# Financial Services

## Union Budget 2016

Post-Budget sectoral point of view

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# Table of contents



# Context

## Key insights

### Banking sector

- The total bank credit has more than doubled from INR34,967 billion to INR73,882 billion in last five years, (111 per cent growth)[1]
- Total deposits of scheduled commercial banks, excluding regional rural banks, nearly doubled from INR47,469 billion to INR94,351 billion in last five years, (99 per cent growth)[1]
- Incremental credit deposit ratio grew from 72.5 in 2010 to 92.6 in 2012, and dropped to 72.4 in 2015[1]
- Lower credit off-take by borrowers was due to curtailed capital expenditure and a moderate working capital requirement. The former was due to excess capacity while the latter was a result of lower commodity prices
- Net interest margins of scheduled commercial banks was at 2.6 per cent in March 2015, compared to 2.5 per cent in March 2010[1]
- Gross Non Performing Assets (GNPAs) grew from INR847 billion in 2010 to INR3,243 billion in 2015 (283 per cent growth)[1]
- There is continued stress in sectors like mining, iron and steel, textiles, infrastructure and aviation, and banking, where adherence to stringent regulatory requirements for NPA provisioning and lower asset sales to asset reconstruction companies are some of the factors that have kept the GNPAs at high levels.

### Insurance sector

- Insurance has been perceived as a mere tax saving tool in India. The need of the hour is to spread awareness related to long-term savings and build a corpus of funds for emergencies
- During the first decade of insurance sector liberalisation, the sector has reported consistent increase in insurance penetration from 2.71 per cent in 2001 to 5.20 per cent in 2009. However, since then, the level of penetration has been declining, reaching 3.3 per cent in 2014[2]
- Globally, the share of life insurance business in total premium was 55.55 per cent in 2014-15, while in India it was at very high at 79.12 per cent[2]
- Gross underwritten premium grew from INR384 billion in 2010 to INR847 billion in 2015 (121 per cent growth)[2]
- India's insurable population is anticipated to touch 750 million in 2020, with life expectancy reaching 74 years. Demographic factors such as growing middle class, young insurable population and growing awareness of the need for protection can help support the growth of the Indian insurance industry.

### Mutual funds

- Assets Under Management (AUM) with mutual funds in India have significantly grown from INR30,694 billion in March 2013 to INR40,682 billion in March 2015 (33 per cent growth)[3]
- During 2014-15, combined net investments by mutual funds in debt and equity were INR6,27,741 crore as compared to INR5,22,023 crore in 2013-14, accounting for an increase of 20.3 per cent[3]
- The AUMs declined by 11 per cent to INR36,354 billion by December 2015.[4] The fall was primarily due to the recovery of the American economy for the first time since the 2008 crisis and the financial crisis in China
- Though mutual funds have seen overall growth in the last 10 years, they have faced a significant challenge with respect to penetration into new markets and increase in the number of investors.

## Key issues/challenges

### Banking

- Banks in India, especially those in the public sector, face challenges with regard to asset quality, profitability and capital. Deterioration in asset quality has been one of the key factors responsible for the fall in their profitability. In some cases, it might raise questions on the long-term sustainability of some banks, unless these are bailed out
- Five sub-sectors, namely, mining, iron and steel, textiles, infrastructure, and aviation, together constituted more than half of the total stressed advances. The performance of these sectors and their impact on the asset quality of banks continue to be a matter of concern
- The impact of global regulations related to anti-money laundering and know your customer (for instance FATCA/CRS) are increasing compliance requirements
- There is a pressing need to develop digital technologies such as mobile banking to reduce the transactional costs of delivering currency notes and facilitate transactions and deepen financial inclusion.

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1. RBI Annual reports – March 2010 to March
2. IRDA Annual report 2014-15.
3. SEBI Annual report 2014-15.
4. AUM data from AMFI, December 2015

### Insurance

- Need to increase the number of lives insured and increase penetration in rural areas. Deepen awareness among prospective clients about how insurance solutions can help meet their long-term financial goals besides short-term tax saving benefits
- Transparency and developing technologies to improve customer service are some of the pressing needs this sector faces. This can help address consumer grievances such as false selling, delays in claim settlements, etc.

### Mutual funds

- The cost of distribution is higher, beyond metro cities, which makes it economically unviable for a majority of distributors and AMCs to push sales in these geographies. Due to the relatively smaller ticket size, brokers perceive selling mutual funds in these cities as an economically unattractive option[5]
- There is a need to retain investors in a falling stock market through easy switches between equity and debt schemes. Stock market savvy investors with higher risk appetite, good understanding and better resources may prefer to invest directly in the equity and equity derivatives segment.

## Government's stance

- The government is committed to provide a stable and predictable taxation regime, and reducing black money
- Government to ensure the passage of Constitutional amendments to enable the implementation of the GST, passage of Insolvency and Bankruptcy law and other important reforms, which are pending before the Parliament
- Enactment of laws to ensure that all government benefits are conferred upon persons who deserve it, by giving a statutory backing to the 'Aadhar' platform
- A new policy for managing the investments, disinvestments/strategic sale of the government's stake in Central Public Sector Enterprises (CPSEs) has been approved, which would be identified under the National institution for Transforming India (Niti) Aayog for strategic sale
- A massive nationwide roll-out of ATMs and micro ATMs in post offices over the next three years, for providing better access to financial services, especially in rural areas
- General insurance companies owned by the government to be listed in stock exchanges, for the purpose of ensuring higher levels of transparency and accountability
- The plan and non-plan classification to be done away with from FY2017-18. The Finance Ministry would closely work with state finance departments to align central and state budgets in this matter
- The government proposes to constitute a committee to review the implementation of the Fiscal Responsibility and Budget Management (FRBM) Act and give its recommendations on the way forward, especially in the context of economic uncertainty and volatility. It is felt that it may be better to have a fiscal deficit range as the target, which could give necessary policy space to the government to deal with dynamic situations.

## Expectations (policy/fiscal/tax)

### General

- To qualify for the safe-harbour rule, funds need to meet stringent criteria. Many of these conditions are cumbersome and tough to comply with. It was expected that the government would liberalise these conditions by providing, inter alia, that regulated entities like Foreign Portfolio Investors (FPIs) and Foreign Venture Capital Investors (FVCIs) should automatically qualify as eligible investment funds, for ascertaining the number of members. Direct as well as underlying members should be considered and the threshold of participation interest of a single investor in the fund should be increased to 49 per cent
- The current indirect transfer tax provisions cover any redemptions, transfers, and buy-backs of shares/units of offshore entities, which may be focussed on India or derive substantial value from Indian investments. This may lead to double taxation as the exit by an offshore entity from its Indian investment would be taxable in India and, subsequently, when the returns are distributed to the investors in offshore entities, they may also come under the purview of indirect transfer tax provisions. Accordingly, it was expected that once tax laws are applied on direct transfers, the subsequent distribution will not be covered by indirect transfer tax provisions

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5. KPMG in India analysis, 2016

- Even though the implementation of the General Anti-Avoidance Rules (GAAR) is more than a year away and would only apply to transactions post 1 April, 2017, the government is expected to provide more information on the blueprint to alleviate fears and concerns in the minds of investors
- A road map detailing the implementation of the Goods and Services Tax (GST) was another key expectation
- Reforms in CENVAT Credit Rules for a smoother transitioning to GST, including no time limit for availing CENVAT Credit was also expected
- Easy taxation policies across states for e-commerce companies were also expected.

## Banking and Non-Banking Financial Companies (NBFCs)

- Some of the key expectations from this section of the industry include provisions for capital inclusion in public sector banks, clear merger and acquisition tax guidelines and exclusion of interest paid to NBFCs from tax under provisions of Section 194A of the IT Act.

## Insurance

- Some of the key expectations from this section of the industry include creating a re-insurance market in India, taking into consideration the long gestation of insurance business. The period of carry forward and set-off of losses should be increased to an indefinite period from the present level of eight years
- No Minimum Alternative Tax (MAT) to be levied on general insurance industry to bring it at par with the life insurance industry, TDS reversals in case of cancellations during the free look period of 15 days to be allowed.

## Mutual funds/capital market

- Key expectations from this segment include exemption of capital gains for switching of investments under various plans of a mutual fund scheme or inter-scheme, need for clarity regarding the taxability of offshore funds in India, exclusion of MAT provisions to FPIs/foreign companies who do not have physical presence in India.

# Key policies/fiscal and tax proposals

## Key announcements[1]

### General

- The existing 24 per cent limit for investment by FPIs in listed CPSEs other than banks to be increased to 49 per cent
- The investment basket of FPIs to be expanded to include unlisted debt securities and pass through securities issued by securitisation Special Purpose Vehicles (SPVs). This can help broaden the corporate bond market base
- Amendments in the Companies Act to help provide an enabling environment for start-ups. Registration of companies to be done in one day
- With a view to promote the 'Make in India' programme and following the practices in advanced countries, foreign investors are expected to be accorded residency status, subject to certain conditions. Currently, these investors are granted business visa only up to five years at a time
- In order to ensure the effective implementation of bilateral investment treaties signed by India with other countries, the Finance Minister (FM) has proposed introducing a Centre-State Investment Agreement. This can help ensure fulfilment of the obligations of state governments under these treaties. States opting to sign these agreements are likely to be seen as more attractive destinations by foreign investors
- Clarification has been provided through an amendment on the non-applicability of MAT to foreign companies which do not have a permanent establishment/place of business in India
- Redemption of Sovereign Gold Bonds under the Sovereign Gold Bond Scheme, 2015 by an individual to be exempt from capital gains tax. Indexation benefits shall be available upon the transfer of Sovereign Gold Bonds to all assesses
- In case of rupee denominated bonds issued outside India by Indian corporates, capital gains arising to the non-resident due to the appreciation of rupee shall be exempt from tax in India
- Interest income earned by an assessee from deposit certificates issued under Gold Monetisation Scheme, 2015, shall be exempt from tax (with effect from Assessment Year (AY) 2016-17).

#### Place of Effective Management (POEM)

- Provisions regarding POEM have been deferred by one year and shall be effective from AY2017-18. In order to implement the provisions, the government shall notify the rules of residence and provide for the transition mechanism for assessing a foreign company which is said to be resident in India (due to its POEM being in India) for the first time, and where the said company has never been resident in India before.

#### Buy-back of shares

- Section 115QA of the Act would apply to any buy backs of unlisted shares undertaken by the company in accordance with the provisions of the law relating to the companies (not necessarily restricted to section 77A of the Companies Act, 1956) (with effect from 1 June 2016).

#### Carve out of deduction/exemption

- With the intent of cutting the domestic corporate tax rate from 30 per cent to 25 per cent over next four years and the simultaneous phasing out of the respective deduction/exemption, it has been proposed that profit-linked, investment-linked and area-based deductions should be phased out for all tax payers and the provisions having a sunset date shall not be modified to advance/extend the date.

#### GAAR

- No deferment of GAAR; to be applicable from 1 April 2017.

#### Other tax measures

- In line with the Base Erosion and Profit Shifting (BEPS) Action Plan 13, the Transfer Pricing (TP) documentation rules has to undergo a change with the introduction of Country-by-Country (CbyC) reporting
- CbyC reporting requirement to be effective from 1 April 1 2017 (i.e. AY2017-18)
- With the introduction of 0.5 per cent 'Krishi Kalyan' cess on value of all taxable services, the effective service tax rate has been marginally increased to 15 per cent with effect from 1 June 2016
- Limitation period for recovery of service tax short levied/not levied/short payment/non-payment/erroneous refund has been increased from 18 months to 30 months
- Interest rates on delayed payments of duty/tax are rationalised at 15 per cent, except in case of service tax collected, but not deposited to the exchequer, in which case the rate of interest is going to be 24 per cent.

### Finance companies – banking and non-banking

- FDI to be allowed beyond 18 specified NBFC activities in automatic route
- Deductions for provisions for bad and doubtful debts extended to NBFCs, to the extent of 5 per cent of the total income
- Income from investments in a Securitisation Trust to now be taxable in the hands of the investors on pass through basis, but subject to TDS by the Trust (with effect from 1 June 2016)

1. Union Budget 2016-17, http://indiabudget.nic.in/glance.asp, 29 February 2016

- Rule 6(3B) of CENVAT Credit Rules, 2004 amended to allow banks and other financial institutions to reverse credit with respect to exempted services on an actual basis. This is in addition to the option of 50 per cent reversal.

## Insurance/pension

- Foreign investment in insurance and pension sectors in the automatic route to be permitted up to 49 per cent, subject to extant guidelines on Indian management and control
- Service tax exemption on services of life insurance business has been provided by way of annuity under the National Pension System (NPS) regulated by Pension Fund Regulatory and Development Authority (PFRDA) of India
- Services of a general insurance business has been provided under the Niramaya Health Insurance scheme, launched by National Trust for the Welfare of Persons with Autism, Cerebral Palsy, Mental Retardation and Multiple Disabilities in collaboration with private/public insurance companies that are now exempted from service tax
- Services provided by Insurance Regulatory and Development Authority (IRDA) of India are now exempted from service tax
- The service tax liability on single premium annuity (insurance) policies has been rationalised and the effective alternate service tax rate (composition rate) has been prescribed at 1.4 per cent of the total premium charged in cases where the amount allocated for investment or savings on behalf of policy holder is not intimated to him/her.

## Capital markets/mutual funds

- Hundred per cent FDI in Asset Reconstruction Companies (ARCs) is now permitted through the automatic route. FPIs are to be allowed up to 100 per cent of each tranche in securities, with receipts issued by ARCs subject to sectoral caps
- The investment limit for foreign entities in Indian stock exchanges is to be enhanced from 5 to 15 per cent on par with domestic institutions
- The transfer of units on the consolidation of plans within a mutual fund scheme shall not be chargeable to tax
- Clarity has been provided under Section 112(1)(c)(iii) – 10 per cent tax rate benefit should now be available to long-term capital gains derived by non-residents on the transfer of shares of a private limited company. (with effect from AY2017-18)
- In the Budget speech, the FM proposed reducing the period of holding of unlisted shares from three years to two years to qualify as long-term capital assets. However, no amendment to that effect has been provided in the fine print.

### Fund management activity from India

- No major amendment was announced in the safe harbour rule. The condition which prohibited funds from carrying on their businesses from India is proposed to be omitted, i.e. funds can carry on or control or manage any business from India
- Services provided by mutual fund agents/distributors to a mutual fund or asset management company are being put under forward charge, i.e. the service provider would be liable to pay service tax instead of the reverse charge mechanism
- Services provided by Security and Exchange Board of India (SEBI) are exempted from service tax.

## International Financial Services Centre (IFSC)

- With a view to boost the growth of IFSC and turn it into a financial service hub, various incentives are being proposed in order to render a competitive tax regime. These include:

  - A unit located in IFSC shall be subject to MAT at a concessional rate of 9 per cent

  - There will be no capital gains tax on income arising from transaction undertaken in foreign currency on a recognised stock exchange, located in IFSC

  - No tax will be levied on the distribution of dividends either in the hands of the unit located in IFSC or persons receiving such dividend income

  - Securities/commodities listed on a recognised stock exchange in an IFSC location are to be exempt from Securities Transaction Tax (STT) and Commodities Transaction Tax (CTT) with effect from 1 June 2016.

## Our point of view

The Union Budget 2016 mostly focussed on the agriculture and rural sectors, with a clear mandate of benefitting the poor. The key announcements made by the government with respect to investors are likely to have the following impact:

- The clarity regarding non-application of retrospective taxes is a welcome announcement for investors
- The benefits laid out for start-ups may be closely looked into by private equity/venture capital firms, who have invested heavily in new companies last year; it is likely to attract more investments in start-ups in India
- Easing of FDI norms should attract higher capital investments in respective sectors
- The Code on Resolution of Financial Firms could help banks deal with the bankruptcy cases and aid in quick redressal
- Monetary Policy Committee could bring more coordination between RBI and the finance ministry
- Complete pass-through to ARCs is likely to help the banking sector deal with stressed assets problem more effectively
- Pass-through status to securitisation trusts could reduce litigation and give a new lease of life to them, as they attract investments from financial institutions
- Recapitalisation of PSU banks is required, but the amount sanctioned may not be sufficient. However, the government has committed to raise more money, if required
- Deduction for bad debts to NBFCs could provide a level playing field for the NBFCs vis-à-vis the banks
- The stake sale could help IDBI to help the bank raise capital through the Qualified Institutional Placement (QIP) route and help broaden the investor base too
- Micro ATMs at post offices may aid the post office revenue generations and prospective new lines of businesses
- The governance of public sector banks would be aided by the Bank Board Bureau
- The listing of general insurance companies could bring better market pricing in the general insurance industry
- The relaxation of FDI in insurance is likely to see more foreign players coming in and expansion of services and competitive pricing of products and services
- Retail participation in government securities may further deepen market liquidity and provide investors with safer investment avenue
- The government has brought in the much awaited amendment in the Income-tax Act, relating to non-applicability of MAT to foreign companies
- GAAR implementation could help avoid black money in the economy and generate tax revenue
- Tax holidays and capital gains exemption have been provided to start-ups
- Additional TP documentation (i.e. CbyC reporting requirements) shall be maintained and filed with tax authorities, or stringent penalty consequences may follow for non-reporting or providing inaccurate particulars
- The existing time limit for completion of assessment has been reduced by three months, irrespective to whether the reference to the Transfer Pricing Officer (TPO) has been made by the Assessing Officer (AO). The amendment is expected to be brought into effect from 1 June 2016
- Owing to the proposed increase in service tax rate on account of 'Krishi Kalyan' cess, the overall incidence on the financial services sector could marginally increase
- The reversal of CENVAT Credit on income from an activity which is not a service to result in increased reversal of the same
- Filing of annual returns can lead to additional compliance
- The option provided to banks and other financial institutions to reverse credit with respect to exempted services on actual basis may help the industry players in managing the CENVAT Credit
- With the services of mutual fund agents and distributors being put under forward charge, administration of mutual funds may become easier.

# Unfinished agenda

## What remains

- In relation to start-ups, amendment in Section 79 for the purpose of permitting set-off and carry forward of losses to subsequent years, upon a change in more than 51 per cent of ownership, still needs to be addressed
- Recapitalisation of public sector banks has fallen short of the industry's expectations
- Interest paid to NBFCs has not been excluded under section 194A of the Income Tax Act
- General insurance industry has not been exempted from MAT
- Set-off and carry forward of losses has not been increased beyond eight years for insurance companies
- Clarity is still required on POEM
- Safe-harbour qualifying norms still need to be eased
- Further details with respect to GAAR implementation are needed
- Rationalisation of indirect transfer provisions is needed
- There is no change in time limit for availment of input services
- The road map for GST implementation was missing from the Budget announcement.

## What is expected going forward

- Quick resolution in getting important bills such as GST, and Insolvency and Bankruptcy law, passed in the Parliament
- Implementation of policies for divestments/strategic sales in CPSEs
- Comprehensive Code for Resolution of Financial Firms to be introduced as a Bill and passed in the Parliament during the course of this year
- In addition to the pro-farmer and pro-poor provisions in the current Budget, development and bringing in foreign investments remain as key agendas for the government, going forward. Additionally the government's increased focus on start-ups is likely to improve investor confidence as they look at high-growth investment opportunities in India
- Constitution of a committee to review the implementation of the FRBM Act and give its recommendations
- Plans to set up the national investment infrastructure fund for facilitating infrastructure investments in the near future
- In order to reduce cash transactions and eliminate black money from the system, the government is likely to incentivise credit or debit card transactions, and discourage cash transactions.

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