Policy and tax reforms impacting the Financial Services Sector

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The Budget 2023, presented by the Hon'ble Finance Minister, Ms Nirmala Sitharaman, hopes to build on the foundation laid in the previous Budget, and the blueprint drawn for India@100. It continues to build on the vision drawn in the Budget 2022 and aid faster growth of the economy.

Financial Sector is one of the seven priorities of the Government of India as laid down in the Budget; the following are key changes/ initiatives proposed to the Financial Sector:

- Revamping of the credit guarantee scheme for MSMEs through introduction of INR 9,000 crores in the corpus enabling additional collateral-free guaranteed credit of 2 lakh crore;
- Setting-up of a national financial information registry to serve as the central repository of financial and ancillary information;
- To facilitate optimum regulation in the financial sector, public consultation, as necessary, will be brought to the process of regulation-making and issuing subsidiary directions;
- Financial sector regulators will carry out a comprehensive review of the existing regulations. Moreover, time limits to decide the applications under various regulations will also be laid down;
- Single window clearance approach for registration by IFSCA along with introduction of further amendments/ policies with a continued objective of promoting the IFSC;
- Given the consistent growth of digital payments in India, the fiscal support for digital public infrastructure will continue in FY 2023-24; and
- Introduction of additional measures to improve governance and investor protection in the banking sector and ensure capacity building in the securities market.

From a procedural perspective on direct taxes, the Budget proposals aim to maintain continuity and stability of taxation, further simplify and rationalise various provisions to reduce the compliance burden, promote the entrepreneurial spirit and provide tax relief to citizens.

From an indirect tax standpoint, the proposals aim to promote exports, boost domestic manufacturing, enhance domestic value addition, encourage green energy and mobility. Changes have been proposed keeping in mind that fewer tax rates helps in reducing compliance burden and improving tax administration.

How does the budget impact the Financial Services sector?

Policy Proposals

- Revamping of the credit guarantee scheme for MSMEs through introduction of INR 9,000 crores in the corpus enabling additional collateral-free guaranteed credit of INR 2 lakh crore.
- Proposal to set up a national financial information registry to serve as the central repository of financial and ancillary information.
- Public consultations to be brought to the process of regulation-making and issuing subsidiary directions.
- Financial sector regulators to carry out a comprehensive review of existing regulations to simply, ease and reduce cost of compliances.
- Amendments proposed in the Banking Regulation Act, the Banking Companies Act and the RBI Act to improve bank governance and enhance investor protection.
- Powers under the SEZ Act will be delegated to the IFSCA.
- Single window IT system to be set-up for registration and approval from IFSCA, SEZ authorities, GSTN, RBI, SEBI and IRDAI.
- IBU of foreign banks to be permitted to undertake acquisition financing.
- Subsidiary of EXIM Bank will be established in IFSC to promote trade re-financing.
- IFSCA Act will be amended to introduce provisions for arbitration and avoid dual regulation under SEZ Act.
- Offshore derivative instruments to be recognized as valid contracts.
- Proposal to set-up Data Embassies in IFSC.

Highlights

Government regulations

Incentives for IFSC

INR 9,000 Cr

Credit guarantee scheme for MSMEs

Key amendments[1]

- **Tax measures and incentives for IFSC**
  - In case of relocation of a Fund to IFSC, it is proposed to extend the sunset clause for tax exempt transfer of assets of the Original Fund to the Resultant Fund located in IFSC from 31 March 2023 to 31 March 2025.
  - Income of non-residents on transfer of ODIs entered into with IBU is exempt from tax. It is now proposed to provide an exemption to any income distributed (such as dividends or interest) on the ODI entered into with an IBU, provided such income is chargeable to tax in the hands of the IBU. This will avoid double taxation at IBU and investor level.
  - It is proposed to amend the definition of 'Specified Fund', 'Resultant Fund' and 'Investment Fund' under the IT Act to bring reference to the IFSCA (Fund Management) Regulations, 2022.
- **Proceeds from specific high premium life insurance policies (other than ULIPs) to be taxable as income from other sources; death proceeds continue to be exempt**
  - Presently, any sum received under LIPs, issued on or after 1 April 2012, is exempt from tax if the premium payable for any of the years during the policy term does not exceed 10 percent of the actual capital sum assured. Where the percentage cap is not met, sum received is taxable except where it is received on death of the person.
  - In case of ULIPs, in addition to taxability based on the percentage cap, the sum received (otherwise than on death) under ULIPs issued on or after 1 February 2021 is taxable as capital gains if the amount of premium or aggregate of premium payable for any of the previous years during the term of such ULIPs exceeds INR 2,50,000.

[1] All amendments are effective from financial year starting 1 April 2023 (i.e. assessment year 2024-25), unless stated otherwise.

- It is now proposed that, in addition to taxability based on percentage cap, any sum received (including bonus) under LIPs (other than ULIPs for which aforesaid provision already exist), issued on or after 1 April 2023, shall be taxable if the amount of premium payable for any of the years during the policy term exceeds INR 5 lakh.
- It is further proposed that if the premium is payable by a taxpayer for more than one such LIPs, issued on or after 1 April 2023, exemption shall be available only with respect to those policies where the aggregate amount of premium payable for any of the previous years during the term of those policies does not exceed INR 5 lakh.
- Death proceeds from aforesaid LIPs to continue to be exempt from tax.
- Any sum received (including amount allocated by way of bonus) under LIPs (other than aforesaid ULIPs and Keyman Insurance Policies) for which no exemption is available to be taxable as income from other sources to the extent such sum exceeds the aggregate of premiums paid during the term of such policies for which deduction has not been claimed earlier and the manner of computation of such income shall be prescribed.
- The existing provisions dealing with rebate in respect of life insurance premium (applicable upto assessment year 2005-06) currently being redundant has been omitted along with corresponding references under other provisions of the IT Act.

- **Non-applicability of limit on interest deduction to certain NBFCs**
    - Presently, the provisions relating to limit on interest deduction (thin capitalisation norms) are not applicable to an Indian company or a permanent establishment of a foreign company engaged in the business of banking and insurance.
    - It is now proposed to extend the non-applicability of the said provisions to a certain class of NBFCs that may be notified by the Central Government.
- **Categorisation of NBFCs**
    - Given the current categorisation norms followed by the RBI for NBFCs, the provisions of section 43B of the IT Act (dealing with deductibility of interest payments to certain NBFCs) and section 43D of the IT Act (dealing with taxation of interest income in relation to certain categories of bad or doubtful debts of certain NBFCs) are proposed to be amended by deleting the references to the erstwhile categories of NBFCs and mentioning that the said provisions will be applicable to 'such class of NBFCs as may be notified by the Central Government in the Official Gazette in this behalf".
- **Proposed amendments impacting REIT/ InVIT (Business Trusts)**
    - Currently, interest, dividend and rental income have been accorded a pass-through status at the level of Business Trusts and are taxable in the hands of the unit holder. It is now proposed that any sum distributed by a Business Trust (not being interest, dividend and rental income) shall be taxable in the hands of the unit holders as 'Income from Other Sources'. It is also being proposed that where the sum received by a unit holder from a Business Trust is for redemption of unit or units held by him, the sum received shall be reduced by the cost of acquisition of the unit or units to the extent such cost does not exceed the sum received.
    - Section 194LBA of the IT Act, inter-alia, provides that Business Trust shall withhold and deposit tax at the rate of 5% on interest income of non-resident unit holders. Given that in some cases the rate of withholding may be required to be reduced due to an exemption (such as in the case of Sovereign Wealth Funds and Pension Funds), an amendment is being proposed in section 197 of the IT Act, to enable such unit holders to obtain a lower/ NIL withholding tax certificate.
- **TDS in respect of certain payments with respect to units of Mutual Fund**
    - Section 196A of the IT Act provides for withholding tax on payment of incomes to a non-resident (including a foreign company), in respect of certain units of a Mutual Fund or from the specified company referred to in the Explanation to clause (35) of section 10 of the IT Act at the base rate of 20%.
    - It is proposed to amend the provisions of section 196A of the IT Act to provide that taxes may be withheld at the lower rate of 20% or the rate mentioned in the relevant tax treaty entered into by India with the home country of the non-resident.

- **Enlarging the scope of the gift tax provisions related to issue of shares by including non-residents**
    - Under the existing provisions of the IT Act, where a closely held company receives any consideration from any person being a resident (subject to certain exceptions), for issue of shares which exceeds the FMV of such shares, the difference is chargeable to tax under the head 'Income from Other Sources'.
    - Currently, these provisions are applicable only where the consideration is received from a 'resident'. The Budget 2023 now proposes to include the consideration received from 'non-residents' as well within the ambit of the above provisions. This seems to be another step proposed to be taken to prevent generation and circulation of unaccounted money through share premium receipts.
- **Increasing rate of TCS on certain remittances**
    - It is proposed that the rate of TCS on foreign remittance through the Liberalized Remittance Scheme and on sale of overseas tour package be increased to 20% (as against 5% currently) without any threshold limit. The rate of TCS for the purpose of education and medical treatment remains unchanged at 5% with the benefit of the threshold of INR 7 lakh being available.
    - This amendment will take effect from 1 July 2023.
- **Withdrawal of withholding tax exemption on interest paid/ payable to a resident on listed securities**
    - The existing provisions of the IT Act provides an exemption from withholding of taxes in case of interest payments on listed securities (such as debentures, bonds, etc.) made to a resident. Considering the concerns around under-reporting of such interest income by the recipient investors, the Budget 2023 now proposes to withdraw the above exemption.
- **Increasing threshold limit for co-operatives to withdraw cash without TDS**
    - Section 194N of the IT Act provides that a banking company or a co-operative society engaged in carrying on the business of banking or a post office, which is responsible for paying any sum to any person (referred to as the recipient) shall, at the time of payment of such sum in cash, deduct an amount equal to 2% of such sum, as income-tax. The requirement to deduct tax applies only when the payment of amount or aggregate of amount in cash during the year exceeds one crore rupees.
    - However, in case of a recipient who has not filed an income-tax return for all of the three previous tax years immediately preceding the year in which such payment is received, tax is to be deducted at the rate of 2% on any sum exceeding INR 20 lakh but not exceeding INR one crore in aggregate during the financial year and, at the rate of 5% on sum exceeding INR one crore in aggregate during the financial year.
    - It is proposed to amend section 194N of the IT Act to now provide that where the recipient is a co-operative society, the above provisions shall apply only in cases of withdrawals exceeding INR three crores in a financial year.
- **Scheme for taxation of MLD**
    - Certain hybrid securities that combine features of a plain vanilla debt and exchange traded derivatives are being issued through private placements and listed on stock exchanges (referred to as market linked debentures). The terms of issuance, rate of return, etc. of such MLDs differ from plain vanilla debt securities.
    - Gains on transfer of listed MLDs are generally taxable as long-term capital gains (considering period of holding of 12 months) at the rate of 10% without indexation. A special computation mechanism for taxation of MLD is proposed to be introduced. For this purpose, MLD has been defined to mean a security by whatever name called, which has an underlying principal component in the form of a debt security and where the returns are linked to the market returns on other underlying securities or indices, and includes any security classified or regulated as a market linked debenture by the SEBI.
    - Considering the 'derivative' nature/ feature embedded in such securities, it is proposed that gains arising on transfer, redemption or maturity of MLD will deemed to be in the nature of 'short-term capital gains' (regardless of period of holding) and taxable at the applicable rates. A deduction shall be allowed for cost of acquisition and expenses exclusively incurred in connection with such transfer, redemption or maturity. However, no deduction shall be allowed for Security Transaction Tax.
- **Penalty for cash loan/ transactions against primary co-operatives**
    - Under the existing provisions, where a person takes any loan/ deposit or repays any loan/ deposit otherwise than through account payee cheque or account payee bank draft or online transfer through a bank account, exceeding INR 20,000, then penalty provisions under section 269SS and section 269T of the IT Act would apply.

    - The Budget proposes to increase the monetary limit from INR 20 thousand to INR 2 lakhs, in the case of PACS and PCARD. Thus, where a deposit is accepted by PCAS and PCARD from its members or such a loan is taken by the members in any form (other than as prescribed), the provisions of section 269SS of the IT Act shall apply only if the amount of such sum exceeds INR 2 lakhs. Similar monetary limits have been increased in cases where a deposit is paid by a PACS or a PCARD to its member or a loan is repaid to a PACS or a PCARD by its members.

- **Penalty for furnishing inaccurate statement of financial transaction or reportable account (Section 285BA of the IT Act)**
    - Currently, based on the provisions of the IT Act, where a person furnishes inaccurate statement of financial statements or reportable account, penalty of INR 50 thousand is levied on such person.
    - The Budget 2023 proposes to levy additional penalty of INR 5 thousand on such person where inaccuracy is on account of false or inaccurate information submitted by the account holder. Further, such person can recover the penalty so paid from the account holder or retain out of the money which is in its possession.
- **Facilitating certain strategic disinvestment (Section 72A and 72AA of the IT Act)**
    - In order to facilitate the strategic disinvestment, the Budget 2023 proposes to amend the definition of 'strategic disinvestment' to include sale of shareholding:
        - by Central/ State Government in any company;
        - by public sector company in a public sector company or any company;
    - The Budget 2023 also proposes to extend the benefit of carry forward of accumulated losses and unabsorbed depreciation on amalgamation of banking company with other banking institution or a company subsequent to a strategic disinvestment; provided such amalgamation is carried out within 5 years from the end of the financial year.
- **Key Indirect tax amendments**
    - Input Tax Credit on CSR expenses specifically restricted;
    - Outer limit of three years from prescribed due date defined for filing various GST returns (including annual return);
    - GSTN authorised to share reported data with other systems (to be notified), upon consent from the taxpayer;
    - Prosecution provisions not to be initiated in case of :
        - Obstruction or preventing any officer in discharge of his duties;
        - Tampering of material evidence;
        - Failure to supply information or furnishing incorrect information.

Impact analysis

The Budget 2023 has been presented in a dynamic economic environment with a constantly changing landscape owing to the global economic and geopolitical events. 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 2023 introduces several measures to promote the financial markets, support development of the IFSC and ensure overall fiscal management of the economy.

IFSC has been a focus area for the Government and to ensure ease of setting-up and doing business in IFSC, there have been various policy announcements including delegating powers under the SEZ Act to IFSCA and providing a single window for registrations. Further, from a tax perspective, Budget 2023 has extended the sunset clause for Fund relocations to 31 March 2025 and also provided relief to non-residents earning income from offshore derivative instruments issued by an IFSC Banking unit.

Other key changes proposed by Budget 2023 impacting the financial services sector relate to introduction of a new tax treatment for MLD, coverage of shares issued to non-residents within the scope of gift tax provisions, extending the exemption from thin capitalization rules to certain classes of NBFCs, enabling Mutual Fund unit holders to adopt concessional withholding tax rates under applicable tax treaties, and removal of exemption from withholding tax interest payments made to residents on listed debentures. While clarity as a principle is always welcome, a few of these proposals are likely to impact existing positions adopted by taxpayers.

Looking forward, from a sector point of view, while the Government has introduced rationalizing measures including easing burden of compliance, several asks of the financial services players such as lower tax rate for foreign banks, extension of sunset clause relating to concessional withholding tax rates on interest paid to foreign lenders and FPI, relaxation of withholding tax taxes on interest payments to NBFCs, 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

EL – Equalisation Levy

FMV – Fair Market Value

FPI – Foreign Portfolio investors

GSTN - The Goods and Service Tax Network

IBUs - IFSC Banking Unit

IFSC – International Financial Services Centre

IFSCA - International Financial Services Centre Authorities

IndAS – Indian Accounting Standards

IRDAI - Insurance Regulatory and Development Authority of India

InVIT – Infrastructure Investment Trust

IT Act - The Income-tax Act, 1961

LIPs – Life Insurance Policies

MLD - Market Linked Debentures

MSMEs – Micro, Small and Medium Enterprises

NBFCs – Non-Banking Financial Company

ODI – Overseas Derivative Instruments

PACS – Primary Agriculture Credit Societies

PCARD – Primary Co-Operative Agricultural and Rural Development Bank

RBI - Reserve Bank of India

REIT – Real Estate Investment Trust

SEBI - Securities and Exchange Board of India

SEZ – Special Economic Zone

TCS – Tax Collected at Source

ULIPs – Unit Linked Insurance Policies

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