses for businesses with turnover below EUR 50 000 in the preceding tax year (EUR 100 000 if the business employs one person full time for at least five months).

In general, the balancing of simplicity against more accurate estimation of income may suggest having more than one presumptive tax regime for firms of different sizes and in different circumstances. In practice, many OECD and G20 countries offer more than one type of regime. For example, Brazil operates three presumptive tax systems, the Microempreendedor Individual, the Simples Nacional, and the Lucro Presumido, targeted respectively at micro, small and medium-sized (and incorporated) businesses, with means of calculation varying from a simple lump sum tax under the Microempreendedor Individual and a turnover tax, as noted above, for the small and medium businesses.

Alternatively, other OECD and G20 countries offer different tax rates and thresholds for firms in different sectors, to more closely approximate profit for firms in different circumstances. One example is the presumptive tax system in Italy, which differentiates between 9 sectors, providing thresholds which range from a maximum of EUR 15 000 for professionals to 40 000 for the wholesale and retail trade, or restaurant and accommodation services; and provides profitability ratios that range from 40% for many industries to 78% for professionals and 86% for construction and real estate.

Another critical element of designing simplified taxes is the choice of threshold below which the presumptive tax applies. The threshold should be set at a level that includes the targeted entities, by reference to a clear and easily calculated metric, to remove uncertainty and avoid additional complexity. However, a flexible threshold should also be considered for firms already in the scheme, to avoid barriers to growth beyond the presumptive tax threshold. For this reason, eligibility could be calculated based on an average of more than one year's prior income, so that an increase beyond the threshold in one year does not automatically cause firms to exit the presumptive scheme.

To ensure clarity, the simplified tax system should provide for a certain, simply calculated level of taxable income. Consideration should also be given to the number of payments required throughout the year, which requires balancing the desire for reduced obligations against cash flow concerns, as well as to reducing the documents and records that will be required for the small business to calculate and prove their tax liability**.**

Finally, small businesses should have the ability to opt out of the presumptive tax into the full tax system, under certain constraints to prevent abuse of the rule (such as requiring a business to elect the regime for 3 years). An optional rule allows businesses to take advantage of the scheme if it benefits them but does not force them to do so if not, and may therefore encourage participation in the full tax system. However, this optionality can create additional complexity.

Options for reforming SME taxation in India

There are a range of reforms that could be considered in India to encourage tax compliance and to make the tax system more conducive to SME creation and growth. This section discusses three possible areas of reform: firstly, providing a path from the current presumptive system to the general PIT system; secondly, introducing a lump-sum presumptive tax to ensure that smaller firms (above a certain subsistence level) are included in the tax net; and thirdly, improving tax administration and compliance for SMEs to strengthen support for SME compliance and audit.

Create a path to the full income tax system from the current turnover-based presumptive tax

The current turnover-based presumptive tax system offers a clear, easily calculated taxable income for SMEs, reducing their compliance burden and consequently encouraging participation in the tax system. Similar presumptive taxes are seen in a number of OECD and G20 countries.

While useful to simplify tax compliance requirements for SMEs, as with all presumptive taxes, the preferential treatment under the presumptive tax can itself provide an incentive for an SME not to grow past the threshold for the presumptive tax. To provide a path for growth from SMEs in the presumptive tax system toward participation in the full income tax system, India could consider a number of adjustments to the current presumptive tax. These include:

- Reviewing profit margins in India to ensure that 8% of turnover is the appropriate basis for the tax, and consider whether different sectors should calculate their taxable income according to different percentages, due to inherent differences in profit margins. Ensuring that the basis for calculation of the turnover-based presumptive tax is as close as possible to the profit margins of the business will minimise the difference between the levels of tax payable under the presumptive and full PIT system and therefore the increase in tax payable on entering the full PIT system.

- Introducing a flexible threshold for firms who may temporarily exceed the top threshold for the turnover tax so that fluctuations in turnover do not remove a firm's eligibility for the presumptive regime. For example, for a firm already subject to the presumptive tax, the average of the previous three years' income could be used as the basis of calculating eligibility for the next year of the presumptive tax. Such a threshold would also reduce incentives for SMEs to restrict growth to stay within the threshold in any given year.

- Giving firms entering the full income tax system a temporary and graduated reduction in their tax burden, to ease transition into the normal income tax system: for example, a reduction of 30% in the first year in the income tax system, 20% in the second year, and 10% in the third year. A similar approach is used in Mexico under their Regimen de Incorporacion Fiscal, where SMEs entering the tax system receive a graduated reduction in taxes payable throughout the first ten years of their operation.

Finally, at present, a firm under the presumptive tax that declares an income of less than 8% of turnover is required to provide evidence of that income, unless the level of income is below the threshold for the first marginal tax rate in the personal income tax. Extending the requirement to prove the level of income to those reporting income below this level (perhaps limited to businesses with a fixed establishment) could strengthen audit of the presumptive tax.

Introduce a small lump-sum tax to encourage formalisation of micro SMEs

To encourage profitable micro and small businesses into the tax net, and to minimise both compliance and administrative costs, India could consider introducing a lump-sum presumptive tax that would serve as the default tax payable by micro and small SMEs (those subject to the rate could be limited to SMEs with a fixed establishment and above a certain size threshold, to ensure that subsistence-level SMEs are not affected). This would be similar to the taxes for very small businesses existing in Brazil, Hungary and Poland (see Box 4 for further information).

Adding another system of taxation would, however, increase the overall complexity of the tax system for SMEs, and so the pros and cons of adding a lump-sum tax would need to be examined in more detail before progressing with such an option. In particular, a number of difficult design issues would need to be considered, such as determining the appropriate thresholds for eligibility and the applicable lump-sum rate.

To facilitate transition in and out of the presumptive tax, the threshold could be set in terms of turnover, and would in practice be bound by the zero-band of the personal tax system at the lower end – i.e. if the profit margin is assumed to be 8% (the level of the current turnover tax), the effective lower threshold for the tax would be INR 3.125 million at the present rate, although were the zero-band to be narrowed, the threshold for the lump-sum tax should also be reduced. The top threshold should be set considering the threshold of the turnover-based presumptive tax (for example, at approximately halfway through the band), to ensure that this tax is an attractive option for those at the top of the lump-sum tax band.

The rate of the lump-sum payment would need to be high enough to incentivise those at the upper end of the eligibility band to enter the turnover tax system, but not so high as to discourage those at the lower end from entering the lump-sum system (Loeprick, 2009). This would require careful analysis of the profit margins of different sectors in India. The amount of tax payable could differ by sector or even by location so that it more closely aligns with profit margins, although this would add complexity.

The lump-sum tax could operate as the default tax for any firm with a fixed establishment within the turnover band, to ease administration and to capture as many firms as possible within the tax net. However, as a lump-sum tax imposes a relatively higher tax burden on firms with lower profitability, SMEs could be given the choice to opt-out of the lump-sum tax into the existing turnover tax. As the threshold for the lump-sum tax will be turnover, calculating respective tax liabilities under the lump-sum tax and the turnover-based presumptive tax would be relatively straightforward for the SME.

The lump-sum tax could also be accompanied by a number of other changes to further simplify tax compliance and payment obligations for SMEs. Firstly, to remove the requirement to comply with VAT rules, the VAT exemption threshold could be set at a level equal to the top of the lump-sum eligibility band, so that no firms paying the lump-sum tax would be required to comply with VAT rules. Alternately, the lump-sum tax could replace all tax obligations of the SME, including VAT, excise taxes and property taxes. Finally, such a lump-sum tax could be accompanied by an information campaign, increased support for SME compliance obligations, basic business services and other non-tax measures to support tax compliance by SMEs.

Enhance administration and compliance support for SMEs

The compliance burden that comes with entering the tax system may be an impediment to tax compliance. The experience of Forum on Tax Administration (FTA) member countries (see OECD, 2012) highlights that the easier a tax administration can make it for businesses to comply, the better the outcomes will be, both in terms of lowering the compliance burden and in observed compliance.

Recent developments in SME tax compliance include two major trends, both of which rely on technology:

- More focus is on building collaborative arrangements upfront, to ensure compliance right from the start and to reduce the costs of compliance to SMEs. The key to these approaches for SMEs is that compliance is ‘designed into’ the business processes of the taxpayer and the value chain as a whole. This can streamline the provision of information from the SME to the tax authority, reducing compliance costs and facilitating tax compliance. More information on the impact of technology on compliance is set out in Box 5.

- Advanced business analytics enable tax administrations to make better use of the data they have available, or can obtain. This allows tax administrations to trace high risk taxpayers at an early stage and to detect high risk tax returns as they are lodged. It also enables the development of much better targeted services to ensure compliance and reduces the amount of information the SME is required to produce in order to comply.

Box 5. **"Tax Compliance by Design": technology and compliance**

Technology is changing the way SMEs operate. As the costs of software have fallen and the emergence of the "cloud" has enabled new ways of delivering technology, SMEs have gained access to new and sophisticated systems for managing their businesses. Most SMEs now use technology in some form to help them keep track of their business and to improve effectiveness. Information and payments are increasingly becoming digital. There is rapid growth of new payment systems using mobile devices and the use of electronic invoices is increasing. Electronic cash registers are used for handling cash transactions and a number of cheap and simple-to-use on-line accounting systems are available in most countries.

"Tax compliance by design" (OECD, 2014b) recognises these fundamental changes in the way SMEs operate and shows how tax compliance can become an integral part of the systems businesses use to carry out their daily transactions with one another and with their customers. Tax compliance can become easy and accurate if it is simply a by-product of the steps a business follows automatically to transact. "Tax compliance by design" assembles the different elements of technology associated with modern commerce into a system that delivers a seamless and secure flow of accurate tax information and tax payments.

There are two basic approaches to achieving tax compliance by design: the "secured chain approach" and the "centralised data approach" (OECD, 2014b). The secured chain approach creates a secured flow of information from the capture of business transactions to the final determination of the correct amount of tax being paid. The role of the tax administration is mainly to act as a facilitator of necessary environmental features in order to secure the flow of information from the taxpayer

Under the centralised data approach, the tax administration captures relevant business transactions at their source in order to calculate the taxable income or VAT base, reducing the information sourced from the taxpayer and reducing the compliance burden. In this approach the tax administration plays a key role as 'financial data centre'. Although such an approach will most likely have difficulty capturing all data it can provide feasible compliance solutions, although this may depend on financial sector cooperation, the type of industry and the possibilities to capture cross-border transactions.

A key feature of both approaches is that tax processes are highly integrated with the underlying business processes. Tax compliance is to a large extent 'embedded' in the daily business processes. This makes tax compliance processes more trustworthy and seamless, and makes it easier and less costly for the SME taxpayer to comply. As the tax administration will receive better and timelier information, it can follow-up more swiftly thus providing SME taxpayers with more certainty on their tax position.

Source: OECD (2015b)

Increased use of electronic transactions can provide a range of benefits for SMEs, including improved profitability, access to new markets, cost savings, and attraction of customers (KPMG, 2015). E-commerce in India is rapidly growing, and approximately 43% of SMEs in India participate in online sales (KPMG, 2015).

In this regard, the recent moves to encourage electronic transactions and record keeping should continue. Careful consideration should be given as to whether information from these transactions can be centrally captured or communicated to the government under the centralised data approach or the secured chain approach described in Box 5, to further facilitate tax compliance.

In addition, administrative reform could focus on streamlining small business tax administration processes to further encourage compliance. The creation of special small business units that cover all forms of taxes can provide an opportunity for the administration to build stronger linkages with the SME community. Such an approach would allow the administration to not only better understand the issues SME taxpayers face in complying but also assist in better determining the range of targeted interventions and support that can best improve outcomes in this sector.

Given the high levels of non-participation by the SME sector, an increased focus on compliance interventions will be required. Therefore increasing audit capacity for SMEs within such small business units will also be essential to encourage a culture of compliance among SME taxpayers. This should be combined with streamlined procedures for the filing and payment of taxes for SMEs, and a stocktake to ensure that local regulations and the coordination of central and local tax rules for SMEs do not discourage formalisation (Loeprick, 2009). Finally, small business tax centres should provide information and compliance support services to SMEs to ensure that tax rules and compliance obligations are well understood.

3.4. Efficiency and effectiveness of tax administration

India has made significant strides recently in improving its tax administration, including through greater use of information technology to inform audit processes, the establishment of a dedicated large taxpayer unit, and an increased use of guidance notes. However, there is still significant need for reform to improve both the effectiveness and efficiency of the tax administration. Acknowledging this, the Indian Ministry of Finance formed a Tax Administration Reform Commission (TARC) in 2013 to provide recommendations for reform. A number of key recommendations from the TARC reports are summarised in Box 6.

Within the broader context of the TARC review, this section highlights three key tax administration issues facing India: the overall capacity of the tax administration – both in terms of number of staff and training; capacity in tax policy and analysis functions; and the degree of coordination between the two separate tax boards. Discussion of audit and dispute resolution processes, in the context of improving taxpayer certainty and encouraging investment, is left to section 4.

Tax administration capacity in India is low

The capacity of the tax administration is low. While the authorised levels of staff in the two tax boards – (Central Board of Direct Taxes, CBDT, and Central Board of Excise and Customs, CBEC) are 57 793 and 66 808 (TARC, 2014), significantly fewer than this are employed (41 357 staff were employed in the CBDT as of 2013; information for the CBEC is unavailable; OECD, 2015c). Furthermore, staff numbers have not increased significantly in the last 10 years despite an expanding tax base and consequent increased workload (Prasanth, 2013).[22] This has consequences on performance. For example, as a result of the increased workload, the percentage of cases selected for scrutiny in the CBDT has decreased from 8% in 1997-98 to around 1.25% in 2011-12" (Prasanth, 2013). Commentary by the private sector has also raised concern regarding the degree of resourcing provided to various administration functions, in particular audit, dispute resolution and advance pricing arrangements (APAs), which can result in significant and costly delays.

22. The number of direct taxpayers increased from 25 million in 2000 to around 35 million by 2012 (Prasanth, 2013).

Box 6. **Key recommendations of the Tax Administration Reform Commission**

The Tax Administration Reform Commission (TARC) was set up in 2013 to provide recommendations for improving the effectiveness and efficiency of the tax administration in India. The TARC submitted four reports to the Minister of Finance between May 2014 and February 2015. The TARC proposed modernising the tax administration, in particular moving the culture of the administration more towards customer services and away from the current adversarial culture. Key recommendations from the TARC reports are summarised below:

- Improving coordination between the Central Board of Direct Taxes (CBDT) and the Central Board of Excise and customs (CBEC) and integrating the two bodies in 10 years. This recommendation has not been accepted as the CBDT and CBEC have distinct domain knowledge, expertise and skil sets. Both are however taking steps to better share data and information and to exploit synergies in policy formulation

- Relying more information technology and integrated databases. In particular, pre-filled tax returns should be provided to all individuals.

- Increasing specialisation of tax officers. Raising the quality of tax administration professionals through skill development.

- Minimising the potential for disputes by issuing clear and lucid interpretative statements on contentious issues. Dispute resolution processes should also be reformed to be faster, less adversarial, more collaborative and customer focused. This recommendation has been accepted by the government.

- Avoiding retrospective amendment of tax legislation. This recommendation has been accepted by the government and the Finance Minister categorically stated that retrospective amendments will be avoided.

- Creating a tax policy unit, advisory in nature. This recommendation was followed by the creation in February 2016 of a Tax Policy Council headed by the Finance Minister as well as a tax policy research unit.

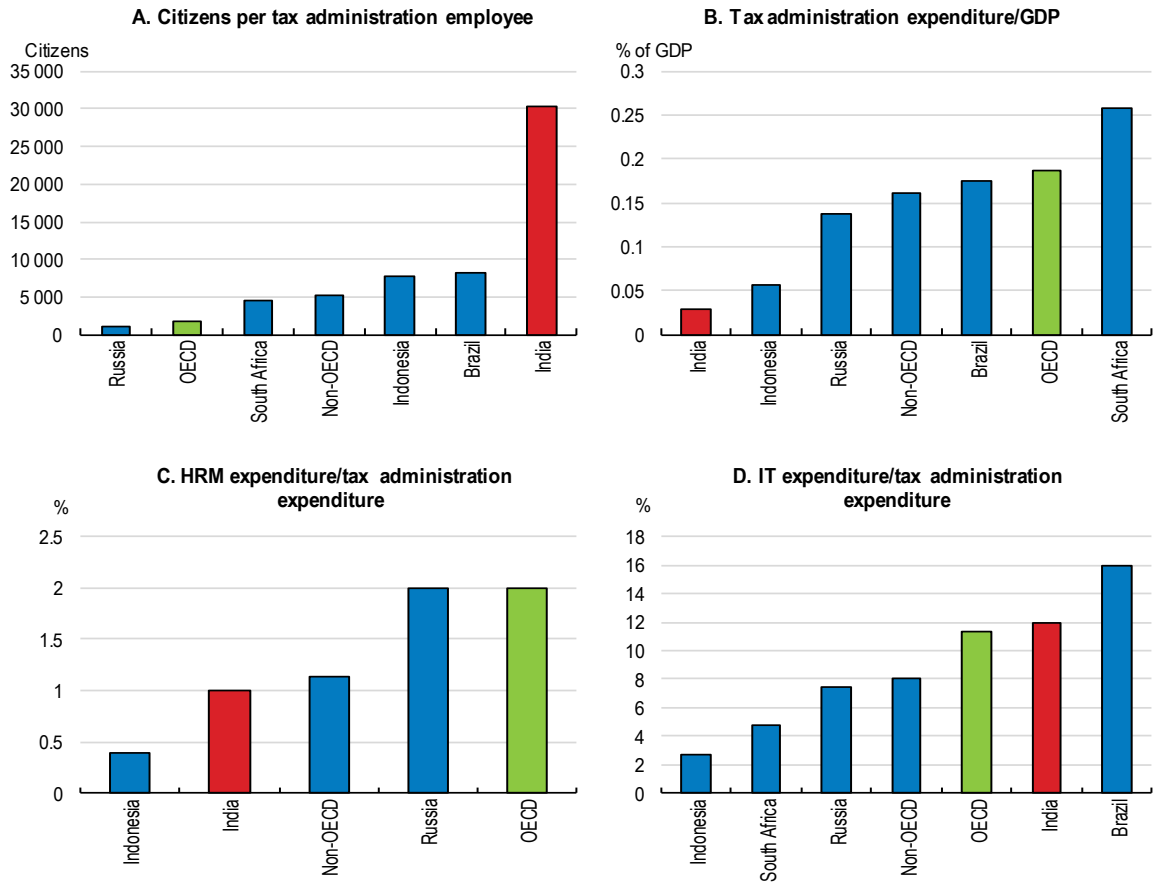
Figure 4 presents information for the CBDT relative to the combined (direct and indirect) tax administrations in other BRIICS and OECD countries for 2013. Panel A shows that the CBDT employs vastly fewer tax officials per citizen than other BRIICS and OECD countries. Even taking the additional 73 000 employees in the CBEC into account, the number of citizens per tax administration employee in India is at best around twice as many as in other BRIICS and OECD countries.

Similarly, India spends significantly less in total on the CBDT as a percentage of GDP than other BRIICS and OECD countries do on their combined tax administrations (panel B). While data are not available on expenditure by the CBEC, the majority of BRIICS and OECD countries can still be expected to spend significantly more on their tax administrations than India.

To increase the education level of staff, the TARC has recommended that 10% of expenditure should be spent on staff training. Currently, the CBDT spends just 1% of its budget on total human resource management, of which training is just one component (panel C). This is similar to other non-OECD countries, though around half the level in the average OECD country. Given total expenditure on tax administration is low, this emphasises the low level of aggregate expenditure on training.

One area that India has prioritised is the increased adoption of information technology (IT). The CBDT compares well internationally, spending 12% of total tax administration expenditure on IT in 2013 (panel D). However, given that aggregate expenditure is so low, expenditure on IT remains low also.

Figure 4. **Tax administration capacity in India is comparatively low**



Note: Data for India only relates to the CBDT. Non-OECD is an average of 18 non-OECD countries for which data are provided in OECD (2015c).

Source: OECD (2015c), Tax Administration 2015: Comparative Information on OECD and other advanced and emerging economies.

Capacity for tax policy analysis is also low

Resourcing for tax policy analysis is also highly limited. The TARC highlighted this issue, noting that this role is performed by around 20 staff in the CBDT's Tax Policy and Legislation (TPL) Unit and CBEC's Tax Research Unit (TRU). They contrast this with the roughly 400-strong department that performs a comparable role in the United Kingdom. This severely restricts the ability of the government to develop, analyse and assess tax policy and administration reform proposals that could improve the tax system – thereby having long term consequences on the Indian tax system. The TARC recommended the creation of a joint tax policy unit in the Revenue Department with 400 staff.

The TPL and TRU staff are drawn almost entirely from tax administration backgrounds. There is therefore merit in not just expanding the number of tax policy staff but also moving towards a more multidisciplinary approach to policymaking, drawing on economists, statisticians, lawyers and general policy analysts in addition to tax administration specialists. Such an expansion of skill sets will enable a broader range of analysis to be undertaken, including revenue forecasting.

In a positive move, the Government announced in February 2016 that a tax policy analysis unit as proposed by the TARC would be created along with a tax council which it would report to and which, in turn, would advise the government on tax reform. The tax policy unit would subsume the TPL and TRU. While a staff of 400 may not be feasible, it will require a substantial increase from the current staff level in the TPL and TRU.

An alternative approach that could also be considered by the government is to base the tax policy analysis unit in the Finance Ministry rather than the Revenue Department – as tends to be the case in most other countries. There are merits to both approaches, and the preferred option depends on a balancing of the need for independence in tax policy making (which favours departmental separation) against the need for strong coordination between tax policy and tax administration functions (which may be more easily achieved when both functions are located within the tax administration). If the tax policy analysis unit is set up in the Revenue Department, as currently planned, it is important to ensure its independence from the tax administration and audit functions of the Revenue Department.

There is limited coordination between the CBDT and CBEC

A key recommendation of the TARC was for the merging of the two boards. This should result in greater efficiency in the operation of the tax system and is consistent with best practice in OECD countries (OECD, 2015c). While this should be the long term goal, such a major restructure may not be feasible in the short term. Nevertheless, India should still look for opportunities to improve coordination between the two boards and to create efficiencies in the short-to-medium term. This can be achieved in a number of ways.

One clear example would be to merge the data processing activities of the two boards as this can both increase efficiency in data processing and better enable the sharing of data across the two tax boards – thereby improving risk profiling and audit activity in general. Improving the operation of the Large Taxpayers Unit (LTU) is another example. While comprising staff from both tax boards, the LTU still effectively operates as two separate units. The LTU needs to be reorganised so that direct and indirect tax audit activity is carried out together and that information from both boards is shared within the Unit.

To improve audit activity of SMEs, an SME unit similar to the LTU could also be formed. Not only would this ensure better coordination of audit activities and information flows, it may help to address difficulties in motivating audit staff to focus on small businesses – where audit activity is often perceived as being less prestigious than other areas. Moving away from imposing audit revenue targets on assessing officers, as discussed in more detail below, would be another important step in motivating a greater focus on SME compliance, and align with best practice in this area.

4. Investors face significant uncertainty regarding the tax rules and their application

Providing certainty to the greatest extent possible for potential investors regarding the tax rules and their application is crucial to creating an attractive environment for foreign investment. Indeed, empirical evidence suggests that an uncertain tax environment can negatively affect investment (Edmiston, 2004).

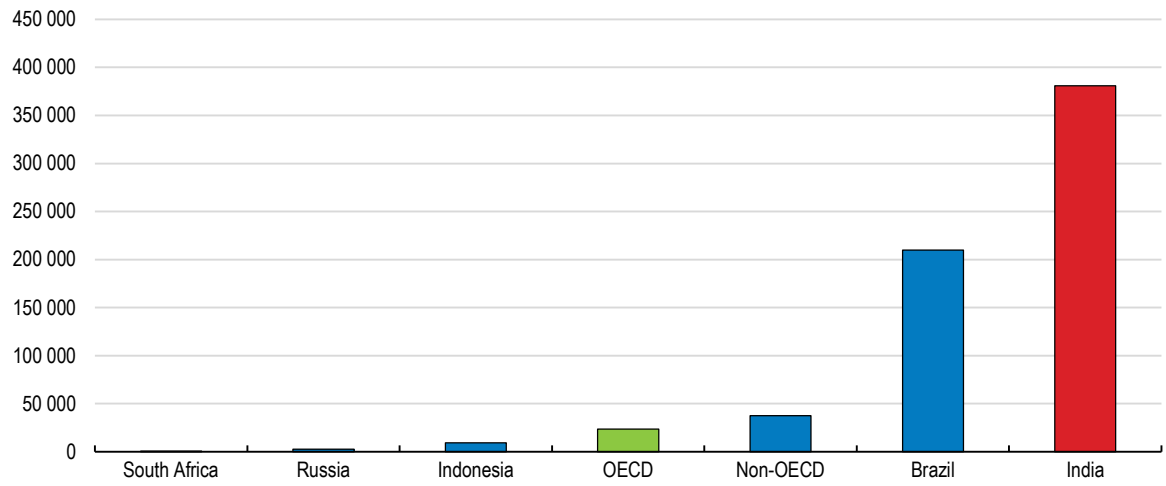
In India, a pattern of aggressive audit activity, aided by a lack of clarity in some areas of the law, together with the recent use of retrospective legislation, has created a highly uncertain tax environment for foreign investors. In particular, the implementation of retrospective legislation on the taxation of indirect transfers of assets, and tax administration rulings regarding the application of the MAT to foreign institutional investors have been particularly damaging. Positive steps are now being made. In particular, recently announced reforms appear to have alleviated the latter concern. Meanwhile, the recent introduction of an advance pricing agreement (APA) regime has increased business certainty for multinationals. Furthermore, the Easwar Committee was set up by the Government in 2015 to identify

parts of the Income Tax Act that are unclear and lead to disputes. It reported its findings in early 2016 and the government is currently considering its recommendations. Nevertheless, issues remain regarding, in particular, audit processes and transfer pricing rules.

4.1. Tax disputes are high

One measure that illustrates the lack of certainty for investors is the number of tax disputes in India. CBDT and CBEC data show that, in the 2012-13 financial year, India had just over 381 000 unfinalised tax disputes. As Figure 5 shows, this is vastly more than that reported by any of the 48 OECD and non-OECD countries that provide such information for the OECD's biannual Comparative Information Series report (OECD, 2015c). Although international comparison is imperfect as different countries may define a dispute differently, the numbers clearly highlight the need to substantially reduce the number of disputes in the Indian system.

Figure 5. **Unfinalised tax disputes in India, BRIICS and OECD countries, 2012/13**



Note: Non-OECD is an average of 18 non-OECD countries for which data are provided in OECD (2015c).

Source: TARC (2014), drawing on CBDT and CBEC data, and OECD (2015c), Tax Administration 2015: Comparative Information on OECD and other advanced and emerging economies.

The majority of India's dispute cases are at the first level of dispute within the tax administration – the appeal of an assessment to either the Commissioner of Income Tax or Commissioner of Excise and Customs. However, India also relies extremely heavily on the court system to resolve disputes, with around 68 000 direct and 80 000 indirect tax cases in dispute with different appellate courts in 2012-13 (Table 9).

Table 9. **Unfinalised tax disputes in India by length of dispute, 2012/13**

Appellate Body	Direct				Indirect			
	< 1 year	1-5 years	> 5 years	Total	< 1 year	1-3 years	> 3 years	Total
Supreme court	1,093	3,881	834	**5,808**	462	1,229	1,390	**3,081**
High Court	7,669	19,526	4,035	**31,230**	3,913	4,331	6,869	**15,113**
ITAT/CESTAT	11,877	16,867	2,271	**31,015**	17,011	25,076	20,076	**62,163**
Commissioner	-	-	-	**199,390**	21,301	9,622	2,302	**33,225**

Source: TARC (2014), drawing on CBDT and CBEC data.

Note: ITAT is the Income Tax Appellate Tribunal; CESTAT is the Customs, Excise and Service Tax Appellate Tribunal. All appeals to the Commissioner of Income Tax are by the taxpayer. Appeals by the CBDT go directly to the ITAT. Data on length of dispute is unavailable for appeals to the Commissioner of Income Tax.

A large number of these tax disputes have been in process for several years. The average time for dispute resolution is estimated at 3-4 years for direct tax appeals to the Commissioner, and 1-2 for indirect tax appeals to the Commissioner. For appeals to the Supreme Court, average times are estimated at 4-7 years for direct tax appeals and 5-8 years for indirect tax appeals (TARC, 2014, citing the Federation of Indian Chambers of Commerce and Industry).

The unnecessary nature of many of these disputes is highlighted by the relative lack of success of appeals by the Department. For example, in the first half of 2014-15, 58% of departmental appeals to the Income Tax Appellate Tribunal were decided in favour of the taxpayer; in the High Court this figure was 59%; and it was 43% for departmental appeals to the Supreme Court (Government of India, 2015). The dispute figures highlight two distinct problems. First, too many audit cases result in a dispute; and second, following a decision by the Commissioner in the taxpayer's favour, too many cases with limited merit are then escalated by the Department to the Courts. The latter problem can be addressed by providing better guidance to assessing officers regarding the circumstances in which a case should be appealed to the courts. The former problem is more endemic, and is discussed in the next section.

4.2. Audit processes

Significant improvements have recently been made in the audit process, including an increased use of third party data and risk-based analysis to inform audit strategy, and increased computerisation of the dispute management process.[23] However, there are a number of factors in the audit area that create an environment where unnecessarily aggressive audit assessments are commonplace, which lead in turn to a high number of disputes and subsequent litigation. In particular, the combination of limited staffing numbers, limited expertise in particular audit areas (due partly to staff rotation), a lack of clear guidelines in many areas (though this is improving), a fear of corruption accusations and the use of audit revenue targets create strong incentives for assessing officers to take a highly defensive approach to assessments.

Staff concerns regarding corruption allegations weigh particularly on the minds of assessing officers. The external audit of all assessments by the Comptroller and Auditor General (CAG), and the imposition of sanctions against assessing officers who are considered by the CAG to have under-assessed, further incentivise the current defensive approach to assessments. Furthermore, the internal practice of acting on anonymous accusations of impropriety has a similar impact.[24] Currently, assessing officers have full control and responsibility for the assessments they make. The introduction of a hierarchy of approval (so that the assessing officer dealing with the taxpayer is not the person who officially signs off on the assessment) may help ensure integrity in the audit process and reduce unnecessary fears of corruption allegations. It may also help to reduce the number of tax disputes.

Concerns about corruption also have a secondary impact on the number of disputes. To reduce the possibility of corruption, a management strategy of staff rotation is in place in both the CBDT and CBEC. However, a consequence of this is that many assessing officers do not have the experience and expertise to effectively undertake assessments. Some degree of specialisation is needed in audit activity, and there is consequently merit in both boards reassessing this rotation policy. Vigilance against corruption remains, of course, necessary. These concerns can, in part, be addressed by creating an environment where the taxpayer feels comfortable to approach the tax administration with such concerns. This may be assisted by ensuring that subsequent to such a taxpayer complaint, a different assessing officer is assigned to that taxpayer to allay any fears of future retribution by the assessing officer.

23. For example, objections to a CBDT demand notice can now be made electronically.

24. The TARC has recommended this practice be stopped due to its significant negative impact on staff morale.

Perhaps the most damaging factor in creating an environment of excessive disputes is the imposition of audit revenue targets on assessing officers. Currently the government sets a tax revenue target for the CBDT and CBEC and this filters down to every level of the tax administration so that each assessing officer is given a specific audit revenue target. Furthermore, and contrary to international best practice, each assessing officer's performance for the year is determined in large part by whether or not they meet this audit revenue target.[25] The overall revenue target is not the result of any empirical forecasting of expected tax revenue, and hence is not necessarily closely linked to the tax revenue that should be generated under the current law. Consequently, there is a risk that the audit revenue targets assigned to assessing officers could be unrealistically high, thereby requiring highly aggressive positions to be taken by assessing officers in order to meet their targets. This possibility is accentuated by a lack of accountability on the part of the assessing officer for the quality of the assessment. That is, the overturning of an assessment on appeal has no bearing on the assessing officer's performance rating. The low success rate on appeal to the Commissioner by the department noted above is suggestive that such targets are indeed excessive and have resulted in unreasonable assessments.

A further implication of imposing audit revenue targets on assessing officers is that it discourages the audit of small businesses where there is far less potential of significant audit revenue. Audit revenue targets also discourage staff from addressing systemic errors by taxpayers.

Moving away from assessing staff performance based on audit revenue targets toward a human resource management strategy based on international best practice would significantly alleviate the above concerns. Targets can still be imposed at the department level – but for the purposes of informing policy and of measuring and minimising the tax gap. They should not filter down to individual assessing officers. Furthermore, these targets should be generated via empirical forecasting based on the actual tax rules in place. If the government then wishes to increase tax revenue it can adjust the law or provide additional resourcing aimed at reducing the tax gap itself. This revenue forecasting would most obviously be performed in the recently announced tax policy analysis unit.

Additional ways to reduce disputes include expanding alternative dispute resolution procedures. For example, the Authority for Advance Rulings (AAR), which is currently only available in international tax matters, could have its scope extended to domestic matters as well. This would require additional resourcing to be provided to the AAR.

4.3. Transfer pricing rules

One area of particular importance for international investors, and where disputes are also common, is transfer pricing. Table 10 shows the significant numbers of transfer pricing audits and finalised case adjustments for 2006-2015. Over this period the number of audits has almost tripled, while the number of adjusted cases has seen a sevenfold increase. However, on appeal the tax administration has been as unsuccessful in transfer pricing cases as in total cases. At the Income Tax Appellate Tribunal (ITAT) level, out of 1 075 rulings made until May 2014 only 13% were ruled in favour of the tax administration, while at the High Court only 7% were ruled in favour of the tax administration (Sekar, 2016).

Table 10. **Transfer pricing audits and adjustments in India**

	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Number of audits	1,501	1,768	1,954	1,830	2,368	2,638	3,171	3,617	4,290
Number of adjusted cases	337	471	754	813	1,207	1,343	1,686	1,920	2,353
Percent of adjusted cases	22%	27%	39%	44%	51%	51%	53%	53%	55%

Source: Annual Reports 2013-14 and 2014-15, Ministry of Finance, as tabulated in Sekar (2016).

25. While most of the Forum on Tax Administration's 46 member tax administrations report the use of audit revenue targets at an administration level, most no longer use audit revenue targets as a formal measurement of staff performance.

These figures suggest that transfer pricing is a particularly problematic area, with too many audit assessments being made that result in disputes that need to be resolved in the courts. Court decisions have tended to favour the taxpayer, suggesting many adjustments should not have been made in the first place.

Moving towards greater alignment of India's transfer pricing rules with the OECD's Transfer Pricing Guidelines may lead to greater taxpayer certainty. For example, Sekar (2016) has recently argued that a majority of transfer pricing litigation in India has been due to the non-alignment of Indian transfer pricing rules in two areas: requiring use of the arithmetic mean (over all comparable corporations or transactions) rather than allowing for a range of admissible transfer prices; and not allowing the use of multiple year data. India has now amended its rules to allow the use of multiple year data.

A very positive step regarding transfer pricing has been the recent introduction of an advance pricing agreement (APA) programme into the transfer pricing regime. The APA programme came into force on 30 August 2012. Under the programme, a taxpayer can apply for an APA prior to a proposed transaction taking place, thereby providing certainty as to the taxpayer's transfer prices and avoiding potential future disputes with the tax administration. Given the large number of disputes in the Indian system, this is a positive step. APAs specify the transactions covered, the transfer pricing method to be used, operational provisions for determining the arms-length price, critical assumptions the APA relies on, the length of the APA and the compliance reporting responsibilities of the taxpayer. APAs are valid for up to five years. The application process is facilitated by a pre-filing meeting between the tax administration and the taxpayer.

The APA programme has unsurprisingly proved very popular – with more than 700 APA applications filed as of 30 August 2016 (Government of India, 2016c). To an extent, however, the programme has become a victim of its own success. The large volume of applications, combined with the complexity of the transactions to be covered in the APAs, initially resulted in significant delays in concluding and signing APAs, with only 98 APAs having been signed as of 30 August 2016. However, the processing of applications does appear to be speeding up, with almost one third of these APAs having been signed in the most recent five months. Increased resourcing in this area would help to further speed up the processing of APA applications.

India's APA programme allows unilateral, bilateral or multilateral APAs to be signed. Applications for unilateral APAs seek just agreement with the CBDT. Bilateral or multilateral APAs seek agreement from two or more jurisdictions and, as such, are more likely to reduce the risk of double taxation, to be equitable to all tax administrations and taxpayers involved, and to provide greater certainty to the taxpayers concerned (OECD, 2010). So far, almost all (94) of the 98 APAs signed have been unilateral (Government of India, 2016c).

4.4. Use of mutual agreement procedures (MAP)

Another positive reform has been in relation to India's use of Mutual Agreement Procedure (MAP) processes under tax treaties. As part of the OECD/G20 BEPS process, India has agreed to implement the minimum standard with respect to dispute resolution mechanisms. India has agreed, in particular, to ensure: (i) that treaty obligations related to the MAP are fully implemented in good faith and that MAP cases are resolved in a timely manner; (ii) the implementation of administrative processes that promote the prevention and timely resolution of treaty-related disputes; and (iii) that taxpayers can access the MAP when eligible.

4.5. Taxation of indirect transfers of assets located in India

India taxes capital gains on the direct sale of assets located in India to resident and non-resident corporations or other entities. Additionally, to prevent avoidance of tax on such sales, India also taxes the "indirect transfer" of shares – whereby a non-resident corporation or entity that holds the asset is sold rather than the asset itself. The indirect transfer rules were introduced in 2012 via retrospective legislation, with application back to 1961, deeming interests in non-resident entities to be situated in India if the interest derives its value, either directly or indirectly, substantially from assets located in India. "Substantially" is defined as exceeding INR 100 million and representing at least 50% of the value of all the assets owned by the corporation (or entity).

While the taxation of indirect transfers of immovable property is not uncommon internationally, it is much rarer to tax indirect transfers of other assets as India does (see Box 7). That said, it is not the policy decision to tax indirect transfers, but the way in which the decision has been implemented – via retrospective legislation – that has been particularly problematic for India's reputation as an attractive investment destination.

Following the change in government in 2014, it was announced that no further retrospective legislation adverse to taxpayers will be introduced. Further certainty could be provided by reforming the indirect transfer regime so that it only applies prospectively. Levying the tax on the resident corporation (via a deemed realisation on transfer of control) rather than the non-resident corporation would aid enforcement, as well as avoid potential double taxation of gains. Deferral of tax until sale to an unrelated party would avoid discouraging efficient business restructuring (see Box 7).

4.6. Application of the minimum alternate tax to non-resident investors

Another positive step in increasing certainty and investor confidence has been the recent announcement by the government that legislation will be introduced to clarify that the minimum alternate tax (MAT) does not apply to non-resident corporations without a permanent establishment in India. It is important that this legislation is progressed through parliament promptly in order to end a period of significant uncertainty for, in particular, pension funds and other foreign institutional investors (FIIs).

As noted in section 2, the MAT is effectively a pre-payment of tax for corporations that currently have very low taxable income due to taking advantage of tax concessions (e.g. for infrastructure investment), and was aimed at resident corporations. However, in August 2012 a ruling was made by the Authority for Advance Rulings (AAR) that the MAT was applicable to both resident and non-resident businesses. Based on this ruling the tax administration began issuing assessment notices to many large FIIs to pay MAT on their Indian-sourced income. These assessments have been contested by many FIIs leading to a lengthy and costly disputes process. FIIs argued that the AAR ruling was contrary to the intent of the concessionary tax regime in place to attract foreign institutional investors, and also raised difficulty in its application given that the MAT is based on book income which foreign corporations are not required to maintain in India.

Box 7. **Approaches to taxing indirect transfers**

A concern for many countries that choose to tax capital gains is tax avoidance via the "indirect transfer" of assets – whereby a non-resident corporation that holds an asset is sold rather than the asset itself. A key policy choice for such countries is whether to tax gains on all assets sold indirectly, a subset of assets, or none. A small number of countries (e.g. China, India, and Indonesia) tax the indirect transfer of all assets under their domestic tax laws. In contrast, most OECD countries that tax capital gains in the hands of non-residents have chosen to tax just the indirect transfer of immovable property. Meanwhile, some countries that tax direct transfers by non-residents have chosen not to tax indirect transfers at all, largely due to perceived difficulties in enforcement against a non-resident taxpayer.

The limitation of taxing rights in the OECD and UN Model Tax Conventions to indirect transfers of immovable property may be justified by the fact that this is the most likely form of asset to be placed in an offshore holding corporation solely for the purpose of avoiding tax on accrued and untaxed capital gains. In contrast, accrued gains on other forms of assets, such as intellectual property, are more likely to be part of a larger business that is sold. As a result, the sale of the business will produce a gain that includes both the untaxed gain from the intellectual property as well as accrued profits retained in the business that have already been taxed under the corporate income tax. Probably because of the risk of economic double taxation of such accrued profits, and because such transactions are unlikely to be primarily motivated by tax avoidance, indirect transfers of such businesses are not taxable under the OECD and UN Model Tax Conventions. Additionally, both conventions require more than 50% of the gain to have accrued either directly or indirectly from the immovable property. This further minimises the amount of accrued profits that may be double taxed.

Different approaches can be taken in implementing a tax on indirect transfers of either immovable or other property. One approach is to tax the indirect transfer itself, for example by deeming the transfer to have occurred in the country where the asset is located, and imposing a tax liability on the non-resident corporation making the sale (e.g. as in India). However, enforcement against a non-resident corporation with no direct presence in the country where the asset is located is difficult. Furthermore, knowledge of the indirect transfer is needed – and this may not be obvious with complicated structures and transactions. An alternative approach is to deem disposition of the asset on change of control. This approach ensures that the taxpayer is the domestic corporation, so that even if it is only later determined that there has been an indirect transfer, the tax (plus interest and penalties) can easily be applied. Additionally, this approach provides an uplift in the asset value so that, if the asset is subsequently sold by the domestic corporation, that corporation will not face double taxation of the same gain. On the other hand, however, that approach may create difficulties if there are unrelated minority shareholders in the domestic corporation.

An emerging area of concern for many developing countries is enforcement of taxation of the indirect transfer of mineral rights. Mineral rights can be expected to be included within the tax net of all countries that tax indirect transfers (e.g. the OECD Model Tax Convention includes mineral rights within its definition of immovable property). However, enforcement of a "bright line" threshold of the value of the gain derived from the mineral rights (e.g. 50%, as in the OECD and UN Model Tax Conventions) may be subject to manipulation by corporations when dealing with a tax administration with limited capacity. Joint work led by the IMF and OECD is currently being undertaken to examine ways to address this issue, with recommendations expected in 2016.

Another issue is the impact of indirect transfer provisions on legitimate business restructuring. Restructuring can occur for various legitimate business reasons – e.g. a change in management approach, adapting to changes in markets, preparing for a share market float – and may result in the indirect transfer of an asset in another country. Ideally, the tax rules should not discourage efficient corporate restructuring. As such, relief may be justified for gains on indirect transfers between related parties, e.g. via deferral of tax until sale to an unrelated party. China, for example, is currently considering providing relief for internal group restructures that meet a reasonable business purpose test.

In an attempt to provide certainty as to the law in this area, the government introduced legislation as part of the 2015 budget process to specify that the MAT did not apply to FIIs from 1 April 2015. This still left significant uncertainty regarding the period prior to 1 April 2015. However, the government has now announced that new legislation will be introduced to clarify that foreign corporations without a PE are not subject to the MAT, with this applicable back to 2001. Furthermore, it has provided certainty as to the law both in prior years and moving forward for other non-resident corporations such as private equity investors that were not covered by the initial legislation.

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ANNEX

Table A1. **ETRs on equity-financed investment, with tax depreciation equal to economic depreciation**

	New Equity	
	CIT=25% / No Acceleration	
	AETR	METR
	(%)	(%)
Non-residential buildings	41.1	41.1
Commercial vehicles	41.0	40.5
Computers (servers and networks)	41.0	40.3
Computers (end-user devices)	40.6	38.9
Plant and machinery (general)	41.1	40.8
Electrical equipment	41.0	40.7
Plant and machinery (pharmaceuticals)	41.1	40.9
Plant and machinery (telecommunications)	41.1	40.8
Pre-packaged Software	40.7	39.5
Custom Software	40.9	40.2
R&D for motor vehicle manufacturing	40.9	40.2
R&D for electronic product manufacturing	40.9	40.0
Average	**40.9**	**40.3**

Source: authors' calculations

Table A2. **ETRs on debt-financed investment, with and without a 20% withholding tax**

	Debt					
	CIT=30% / No WHT		CIT=30% / WHT=20% on interest			
	AETR	METR	AETR		METR	
	(%)	(%)	(rate, %)	(diff., pp)	(rate, %)	(diff., pp)
Non-residential buildings	36.9	-36.6	36.9	0.0	0.5	37.2
Commercial vehicles	37.5	-23.8	37.2	-0.3	4.9	28.8
Computers (servers and networks)	37.7	-20.1	37.3	-0.4	6.3	26.4
Computers (end-user devices)	40.8	17.8	39.7	-1.1	31.3	13.5
Plant and machinery (general)	38.3	-10.6	38.0	-0.3	15.5	26.1
Electrical equipment	36.9	-34.8	36.6	-0.4	-4.7	30.1
Plant and machinery (pharmaceuticals)	37.7	-19.3	37.6	-0.2	10.3	29.6
Plant and machinery (telecommunications)	38.7	-4.2	38.4	-0.4	19.4	23.6
Pre-packaged Software	44.0	38.0	42.5	-1.5	47.4	9.4
Custom Software	40.6	16.5	39.8	-0.8	32.2	15.7
R&D for motor vehicle manufacturing	40.3	13.7	39.6	-0.7	30.4	16.6
R&D for electronic product manufacturing	41.7	24.8	40.7	-1.0	37.9	13.1
Average	**39.3**	**-3.2**	**38.7**	**-0.6**	**19.3**	**22.5**

Source: authors' calculations

Table A3. **ETRs on equity-financed investment with 5% inflation**

	New Equity					
	CIT=30% / No Inflation		CIT=30% / 5% Inflation			
	AETR	METR	AETR		METR	
	(%)	(%)	(rate, %)	(diff., pp)	(rate, %)	(diff., pp)
Non-residential buildings	43.5	35.6	49.4	5.8	56.0	20.4
Commercial vehicles	43.2	33.8	49.5	6.3	56.4	22.6
Computers (servers and networks)	43.1	33.6	49.5	6.4	56.3	22.7
Computers (end-user devices)	46.3	47.1	57.3	11.1	69.3	22.2
Plant and machinery (general)	44.8	41.5	52.4	7.6	62.2	20.7
Electrical equipment	41.9	26.2	46.5	4.6	47.8	21.6
Plant and machinery (pharmaceuticals)	44.3	39.2	51.2	7.0	60.1	20.9
Plant and machinery (telecommunications)	45.2	43.3	53.3	8.1	63.8	20.4
Pre-packaged Software	50.3	58.1	65.6	15.3	76.6	18.5
Custom Software	46.9	49.3	57.8	10.9	69.9	20.5
R&D for motor vehicle manufacturing	46.6	48.3	57.1	10.5	69.0	20.7
R&D for electronic product manufacturing	48.0	52.5	60.3	12.3	72.4	19.9
Average	**45.3**	**42.4**	**54.2**	**8.8**	**63.3**	**20.9**

Source: authors' calculations

Table A4. **ETRs on debt-financed investment with 5% inflation**

	Debt					
	CIT=30% / No Inflation		CIT=30% / 5% Inflation			
	AETR	METR	AETR		METR	
	(%)	(%)	(rate, %)	(diff., pp)	(rate, %)	(diff., pp)
Non-residential buildings	36.9	-36.6	32.1	-4.7	-564.3	-527.7
Commercial vehicles	37.5	-23.8	34.8	-2.7	-110.5	-86.7
Computers (servers and networks)	37.7	-20.1	35.4	-2.3	-82.5	-62.4
Computers (end-user devices)	40.8	17.8	43.2	2.4	33.9	16.1
Plant and machinery (general)	38.3	-10.6	35.5	-2.8	-78.9	-68.3
Electrical equipment	36.9	-34.8	33.6	-3.4	-205.0	-170.2
Plant and machinery (pharmaceuticals)	37.7	-19.3	34.3	-3.4	-137.7	-118.5
Plant and machinery (telecommunications)	38.7	-4.2	36.4	-2.3	-47.8	-43.6
Pre-packaged Software	44.0	38.0	49.3	5.3	55.8	17.8
Custom Software	40.6	16.5	41.6	0.9	23.7	7.2
R&D for motor vehicle manufacturing	40.3	13.7	40.9	0.5	18.3	4.6
R&D for electronic product manufacturing	41.7	24.8	44.0	2.3	38.0	13.3
Average	**39.3**	**-3.2**	**38.4**	**-0.8**	**-88.1**	**-84.9**

Source: authors' calculations