

## Expecting the moon

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The financial sector's wishlist will include tax reforms for private equity and promotion of micro-credit.

When Barack Obama was elected US President, an international magazine said he carried the hopes of a planet. In India, there was much trepidation about the outcome of the recent general elections. With the Congress securing an unexpected majority, there are now almost Obamaesque expectations from this government. There is mounting anticipation that the much awaited reforms across sectors will now be implemented. The Budget 2009 to be announced shortly, will provide an indication of the government's agenda for action and the priorities that it will seek to assign. Propelling growth in the real sector will require a strong financial sector. So what would the financial sector's wishlist from the Centre be?

A thrust that is expected from the budget is a focus on infrastructure. Estimates varyingly place infrastructure spend over the next 10 years at about \$150 billion. A feature that characterises a number of areas of infrastructure is long gestation periods, followed by extended periods of earnings from tolls and user charges. Clearly, the government will not be in a position to fund this level of investment from its resources. Also, policy reforms will be required if this funding has to come from other sources — whether domestic or international.

Besides the equity capital markets, a likely source of long-term capital would be private equity funds. Most of these funds are likely to raise capital from long-term international investors. Current Indian tax provisions create considerable uncertainty with regard to the taxation of income accruing to private equity funds, engendering avoidable complexity coupled with the risk of unfavourable taxing outcomes. Fund raising is challenging globally and the Indian tax framework aggravates the challenge. The complexity in taxation is relatively easy to address, has no revenue considerations, and should be fixed. Beyond equity capital, the more significant source of funding will need to come in the form of debt.

Much has been written on the need for a liquid, deep bond market in India. Despite considerable analysis over the years, we have a very shallow, illiquid corporate bond market. Developing a corporate bond market goes beyond the remit of the budget, but there are some core tax issues that the budget could address. Tax withholding rates on interest payments to non-resident investors are currently pegged at 20 per cent (21.115 per cent, if surcharges and cess are added). This raises the cost of funds, and should be brought down to internationally accepted norms. If infrastructure is a key focus area, then dividends, interest and long-term capital gains from infrastructure funds in qualifying companies should be exempt from tax.

The banking sector will be a likely source of funding for infrastructure. Banks will need to augment their capital significantly, if they have to meaningfully participate in the long-term debt market.

Moving from the macro to the micro, the likely theme of the government will be financial inclusion. Micro-credit organisations play an important role in extending financial assistance to parts of society that conventional banking cannot and will not reach for a long while.

Micro-credit organisations require funding as well. Some of this will take the form of equity, while much will take the form of debt. Policy-level interventions are required to make it easier for micro-credit organisations to register as non-bank finance companies, and for foreign micro-credit entities or entrepreneurs to be able to extend assistance in foreign currency loans.

Greater clarity is required on the taxability of Indian Depository Receipts. The tax treatment in stock lending and borrowing transactions needs to be clarified. While there are policy issues that need to be addressed for stock lending to take off, tax will remain a concern and a potential

impediment unless it is suitably clarified. Considerable tax controversy exists around the deduction for expenses incurred if they could be attributed to the earning of tax-exempt income.

Changes in tax laws over the years have added to, rather than alleviated the uncertainty. The banking industry has grappled with the issue of the levy of service tax on foreign exchange transactions. While the levy of service tax on a fee or commission has been in place for a while and has operated fairly well, this levy on all types of foreign exchange transactions is onerous in the context of the spreads implicit in this business.

With an enabling policy regime, India's financial sector can prove to be a growth multiplier for the real economy. The 2009 budget will provide answers to whether the tax policy implemented by the new government aid or impede.