Finance Industry Development Council

(A body incorporated as a Self Regulatory Organisation for Registered NBFCs – AFCs)

January 07, 2013

Shri. P. Chidambram
Finance Minister
Government of India
North Block
New Delhi - 110 001.

Hon'ble Finance Minister Sir,

SUB: PRE-BUDGET MEMORANDUM - ISSUES RELATING TO ASSET FINANCING NBFCs

Finance Industry Development Council (FIDC) is a Self Regulatory Organization (SRO) cum Representative Body of all the Asset Financing NBFCs, (NBFC-AFCs) registered with the Reserve Bank of India .

Sir, we take this opportunity to express our sincere thanks to Ministry of Finance for inviting us to present our views/issues during the Pre-Budget Discussion every year. Encouraged by this initiative, we are pleased to submit herewith the issues and concerns of NBFC-AFCs for your consideration in the forthcoming Union Budget 2013-14.

1. Role of NBFCs in Promoting Financial Inclusion: Need for Recognition

NBFCs have been recognized for their role in credit delivery in remote corners of India and have carved a niche for themselves in the semi-rural and rural segments of the country. NBFC-AFCs are also playing a vital role in furthering the cause of Financial Inclusion and in credit dispensation to the poor states/credit starved areas for over 5 decades. They specialize in financing to productive assets in the Transportation, Agricultural, infrastructure and SME segments and their customer segments include , First time buyers, SRTOs, Agricultural and Weaker sections of the society, involving people who normally either cannot approach banks for their credit requirements or are unable to provide appropriate documentary proofs of their creditworthiness to the banks. Considering that such are the customers being catered to by the NBFC-AFCs, it is acknowledged time and again that they are thus playing a vital role in enabling the informal segment customers, who are "unbanked", to move away from the Money lenders to an Organised financier and over a period of time move them into the formal segment which enables these customers to be recognised and serviced by the Banking segment as well and thus become "bankable".

However, all talks on Financial Inclusion include banks and Micro Financing Institutions (MFIs) only and leave out NBFCs. This has manifested in NBFCs being denied certain benefits/incentives in areas pertaining to Fund Raising, Taxation and Recovery.

We therefore request you to include NBFC-AFCs in the Government's agenda/action plan for promoting financial inclusion, more so, when the regulatory framework for NBFCs is almost at par with banks.

2. RBI Working Group on NBFCs Has Recommended Tax-Parity with Banks:

Recently, The Working Group on NBFCs constituted by RBI under the chairmanship of Smt. Usha Thorat (Rtd. Deputy Governor RBI) has made recommendations to plug the so called Regulatory Arbitrage between banks and NBFCs. RBI has already issued draft norms based on these recommendations. The Working Group has also recommended that there should be tax-parity between banks and NBFCs.

We therefore request you to kindly grant tax-parity with banks by extending certain tax benefits which are available to banks, public financial institutions etc but have been denied to NBFCs.

The tax issues are explained in detail in the attached Annexure.

We shall be glad to supplement this representation with any additional information that may be required.

We thank you in anticipation of a positive response and assure you of our full co-operation always.

Thanking you,

Yours Faithfully,

For **FINANCE INDUSTRY DEVELOPMENT COUNCIL**

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Encl. As above

Annexure

DIRECT TAX ISSUES

1. TDS on Interest (Sec 194A) – Request for Exemption

As per Sec 194A of the Act, TDS @10% is required to be deducted on the interest portion of the installment paid to NBFCs under loan/finance agreements whereas banking companies, LIC, UTI, public financial institution etc are exempted from the purview of this Section.

NBFCs carry on the financing business mostly to retail customers who are in unorganized sectors which includes large number of individuals, HUFs and SME sectors. Thus, single point collection of tax by way of advance tax payments from NBFCs would mean greater convenience to the department than collecting tax through large number of such customers from all over the country by way of tax deduction at source.

Apart from this, the distinction in the provision puts NBFCs in a disadvantageous position and creates severe cash flow constraints since NBFCs operate on a very thin spread/ margin on interest which at times is even lesser than the TDS deductible on the gross interest and reduces the effective interest rate of the NBFCs on the loans given. NBFCs are bank- like institutions. Therefore, *NBFCs should also be given exemption under section 194A.*

The additional limitations of the existing system are the following:

a) Follow up with every customer for TDS certificates every quarter (details of which are mandatory for claiming the same in the I. T. return) becomes almost impossible. NBFCs have clients who number in thousands and it is practically very difficult to collect details from everyone.

b) Even if the TDS certificate is issued by the customer, if TDS return has not been filed or not filed properly, the credit for such TDS would not be granted to the NBFC as the details of such TDS would not appear in the NSDL system.

c) Once the TDS credit is disallowed, the NBFCs have a hard time following up with the customers and the exchequer has a hard time clearing outstanding demands against NBFCs which, in reality, do not exist.

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2. Tax benefits for Income deferral u/s.43D of the Income Tax Act

Section 43D of the Income Tax Act recognises the principle of taxing income on sticky advances only in the year in which they are received. This benefit is already available to Banks, Financial Institutions and State Financial Corporations. This benefit has also been extended to Housing Finance Companies by the Finance Act, 1999.

In accordance with the directions issued by the RBI, NBFCs follow prudential norms and like the above institutions are required to defer income in respect of their non-performing accounts. Since the directions are mandatory in nature, NBFCs have to adhere to the said directions in preparing their accounts. However, the income tax authorities do not recognise these directions and tax such deferment of income on accrual basis. It is but appropriate that the Income tax authorities accept this principle of income deferral in the case of NBFCs also, who are the only segment of the financial sector denied this tax benefit. *It is, therefore, suggested that Sec.43D of the Income Tax Act be extended to include in its scope NBFCs registered with RBI, as in the case of other institutions.*

3. Allowability of Provision for Non-performing Assets (NPAs) u/s.36(1)(viia) of the Income Tax Act

NBFCs are now subject to directions of RBI as regards income recognition and provisioning norms. Accordingly, NBFCs are also compulsorily required to make provisions for NPAs.

Under the existing provisions u/s.36(1)(viia) in the Income tax Act, provisions for bad and doubtful debts made by banks are allowed as a deduction to the extent of 7.5% from the gross total income and 10% of aggregate average rural advances made by them. Alternatively, such banks have been given an option to claim a deduction in respect of any provision made for assets classified by the RBI as doubtful assets or loss assets to the extent of 10% (increased from 5%) of such assets. However, the benefits u/s.36(1)(viia) are not available to NBFCs. *It is appropriate, in all fairness, that the provision for NPAs made by NBFCs registered with RBI be allowed as deduction u/s.36(1)(viia) of the Income tax Act.*

4. Case for allowing higher Depreciation Rates for Construction Equipment

The I. T. Act allows depreciation at the rate of 100% in case of certain equipment meant for pollution control, solid waste control, mineral oil concerns, mines and quarries, energy saving devices and renewable energy devices. The Act also allows high rate of depreciation (30%) to motorcars, buses, lorries and taxies used in the business of running them on hire. The DTC also prescribes the same rates for these categories.

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However, construction equipment which contribute immensely to infrastructure development are not given this benefit of higher depreciation rate when they are financed, instead the depreciation rate for such vehicles is only 15%. For other plant and machinery too, the rate is 15%. This acts as a roadblock to infrastructure development.

NBFCs often finance construction equipment and other plant and machinery under lease agreements. Although the basic features of 'running an asset on hire' and 'providing an asset on lease' are same, tax authorities are not allowing a higher rate of depreciation for lease on construction equipment and other plant and machinery, although these assets are subject to higher wear and tear in the hands of the lessees. In this backdrop, we would like to propose that construction equipment and all plant and machinery provided by NBFCs to users under hire / lease should be entitled to a higher depreciation rate. By incorporating "hire / lease" in the text, the present problem can be addressed.

In today's age of rapid technological progress, assets like construction equipment and plant and machinery become obsolete faster. Thus, keeping in mind the nature of the asset, its average life-cycle and the pace of technological development, the depreciation rate should be 30%-50%. This will also give an impetus to the infrastructure spend and will incentivize such investments.

5. Case for allowing additional depreciation to the Operating Lease Provider

In terms of Clause (iia) of Sub Section 1 of Section 32, besides normal depreciation, additional depreciation @ 20% of the cost of new plant and machinery (not the used one) is allowed in the year of the addition to an assesee engaged in the business of manufacture or production of any article or thing or in the business of generation or generation and distribution of Power.

Now, any entity which is financing Solar Power Generating System and Wind Mills on Operating Lease is actually enabling the lessee in generating power with the leased assets. However, since the assets have been given on OL, hence the lessee is not getting any kind of depreciation benefit. At the same time, as a lessor, the financier is getting only normal depreciation benefits. Thus, neither the lessor and nor the lessee is getting the benefit of additional depreciation. This cannot / should not be the intent of the legislation. So, though the financier is not generating power directly, but ultimately power is being generated by the lessee to whom the asset has been given on OL. *Therefore, the financier (who is the lessor), as a passive user, should be allowed to get the benefit of additional depreciation of 20% in the first year of use of the asset.*

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6. Restoration / Reintroduction of Sec. 10(23G) along with exemption in MAT also for the Development of Infrastructure

The 2006 Union Budget announcement pertaining to removal of incentives on infrastructure financing under Sec. 10(23G) of I. T. Act from fiscal year 2007-08 onwards is adversely impacting the process of infrastructure creation. Under Sec. 10(23G) of I. T. Act, for companies engaged in infrastructure projects by way of equity or debt or both, their net income from such investments (in the form of dividend or interest or long term capital gain) was exempt from tax. The withdrawal of this exemption was supposedly on the ground of a benign interest rate regime in 2006. However, interest rate has climbed up. The tax benefit also enabled project developers to bring down their borrowing cost. Removal of such a cushion has put a question mark on the viability of many projects and is acting as an impediment for future investments.

Section 10(23G) was enacted to exempt income by way of dividends other than dividend referred to in section 115-O, interest or long term capital gain of an infrastructural capital fund or an infrastructural capital company, etc. by way of shares or long term finance in any enterprise or undertaking engaged in the business referred to in section 80IA(4) or section 80IAB(3) or housing project referred to in 80IB(10) or hotel project or a hospital project duly approved by the central government. However, this is subject to payment of MAT.

Reviving the investment cycle in infrastructure is of paramount importance now as that would help stimulating domestic demand. However, *keeping in mind the fact that high interest rates are discouraging infrastructure investments, Sec. 10(23G) needs to be re-introduced and MAT be also exempted.*

INDIRECT TAX ISSUES

1. Service Tax on Hire Purchase/Lease Transactions

Service Tax is imposed on Hire Purchase and Finance Leasing transactions. Both these transactions have been defined as "sale" transactions. Constitutionally any transaction can either be a "Sale" or a "Service", but cannot be both. Service tax is imposed on the interest component of Hire Purchase /Finance Lease transactions. Also in addition, VAT is also levied on the installment amounts in most of the states. Such dual taxation on transaction of lease and hire purchase is impacting the profitability and sustainability of finance industry. After receiving lot of representations from the industry, Government on this matter in March 2006 came out with abatement to the extent of 90% of the interest component. In terms of small retail customers, who depend on lease and hire purchase for their finance needs, taxing these products would bring undue financial

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hardship on them. In our view, levy of service tax is unjustified, when VAT is levied on the total installment amount. Thus, *even a partial levy i.e. incidence of a service tax on 10% of the interest component should be withdrawn. Lease and Hire Purchase transactions should be considered as 'Deemed Sale' and subject only to VAT not Service Tax.*

2. Rule 6(3B) and Sec. 65 of the Finance Act 1994 (Service Tax)

Under the above-mentioned rule, a banking company and a financial institution including an NBFC, providing taxable service specified in sub-clause (zm) of clause (105) of Sec. 65 of the Finance Act, shall pay for every month an amount equal to 50% of the CENVAT Credit availed on inputs and inputs services in that month. Tax research unit of Ministry of Finance explained vide D.O.F.No. 3345/3/2011-TRU dated 28th February 2011, Para 1.16 of Ann-C that substantial part of the income of a bank is by way of interest in which a number of inputs and input services are used. There have been difficulties for the department in ascertaining the amount of credit flowing into earning these amounts. Thus, a banking company or an FI, including NBFC, providing banking and financial services, are being obligated to pay an amount equal to 50% of the credit availed.

We most humbly like to submit that every loan transaction which fetches interest income is associated with various fees income viz. Management Fees, Processing Fees, etc. which are subject to Service Tax. Interest income from Loan is out of the purview for valuation of Service Tax but its associated fee based incomes are subject to Service Tax.

The need of the hour is a circular for clarification. *A circular under Sec. 65 may be issued to the effect that those NBFCs which deposit an amount of Service Tax in relation to fee based income which is associated with loan transactions must be allowed to avail 100% Cenvat Credit on input services availed instead of arbitrary 50% Cenvat Credit availed as proposed in the Union Budget of 2011-12.*

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