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)
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January 12, 2015

Shri Arun Jaitleyji
Minister of Finance
Government of India
North Block
New Delhi - 110 001.

Hon'ble Finance Minister Sir,

SUB: PRE-BUDGET MEMORANDUM - ISSUES RELATED TO NBFCs, SPECIALLY THOSE ENGAGED IN ASSET FINANCING

Finance Industry Development Council (FIDC) is a Self Regulatory Organization (SRO) cum Representative Body of all the Non-Banking Finance Companies (NBFCs) registered with Reserve Bank of India and engaged in Asset Financing. We would like to express our sincere thanks to Ministry of Finance for inviting us to present our views/issues during the Pre-Budget Discussion every year.

Sir, we take this opportunity to convey our appreciation of the Financial Sector Reforms being undertaken by Ministry of Finance which shall go a long way in positioning India as the fastest growing economy and the most preferred destination for foreign investment.

NBFC Sector

1. As per the Financial Stability Report dated December 2014, the NBFCs' share in total assets of the Indian financial system stands at 9% which is more than the mutual funds, urban cooperative banks and regional rural banks.
2. NBFCs have mastered the art of lending to the "unbanked" segment thereby furthering the Government's agenda on financial inclusion for the last seventy years now.
3. NBFCs have been the pioneers in asset backed retail lending thereby playing an instrumental role in the development of important sectors like transport , infrastructure and SMEs/ MSMEs
4. Recent studies done by credit rating agencies show that few of the leading NBFCs have overtaken some of the scheduled commercial banks in terms of their balance sheet size
5. Credit Rating agencies have also predicted that NBFCs are likely to overtake banks in retail lending in the near future
6. NBFCs are known to be better asset managers as reflected in their overall asset quality
7. Inspite of the fact that bank funding is one of the major sources of funds for NBFCs, none of the NBFCs have defaulted in meeting their liabilities towards the banks in the recent past
8. NBFCs have a regulation history of more than 18 years and all the key parameters of our activities are well regulated, almost at par with banks
9. 100% FDI is permitted in the NBFC sector which has projected this as an important attraction for FDI investment

Initiatives taken by Government of India and RBI , Which hold the Key

From the NBFCs' perspective following three key initiatives taken by Government of India and RBI shall be the guiding factors for the future growth of the NBFC sector :

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1. ***Ease of Doing Business***

This initiative taken by the Government of India at the behest of Hon'ble Prime Minister is a widely welcome and appreciated move. Enforcement of GST shall be a quantum jump in this direction.. However, there are some tax issues specially pertaining to TDS, Income recognition on NPAs and dual taxation on Lease / Hire Purchase (Details in paras 1&2 of Direct Tax Issues in Annexure -1 and Para 1 of Indirect Tax Issues in Annexure -2) which gravely impact the ease of doing business for NBFCs and their borrowers.

2. ***Revised Regulatory Framework For NBFCs Brings Parity with Banks and Other FIs – Need to bring Parity in Taxation Matters***

RBI had issued the Revised Regulatory Framework for NBFCs in November 2014 with the key objective of "addressing regulatory gaps and arbitrage arising from differential regulations, both within the (NBFC) sector as well as vis- a – 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 recommendation of the expert committees set up by RBI. Based on this move by RBI, you had accepted our demand to give coverage to NBFCs (with asset size of 500 cr and above) under the SARFAESI Act, in the last years Union Budget.

Sir, but the job remains half done on 2 accounts:

i) The notification on SARFAESI Act is still pending

ii) There is an urgent need to bring parity with banks and other FIs in matters relating to tax benefits (Details in para 1,2 & 3 of Direct Tax Issues in Annexure -1)

3. ***Shift From "Entity "Based Regulation To "Activity "Based Regulation***

Based on the recommendations of Financial Sector Legislative Reforms Commission (FSLRC), Ministry of Finance and RBI have now embarked upon focusing on "activity" based regulation rather than the prevailing "entity" based regulation. RBI has stated this clearly in the circular issued on the Revised Regulatory Framework for NBFCs. The objective of this shift is to again bring parity between various entities engaged in similar activity thereby making things simple.

However NBFCs are suffering from a distinct negative bias on tax issues (Please refer to Para 1,2 &3 of Direct Tax Issues), inspite of indulging in similar activities like banks and other financial institutions

The Tax 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.

Yours Faithfully,
For **FINANCE INDUSTRY DEVELOPMENT COUNCIL**

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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.

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.

Therefore, *NBFCs, like banks, should also be given exemption under section 194A, to bring parity and increase the ease of doing business.*

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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 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.*

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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.

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.

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Annexure-2

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. This dual taxation on the same component of Lease / Hire Purchase transactions has made these transactions unviable as compared to a simple Loan against hypothecation.*

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.

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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.*