Financial Services- Policy and Tax Issues

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During the last decade, the financial sector has gone through a complex process of restructuring, capitalising on new opportunities as well as responding to new challenges. Several new financial instruments and products have been introduced. Existing sectors have been opened to new private players. This has given a strong impetus to the development of the financial sector. New players have adopted international best practices and modern technology to offer a more sophisticated range of financial services to customers. This has led to existing players upgrading their product offerings and distribution channels.

With the Union Budget round the corner, further expectations and anticipation revisit the financial sector as well. Hopefully, Budget 2006 would address some of the following issues:

Issue No 1: Road Map for the presence of foreign bank in India.

Current Scenario

- The road map has set out plans for the expansion route for banks into two phases. During the first phase between March 2005 and March 2009, foreign banks may establish a presence by way of setting up a wholly owned subsidiary (WOS) or conversion of existing branches into a WOS. The second phase will commence in April 2009 after a review of the experience gained after due consultation with all the stake holders in the banking sector. The review would examine issues concerning extension of national treatment to WOS, dilution of stake and permitting mergers/acquisitions of any private sector banks in India by a foreign bank.

Problem faced

- On ownership norms, while 74% foreign investment is allowed in existing private banks, one needs clarity in respect of the permissible levels of FII and FDI holding.

- In case of private sector banks, voting rights of foreign investors is currently capped at 10% of the total voting rights of all the shareholders. Many foreign banks are keen to enter the Indian market by making equity investments in local banks.

- On the taxation front, a long outstanding issue which affects foreign banks from some countries is the higher rate of tax applicable to foreign branches than the rate applicable to Indian banks in spite of tax treaties providing for non-discrimination.

Option

- As the Road Map tabled by the RBI last year has not fully met with the expectations of key players in the banking sector, extension of national treatment to WOS, dilution of stake and permitting mergers/acquisitions of any private sector banks in India by a foreign bank could be considered in the first phase.

- The decision to align voting rights with the shareholding pattern would encourage foreign banks to enter the Indian market spurring growth.

- It is high time the government resolves the issue discrimination in the rate of tax applicable to foreign branches and end unnecessary litigation.

Issue No 2: Taxation of Asset Reconstruction companies.

Current Scenario

- One of the significant initiatives this year, has been to clarify FDI norms in asset reconstruction companies (ARC). This step was imperative for development of markets for distressed credit similar to those in other countries.

- The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act which provides legal support to the resolution process of resolving the distressed credit problem, empowers ARCs to set up trusts to resolve bad loans. The income of the trusts gets passed over to the investors who hold security receipts issued by the ARCs.

Problem faced

- There is lack of clarity on taxation of such trusts and the investors.

- Some clarity on the character of income generated on the security receipts and the applicability of withholding tax on distribution of income by the trusts would also be welcome.

Option

- Trusts could be made exempt like mutual funds or pass-through like venture capital funds.

Issue No 3: FDI in proprietary trading of derivatives by foreign broking companies

Current Scenario

- On the capital markets side, evolution of a broad based, active and liquid derivatives market is required to provide a spectrum of products for effectively managing exposures. Foreign players are interested in setting up subsidiaries for market making in derivatives, which would essentially mean trading in derivatives.

- Currently, any investments in the specified 19 categories is allowed subject to minimum capitalisation requirements, depending upon the level of foreign ownership.

Problem faced

- Among the 19 categories, although stock broking is covered, clarity is needed on allowability of foreign investment in proprietary trading in derivatives and other securities.

Option

- Changes in the FDI policy, allowing proprietary trading in derivatives and other securities would help deepen the derivatives market.

Issue No 4: Taxation of derivatives

Current Scenario

- A significant step in the capital markets was the recent introduction of the Securities Transaction Tax (STT). Consequently, the government exempted long term gains (if held for more than 12 months) from tax and reduced tax on short term gains. Apparently the intention was to shift from income-based tax to transaction based tax on exchange-oriented transactions.

Problem faced

- Exchange based derivatives transactions have also been subjected to STT (payable by the seller). However, no corresponding amendment in the capital gains tax liability on such transactions has been made. This results in an anomaly so far as capital gains tax on derivatives is concerned.

Option

- Exchange based derivatives transactions should also be taxed on par with exchanged based share transactions.

Issue No 5: Taxation of Mutual funds

Current Scenario

- Under the FOF scheme, investments are made in other mutual fund schemes rather than in securities. Unlike equity schemes where there is no tax on dividend distribution, FOFs are still required to pay the dividend distribution tax. Further, while equity funds are exempt from capital gains tax for investors for holding for more than a year, FOFs do not qualify under the same clause. This is because they do not purchase equities as an asset class, but equity funds as securities.

Problem faced

- In the absence of tax parity with equity funds, Fund of Funds (FOF) schemes floated by mutual funds are not tax efficient and therefore have not really take off. The market for FOF schemes will only develop if these schemes are treated at par with equity funds.

Option

- The law should be amended to make FOF schemes eligible for the benefits provided to equity funds.