FIDC

Finance Industry Development Council

(A body incorporated as a Self Regulatory Organisation for Registered NBFCs - AFCs)
101/103, Sunflower, 1st Floor, Rajawadi Road No.2, Ghatkopar (East), Mumbai – 400 077 (India)
Tel: 022 21027324/9820035553 • E-mail: maheshthakkar45@yahoo.in website: www.fidcindia.org

January 15, 2015

Shri Arun Jaitley
Minister of Finance
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 NBFCs, specially those engaged in asset financing, for your consideration in the forthcoming Union Budget 2015-16.

Though these issues have been pending for a long time, but due to the recent changes in the regulations made by RBI, it has become imperative that these issues are addressed in the forthcoming budget

1. **Revised RBI Regulatory Framework for NBFCs Brings Parity With Banks And Other FIs – Need to bring Parity in Taxation and Recovery**

Reserve Bank of India has enforced a Revised Regulatory Framework for NBFCs vide their circular dated November 10, 2014. One of the key objectives of this framework as stated by RBI is to “address regulatory gaps and arbitrage arising from differential regulations, both within the (NBFC) sector as-well-as vis-à-vis other financial institutions”. As a result the Asset Classification (NPA classification) norms have been brought at par with banks. This has been done based on the recommendations of the Expert Committees set-up by RBI.

We hereby request you to kindly do justice to the NBFC sector by bringing parity with banks and other FIs in matters relating to Income tax benefits (as mentioned under Direct Tax Issues of Annexure-1) and Recovery (as mentioned in Annexure-2). These were also recommended by the RBI Expert Committees.

2. **RBI’s Framework for Revitalizing Distressed Assets in the Economy have recommended Parity with Banks in Recovery Matters:**

The recently notified Framework for Revitalizing Distress Assets in the Economy by RBI, has recommended that NBFCs (Systemically Important NBFCs) should be given parity with banks and FIs in recovery related matters.

We therefore request you to kindly bring parity by extending coverage under SARFAESI Act, which are available to banks and public financial institutions but have been denied to NBFCs.

101/103, Sunflower, 1st Floor, Rajawadi Road No.2, Ghatkopar (East), Mumbai – 400 077 (India)

Tel: 022 21027324/9820035553 • E-mail: maheshthakkar45@yahoo.in website: www.fidcindia.org

3. 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.

The tax and recovery related issues are explained in detail in the attached Annexures -1 and 2.

We shall be glad to supplement this representation with any additional information / clarification 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**

MAHESH THAKKAR
DIRECTOR GENERAL

Encl. As above

101/103, Sunflower, 1st Floor, Rajawadi Road No.2, Ghatkopar (East), Mumbai – 400 077 (India)
Tel: 022 21027324/9820035553 • E-mail: maheshthakkar45@yahoo.in website: www.fidcindia.org

Annexure-1

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, like banks, 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.

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 like banks and FIs, follow prudential norms and 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 subject to directions of RBI as regards income recognition and provisioning norms. Accordingly, NBFCs are also compulsorily required to make provisions for NPAs. The revised regulatory framework has brought NPA classification norms at par with banks and other FIs.

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, specially after the revised regulatory framework enforced by RBI, 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. **Calculation of Book profit U/s 115JB: -**

As per the existing provisions while calculating book profit any transfer to any reserves is required to be added to calculate the taxable book profit. However in case of a Non Banking Finance Company (NBFC) certain statutory reserves under the Companies Act, RBI Act etc. are required to be created which are in substance "charge against profit" and not "an appropriation out of profit". Similarly certain other reserves (e.g. Debenture Redemption Reserve etc.) are also required to be created by charging against profit to repay long term borrowings (e.g. Debenture etc.) in future. All such statutory / compulsory transfer to

Reserves are in the nature of provisions against known / ascertained liabilities and by no stretch of imagination can be termed as a creation of voluntary Reserve by transfer and/or appropriation out of profit. These are "Specific Reserves" to be utilized for specific purposes only and the assessee does not have any choice of not creating such Reserves as per the statutory requirements.

Further as per the statutory provisions contained under the RBI Laws, an NBFC is required to make provision for Non Performing Assets (NPAs). The said provisions are in the nature of statutory charge against the book profit of an NBFC and equating the same as "an amount set aside as provision for diminution in the value of any asset" and thereby increasing the taxable book profit of an NBFC is not justified.

Again, the mechanical disallowance U/s 14A r.w. Rule 8D is also being added to the book profit by the AO irrespective of the fact whether assessee has actually debited any such expenditure in its P&L Account.

Accordingly it is suggested that –

(i) *An NBFC should be allowed deduction in respect of Special Reserves created by it by way of charge against profit in its P&L Account while calculating its book-profit taxable U/s 115JB of the Act;*

(ii) *An NBFC should be allowed deduction in respect of Debenture Redemption Reserve or any other Reserve created by it by way of charge against profit in its P&L Account to repay any known and ascertained long term liabilities while calculating its book-profit taxable U/s 115JB of the Act;*

(iii) *An NBFC should be allowed deduction in respect of statutory provision for Non-Performing Assets (NPAs) made by it by way of charge against profit in its P&L Account while calculating its book-profit taxable U/s 115JB of the Act;*

(iv) *The mechanical disallowance of expenditure U/s 14A r.w. Rule 8D alleged to have been debited by the Assessee in its P&L Account should be done away with while calculating its book-profit taxable U/s 115JB of the Act;*

5. **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.

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.

6. 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.*

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

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.*

101/103, Sunflower, 1st Floor, Rajawadi Road No.2, Ghatkopar (East), Mumbai – 400 077 (India)
Tel: 022 21027324/9820035553 • E-mail: maheshthakkar45@yahoo.in website: www.fidcindia.org

2. 100% Cenvat to be Allowed for NBFCs

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

3. Amendment in CST Act to specifically include Sec. 5(2) and Sec. 6(2) for Lease/HP Transaction

Operating lease transaction came within the tax net under various state sales tax statutes by virtue of the 46th Constitutional Amendment Act, 1982. In line, Section 2(g) of the Central Sales Tax Act, is amended by Finance Act No. 20 of 2002 which received the assent of President of India on 11.05.2002.
There are number of Judgements of High Courts and Supreme Courts where it is held that Deemed Sale is at par with normal Sale. Since the assessment under CST is done by respective State Authorities while CST Act is administered by

Centre. Authorities in the states have been treating Operating lease transaction as different from Normal Sale and are rejecting claims of High Sea Sales and Sale in Transit 6(2). In the absence of clear explanation under Sec 5(2) and 6(2) for allowing exemption from CST State VAT authorities who have been denying benefit of the exemption, by treating deemed sale as different from Normal Sale and thus rejecting exemption form CST.

The present provisions under section 5(2) and 6(2) of the CST Act are read as;

> "Section 5(2) - A sale or purchase of goods shall be deemed to take place in the course of the import of the goods into the territory of India only if the sale or purchase either occasions such import or is effected by **a transfer of documents of title** to the goods before the goods have crossed the Customs frontiers of India."

> "Section 6(2) - (2) Notwithstanding anything contained in sub-section (1) or sub-section (1A), where a sale of any goods in the course of inter-State trade or commerce has either occasioned the movement of such goods from one State to another or has been effected by a **transfer of documents of title t**o such goods during their movement from one State to another, any subsequent sale during such movement effected by a transfer of documents of title to such goods to a registered dealer, if the goods are of the description referred to in sub-section (3) of section 8, shall be exempt from tax under this Act"

Most of the construction equipment, machinery given by NBFCs are under operating lease for Public Infrastructure. Thus, such an erroneous treatment puts unnecessary burden and cost. *It is requested to kindly make appropriate amendment(s) in the legislation so as to get the explanation making exemption under 5(2) and 6(2) equally applicable for Deemed Sale also or issue a requisite clarification for correct field formation.*

All these have led to the untimely and unfortunate death of Leasing in India. NBFCs have moved to simple Loans against Hypothecation. We need to appreciate the fact that Leasing is the most preferred and viable mode of lending all over the world. As such, there is an urgent need to bring clarity on the tax treatment of Lease and promote leasing in India.

FIDC

Finance Industry Development Council

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

101/103, Sunflower, 1st Floor, Rajawadi Road No.2, Ghatkopar (East), Mumbai – 400 077 (India)

Tel: 022 21027324/9820035553 • E-mail: maheshthakkar45@yahoo.in website: www.fidcindia.org

Annexure-2

RECOVERY MECHANISM – COVERAGE UNDER THE SARFAESI ACT

We reiterate our demand that in spite of the fact that NBFCs are today regulated almost at par with banks, they have been denied the benefit of any defined recovery mechanisms which are available not only to banks but also non bank entities like Housing Finance Companies.

Recently, RBI has amended the NBFC norms based on the recommendations made by the Working Group on NBFCs (Usha Thorat Committee) and the Committee on Comprehensive Financial Services for Small Businesses and Low Income Households (Nachiket Mor Committee). The genesis of these amendments is to bring parity with banks when it comes to NPA classification norms. As such, it is all the more important to bring total parity with banks by giving NBFCs tools for recovery, as available to banks. Without adequate tools for recovery, expecting NBFCs to comply to the new NPA classification norms shall be like thrusting a soldier to fight a battle without giving him adequate arms/protection.

RBI had issued a "Framework for Revitalizing of Distressed Assets in the Economy" in order to check the growing menace of NPAs. This framework is equally applicable to banks and Systemically Important NBFCs and has recommended coverage of these NBFCs under the SARFAESI Act.

Since the new framework has already been enforced, coverage of Systemically Important NBFCs (NBFC- ND – SI) and Deposit taking NBFCs (NBFC – D) under SARFAESI Act needs to be given top priority. Moreover, both the expert committees, mentioned above, had also recommended the same.

****