Union Budget 2014-15

Banking, Financial services and Insurance

July 2014

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Overview

At a time when businesses across industries were looking forward to new reforms, improved focus on economic growth and investments, the BFSI sector being the lifeline for the growth, especially had a long wishlist.

The Finance Minister made a note of the importance of the BFSI sector in propelling growth in the economy and has mentioned that the Government aims to provide all households with banking facilities to empower the weaker sections. While banking licences were given to some corporates recently RBI has also been tasked to create a framework for licenses of small banks. The Finance Minister has also stated that he will examine proposals to give additional autonomy to banks.

FDI in insurance to be increased to 49%: A very welcome move for the capital-starved insurance sector which has low penetration levels currently and needs to invest in deepening and widening its reach within India.

While some clarifications still remain unanswered like bringing the FPI at par with FII for tax benefits there is lots to rejoice with the clarification on the nature of income of FII's and given the intent of the Government, we believe a lot of other such issues will get resolved in due course…

We share herein some of the key policy initiatives for this sector in the Budget and the tax proposals!

Key policy initiatives

Government has proposed a constructive roadmap for strengthening the BFSI sector. While presenting the Budget, the finance minister said financial stability is the foundation of a rapid recovery.

The financial sector is critical for the growth of Indian economy. The recommendations of Financial Sector Legislative Reforms Commission such as enactment of the Indian Financial Code are considered essential to enhance governance and accountability.

Capital markets have been the center of risk capital for growth of India. A number of measures to fuel the capital markets have been proposed vide the Budget. Financial security is key to recovery and thus the Banking system needs to be strengthened.

Some of the major challenges faced by the financial services industry in the prevailing economic conditions include the following:

- Lack of availability of long term financing for infrastructure has been a hurdle in boosting greater participation by private sector
- Increase in Non Performing Assets of public sector banks
- Insurance penetration and density being very low, benefits of insurance are yet to reach the people at large
- Decline in savings rate at a micro level
- Rising inflation

Key policy initiatives

Government has accorded importance to fiscal prudence and has proposed to provide stable and investor friendly tax regime. Some of the key policy initiatives have been summarised below:

Financial sector

- liberalisation of American Depository Receipts / Global Depository Receipts regime to allow issuance of depository receipts on all permissible securities
- withdrawal of restrictions and deepening of currency derivative markets and corporate bond market
- International settlement of Indian debt securities allowed
- Uniform Know Your Customers (KYC) norms for entire financial services sector and inter-usability of the KYC records
- Single DMAT account for all financial products
- Similar tax treatment for pension fund and mutual fund linked retirement plan
- revamp of Indian Depository Receipts
- Introduction of a liberal and ambitious Bharat Depository Receipts

Capital market

- Ongoing process of consultations with all the stakeholders on the enactment of the Indian Financial Code and reports of the Financial Sector Legislative Reforms Commission to be completed
- On going consultation with all stakeholders on the enactment of Indian Financial Code
- Monetary Policy Framework to be announced in consultation with Reserve Bank of India
- In order to strengthen capital market, adoption of New Accounting Standards for Indian companies voluntary from Financial Year 2015-16 and mandatory from Financial Year 2016-17

Key policy initiatives

Banks

- Infusion of additional capital by way of equity in line with Basel-III norms
- Shareholding of public sector banks to be divested in a phased manner by increasing shareholding of Indian citizens
- Reserve Bank of India to create framework for license of small banks and for other differentiated banks
- Six new Debt Recovery Tribunals to be set up to recover Non Performing Assets
- Banks will be encouraged to extend long term loans to infrastructure sector with flexible structuring
- Banks will be permitted to raise long term funds for lending to infrastructure sector with minimum regulatory pre-emption such as Cash Reserve Ratio, Statutory Liquidity Ratio and Priority Sector Lending

Insurance

- Foreign Direct Investment (FDI) enhanced from 26% to 49% with full Indian management and control
- Additional FDI introduced under Foreign Investment Promotion Board approval route
- Pending Insurance Law Amendment Bill to be brought for consideration of Parliament

Mutual Fund/Venture Capital Funds/Venture Capital Companies/Securitisation Trusts

- Pass through status for Real Estate Investment Trust (REIT)
- Modified REIT type structure to be introduced in order to boost Infrastructure sector as Infrastructure Investment Trusts (InvTrusts)
- Attract long term finance from foreign and domestic investors

Key policy initiatives

Tax proposals

- A high level committee to be set up by the CBDT to scrutinise all fresh cases arising out of retrospective amendments through Finance Act, 2012 in respect of indirect transfer
- A high level committee to be set up to interact with trade and industry on a regular basis. Clarifications on tax issues to be provided by CBDT and CBEC based on the recommendations of such committee
- Kissan Vikas Patra (KVP) to be reintroduced
- National Saving Certificate with insurance cover to provide additional benefits for small saving class

Direct tax proposals

Disallowance of expense in case of TDS defaults

Payments to non-resident:

- Presently, any default in depositing TDS on non-residents payments within the time frame prescribed, results in disallowance of the expense under Section 40(a)(i) of the Income Tax Act (the Act). The expense so disallowed is deductible in the year in which the TDS is deposited
- Budget proposes to allow such expenses in the year of incurrence itself, if the tax is withheld in the year and is deposited before the due date for filing the tax return for that year

Payments to resident:

- Presently, any default in depositing TDS with respect to certain payments to residents, results in disallowance of the entire expense under Section 40(a)(ia) of the Act
- Budget proposes to limit the disallowance to 30% of the expense
- Currently, non-deposit of TDS on certain expenses results in disallowance of the expense. Budget proposes to widen the ambit of disallowance under the Section 40(a)(ia) by including all amounts payable to residents on which tax is deductible
- The amendment is proposed to be effective from FY 2014-15

Direct tax proposals

Amendment in definition of non speculative transaction under Section 43

- Budget has proposed that commodity derivatives transactions which is chargeable to commodities transaction tax of Chapter VII to Finance Act 2013, will only be considered as non speculative transaction
- This was also earlier clarified by the CBDT while explaining provisions of Finance Act, 2013. This proposed amendment will have retrospective effect and will be applicable from FY 2013-14

Dividend Distribution Tax (DDT)

- Under the existing provisions, a domestic company is liable for payment of DDT at the rate of 15% on any amount declared, distributed or paid by way of dividends to the shareholders under Section 115-O
- Budget proposes to amend this Section to provide that DDT shall be levied on grossed up distributable amount i.e. the amount distributed and the DDT amount
- This amendment will take effect from 1 October 2014

Considering the proposed mechanism of computing tax on dividends distribution by corporates, the tax outflow will increase

Direct tax proposals

Payments in respect of certain life insurance policies are liable for tax withholding

- New Section 194DA proposes tax withholding on payment in respect of life insurance policies where proceeds are not tax exempt
- Tax withholding will apply @ 2% on payment in excess of Rs 1 lakh
- This provision will take effect from 1 October 2014

Transfer of Government security

- Transfer of government securities (carrying periodic interest payouts) between two non-residents are not to be considered as transfer for the purpose of taxation under the head of capital gains
- This provision will take effect from FY 2014-15

The proposal to keep transfer of Government securities between two non-residents outside the ambit of capital gains and will pave the way for more foreign investors

Long term capital gains on transfer of units - withdrawal of concessional rate

- In case of listed securities, mutual fund units and zero coupon bonds tax on long-term capital gains is restricted to 10% of capital gains, without providing the benefit of indexation. It has been proposed to restrict the benefit of 10% taxation to listed securities (other than units) and zero coupon bonds, as long-term capital gains is exempt in case of transfer of an equity oriented fund which are subject to securities transaction tax
- This provision will take effect from FY 2014-15

The amendment has clarified several ambiguities. This is because this provisions exempts the long-term gains on sale of units of equity oriented mutual funds from tax liability

Direct tax proposals

Introduction of a new taxation regime for REIT and InvTrust (Business trust)

- Budget has brought in the tax framework for REITs and InvTrusts, even though the regulations are yet to be notified by the SEBI
- Salient features of REITs / InvTrust:
  - Units of REIT and InvTrust to be listed on recognised stock exchanges in India
  - Income bearing assets to be held under Indian Special Purpose Vehicles (SPVs), which in turn would be held by REIT/ InvTrust
  - Units of REIT/ InvTrust to be granted same status as listed equity shares i.e. they will be liable to the same rates of Securities Transaction Tax (STT) as well capital gains tax
  - Swap of shares of SPV by Sponsors for units of REIT/ InvTrust would be exempt
- These provisions are proposed to take effect from 1 October 2014
- Budget proposes to provide a clear tax framework for REITs. This will pave way for the advent of REIT in India. The regulatory framework of REIT is still in a consultative stage. However, in the present form , REIT funds would substantially be available for the acquisition of completed and income bearing assets. The risk profile of the REIT assets can perhaps be increased, and a little more than a mere 10% can be made available for assets other than completed and income bearing assets

Direct tax proposals

Taxability of REITs / InvTrusts:

Nature of income	REITs / InvTrusts	Unit holders
Interest	Exempt (considered as pass through)	Taxable (on distribution) (Non-resident – 5%, Others – 10%)
Dividend	Exempt	Exempt
Capital gains on exit by REITs/ InvTrusts	At the rates applicable to income under the head capital gains	Exempt (on distribution)
Capital gains on sale of units of REITs/ InvTrusts	NA	Long-term – exempt Short-term – 15% (in case of sponsors long term – 20%, short term – 30%, period of holding and cost of shares of SPV considered)
Other income	Maximum Marginal Rate	Exempt (on distribution)

Mechanism to compute distributed income by mutual funds

- As per the existing regime, the income distribution tax payable by mutual funds is computed on the amount of distributed income. There has been some ambiguity around the term distributed income. This is regarding whether it is to be considered as net of additional tax or as a gross value. In order to end the uncertainty, the mechanism of computing distributed income for the purpose of discharging additional tax has been proposed. Under the proposed mechanism, the additional tax needs to be computed on the distributed income before deduction of additional tax i.e. after computing the gross value
- This provision will take effect from 1 October 2014

Considering the proposed mechanism of computing tax on dividends distribution by mutual funds, the tax outflow will increase which would impact the mutual fund industry

Direct tax proposals

Tax withholding on interest income earned by non-resident

Tax withholding at the rate of 5% on interest payment for non-residents in respect of foreign currency borrowings is proposed to be extended to business trusts as well

Such concessional treatment is proposed to be applicable for monies borrowed before 1 July 2017 (as against the present time limit of 1 July 2015)

Under the existing provisions, apart from foreign currency loan, this reduced withholding tax rate of 5% applies only to interest on long-term infrastructure bonds. This benefit is now proposed to all long-term bonds (i.e. whether infrastructure bonds or not)

This provision will be effective from 1 October 2014

Mandatory filing of return of income

- Following entities are mandated to file a return of income if their income exceeds maximum amount not chargeable to tax without giving effect to exemption provisions prescribed under Section 10 of the Act

  1. Mutual Funds covered under Section 10 (23D) of the Act
  2. Securitisation Trusts covered under Section 10(23DA) of the Act
  3. Venture Capital Company or Venture Capital Funds covered under 10(23FB)

- Infrastructure Investment Trust and Real Estate Investment Trusts are also mandated to file a return on income
- This provision will take effect from FY 2014-15

Indirect tax proposals

Service Tax

- The following services has been exempted effective from 11 July 2014 by including the same in the Mega Exemption notification:
  - Life micro-insurance products [*have the same meaning assigned in Regulation 2(e) of the Insurance Regulatory and Development Authority (Micro-Insurance) Regulation, 2005]* approved by the Insurance Regulatory and Development Authority, with maximum amount of cover of INR 50,000.
  - Services received by the Reserve Bank of India from outside India in relation to management of foreign exchange reserves such as external asset management, custodial services, securities lending services

Reverse Charge

- 100% reverse charge on services received from recovery agents by banks/financial institutions

General update

- No amendments have been proposed regarding general tax rate structure of Indirect taxes levied in India
- No concrete announcement on GST implementation timeline and roadmap
- Government hopes to find a solution during this fiscal and approve the legislative scheme in discussion with States after giving due consideration to their apprehensions

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