The Conundrum of Taxing: Banking Interest Under GST

The banking sector is the lifeline of a modern economy that acts as an intermediary between people having surplus money and those requiring money for various commercial and non-commercial activities. Since financial services are consumed by all the industries, it is imperative to tax it properly and to maintain the credit chain so that it will not result in increasing the cost of the goods and services. This intermediary service is generally exempted from GST worldwide which sounds innocuous, but has extensive ripple effects. The reason behind this exemption is not linked to any economic motive or relief, rather it is the inability of the governments in determining the value on which tax should be levied for such intermediary or financial service. Read on…

CA. Richi Jain
The author is a member of the Institute. She can be reached at richijain06@gmail.com

The article aims to look at the deformation created by this exemption and the possible ways of taxing the financial services highlighting how the recent amendments in the Indian monetary policy to fix interest rates for loans given out by banks, presents an opportunity to tax this sector efficiently.

1. Source of earnings for financial services

Banks are not involved in mere transaction of money. They earn their share of income by charging interest and fees on the loans, deposits and other services, either directly or indirectly and thus making these receipts liable to GST. The typical form of income earned by financial institutions and their treatment under Indian GST law is explained in detail below:

i. **Explicit fee**: Explicit fees are those bank charges wherein a fixed amount is charged by the banks for performing various services. Examples of such services can be performing agency functions, maintaining accounts and other miscellaneous services including ATM, demand draft, locker, foreign exchange transfers, portfolio management, internet banking, etc.

All such explicit charges are liable for GST. Also, no such complications are involved in determining the value of the services and GST can be charged outrightly on the explicit fee amount.

ii. **Implicit margin fee**: It is the margin earned on intermediary services provided by the bank by pooling money as a deposit and lending it as a loan i.e., the difference between interest on loan earned and interest on deposit given. Capital exchange of cash flows in deposits and loans is mere transaction in money and does not have any GST implication. This is the difference between interest earned and interest given that shows the value addition in the services and thus, should be liable to GST.

However, exemption from GST has been granted for every deposit, loan or advance insofar as the consideration is represented by way of interest or discount. Thus, banks are not liable to pay any GST on implicit margin fee earned by them. This seems to be a big relief briefly, but carries several implications of cause and effect.

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One of the biggest challenges associated with this exemption is the requirement to reverse input tax credit used in providing such exempted supply. Though, relaxation from reversal of credit associated with such margin has been given to the normal business, however such relaxation is not applicable to the banks. Banks have an option to reverse either the input tax credit associated with such exempted supplies or to reverse fifty per cent of the all the eligible input tax credit on inputs, capital goods and input services claimed in the business.

Thus, such relief in form of the exemption is associated with a cost of ITC which further gets included in the cost of providing the output services by the businesses and impact the pricing of goods and services, directly or indirectly.

2. Inefficiency due to exemption

The activity of lending and depositing from which a bank earns such margin fees is among the core activities of a bank and the major chunk of the revenue is earned by the bank from this activity. The exemptions on such services are the worst form of benefit provided to the industry, given that instead

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of providing benefit, it adds further complexity and cost to the industry as explained below:

i. **Cascading effect**: No GST is applied to goods and services exempted from tax, but concomitantly, no input credit is allowed for the GST paid on inward purchases associated with such supplies. This blockage of input taxes gives rise to cascading of tax. In the case of supplies made to business customer, where there is no output VAT on the exempted service, the non-deductible input GST paid by the financial institution gets embedded in the cost of the financial supply. This cost, in turn, gets embedded in the price of the product supplied by the business customer and results in the cascading effect of taxes.

ii. **Competitive deformity**: Competitive deformity will be there between supply made by domestic supplier of financial service and foreign supplier of financial service. The domestic supplier would bear an

impact of blocked input taxes, while it may not be there on financial services received from outside India.

iii. **The impact of making a tax-neutral business decision**: If the banking function of an entity is outsourced to some other entity of the same group, the cost charged by such other entity will embed the cost of the restricted part of ITC which is not available on providing banking services. Thus, the exemption system creates a self-supply bias for business inputs resulting in inefficient utilization of resources and not giving the freedom to make a tax-neutral decision.

iv. **Input allocation**: While there are provisions to reverse the input tax credit relating to exempt supplies, in practical terms, it is very difficult to identify the input tax relating to exempt supplies. In India, the law gives the option of reversal considering gross revenue of interest as an exempted service using a method of fixed reversal of 50% of the eligible input tax credit. However, this allocation does not indicate true allocation of input tax to taxable and exempt service, and sometimes may result in major loss of input tax credit associated with taxable supplies.

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The moot question here is whether the government is aware about such inefficiencies and associated problems. If yes, then why have such exemptions been provided and continued to operate? Is the intention linked to providing tax benefit? Well, the answer is negative. As the title of article suggests, the rationale behind such an exemption is not to provide any economic or social benefit, rather it is the practical difficulty or complexity of determining the value of service on which tax should be discharged.

3. Reason behind the exemption

Interest charged by bank for providing loans and advances is the representative of the following elements:

i. Risk of bad debt

ii. Time value of money

iii. Service charge of pooling funds and distributing i.e., intermediary service.

Where the first two components do not provide any value addition to supply, the third component is the

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real consideration on which GST is to be charged which is often intermingled with the other two elements. Thus, this consideration is not easily identifiable to charge GST.

Similarly, interest paid on the deposit reflects the time value of funds provided by the depositors and risk, minus a service charge for the deposit services provided by the bank to the depositors.

This is the margin between interest charged by the banks on loans and interest paid by the bank on deposits which is the real indicator of value addition which nullifies and balances the impact of risk and time value of money. Thus, it is this margin on which GST is to be charged. This method is easy to conceptualize, yet difficult to implement as it is not practically feasible to map interest on loan and interest on deposit for individual transactions and to be able to compute the difference between the two for applying GST under an invoice-based method.

This revenue cannot be appropriately taxed under

the normal invoice-credit system and there is no readily apparent means under the normal invoice-credit system to allocate the margin to individual transactions. Accordingly, due to such uncertainties and the absence of any basis to calculate such margin, the government must provide exemption for such transactions.

4. Possible solutions/ methods to bring interest transactions under tax ambit

Various alternatives have been adopted by different countries for taxation of financial services to reduce or do away with the distortion created by exemption of such services. One of such method is zero rating or conditional zero rating of B2B supplies of financial services. Here no tax is charged and no credits are allowed for B2B financial services. However, the major issue involved in this method is the identification of input relating to B2B supplies and allocating it accordingly.

Further, tax experts have suggested the following methods for determining the value of such transactions for the purpose of GST:

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i. **Basic cash flow method**: As per this method, all cash inflows whether interest earned or capital received by banks would be treated as consideration on which GST should be paid. All cash outflows whether interest paid, or capital would be treated as purchases in respect of which input tax credit can be claimed. This is the simplest approach to determine the value of margin and apply tax accordingly. However, it results in large volume of cash flows to and from Government and taxing capital nature of income which is against the spirit of VAT or GST laws.

ii. **Reverse charging approach**: This method applies reverse charge on borrowing made by banks. This way credit can be claimed on interest paid on deposit. This credit can be used to discharge interest on loan.

A franking account can be maintained to remove the problem of mapping loan and deposit transaction. This is a weighted average method to use the input tax credit of tax paid on deposit while discharging GST on interest on loan. However, it bring the complexity in implementation.

iii. **Tax Calculation Account (TCA) method**: Under the TCA system, the taxable margin for loan transaction is the interest charged by the financial institution with respect to the loan minus the opportunity cost of funds. In the case of a deposit, the base is the opportunity cost of funds minus the interest paid to the depositor. The impact of such a system shall be that banks will end up paying tax on interest on loans and less interest on deposit.

If a bank charges 8% interest on a loan, and the opportunity cost of funds is 6%, the taxable margin for GST on loan will be 2%. If the interest on deposit paid by the bank is 4%, and the opportunity cost of funds is 6%, the taxable margin for GST on deposit will be 2%. Thus, effectively, the bank will be paying tax on 8% - 4% that is, 4%.

In this way banks do away with the problem of matching each individual transaction of loan and deposit. This method operates on the basis of several assumptions. One basic assumption is that deposit and loan has been made at the beginning of period and have been withdrawn or discharged at the end of period. If it is not the case, a notional entry for such assumption has to be made at the end of each period to satisfy such assumption. Another basic assumption is that the value of deposits and loans in the firm are equal.

Most feasible option for calculation of GST

It can be observed that TCA is the most effective method of taxing interest margin. However, the problem associated with this method is to determine the cost of funds. This is because interest rate is generally fixed by the bank as a margin above the benchmark rate based on the Marginal Cost of Lending Rate (MCLR). This benchmark rate represents the cost of funds and it varies from bank to bank.

To explain it further, MCLR is an internal benchmark rate that depends on various factors such as fixed deposit rates, source of funds and savings rate. The price of loan comprises the MCLR and the spread or the bank's profit margin. The biggest problem with this system is the lack of required transparency of policy rates or MCLR. When the RBI cuts repo rate there is no guarantee that a borrower will get the benefit of the rate cut or that it will be transmitted down to him. Also, due to internal benchmarking of loan price, policy rate cuts often don't reach the borrowers.

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Banks are free to choose from the options of the external benchmarks provided by Central Government. This system will ensure greater transparency and also ensures that benefit of cut in interest rate will be passed on till customer level automatically. Also, it is now possible to determine the cost of funds of bank due to uniform policies and publicly available rates which will be used to benchmark the lending interest rates.

Thus, TCA method can now become the basis of calculations for ascertaining the value of providing loan services. The valuation for the purpose of GST shall be the value ascribed to the lending service that will be the interest charged by the bank minus the cost of funds ascertained from the RBI Repo rate or whichever rate the bank choses as the benchmark rate.

Before parting

Since interest forms part of all financial transaction and is an integral part of all businesses, it being treated as an exempted service warps the credit chain significantly. In India, all banks lose 50% of their credit, which makes these services costlier. Also, this cascading gets

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embedded in the cost of goods and services of the business when they avails these financial services, thus inflating the price of goods and services, defeating the intention of tax on value addition concept. Taxing the interest as per the mechanism discussed in the article may make the system more efficient and restore the credit chain.

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