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Financial services insights: Tax & regulatory update

Vol 2 - Q2 2018

Content

Section	Page
Preface	03
Key regulatory updates	
SEBI updates	05
RBI updates	08
Key tax updates	
Direct tax updates	13
Indirect tax updates	15
Key jurisprudence	
Direct tax	17
Transfer pricing	18
Indirect Tax	19

Preface

According to a World Bank report dated 14 March 2018, private investments in India are expected to grow more than the private consumption and thereby drive the growth in India's GDP to around 7.5% in FY 2018-19. This growth will also be supported by other factors such as strong sales growth of corporations, record food grains output, depleting finished goods inventories and restart of investments in fixed assets by Indian corporates.

The banking sector plays a fundamental role in the transformation of an economy. The government has enacted a series of laws intended to reform and strengthen the banking sector to restore investors' confidence and to make capital more accessible. The bank re-capitalisation plan by the Government of India is expected to push credit growth to 15%, as against the actual growth of around 10% during FY 2017-18.

Over the past five years, the assets of the banking sector have impaired considerably, necessitating extensive provisioning and de-leveraging, thereby constraining banks' capacity to lend. In the interim, businesses have switched to alternate and more cost-effective sources of funds to meet their financing needs. In order to clean their balance sheets and improve their performance, banks may consider taking recourse to the IBC.

Recently, Tata Steel successfully acquired Bhushan Steel under the IBC by paying 78% of the total dues. The lenders are hopeful to recover a sizeable portion of their stressed assets under IBC, much higher than under erstwhile recovery laws.

The balance sheets of NBFCs grew at over 14.9% in FY 2017-2018, on the back of credit expansion by loan companies and asset finance companies. This was primarily driven by strong growth in credit to retail and services sectors.

Recent initiatives (such as PMJDY, Aadhaar-enabled e-KYC and development of robust payment infrastructure like UPI) have opened vast opportunities for incumbent financial institutions and FinTechs to introduce large-scale innovations in financial services to boost financial inclusion.

FinTechs are targeting hitherto excluded sections of the population. Given the potential of the MSME sector in India (around 51 million units account for 8% of GDP, 45% of manufacturing output, 40% of exports, and employment for 120 million), FinTechs and NBFCs could provide an alternate source of finance and fill the large funding gap faced by small businesses.

The Monetary Policy Committee in its second bi-monthly Monetary Policy Statement for FY 2019 increased the repo by 25 basis points for the first time in four years, against the backdrop of increasing inflationary pressure due to rising crude prices.

Considering the importance of the financial services sector in the Indian economy, the Government, over the past couple of years, has endeavoured to address the tax and regulatory issues faced by the industry to make India a more competitive economy and to provide easy access to the foreign capital in the Indian markets. Some of these steps undertaken by the Indian Government in the last two months include issuing clarifications to boost activities in IFSCs, issuing minimum capitalisation norms for FDI in unregistered/unregulated financial service entities, liberalising norms for FPI investments and liberalising ECB norms.

This publication seeks to keep various stakeholders in the industry abreast of key developments on the tax and regulatory aspects in the financial services sector.

We hope you enjoy reading the second edition and look forward to your valuable feedback.

Key
regulatory
updates

SEBI updates

a. KYC norms for FPIs enhanced by SEBI

(CIR/IMD/FPIC/CIR/P/2018/64 dated 10 April 2018)

SEBI had issued circulars in September 2012 and September 2013 prescribing risk-based documentation requirement for eligible foreign investors. In continuation to those circulars, SEBI has issued a circular with enhanced KYC norms for FPIs.

Salient features of the circular

i. Identification and reporting of BO

- The circular defines BO as 'Natural Person(s)' who owns or controls an FPI and is identified in accordance with Prevention of Money-Laundering (Maintenance of Records) Rules, 2005 (PMLA Rules).
- As per the circular, BOs of corporate or trust structure FPIs should be identified on controlling ownership interest and control basis. In case of partnership firms and unincorporated association of individuals, BO should be identified on ownership or entitlement basis.
- The materiality threshold for BOs of FPIs on controlling ownership interest basis shall be 25% in case of company and 15% in case of partnership firms, trusts and unincorporated association of persons.
- For identification of BO in respect of FPIs coming from 'high-risk jurisdictions', a lower materiality threshold of 10% is applicable. SEBI has directed the intermediaries to ensure compliance with the Master Circular, which also provides guidelines for identification of High Risk Jurisdictions.
- The materiality threshold to identify BO to be applied at the FPI level and next look through principal to be applied only for BO with holdings equal and above materiality threshold in the FPI.
- In case no material owner is identified in the FPI using materiality threshold for controlling ownership interest basis and control basis (for companies and trusts), the senior managing official shall be considered as the BO.
- FPIs set up as companies/trusts and represented by service providers like lawyers and accountants will need to provide information of the real owners/effective controllers of those companies/trusts.
- In case control is exercised by BO through means like voting rights, agreements and arrangement, the same should also be specified. It is also clarified that BO should not be a nominee of another person.
- BO should not be:
  - a person mentioned in United Nations Security Council's Sanctions List
  - from a jurisdiction which is identified in the public statement of FATF as:
    - I. a jurisdiction having a strategic Anti-Money Laundering or Combating the Financing of Terrorism deficiencies to which counter measures apply; or
    - II. a jurisdiction that has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with the FATF to address the deficiencies.

iii. Indians as BO of FPIs

- The circular clarifies that NRIs/OCI and resident Indians cannot be BOs of FPIs. However, an exception is given to an FPI promoted by NRIs/OCIs if it is a category-II IM of other FPIs and is a non-investing entity.
- All existing FPI structures which do not meet the above requirement of BO are prohibited to create fresh position in derivatives at the end of expiry of April 2018 derivative contracts. Hence, FPIs were required to unwind their position in derivative segment on or before 26 April 2018 if their BO was not in accordance with the framework prescribed in the circular.
- A period of six months from the date of this circular has been provided to existing FPIs to align their structure in line with the circular or close their existing position in Indian securities market.

iv. Bearer share structure

- It needs to be ensured that FPIs or their BOs identified on the basis of aforementioned thresholds have not issued any bearer shares, or
- If the legal constitution of FPIs or their BOs permit issue of bearer shares, then the FPIs shall certify that they have not issued, do not maintain and will not issue any bearer shares to their investors.

A period of six months from the date of this circular has been provided to ensure compliance with this requirement

v. KYC review

Currently, KYC review is required as and when there is change in material information/ disclosure. As per the circular, KYC review of FPIs should be on a periodical basis based on risk categorisation of FPIs. KYC review of high-risk clients should be done on an annual basis and for all other clients, KYC review should be conducted every 3 years.

v. Clubbing of investment limit for FPIs

The Finance Act 2018 has levied 10 per cent long term capital gain (LTCG) tax on transfer of following securities (hereinafter collectively referred to as 'listed securities'), which were exempt till now:

- It has been specified that clubbing of investment limit for FPIs shall be on the basis of BO identified as per the circular.
- Accordingly, a period of six months from the date of this circular has been provided to ensure compliance by all existing FPIs whose clubbed investment in equity share of a company is not in accordance with Regulation 21(7).
- In respect of any future breach of clubbing limit, the following two options are provided:
  - The said investments shall be treated as FDI from the date of breach, or
  - FPI in breach shall have to divest its holding within five trading days from the date of settlement of the trades to bring its shareholding below 10% of the paid up capital of the company.

Our comments: Recent circulars issued by SEBI have relaxed the entry norms and compliance requirements for foreign investors. Although this circular provides detailed guidelines for identification of BO, several terms used in the circular are open for interpretation.

Some of the issues that need further clarity from the regulator are as under:

- Whether an IM will be considered a BO if it exercises control over management of an FPI but does not hold any economic interest
- Whether NRIs/OCIs can be appointed as senior management officials of an FPI if the BO is not identified by ownership/control test
- Whether NRIs/OCIs can be appointed as senior management official of an IM who exercises control over FPI
- If custodian/DDP will be required to maintain their own list of high-risk jurisdictions, whether any further guidelines will be issued to avoid disparate lists by DDPs
- Whether NRIs can collectively invest more than 49% in a Category II FPI
- Whether an NRI/OCI can be the IC of the FPI

b. SEBI issues clarification on clubbing of investment limit of foreign government/ foreign government-related entities

(SEBI/HO/IMD/FPIC/CIR/P/2018/66 dated 10 April 2018)

In continuation to the circular issued on 10 April 2018 on enhanced KYC requirement for FPIs, SEBI has issued clarifications on clubbing of investment limits of foreign government/foreign government-related entities. The clarifications have been issued by way of frequently asked questions which address issues such as what constitutes an investor group, how to ascertain if an FPI is part of any investor group, how the BO should be determined etc.

The key takeaway from the SEBI circular are as under

- The BO of foreign government entities/its related entities shall be determined in accordance with Rule 9 of the Prevention of Money Laundering (Maintenance of Records) Rules, 2005 (hereinafter referred to as PMLA Rules). The said PMLA Rules provide for identification of BO on the basis of two methodologies, namely (a) controlling ownership interest (also termed as ownership or entitlement) and (b) control in respect of entities having company or trust structure. In respect of partnership firms and unincorporated associations, ownership or entitlement is the basis for identification of BO.
- All foreign governments/related entities from the same jurisdiction shall be treated as part of the same investor group and the investment limits of all such entities shall be clubbed as applicable to a single FPI, ie below 10% of the total paid up capital of the company.
- However, in cases where the Government of India enters into agreements or treaties with other sovereign governments and where such agreements or treaties specifically recognise certain entities to be distinct and separate, SEBI may, during the validity of such agreements or treaties, recognise them as such, subject to conditions as may be specified by it.
- Foreign government agency is an arm/department/body corporate of the government or is set up by a statute or is majority (ie 50% or more) owned by the government of a foreign country and has been included under Category I FPIs.
- The investment by foreign government agencies shall be clubbed with the investment by the foreign government/its related entities for the purpose of calculation of 10% limit for FPI investments in a single company, if they form part of an investor group.

- The Government of India, vide letter No. 10/06/2010-ECB dated 06 January 2016 has exempted World Bank Group, viz IBRD, IDA, MIGA and IFC, from clubbing of the investment limits for the purpose of application of 10% limit for FPI investments in a single company.
- The investment by foreign government/its related entities from provinces/states of countries with federal structure and with distinct beneficial ownership constituted with objectives suitable for their respective provinces, shall not be clubbed if the said foreign entities have different BO identified in accordance with PMLA Rules.
- DDPs/custodians of securities can approach NSDL to get information regarding aggregate percentage holdings of group entities.
- The FPIs investing in breach of the prescribed limit shall divest their holdings within five trading days from the date of settlement of the trades causing the breach. Alternatively, the investment by such FPIs shall be considered as investment under FDI at the FPI's option. However, the FPIs need to immediately inform of such option to SEBI and RBI, since they cannot hold equity investments in a particular company under FPI and FDI route simultaneously.

Our comments: The circular is a welcome move as it provides much-needed clarity on clubbing of investment limit. Although the circular is issued in relation to foreign government entities and its related entities, one may rely on this circular for identifying investor group and clubbing of investment for all other FPIs

c. Trading hours on stock exchanges

(SEBI/HO/MRD/DRMNP/CIR/78 dated 4 May 2018)

Pursuant to the approval of the SEBI Board, in its meeting held on 28 December 2017, stock exchanges have been permitted to trade commodity derivatives along with other segments of securities market effective from 1 October 2018.

With a view to enable integration of trading of various segments of securities market at the level of exchanges, it has been decided to permit stock exchanges to set their trading hours in the equity derivatives segment between 9:00am and 11:55pm, similar to the trading hours for the commodity derivatives segment, which are currently fixed between 10:00am and 11:55am, provided that the stock exchange and its clearing corporation(s) have in place risk management system and infrastructure commensurate to the trading hours.

In case stock exchanges are desirous of extending the trade timings beyond the extant trading hours, prior approval from SEBI shall be sought along with a detailed proposal including the framework for risk management, settlement process, monitoring of positions, availability of manpower, system capability, surveillance systems, etc. The provisions of this circular shall be applicable from 1 October 2018.

d. Investment of own funds (excluding funds lying in Core Settlement Guarantee Fund) by Clearing Corporations in IFSC

(SEBI/HO/MRD/DRMNP/CIR/P/2018/82 dated 21 May 2018)

Currently, clearing corporations are permitted to invest their own funds as well as funds lying in Core Settlement Guarantee Fund in fixed deposits/central government securities and liquid schemes of debt mutual funds.

Upon review of investment instruments/avenues available for clearing corporations in IFSC and based on the feedback received, SEBI has decided to permit clearing corporations in IFSC to invest their own funds in AAA rated foreign sovereign securities. However, the investment in such AAA rated foreign sovereign securities shall not exceed a limit of 10% of the total investible resources, excluding funds lying in core settlement guarantee fund of the clearing corporation.

e. SEBI permits 'Segregated Nominee Account Structure' in IFSC

(SEBI Circular dated 24 May 2018 – SEBI/HO/MRD/DRMNP/CIR/P/2018/83)

The government has set up India's first IFSC, which brings together world-class infrastructure, connectivity, people and technology on a single platform for businesses across the world. In March 2015, SEBI had issued a detailed set of guidelines for establishing IFSCs as part of its efforts to establish a financial hub in the country.

In order to facilitate ease of market access for foreign investors, SEBI has now permitted foreign investors to trade on stock exchanges located in IFSCs through Segregated Nominee Account Providers (Providers). The circular specifies the regulatory requirements for the providers such as registration requirement, eligibility criteria, KYC of end clients, margin computation and reporting, etc.

Our comments: The circular will ease access norms for foreign investors. Foreign investors who are not investing in India under the FPI route would be able to simply access the Indian capital market in IFSCs through Providers. The relaxation in funding requirement on the margin payable by the end client would definitely provide the much-needed boost for investment in IFSCs. However, further guidelines by stock exchanges on the operational aspect of the Nominee Account Structure will be appreciated.

RBI updates

a. Government issues minimum capitalisation norms for FDI in unregistered / unregulated financial services entities

(Press release dated 16 April 2018 (Release ID: 1529264)

MoF, vide its recent press release, has prescribed minimum capital requirements for FDI in 'other financial services' activities which are unregulated or partially regulated by any financial sector regulator (and in which FDI is allowed under government route).

RBI had vide its notification in 2016 allowed 100% FDI under the automatic route in the financial services activity regulated by financial sector regulators, ie RBI, SEBI, IRDA, PFRDA or any other financial sector regulator. It had been specified that FDI in other financial services, which are not regulated or partially regulated (or 'where there is a doubt of regulatory oversight') shall come under government approval route.

Minimum capitalisation norms for FDI

Activities	Minimum capitalisation
Fund-based activity (such as merchant banking, stock broking, asset management, venture capital, housing finance, credit card business, micro credit, and rural credit)	$20 mn
Non-fund based activity (such as investment advisory services, financial consultancy, forex broking, money changing business, and credit rating agencies)	$2 mn

Our comments: The press release issued by MoF has now prescribed the minimum capital norms for unregulated/partially regulated financial service activity entities which were previously not provided in the Consolidated FDI Policy Circular of 2017. However, the press release throws up some grey areas and issues. For instance, most of the fund-based activities (merchant banking, leasing and finance, venture capital, housing finance, etc) are already regulated by regulators like SEBI and RBI and hence cannot be considered as unregulated financial services. Moreover, it is not clear whether minimum capital will be required irrespective of the percentage of FDI coming in. It is hoped that these concerns will get appropriately addressed and clarity provided when DIPP/ RBI issues the requisite press note/notification for giving effect to this policy announcement. Also, clarity is awaited on whether these new capital norms would also apply to only new players or existing players as well. Further, for non-fund based activities such as investment advisory, money changing activities, IM, etc, where they are directly or indirectly regulated and are required to get capital as per their relevant regulations, under the new FDI norms they would be required to get much higher capital into India and it could possibly be detrimental for new players.

b. RBI liberalises norms for investment by FPIs in debt

(A.P. (DIR Series) Circular No.31 dated 15 June 2018)

Based on feedback from custodians, FPIs and other stakeholders, RBI released a circular on 15 June 2018 to provide operational flexibility as well as transition path for FPIs to adapt to the changes in the regulation. The two recent circulars dated 27 April 2018 and 1 May 2018 issued by the RBI in relation to FPI investment in debt securities stand withdrawn.

The salient features of the circular are as under:

i. Revision of minimum residual maturity requirement

- The circular withdraws the minimum residual maturity requirement for G-secs and SDL
- The minimum residual maturity requirement for CBs is reduced to one year.
- Investment by FPI in these securities with residual maturity less than one year should not exceed 20% of the total investment of that FPIs in that category at any point of time.
- The requirement of having residual maturity period of less than one year will be applied on end-of-day basis
- Investments made prior to 28 April 2018 have been grandfathered, ie short-term investments may exceed 20% of total investments if the short-term investments consist entirely of investments made prior to 28 April 2018.
- Investment by FPIs in SRs issued by ARC will be exempt from the minimum residual maturity criteria.

ii. Revision of security-wise limit

- The cap on aggregate FPI investments in any Central Government security has been revised to 30% of the outstanding stock of that security, from the erstwhile limit of 20%.

iii. Online monitoring of G-Sec utilisation limits

- The RBI has decided to discontinue the auction mechanism with effect from 1 June 2018. Henceforth, the utilisation of investment limits shall be monitored online.
- Any transaction that leads to breach of the investment limit for the category will need to be reversed
- Further, upon sale/redemption of securities (in G-secs and SDLs), the concerned FPIs may reinvest within a period of two working days from the date of sale/redemption (including the date of sale/redemption). If the reinvestment is not made within that time period, reinvestment shall be subject to the availability of limits for that category.
- The primary responsibility of complying with all limits shall lie with the FPIs and custodians.

iv. Concentration limit

Investment by any FPI (including investments by related FPIs) in each of the three categories of debt, viz G-secs, SDLs and corporate debt securities, shall be subject to following concentration limit:

I. **Long Term FPIs –** 15% of prevailing investment limit for that category

II. **Other FPIs –** 10% of prevailing investment limit for that category

For FPIs having investment in excess of concentration limit on the effective date (date on which the aforesaid concentration limits comes into existence), the circular provides a one-time relaxation to such FPIs to undertake additional investment, subject to fulfilment of certain conditions.

v. Single/Group investor-wise limit in corporate bonds

- FPIs along with related FPIs will now not be permitted to invest in excess of 50% of any corporate bond issue. However, where an FPI along with the related FPIs, has invested more than 50% of any single issue, such FPI should not make further investment in that issue until the aforesaid conditions is met.
- FPIs are not permitted to have an exposure of more than 20% of their corporate bond portfolio to a single corporate (including exposure to entities related to the corporate). However, where an FPI already has exposure in excess of 20% to any corporate, then it should not make further investment in that corporate until the aforesaid condition is met.
- Existing investments have been grandfathered and transitional provisions have been introduced.
- In case investment has been made by an FPI to any corporate (including exposure to entities related to the corporate) in excess of 20% of its corpus prior to 28 April 2018, it has been grandfathered. However, the FPI shall not make further investments in that corporate.
- Further, new investments made by existing FPIs after 27 April 2018 would be exempted from this requirement till 31 March 2019. These 'new' investments will, however, have to comply with this requirement thereafter.
- FPIs registered after 27 April 2018 are permitted to comply with this requirement by 31 March 2019 or six months from the date of registration, whichever is later.
- The above requirement would not be applicable to investments by MFIs and investments by FPIs in SRs.

vi. Pipeline investment in corporate bonds

- Investment transactions by FPIs in corporate bonds that were under process but had not materialised as on 27 April 2018 shall be exempt from the requirement of investor-wise limit in corporate bonds subject to the satisfaction of the custodian, based on the following conditions:
  - The major parameters such as price/rate, tenor and amount of the investment have been agreed upon between the FPI and the issuer on or before 27 April 2018.
  - The actual investment will commence by 31 December 2018.
  - The investment is in conformity with the extant regulations governing FPI investments in corporate bonds prior to 27 April 2018.
- Custodians may permit the pipeline investments by FPIs based on their assessment of adherence to the above conditions without reference to the RBI.

vii. Other changes

Investment in partly paid instruments by FPIs has been disallowed.

Our comments: The circular is a welcome move as the RBI has addressed some of the concerns of the stakeholders and provided for a smooth transition to the new regulations. It brings much-needed relief to FPIs as well as Indian corporate borrowers as it allows an FPI to hold its existing short-term debt investments till maturity subject to credibility conditions. Also, the circular allows FPIs to subscribe up to 100% of the corporate bond issue where they had either signed a term sheet or reached such a similar understanding with the Indian borrower company before 28 April 2018.

c. RBI liberalises ECB norms

(RBI/2017-18/169 A.P. (DIR Series) Circular No.25 dated 27 April 2018)

In response to requests from corporates for relaxation in the existing ECB framework, RBI has liberalised the ECB guidelines.

Amendments made by the circular to current ECB guidelines are as under:

i. Rationalisation of all-in-cost ceiling for ECB and RDBs

I. To harmonise existing provisions of foreign currency, rupee ECBs and RDBs, a uniform all-in-cost ceiling of 450 basis points (bps) over the benchmark rate has been stipulated by the RBI.

II. The benchmark rate will be 6-month US dollar LIBOR (or applicable benchmark for respective currency) for Track I and Track II ECB and it will be prevailing yield of the Government of India securities of corresponding maturity for Track III (Rupee ECBs) and RDBs.

ii. Revisiting ECB liability to equity ratio provisions

The ECB Liability to Equity Ratio, for ECB raised from direct foreign equity holder under the automatic route has been increased to 7:1. However, this ratio would not apply where aggregate ECBs raised by an entity are up to $5 mn or equivalent.

iii. Expansion of 'eligible borrowers' list for the purpose of ECB

The circular has widened the pool of eligible borrowers for ECB by permitting the following entities in the eligible borrowers' list:

a. HFCs, regulated by the National Housing Bank, to avail ECBs under all tracks.

b. Port trusts constituted under the Major Port Trusts Act, 1963 or Indian Ports Act, 1908, to avail ECBs under all tracks.

   However, the aforementioned entities would be required to have a board approved risk management policy and keep their ECB exposure hedged 100% at all times for ECBs raised under Track I.

c. Companies engaged in the business of maintenance, repair, overhaul and freight forwarding to raise ECBs denominated in Indian rupees only.

iv. Rationalisation of end-use provisions for ECBs

The policy governing end use of ECBs has also been rationalised and a 'negative list' for all Tracks has been listed which includes the following:

a. Investment in real estate or purchase of land except when used for affordable housing as defined in Harmonised Master List of Infrastructure Sub-sectors notified by the Government of India, construction and development of SEZ and industrial parks/integrated townships

b. Investment in capital market

c. Equity investment

Additionally, for Tracks I and III, the following negative end uses will also apply except when raised from direct and indirect equity holders or from a group company, provided the loan is for a minimum average maturity of five years:

d. Working capital purposes

e. General corporate purposes

f. Repayment of rupee loans

For all Tracks, the following negative end use will also apply:

g. On-lending to entities for the activities (a) to (f) listed above.

Our comments: RBI's circular simplifying ECB guidelines aims to provide access of cheaper funds to Indian corporate borrowers to enable them to meet their capital requirement. Also, the circular now opens a new window of funding for HFCs and port operators in India, enabling them to raise low-cost overseas funding. Reducing the end-use restriction by introducing only the negative list for all tracks, the circular allows Indian corporates to borrow foreign capital for business activities which were earlier not allowed.

d. RBI eases norms for setting up IFSC banking units

(RBI Circular BR.IBD.BC.105/23.13.004 /2017-18 dated 17 May 2018)

RBI had issued a circular in 2015 formulating a scheme for the setting up of IBUs in IFSCs by Indian banks and foreign banks (already with a presence in India). One of the key conditions under the circular was the requirement for the parent bank to provide a minimum capital of $20 mn or equivalent in any foreign currency to its IBUs.

The RBI, vide its recent circular dated 17 May 2018, has amended the provisions to clarify that minimum capital is required to be maintained at all times at the parent level and not at the IBU level. The circular also prescribes additional conditions for IBUs.

The key amendments in relation to the capital requirement for IBUs are as under:

- **Indian banks setting up an IBU**
  - The parent bank will be required to provide a minimum capital of $20 mn or equivalent in any foreign currency to its IBU. This level should be maintained at all times.
  - The minimum prescribed regulatory capital, including for the exposures of the IBU, shall be maintained on an ongoing basis at the parent level.

- **Foreign banks (with a presence in India) setting up an IBU**
  - The parent bank will be required to provide a minimum capital of $20 mn or equivalent in any foreign currency to its IBU. This level should be maintained at all times.
  - The minimum prescribed regulatory capital, including for the exposures of the IBU, shall be maintained on an ongoing basis at the parent level as per the regulations in the home country.
  - The IBU shall submit to the RBI a certificate to this effect obtained from the parent on a half-yearly basis.
  - The parent bank will be required to provide a 'Letter of Comfort' for extending financial assistance, as and when required, in the form of capital/liquidity support to the IBU.

Our comments: This circular would provide clarity as well as a much-needed boost to banks which are looking at setting up a branch in an IFSC. In view of maintaining capital at the parent level, banks (Indian as well as foreign) will not have to infuse separate capital into IBUs. This relaxation, coupled with fiscal benefits provided to IBUs, would attract banks, especially foreign banks, to set up a presence in IFSCs.

e. RBI tightens Liberalised Remittance Scheme norms

(A.P. (DIR Series) Circular No. 32 dated 19 June 2018)

- The RBI has recently tightened the norms for LRS by making quoting of PAN mandatory for all transactions and amending the definition of a 'relative'.
- Under the LRS, there are specific allowances for making remittances for maintenance of close relatives abroad, granting loan in rupees to an NRI / PIO relative or making a rupee gift to an NRI / PIO relative.

Salient features of the circular

- RBI has made quoting of PAN mandatory for all transactions. Prior to this, it was mandatory only for transactions above $25,000.
- The definition of 'relative' has now been aligned with the definition given under the Companies Act, 2013.
- The term 'relative' with reference to a person as per the Companies Act, 2013 means anyone who is related to another in the following manner:
  - If they are members of a HUF
  - If they are husband and wife
  - If one person is related to the other as under:
- Father, including step-father
- Mother, including step-mother
- Son, including step-son
- Son's wife
- Daughter
- Daughter's husband
- Brother, including step-brother
- Sister, including step-sister

Key tax updates

Direct tax updates

a. CBDT notifies protocol amending the DTAA between India and Kazakhstan

(Press release dated 13 April 2018)

CBDT has notified the protocol amending the DTAA with Kazakhstan. The salient features of the protocol are as under:

Salient features of the circular

i. Identification and reporting of BO

- It provides internationally accepted standards for exchange of information on tax matters.
- Limitation of Benefit clause has been inserted to provide a 'main purpose test' to prevent misuse of the DTAA and allow application of domestic law against tax evasion and avoidance.
- In line with BEPS Action Plan to meet minimum standard of providing access to Mutual Agreement Procedure in transfer pricing cases, the protocol includes specific provisions to facilitate relieving economic double taxation in transfer pricing cases.
- It replaces the existing Article on 'Assistance in Collection of Taxes' with a new Article to align it with international standards.

b. Requirement for obtaining PAN card u/s 139A of Income-tax Act, 1961 eased for corporate taxpayers

(Press release dated 14 April 2018)

- In case of a company, an application for incorporation, allotment of PAN and allotment of TAN may be made through a Common Application Form submitted to the MCA. In these cases, the COI issued by MCA contains a mention of both PAN and TAN.
- The Finance Act, 2018 amended section 139A of the Income-tax Act, 1961 and removed the requirement of issuing PAN in the form of a laminated card. Hence, the CBDT has clarified that PAN and TAN mentioned in the COI issued by MCA will also be treated as sufficient proof of PAN and TAN for the said company taxpayer.

c. CBDT notifies protocol amending the DTAA between India and Kuwait

(Press release dated 7 May 2018)

A protocol to amend the existing DTAA between India and Kuwait for the avoidance of double taxation and for the prevention of fiscal evasion with respect to taxes on income was signed on 15 January 2017. The said protocol has entered into force on 26 March 2018.

The protocol updates the provisions in the DTAA for exchange of information as per international standards. Further, it enables sharing of the information received from Kuwait for tax purposes with other law enforcement agencies with authorisation of the competent authority of Kuwait and vice versa.

d. Extension of time of the Task Force for drafting a New Direct Tax Legislation

(Press release dated 22 May 2018)

A Task Force was constituted by the government in November 2017 to review the existing Income-tax Act, 1961 and to draft a new direct tax law in consonance with economic needs of the country. It was required to submit its report to the government within six months. The government has now extended the term of said Task Force by a period of additional three months.

e. Amendment in valuation rules for unquoted equity shares [under Rule 11UA (2)(b) of Income-tax Rules, 1962]

(Press release dated 24 May 2018)

Income Tax Rule 11UA deals with determining the FMV of jewellery, archaeological collections, shares and securities for the purpose of Section 56. As per Clause (b) of Sub-Rule 2 of Rule 11UA, merchant bankers and accountants were allowed to determine the FMV of unquoted equity shares as per the Discounted Free Cash Flow method. Notification No. 23/2018 dated 24 May 2018 amended Rule 11UA(2)(b) to omit accountants from determining FMV for unquoted equity shares.

f. CBDT issues final notification on taxation of foreign companies with POEM in India

(Notification No. 29/2018/F.No. 370142/19/2017-TPL dated 22 June 2018)

CBDT has recently issued a final notification providing modifications, exceptions and adaptations that are allowed to a foreign company treated as a resident in India by virtue of its POEM being in India. The notification provides for the determination of the WDV of the assets, brought forward loss and unabsorbed depreciation; applicability of provisions relating to tax deduction at source; and claim of taxes paid in foreign jurisdiction. Further, it has been clarified that the provisions of the notification will not apply to income which was taxable in India, irrespective of the company's residential status. The key feature of the notification is as under:

i. Determination of WDV of the assets

The opening WDV of the assets of a company assessed to tax and required to account for depreciation on its assets shall be taken as per the tax records. However, a company which is assessed to tax but not required to account for depreciation shall have to compute its WDV assuming that requisite depreciation has been claimed as required by the laws of the foreign jurisdiction. The 'book WDV' shall be considered for a company not assessed to tax in the home jurisdiction.

ii. Treatment of brought forward loss/ unabsorbed depreciation

Basis of computation:

Losses brought forward and unabsorbed depreciation as per the tax records shall be considered for set-off where the foreign company is assessed to tax. Where the foreign company is not assessed to tax, brought forward loss/unabsorbed depreciation as per the books of account shall be allowed to be brought forward for India tax purposes.

Limitation on carry forward of losses:
Losses shall be allowed to be carried forward up to eight years from the year of incurrence in the home jurisdiction.

Mode of set-off: Set-off of losses/unabsorbed depreciation shall be allowed only against such income which becomes chargeable to tax in India on account of its POEM in India, ie set-off shall not be available against income which was chargeable to tax in India, irrespective of the residential status of the foreign company.

Variation in accounting period: In case the accounting period of the foreign company does not end on 31 March, the foreign company would be required to draw up its accounts in the manner prescribed up to 31 March of the year preceding the financial year in which its POEM was established in India. The brought forward loss/depreciation shall be allocated proportionately to determine the loss/depreciation eligible to be brought forward for India tax purposes.

Subsequent revision of amount: In case of any revision/ modification in the brought forward losses and unabsorbed depreciation of the foreign company as originally adopted in India, due to any action of the tax or legal authority, such revision shall be factored accordingly for the purposes of carry forward and set-off.

Applicability of TDS provisions

It has been clarified that compliance with TDS provisions applicable to a foreign company prior to its becoming an Indian resident shall be considered sufficient compliance. In case of a conflict in the provisions, the TDS provision applicable to a foreign company shall prevail over the TDS provision applicable to a resident

Claim of credit of foreign taxes paid

Credit of foreign taxes paid shall be allowed in accordance with the provisions in domestic tax law or tax treaty as may be applicable. Further, where an income is offered to tax in India in more than one year, credit of tax shall also be spread over those years in the same proportion in which such income is offered/assessed to tax in India.

Applicability of the notification in the succeeding year

The notification shall also apply to the succeeding year where the foreign company continues to have a POEM in India subject to the condition that the WDV, brought forward loss and unabsorbed depreciation adopted on the first day of the succeeding year shall be those as have been arrived at on the last day of the preceding previous year in accordance with the provisions of this notification.

Applicability of the notification to foreign income

It has been clarified that the tax exceptions, modifications, etc as referred to in the notification (ie WDV, brought forward losses and unabsorbed depreciation, foreign tax credit, etc.) shall be available only in respect of such income of the foreign company which is chargeable to tax in India pursuant to its becoming a resident in India.

Conflict between provisions applicable to a resident and a foreign company

It has been clarified that in case of conflict between the provisions applicable to a foreign company as a 'resident' and as a 'foreign company', the latter shall generally prevail. Thus, a foreign company will be subject to the 40% tax rate as applicable to foreign companies even though it is treated as an Indian resident by virtue of POEM provisions.

Our comments: A foreign company which becomes a resident in India due to its POEM would need to offer its global income to tax in India and undertake requisite tax compliance as well. The fact that POEM may be determined in the course of assessment proceedings would pose timing challenges in undertaking India tax compliances.
The modifications provided in the notification bring in some clarity and ease of compliance. However, there are still areas, such as compliance with transfer pricing regulations, advance tax and minimum alternate tax, on which clarity will be welcome.

Indirect tax updates

g. Country-wide intra-state e-way bill system mandatory from June 2018

The government had made e-way bill mandatory for inter-state movement of goods w.e.f.1 April 2018 vide Notification No. 15/2018-Central Tax dated 23 March 2018. It is mandatory to generate the e-way bill for intra-state movement of goods in all the states from June 2018. Already, many states have made the e-way bill mandatory for intra-state movement of goods vide various notifications issued under the state GST acts of the respective states.

h. Simplifying the process of furnishing Letter of Undertaking

It was clarified by Government vide Circular No 40/14/2018-GST dated 6 April 2018 that a Letter of Undertaking has been deemed to have been accepted as soon as an Application Reference Number is generated and no documents need to be physically submitted to the department.

i. Key highlights of the 27th GST Council meeting held on 4 May 2018 as per the press release issued by MoF:

The GST Council has made the following key proposals during the meeting held on 4 May 2018

i. One monthly return

Every registered dealer except composition dealers to file one monthly return and return filing date to be determined based on turnover of such person. Composition dealers and dealers having nil transaction to file quarterly returns.

ii. Unidirectional flow of invoices

Invoices to be uploaded by seller will be available for viewing on real-time basis and the buyer can claim input tax credit based on the uploaded invoices. Invoices for B2B transactions to use harmonised system of nomenclature at four-digit level or more.

iii.Concessional rate of GST for digital payments

Keeping in view the need to move towards a less-cash economy, the GST Council has proposed a concession of 2% in the GST rate where the GST rate is 3% or more on B2C supplies, for which payment is made through cheque or digital mode, subject to a ceiling of INR 100 per transaction.

j. Levy of GST under Reverse Charge Mechanism on Priority Sector Lending Certificate

The Government has issued Notification No.11/2018-Central Tax (Rate) dated 28 May 2018 which seeks to amend Notification No. 4/2017-Central Tax (Rate) dated 28 June 2017 so as to notify levy of GST on Priority Sector Lending Certificate under Reverse Charge Mechanism.

Key jurisprudence

Direct tax

a. TechSpan India Private Ltd & Anr [TS-200-SC-2018]

A tax officer can re-open a closed assessment order where he/she has 'reason to believe' that some income has escaped assessment. However, in this case the SC has held that 'reason to believe' should be interpreted schematically and the tax officer should not reopen a case on the basis of mere change of opinion.

In this ruling, the SC held as under:

- The SC relied on its ruling in the case of Kelvinator of India Ltd, wherein it was held that a tax officer has no power to review but has the power to re-assess and re-assessment cannot be made on the basis of 'mere change of opinion'.
- The SC analysed the meaning of 'forming of an opinion', which means formulation of belief on a particular question as a result of understanding, experience and reflection. Therefore, it was held, a 'change in opinion' would occur only if there was an earlier formulation of an opinion.
- The SC stated that it is important to verify whether the tax officer in his/her original assessment order has expressly or by necessary implication expressed an opinion on the matter for which the re-assessment proceedings have been initiated.
- The SC further stated that where the original assessment order is non-speaking, cryptic or perfunctory in nature, it may be difficult to conclude that the tax officer has formed an opinion on the issues raised during the course of re-assessment proceedings.

Our comments: Interpretation of the words 'reason to believe' in the context of re-assessment proceedings has been the subject matter of litigation. The SC in this ruling has reaffirmed its earlier decisions that merely a 'change of opinion' based on the same facts cannot be a sufficient reason to believe that income has escaped assessment. In this case, the SC laid emphasis on the evidence of formation of opinion at the stage of original assessment and held that it must be discernible, either from expressed words or by necessary implication

b. JM Financial Services Ltd [ITA no.3041 / Mum / 2016)]

The taxpayer was engaged in the business of capital market broking and other activities related to securities business. During a tax survey, discrepancies were found relating to non-deduction of tax at source on certain expense incurred under the head finance cost. The said expense was paid in relation to payment made to NSCCL under SEBI Securities Lending and Borrowing Scheme, 1997 for settling short selling of securities.

The taxpayer relied upon the decision of the Hon'ble Jurisdictional HC in case of Industrial Development Bank of India v ITO, 293 ITR 267 (Bombay) and contended that since the identity of the persons to whom the amount is ultimately paid or credited is unknown, TDS provisions cannot be applied.

The tax officer did not find any merits on taxpayer's argument and observed that NSCCL is neither exempt from provisions of TDS under section 197(1) of the Act nor exempt by way of any CBDT circular or notification.

On further appeal, the CIT(A) upheld the order of the tax officer.

The Hon'ble ITAT held that the CIT(A) had correctly appreciated the role of NSCCL that NSCCL only acts as an intermediary or facilitator of the transaction of lending and borrowing securities and that the borrowing fee is not an income of NSCCL. On the issue of withholding of tax on amount paid by the taxpayer to the lenders of securities through NSCCL, the ITAT found force in the taxpayer's contention that since the identity of the persons to whom the amount is ultimately paid or credited is not known, TDS provisions cannot be applied. However, ITAT restored the matter to the tax officer to ascertain the taxpayer's claim that the identity and other details of the lenders were not known at the time of paying the borrowing fee to NSCCL or even prior to it.

Our comments: The ITAT's decision may be relevant for companies operating as approved financial intermediaries under the SEBI Regulations or any other Regulations, where the identity of the ultimate payee is not known at the time of making the payment to an intermediary.

c. CIT v Virtual Soft Systems Ltd [TS-205-SC-2018]

The taxpayer leased out certain assets on a finance lease. In its books of account, it followed the Guidance Note on Accounting for Lease and claimed a deduction of lease equalisation charges apart from depreciation as prescribed. The lease equalisation charges were claimed as deductible along with depreciation in the tax computation. The tax officer disallowed the claim made in the return of income and added it to the income of the taxpayer. The disallowance was upheld by the CIT(A).

On further appeal, the ITAT agreed with the taxpayer's contentions, which were also upheld by the HC. Aggrieved with the HC order, the Revenue Department filed an appeal in the SC.

The SC upheld the tax deductibility of lease equalisation charges from the lease rental earned by a taxpayer in the course of a finance lease transaction. The lease equalisation charges were reduced from the rental amount by the taxpayer in accordance with the Guidance Note on Accounting for Leases issued by the ICAI. The SC has also held that there is no express bar in the Income-tax Act, 1961 regarding the application of AS issued by ICAI.

Our comments: The decision of the Apex Court giving finality to the tax treatment of lease equalisation charges is a positive step, and it also reaffirms the applicability of the AS issued by the ICAI for determination of 'real income' for the purpose of tax computation. It is important to note that this Guidance Note is not applicable for assets leased on or after 1 April 2001. In respect of such assets, either AS 19 Leases or Ind AS 17 Leases is applicable. Under AS 19 as well as Ind AS 17, assets given on a finance lease are de-recognised and finance income is recognised based on a pattern that reflects a constant periodic rate of return on the net investment. Thus, a finance lease under AS 19 or Ind AS 17 does not require any lease equalisation adjustment.

Further, lease equalisation is prescribed for accounting of an operating lease where relevant. In this regard, while the SC decision does indicate that lease equalisation reflects 'real' income, one would need to evaluate its applicability in case of operating lease transactions.

d. M/s. Vora Financial Services P Ltd v ACIT (ITA No. 532/ Mum/ 2018)

The Mumbai bench of the ITAT ruled that buy-back of its own shares by a closely held company at less than the book value of such shares would not be considered as income from other sources under the provisions of the Act.

The ITAT held that for such provisions to be attracted, the shares should become property of the recipient. In the present case, the taxpayer had purchased its own shares under a buy-back scheme and the shares were extinguished by reducing the capital.

Since the shares did not meet the test of becoming 'property' of the company, provisions relating to income from other sources could not be invoked in case of buy-back of own shares.

Thus, the ITAT held that the shares referred to in the definition of 'property' cannot be own shares but have to be shares of any other company.

Our comments: The applicability of provisions relating to income from other sources to share buy-back transactions has been a grey area in the absence of any specific guidance or judicial pronouncement. This judgement now provides some clarity to companies on the taxability of share buy-back transactions.

Transfer pricing

e. Citi Financial Insurance (I) Ltd [TS-339-ITAT-2013(Mum)-TP]

The taxpayer, Citi Financial Insurance (I) Ltd, an insurance intermediary, is engaged in the insurance business as a corporate insurance agent. During assessment proceedings, the tax officer observed that the taxpayer had debited professional charges at INR 2.61 cr in the P&L account, which included a payment of INR 2.58 cr to its AE (Citi Bank NA) as referral fees/royalty. The taxpayer explained that the payment was for using the AE's database to sell policies. The tax officer disallowed the entire payment u/s 37 of the Act on the ground that the service agreement between the taxpayer and its AE was invalid and that no services were rendered by the AE. Alternatively, the tax officer held that the international transaction was not at ALP. The CIT(A) confirmed the tax officer's action and disallowed the entire claim. Aggrieved, the taxpayer preferred an appeal before the Mumbai ITAT.

The ITAT remarked that the primary onus was on the taxpayer to establish that the payments were made against the services rendered by the AE. However, the ITAT noted that while the tax officer emphasised much on the validity and legality of the agreement, the merits of the issue, nature of service and whether the services were rendered by the AE were not dwelt upon. The ITAT further observed that Revenue had also not dealt with the TP issues and computation of the ALP but had restricted his finding to disallowance u/s 37.

The ITAT therefore remanded the matter back for fresh adjudication with a direction to record findings on the aspect of rendering of services by the AE and the nature of services, irrespective of the agreement in question.

Our comments: Lack of robust documentation to substantiate the authenticity of the services availed is a key concern in the above litigation. Also, the fact that only availability of documents/ agreement cannot be the deciding factor but appropriate proofs/ documents are needed to support the need, the benefit test will have to be supplemented to strengthen the taxpayer's case.

f. Swiss Re Global Business Solutions India Private Ltd (TS-161-ITAT-2018(Bang)-TP)

The taxpayer, Swiss Re Global Business Solutions India Private Ltd, is engaged in the provision of Information Technology Enabled Services (ITES).

During AY 2013–14, the TPO rejected certain comparables applying various filters for excluding the comparables taken in the TP study by the taxpayer for provision of ITES leading to a transfer pricing adjustment of INR 5 cr.

The assessee contended that the TPO did not apply these filters uniformly to all the comparables either taken by the assesse or selected by himself. For instance, the TPO excluded certain comparables whose ITES income is less than 75% of its

total operating revenue, without considering the fact that the segmental details of the comparables are readily available. The TPO further rejected certain functionally similar comparables, which were proposed by the taxpayer during TP assessment proceedings.

The ITAT noted that while selecting the comparables, the tax officer also failed to apply the filters uniformly to all the comparables and hence remitted the issue back to the TPO to re-examine the comparables selected by the assessee in its TP study as well as the comparables selected by the TPO by applying the same filters uniformly.

Our comments: Uniformity in selection or rejection process of comparables has been the subject matter of litigation. Taxpayers need to take care of consistency and uniformity aspect when it comes to selection process of comparables.

g. GKN Driveline (India) Ltd [TS-297-ITAT-2018(DEL)-TP]

The Delhi Bench of the ITAT in this case held that an AE cannot be considered a tested party if sufficient details are not made available to ascertain that the AE is a tested party with least complex operations and limited risks.

During AY 2012–13, the taxpayer had entered into various international transactions and followed the transaction-by-transaction approach to determine the ALP. During the TP assessment proceedings for AY 2012–13, the tax officer proposed adjustment on the purchase of raw materials and components from the AE. The tax officer contended that sufficient details of the AE (financial statements, etc) were not provided and hence rejected the selection of the AE as a tested party.

The ITAT decided not to set aside the matter to the tax officer as the taxpayer was unable to submit the AE's financial data before the lower authorities as well as before the ITAT.

Our comments: Accessibility to data in order to substantiate FAR or characterisation of tested party in the context of the said transaction has been the subject matter of litigation. Taxpayers need to be more careful to ensure that the data available with them in relation to AEs as well as overseas comparables is complete and transparent. Taxpayers in any industry can face this issue.

Indirect tax

h. DBS Bank Limited India Branches v Union of India & Anr [W.P.(C) 8732/2017]

A writ petition was filed by DBS Bank on 25 September 2017 challenging the levy of IGST on the services provided to its head office situated outside India. The bank contended that there was no levy of service tax on such transactions before implementation of GST. Further, the provision under section 7(5)(a) of IGST Act, 2017 which deems such transactions to be an inter-state supply violated Article 14 of the Constitution of India.

However, the said writ petition has now been withdrawn.

i. Punjab National Bank v Commissioner of Central Excise and Service Tax Bhopal (2018-TIOL-1395-CESTAT-DEL)

The Punjab National Bank (the Bank) insured the deposits made by various parties as mandated by DICGC. CENVAT credit of service tax charged on the insurance charges was denied on the grounds that insurance of deposit is not an input service.

CESTAT remarked that there is certain level of risk against lending which is made out of deposits received from depositors. Therefore, in taking insurance to protect the interest of the bank being integrally connected with the business of banking, CENVAT credit of service tax paid claimed is allowable.

Accordingly, the appeal was allowed with consequential relief.

Glossary

AE	Associated Enterprise
ALP	Arm's Length Price
AS	Accounting Standard
AY	Assessment Year
BEPS	Base Erosion and Profit Shifting
BO	Beneficial Owner
CBDT	Central Board of Direct Taxes
CENVAT	Central Value Added Tax
CESTAT	Customs, Excise and Service Tax Appellate Tribunal
CIT(A)	Commissioner of Income Tax (Appeals)
COI	Certificate of Incorporation
DDPs	Designated Depository Participants
DICGC	Deposit Insurance and Credit Guarantee Corporation
DTAA	Double Taxation Avoidance Agreement
ECB	External Commercial Borrowings
FATF	Financial Action Task Force
FDI	Foreign Direct Investment
FMV	Fair Market Value
FPI	Foreign Portfolio Investment
FY	Financial Year
GDP	Gross Domestic Product
G-sec	Government Securities
GST	Goods and Services Tax
HC	High Court
HFCs	Housing Finance Companies
HUF	Hindu Undivided Family
IBC	Insolvency and Bankruptcy Code
IBUs	International Banking Units
ICAI	Institute of Chartered Accountants of India
IFSC	International Financial Service Centre
IGST	Integrated Goods and Service Tax
IM	Investment Manager
Ind-AS	Indian Accounting Standard
ITAT	Income Tax Appellate Tribunal
KYC	Know Your Client
LIBOR	London Inter Bank Offer Rate
MCA	Ministry of Corporate Affairs
LRS	Liberalised Remittance Scheme
MoF	Ministry of Finance
MSMEs	Micro, Small and Medium enterprises
NBFCs	Non-Banking Finance Companies
NPAs	Non-Performing Assets
NRIs	Non-Resident Indians
NSDL	National Securities Depository Limited
OCI	Overseas Citizen of India
PAN	Permanent Account Number
PIO	Person of Indian Origin
POEM	Place of Effective Management
PMJDY	Pradhan Mantri Jan Dhan Yojna
RBI	Reserve Bank of India
RDBs	Rupee Denominated Bonds
SC	Supreme Court
SDLs	State Development Loans
SEBI	Securities and Exchange Board of India
SEZs	Special Economic Zones
SRs	Security Receipts
TAN	Tax deduction and collection Account Number
TP	Transfer Pricing
TPO	Transfer Pricing Officer
USD	United States Dollar
WDV	Written Down Value

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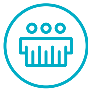
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