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Union Budget 2022

Tax Alert - Financial Services sector

Policy and tax reforms impacting the Financial Services Sector

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The Budget 2022, presented by the Hon'ble Finance Minister, Ms Nirmala Sitharaman, seeks to lay the foundation and give a blueprint to steer the economy over the next 25 years – from India at 75 to India at 100.

It continues to build on the vision drawn in the Budget 2021 and aid faster growth of the economy.

From a Financial Services perspective, the following key changes/ initiatives are being proposed:

- Setting-up of 75 Digital Banking Units in 75 districts by scheduled commercial banks;
- Proposal to replace 'The Special Economic Zones Act' with a new legislation that will enable the states to become partners in 'Development of Enterprise and Service Hubs';
- Introduction of further tax benefits with a continued objective of promoting the IFSC;
- Taxation of virtual digital assets; and
- Setting up of an expert committee to holistically examine regulatory and other frictions related to venture capital and private equity investments into India.

From a procedural perspective on direct taxes, the Budget proposes several changes related to implementation of the faceless assessment schemes, filing of 'Updated Returns', operation of re-assessment provisions, rationalization of surcharge rates etc.

From an indirect tax standpoint, the key amendments relate to introduction of more stringent vendor related compliance criteria for claiming Goods and Service Tax input tax credits.

How does the budget impact the Financial Services sector?

Key policy proposals

- RBI to introduce Digital Rupee using blockchain and other technologies.
- The Special Economic Zones Act will be replaced with a new legislation that will enable the states to become partners in ‘Development of Enterprise and Service Hubs’.
- An expert committee to be set-up to holistically examine regulatory and other frictions related to venture capital and private equity investments into India.
- Scheduled commercial banks to set up 75 digital banking units in 75 districts.
- The financial support for digital payment ecosystem announced in Budget 2021 to continue to encourage further adoption of digital payments.
- Amendments in IBC to enhance the efficacy of the resolution process and facilitate cross border insolvency resolution.
- The Centre for Processing Accelerated Corporate Exit (C-PACE) will be established to facilitate and speed up voluntary winding-up of companies within 6 months.
- Emergency Credit Line Guarantee Scheme extended up to 31 March 2023.
- 1.5 lakhs post office to connect with core banking system enabling financial inclusion and access to accounts through net-banking, mobile banking, ATMs, etc.
- For timely settlement of disputes under international jurisprudence, International Arbitration Centre to be set-up in IFSC.
- World-class foreign universities and institutions will be allowed in the IFSC to offer various courses to facilitate availability of high-end human resources for financial services and technology.
- Surety bonds to act as substitute for bank guarantee for government procurements. IRDAI has given the framework for issue of surety bonds by insurance companies.

Highlights

- Promoting Digital India
- Setting up digital banking units
- Amendments to IBC to enhance efficacy
- Promoting development of IFSC
- SEZ Act to be replaced with new legislation

Key amendments

- **Tax measures and incentives for IFSC**
  - It is proposed to grant an exemption on income arising to or received by a non-resident on transfer of offshore derivate instruments or over the counter derivatives entered into with an OBU in the IFSC, subject to prescribed conditions.
  - It is proposed to grant an exemption on income of a non-resident from portfolio of securities/ financial products/ funds managed by a portfolio manager in IFSC, received in an account maintained with an OBU in IFSC, to the extent such income accrues/ arises outside India and is not deemed to accrue/ arise in India.
  - Category I or Category II AIF in IFSC will be exempt from the provisions of the IT Act which taxes consideration received on issues of shares at premium exceeding fair market value to residents; This brings parity with AIFs outside IFSC which were already excluded from the provisions.

- Following incentives currently applicable to aircraft leasing activities in an IFSC also extended to leasing activities in relation to 'ships' (if the unit has commenced its operations on or before 31 March 2024):
  - Interest and royalty income paid by a unit in IFSC to a non-resident on account of lease will be exempt; and
  - Income arising from the transfer of a ship leased by a unit in IFSC will be eligible for deduction under 80LA of the IT Act.

- **Scheme for taxation of virtual digital assets**
  - Gains arising on transfer of virtual digital assets will be taxed at the rate of 30% without deduction of any expenditure (other than cost of acquisition) or allowance or set off of any loss.
  - Further, no set-off of any loss arising on transfer of virtual digital assets shall be allowed against any income computed under any other provision of the IT Act and such loss shall not be allowed to be carried forward to subsequent assessment years.
  - Gifting of virtual digital assets will be taxable in the hands of recipient being a resident.
  - Virtual digital assets have been defined to include non-fungible tokens as well as any other tokens of similar nature.
  - It is also proposed to provide for deduction of tax on payment for transfer of virtual digital asset to a resident at the rate of one per cent of such sum. Certain exemptions for non-deduction of taxes have also been provided. This provision shall apply from 1 July 2022.

- **Provisions pertaining to dividend stripping to be made applicable to units of InvIT/ REIT/ AIF**
  - Currently, where a taxpayer incurs any losses (to the extent of dividend or income received) on sale of securities (being shares and stocks) or mutual fund units, the said loss is ignored for the purposes of computing the income chargeable to tax, if the following conditions are satisfied:
    - Taxpayer acquires the securities (being shares and stocks) or mutual fund units within a period of three months prior to the record date (i.e. the date fixed by the company/ mutual fund for the purposes of entitlement of the holder of the securities to receive dividend or income, as the case may be);
    - The taxpayer sells or transfers such securities (being shares and stocks) within a period of three months or mutual fund units within a period of nine months after the record date; and
    - The dividend or income distributed on such securities (being shares and stocks) or mutual fund units is exempt from tax.
  - It is proposed to amend the definition of 'unit' to include units of an InvIT or REIT or AIF. Additionally, the term 'record date' is proposed to be amended to include date fixed by the InvIT/ REIT/ AIF for the purposes of entitlement of the holder of the units to receive income on their holdings.

- **Provisions pertaining to bonus stripping to be made applicable to securities (being shares and stocks) and units of InvIT/ REIT/ AIF**
  - Currently, losses incurred by a taxpayer on sale of mutual fund units are ignored for the purposes of computing the income chargeable to tax, if the following conditions are satisfied:

    - Taxpayer acquires mutual fund units within a period of three months prior to the record date (i.e. the date fixed by the mutual fund for the purposes of entitlement of the unitholder to receive additional units without consideration);
    - Taxpayer is allotted additional units without any payment on the basis of original holding;
    - Taxpayer sells or transfers the original mutual fund units within a period of nine months after the record date while continuing to hold all or any of the additional units.
- The Bill proposes to extend the applicability of bonus stripping provisions to all securities (being shares and stocks) and units of InvIT/ REIT/ AIF.

Conversion of interest into debenture or any other instrument not to be regarded as 'payment'

- The current provisions of the IT Act provide that deduction with respect to interest payable on loan or borrowing from, inter alia, specified institutions/ NBFCs/ scheduled or co-operative banks shall be allowed to be claimed as deduction on payment basis.
- Further, the existing provisions provide that where such interest has been converted into a loan or advance, then such interest shall not be deemed to have been actually paid for the purposes of claiming a deduction.
- It is now proposed to expand the above list to by introducing an amendment whereby conversion of interest payable into a 'debenture or any other instrument by which liability to pay is deferred to a future date' shall also not be deemed to have been actually paid and accordingly, will not be allowed as a deduction.

Expense incurred to earn exempt income disallowed in all circumstances

- The existing provisions of the IT Act disallow any expenditure incurred to earn income exempt from income tax. Hitherto, there arose a controversy over allowability of such expense when no corresponding income is earned in such year, with many courts holding the expense to be deductible.
- In order to set the controversy to rest, the Budget 2022 proposes to clarify that expense incurred to earn exempt income shall be disallowed even in cases where no corresponding income is earned during the year.
- This amendment will be effective from assessment year 2022-23.

Disallowance of surcharge and cess

- There has been a dispute with conflicting rulings on deductibility of surcharge and cess levied on income-tax as an expense while computing business income. The Budget 2022 now proposes to clarify that deduction for surcharge and cess will not be allowed in the computation of business income of the taxpayer.
- This amendment is effective retrospectively from assessment year 2005-06.

Withdrawal of concessional rate of taxation on dividend income received by Indian company from specified foreign company

- Under the existing provisions of IT Act, if dividend income is received by an Indian company from a foreign company in which the Indian company holds 26% or more of the nominal value of equity shares (specified foreign company), a concessional tax rate of 15% (excluding surcharge and cess) was applicable in the hands of the Indian company on such dividend income.

- The Budget 2022 now proposes that the concessional rate of taxation for an Indian company on dividend received from a specified foreign company will not be applicable and same will be taxable under the regular tax rates.

- **Disallowance of expenditure incurred for any purpose which is in contravention of any law**
  - Under the IT Act, any expenditure incurred for any purpose which is an offence or prohibited by law are disallowed while computing the business income. However, certain taxpayers claimed above expenses which were in violation of foreign law or for compounding of an offence under foreign law and same was also accepted by certain appellate authorities.
  - In order to set the controversy at rest, the Budget 2022 now specifically proposes that expenses which are in the nature of offences, either as per Indian law or as per foreign law will also be disallowed. Further, expense incurred towards compounding of offences under any Indian or foreign law will also be disallowed.
  - Additionally, the Budget 2022 proposes to clarify that any benefit or perquisite to any person, where acceptance of such benefit is in contravention with the guidelines/ laws regulating the conduct of such person, will also not be deductible expense.
  - These amendments will be effective from assessment year 2022-23.

- **Key Indirect tax amendments**
  - Restrictions introduced on availment of input tax credit for invoices in relation to vendors where:
    - There is a continued default in payment of tax by vendor (period to be specified);
    - Difference between GSTR-1 and GSTR-3B of the vendor (limits to be prescribed);
    - Availment of excess input tax credit by vendor (limit to be prescribed);
    - Breach of prescribed tax payment through Electronic Credit Ledger by the vendor;
    - New registered vendors (for specified period).
  - Regulations now require sequential filing of returns of outward supplies (GSTR 1) and tax payment (GSTR 3B).
  - GST registration liable to be cancelled if the returns have not been filed for continuous period prescribed (earlier six months prescribed).
  - Few relaxations introduced:
    - Time limit extended to 30 November in case of
      (i) Issuance of credit notes;
      (ii) Rectification of errors or omission in returns.
    - Transfer of amount available in electronic cash ledger under CGST or IGST of a 'distinct person' (GST registrations within the same PAN) allowed.
    - Retrospective reduction in interest rate to 18% for wrong availment and utilization of input tax credit.

Impact analysis

The Budget 2022 has been presented in a dynamic economic environment with a constantly changing landscape owing to the COVID-19 pandemic. From a financial services standpoint, the Government has been issuing newer regulations on an on-going basis to deal with concerns related to asset quality, credit losses, liquidity stress, etc.

The Budget 2022 introduces several measures to promote the financial markets, support development of the IFSC, promote public-private capital investments and ensure overall fiscal management of the economy.

On the tax front, the Government seems to have continued its endeavor towards a stable tax regime with no changes in individual and corporate tax rates. While one of the key proposals is introduction of a 30% rate on transfer of 'virtual digital assets' (without allowing for set-off of any losses or claim of any expenditure except cost of acquisition), some other noteworthy proposals include an enablement of filing of 'updated returns', maximum surcharge of 15% applicable to long-term capital gain on listed securities, extended to unlisted securities, extension of tax benefits to start-ups established on or before 31 March 2023, extending bonus/ dividend stripping provisions to all securities (including units of REITs, InvITs and AIFs, etc.

Moreover, Budget 2022 has also proposed nullifying decisions pronounced by Indian Courts in favor of the taxpayers on matters relating to deduction of education cess, disallowance of expenditure when no exempt income has been earned and conversion of interest into loan being eligible as 'payment'. While clarity as a principle is always welcome, the above proposals are likely to impact existing positions adopted by taxpayers.

From a sector point of view, while the Government has introduced transforming measures, several asks of the financial services players such as lower tax rate for foreign banks, non-withholding of taxes on interest payments to NBFCs (especially when the margins have grown thinner owing to the pandemic), clarity on EL provisions for financial services companies, alignment of IndAS provisions with tax laws on aspects related to interest on stressed assets, etc. still need to be dealt with.

Glossary

AIF – Alternative Investment Fund

EL – Equalisation levy

GST – Goods and Service Tax

IBC – Insolvency Bankruptcy Code

IFSC – International Financial Services Centre

IndAS – Indian Accounting Standards

InvIT - Infrastructure Investment Trust

IRDAI – Insurance Regulatory and Development Authority of India

IT Act – The Income-tax Act, 1961

NBFC - Non-Banking Financial Companies

OBU – Off-shore Banking Unit

RBI – Reserve Bank of India

REIT - Real Estate Investment Trusts

SEZ – Special Economic Zone

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