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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To **June 24, 2014**
Mr. G. S. Sandhu,
Secretary, Dept. of Financial Services,
Ministry of Finance,
Government of India,
Jeevan Deep Building, Room No. 6, 3rd Floor,
10, Parliament Street,
New Delhi – 110001.

Dear Sir,

NOTE ON PERTINENT TAXATION & OTHER ISSUES FOR NBFC SECTOR FOR CONSIDERATION DURING UNION BUDGET 2014-15

We **thank you** very much for the courtesy extended to **FIDC** Core Committee members, when we met you at your office at New Delhi on **June 23,2014**, to discuss urgent taxation and long-term issues pertaining to **NBFC sector.**

Sir, as discussed, we are giving hereinbelow the Note on the urgent issues which can be immediately taken up for consideration during Union Budget 2014-15.

The detailed Note on other two long-term issues discussed at the Meeting is being forwarded separately.

1. 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.

2. 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.

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3. 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.

4. Taxation of Securitised Debt instruments

Securitised debt instruments: Section 115TA, introduced in Finance Bill 2013, imposes a distribution tax on securitised debt instruments, to be deducted by the trustee of the transaction - akin to a dividend distribution tax. Therefore, income for an investor in a securitised debt instrument receives tax free income, which in turn triggers the provisions of Section 14A / Rule 8D.

Securitisation cannot be equated to mutual fund activity. Mutual funds are active managers, while the trustee of a securitisation SPV does not have discretion. The trustee is already a representative assesse for the investors, who are also beneficiaries of the trust. Section 115TA has significantly increased the tax rate on income for bank / NBFC investors.

We submit that this section should be repealed completely.

Further, income that mutual funds have realised from investments in securitised debt instruments from 2006 to 2012 have been claimed for tax on the grounds that securitisation SPVs are “association of persons”. This is despite clear regulations governing securitisations from RBI and SEBI. We submit that these claims be removed completely

As a method to enable NBFCs to access alternative channels of financing, domestic and offshore funds could play a significant role. AIFs, as well as FPIs could play a role in financing NBFCs and reducing the risk of banks in financing the NBFC sector. However these are issues –

AIFs – the taxation for AIF is not in line with taxation for AMC managed funds. Fundamentally, an investor should be indifferent between making investments directly, or investing through an AIF. However, all AIFs are taxed as business entities making most AIFs unviable unless the AIF only focuses on high risk / high return investments.

This should revert to the principal of taxation at the investor's end. If so, we believe that AIFs can become an important source of finance for NBFCs.

FPIs – presently, the withholding tax regime inhibits investment with differential taxation from different geographies. The last government harmonised this to 5%, but only until mid-2015. It is not clear what will happen post mid-2015. Further, the tax treatment of FPI investments are not clear.

Also, for no discernible reason, the reduction of w/h tax to 5% was donefor bonds only, and not for commercial paper (in fact the word "bonds" caused a lot of confusion as debentures are not necessarily the same as bonds). Treatment should be uniform between bonds, debentures and commercial paper, from taxation perspective.

5. 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 instalment 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*

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should be considered as 'Deemed Sale' and subject only to VAT not Service Tax.

6. **RECOVERY MECHANISM – COVERAGE UNDER THE SARFAESI ACT**

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 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 (NBFC – ND-SI) and has recommended coverage of these NBFCs under the SARFAESI Act.

Since the new framework has already been enforced , coverage of Systemically Important NBFCs under SARFAESI Act needs to be given priority. Moreover, in addition to banks and Financial Institutions, specified Housing Finance Companies have also been notified under the Act.

We hope you will consider our suggestions favourably and take up the issues further.

We look forward to an **immediate positive response** and are confident that we are in the process of a long and beneficial relationship.

Thanking you,

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

MAHESH THAKKAR
DIRECTOR GENERAL