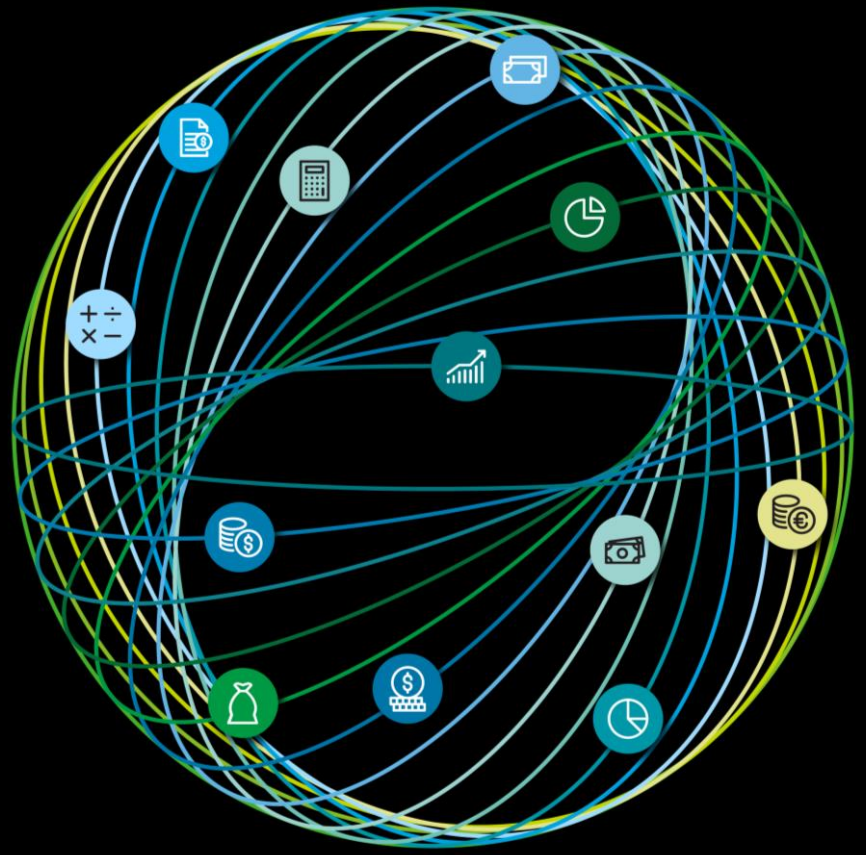
Deloitte.



FinTax Hour
Banking

13 July 2022

Lay of the land | Evolution of neobanking

While traditional banks have long focused on acquiring masses through savings & transaction services, neo-banks carved out a niche within the value chain

Traditional banking

- Used to be a branch / ATM phenomenon
- Digital channels started seeing adoption post 2010
- Focused primarily on CASA related services – transfers, payments, account maintenance

Digital banking

- To compete in the digital era, Banks started to roll out their own platforms
- In addition to basic banking services, multiple add-on layers were added
  - Distinct branding (e.g., Yono, 811)
  - Refreshed UI / UX
  - Addl. digital journeys – fully digital account opening, open FD, apply for loan
  - Cross selling – investment products, insurance, etc.

Neobanking

- Sharp focus on a customer segment with tailored propositions and easily recognizable USPs
- Enabled by a superior tech platform (not just digital channel apps) – more nimble/ agile in product introduction, more efficient processes
- Modern UI/UX
- Modern physical form factors (non-traditional card designs)
- Better use of digital advertising/ creatives

Examples of retail neo-banking brands with recognisable USPs

Source: Company websites, News articles, Deloitte analysis

Key trends in neobanking

Neobanks are differentiating from traditional banks by focusing on the primary needs of customers

Low-cost structure
Lack of need for physical infrastructure saves operational and overhead costs the benefits of which can be passed on to customers by way of low or no fees and high interest rates on deposits

Superior customer service
Greater focus on using technology fosters innovative solutions and enables faster response times, better customer experience and service, and quick and hassle-free on-boarding

Advanced security features
Using two-factor authentication (2FA), biometric verification, encryption technology, and various other security measures to protect customer data and provides high-security features like locking/freezing accounts at any time through the app

Service efficiency
Near real-time services helps customers manage finances, savings, and expenses on the go, 24x7 through a simple, engaging, and customer-friendly user experience

Value added services
Using artificial intelligence to recommend other banking products and services to customers based on their account information, user data, etc.

Key emerging trends

Regulatory uncertainty with no clarity on pure digital banking models expected to be allowed

Full-stack banking solutions from the neobanks

Embedded offerings from neobanks

Becoming regulated entities like NBFC

Impact of tax laws on recent financial innovations such as neobanks

Neobanks

Impact of GST laws on recent financial innovations such as neobanks

Whether banking company?

Banking Regulation Act
Licenses governed by RBI regulations are applicable to a Banking Company

Indian model
Indian neobanks are not directly regulated by the Reserve Bank of India (RBI).

Partnership with licenced banks
Partnership with banks, NBFCs and other financial institutions

GST implications on non-recognition as a banking company

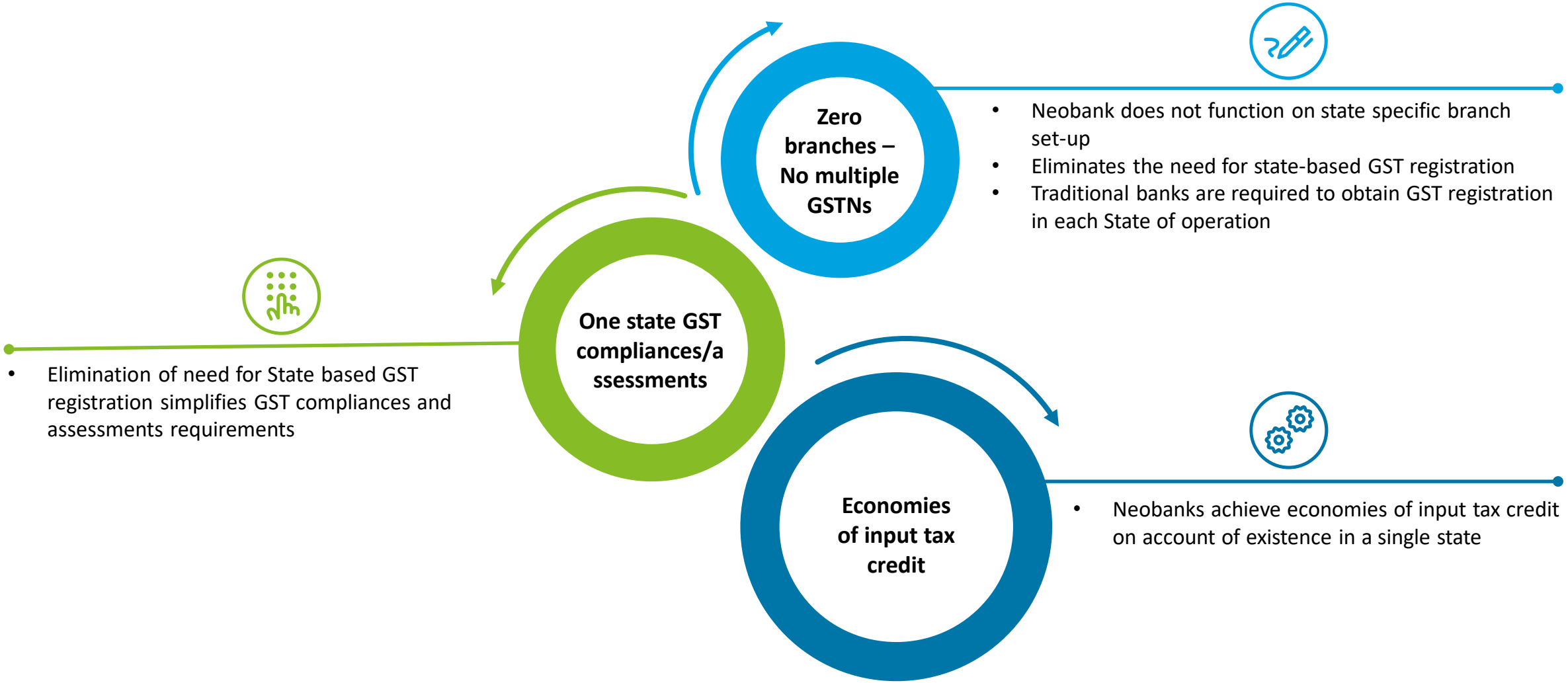
Invoicing provisions
Compliance relaxations such as invoicing etc., may not be applicable to Neobanks

Input tax credit
Option to reverse credit @50% may not be available to Neobanks

E-invoicing exemption
Exemption may not be available as Neobanks may not qualify as a "Banking company"

Neobanks

Impact of GST laws on recent financial innovations such as neobanks



- Neobank does not function on state specific branch set-up
- Eliminates the need for state-based GST registration
- Traditional banks are required to obtain GST registration in each State of operation

- Elimination of need for State based GST registration simplifies GST compliances and assessments requirements

- Neobanks achieve economies of input tax credit on account of existence in a single state

Neobanks

Impact of tax laws on recent financial innovations such as neobanks

- Neobanks have limited fee-based revenue and a fraction of interchange on payments processed through co-branded cards
- They cannot collect low-cost deposits and so rely mainly on equity.
- **Tax – Traditional banks vs Neobanks**
  - Provision for doubtful debts - Section 36(1)(viia)(a)/(b) of the Income-tax Act 1961 (“the Act”) which is applicable to Banks, is not applicable to Neo banks
  - Section 36(1)(viii) of the Act not applicable to neobanks
- **Key tax considerations**
  - Expenditure towards developing the digital platform, whether revenue or capital in nature?
  - Excess consideration received over the fair market value of the shares issued - other income (56(2)(viib))
  - Whether equalisation levy attracted to neobanks, serving as a digital payment intermediary between an Indian buyer and a non-resident ecommerce operator, if treated as agents of the non-residents.
  - Whether neobanks serving as digital payment gateways are required to withhold tax under section 195 of the Act on payments made to non-residents
  - Whether neobanks, serving as a digital payment intermediary between any buyer and a resident seller/merchant, are required to deduct tax under section 194-O of the Act.

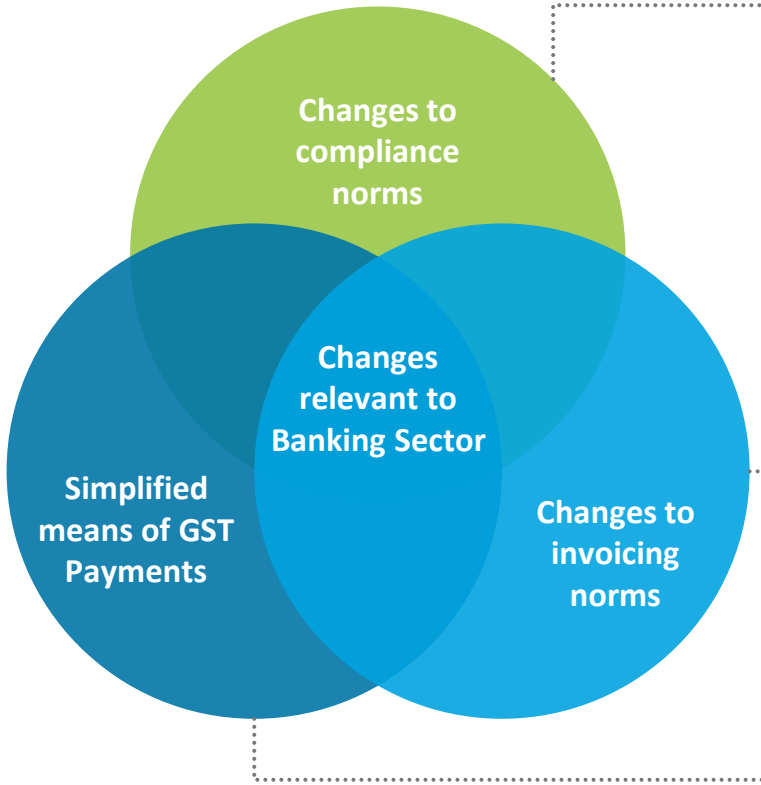
Neobanks

Related party transactions

- **Group structure**
  - Indian promoters and / or Foreign investors - Equity / CCPS / CCDs with a minimal coupon rate
  - Ownership and development of intellectual property
- **Transactions**
  - Interest on debt
  - Payment of royalty / license fee for IP
  - Purchase of IP
  - Other intra-group transactions

Recent tax updates for the banking sector

Key changes at the 47th GST council meeting



Instructions on reporting parameters in Form GSTR 3B

- Government has observed that address of recipient is incorrectly captured especially by banking, insurance, OTT service providers etc., It has been mandated that POS as per correct address of unregistered customers to be captured
- Details of ineligible ITC u/s 17(5) to be disclosed specifically

Changes to invoicing norms

- Banking companies to include the below declaration in invoices:

““We hereby declare that though our aggregate turnover in any preceding financial year from 2017-18 onwards is more than the aggregate turnover notified under sub-rule (4) of rule 48, we are not required to prepare an invoice in terms of the provisions of the said sub-rule.”

Introduction of new modes of payment

- UPI and IMPS modes of payment introduced for the purpose of depositing GST in electronic cash ledger

Key changes at the 47th GST council meeting

Interest on net cash liability only applicable on delayed filing of GST returns

Clarification issue on non-taxability of perquisites provided to employees

Relaxations provided for earlier Fys for GSTR 9 & 9C extended to FY 2021-22 as well

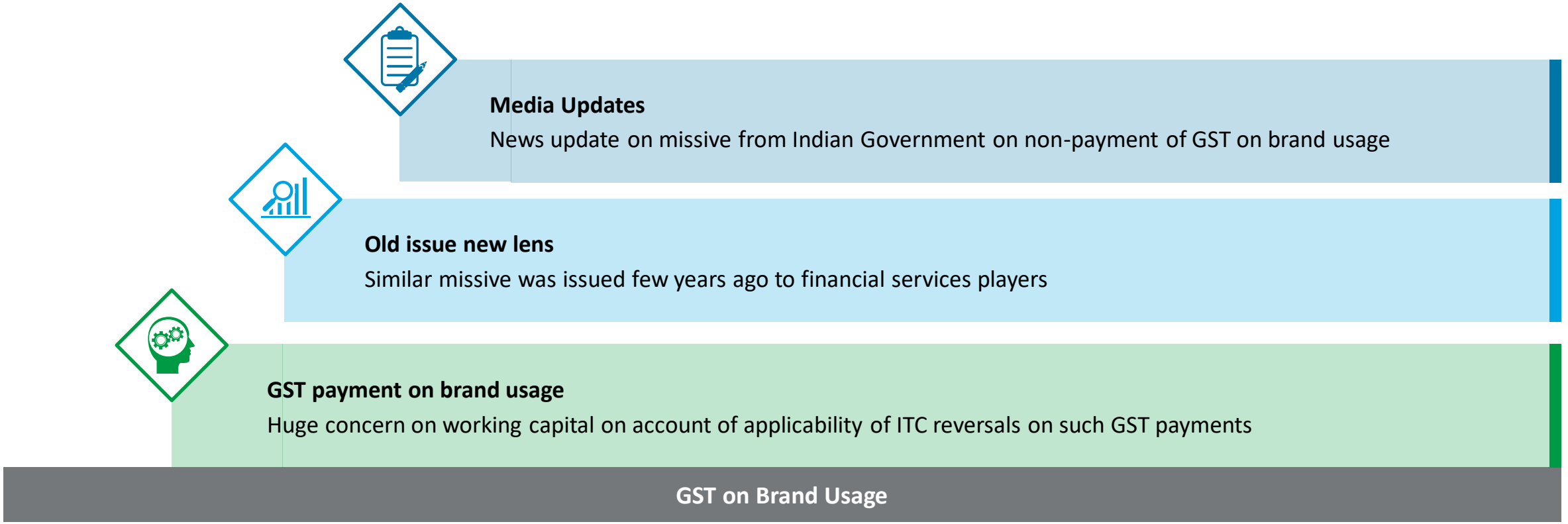
Rules for computation of interest on wrong availment and utilization of credit clarified

Clarifications issued on utilization of balances from Electronic Credit Ledger

Clarifications issued on utilization of balances from Electronic Cash Ledger

Exemption on services provided by RBI, IRDA and SEBI withdrawn

Revival of investigation lens



Recent judicial precedents

Deduction of interest paid by Indian banking branch to HO and taxability of interest received by HO from Indian banking branch

Facts of the case

- The assessee is a Korean resident carrying on banking business, through its permanent establishment (PE), in India.
- The following grounds were raised:
  - deduction of interest paid by India branch (PE) to HO and overseas branches [General enterprise (GE)].
  - Interest received by GE not to be taxed in the hands of GE (though in the return of income it had offered to tax @10%)
  - Interest received by Indian branch from GE not to be taxed in the hands of the branch (PE) (though in the return of income this was offered to tax)

Decision

Re. Deduction for interest paid by PE and taxability of interest received by PE,

- ITAT held that as per the India-Korea DTAA the PE is hypothetically to be considered as a separate entity distinct from its GE. So, in computing the profits of the PE, the interest paid by PE should be allowed as a deduction and interest received by PE should be taxable in the hands of the PE.
- According to the ITAT, presence or absence, of the language used in the protocol to the India-Japan DTAA (subject matter of analysis before the Special Bench shall not change the conclusion of hypothetical independence.

Re. Taxability of interest received by GE from PE

The ITAT held that

- Fiction of hypothetical independence not applicable
- Interest is not taxable in the hands of the GE since the profits attributable to the PE have anyway been offered to tax and so no further income to be taxed in India.
- Also, since it is received from self, it is not taxable.

Recent judicial precedents

Deduction of interest paid by Indian banking branch to HO and taxability of interest received by HO from Indian Banking branch

India Japan DTAA [Article 7(3)]

In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the Contracting State in which the permanent establishment is situated or elsewhere.

Protocol

7. With reference to paragraph 3 of article 7 of the Convention, it is understood that in India the deductions in respect of the executive and general administrative expenses as referred to in the said paragraph shall be allowed in accordance with the domestic law of India, but such deductions shall in no case be less than what are allowable under the Indian Income-tax Act as effective on the date of signature of this Convention.
8. With reference to paragraph 3 of article 7 of the Convention, no deduction shall be allowed in respect of amounts paid or charged (other than reimbursement of actual expenses) by a permanent establishment of an enterprise to the head office of the enterprise or any other offices thereof, by way of:

(a)	**royalties, fees or other similar payments in return for the use of patents or other rights, or for the use of know-how;**
(b)	commission or other charges, for specific services performed or for management; and
(c)	interest on moneys lent to the permanent establishment; **except where the enterprise is a banking institution.**

India Korea DTAA [Article 7(2) and (3)]

2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.
3. In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere, in accordance with the provisions of and subject to the limitations of the tax laws of that State.

Recent judicial precedents

Order passed under faceless appeal scheme without opportunity of personal hearing, set aside

Facts of the case

- The appeal was with respect to order dated 24 November 2021 passed by NFAC giving effect to the ITAT order.
- The said order dated 24 November 2021 was passed under the erstwhile National Faceless Appeal Scheme 2020
- The assessee had requested an opportunity of being heard through video conferencing.
- Despite this specific request and without disposing off the same, NFAC disposed the appeal on the basis of material on record

Decision

- The Chief Commission or the Director General ought to have either granted the opportunity, or, if so deemed fit, declined the same give reason therefor.
- Inaction on the part of the authority concerned cannot meet any judicial approval.
- Matter remitted to the first appellate authority for giving an opportunity for a personal hearing in terms of rule 12 of the new Faceless Appeals Scheme 2021 for adjudication de novo in accordance with the law and by way of a speaking order.

Recent judicial precedents

Expenditure on purchase of CBS whether capital or revenue

Facts of the case

- The assessee Bank had incurred expenses for core banking solution (CBS) (“an application software”) for networking its 125 branches with centralised processing solution.
- It was granted a 'non-exclusive, non-transferable license' to use the software for processing a specified number of loan accounts and deposit accounts of its Customers.
- Apart from the license, the expenditure also included project consultation / program management, customization of the software and providing networking software for the project.
- The assessee claimed the said software expenses as revenue in nature. However, the AO held it as capital in nature and allowed depreciation thereon.
- CIT(A) confirmed the order of the AO.
- The Tribunal allowed it as revenue expenditure relying on the decision of IBM India Limited
- The High court quashed the order of the Tribunal and remitted it back to the Tribunal.

Decision

- The expenditure was to be regarded as revenue expenditure since
- The expenditure only facilitated carrying on the business of the Bank more profitably without touching its profit-making apparatus bank which was receiving deposits and lending/investing them for profit.
- The payment was towards application software which does not result into acquisition of any capital asset and merely enhances the productivity or efficiency of the business, even if enduring in nature.
- The license agreement between the Bank and the Vendor, provided for an annual maintenance and upgrade fee and therefore perpetuity of license could not be looked at in isolation to conclude that it is a capital expenditure.

Recent judicial precedents

Right over mortgage property – Bank vs Tax department

Facts of the case

- One of the respondent, Ms A sole proprietor of Devika agencies, availed credit facilities from the petitioner-State Bank of India ("SBI") against mortgage of immovable properties owned by him. The equitable mortgage was confirmed by separate memorandum and deposit of title deed and was also registered with the sub-registrar.
- SBI, in exercise of their right under the SARFAESI Act and after compliance with all the statutory provisions issued an E-Auction Sale Notice dated 7-11-2015 scheduling the auction on 18-12-2015.
- The sub-registrar refused to register the sale Certificate dated 12-1-2016 issued under the SARFAESI Act, since the same was attached by TRO for the alleged tax dues of Ms. A and the said attachment was recorded in the books of the sub-registrar and therefore, any subsequent mortgagee with the Bank was void under the provisions of the Income-tax Act
- TRO made a finding that the attachment of immovable property made on 10-12-2015 would relate back to 1-3-2013 whereas the property was mortgaged with SBI on 4-4-2013

Decision

- Mortgages that are entered into between parties after initiation of action by Income-tax Department (during pendency of proceedings) are void per section 281 of the Act
- If petitioner bank is able to establish that mortgage was prior to initiation of action by Income-tax Department (prior to the pendency of the proceedings under the Income-tax Act), bank may claim right over mortgaged property.
- Even if the attachment by the Tax recovery officer is after the mortgage of the properties, if the proceedings were pending before the mortgage of the properties, then such mortgage are void as per section 281 of the Act
- Mortgage or attachment made by bank cannot be ground to claim priority based on provisions of SARFAESI Act or DRT Act
- The Court referred to the decision in the case of Janata Sahakari Bank Ltd v. TRO [WP No. 15437 of 2014, dated 19-7-2021]

Other updates

Recent circular and others

CBDT Circular No. 12 of 2022 dated 16 June 2022 – Guidelines under section 194R(2) of the Income-tax Act

- Under the newly inserted section 194R, a question can arise whether waiver of loan (interest and principal) is in the nature of benefit or perquisite thereby subject to TDS under the said section.
- **Clarification in CBDT guidance**
  - Question 3 states that principal loan waived by bank under one time settlement scheme would constitute income falling under section 28(iv) arising from business or exercise of profession.
  - Question 2 states that TDS shall be applicable even if the benefit / perquisite is in cash (whether fully or partially).
- **Points to consider**
  - Can it be said that waiver of loan is a "benefit" when the Supreme Court (SC) held that such waiver represented cash/money, and so provisions of section 28 (iv) were inapplicable?
  - Can a circular go beyond the ambit of main provision which, relying on the decision of the SC, means that it shall not apply if the benefit is in the form of money?
  - Can a proviso go beyond the main section?

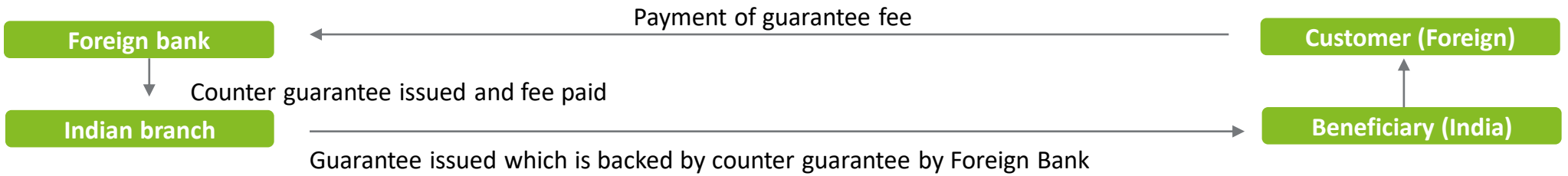
Update On BEPS 2.0

At Davos, the Secretary-General of the OECD, indicated that the implementation of Pillar One would be delayed until 2024.

Recent judicial precedents

Characterisation – Guarantee Vs. Support services

Transaction flow in case of issuance of guarantee backed by a counter guarantee



- Risk lies with the foreign bank providing counter guarantee.
- Indian branch merely acts as a facilitator in processing the transaction.
- Tax authorities treat such facilitation / support services by Indian branch as primary guarantee.
- Tribunal has held such transaction as support services in few of its rulings.

Tribunal's observations

- Tribunal observes that entire risk of discharging the bank guarantee is borne by the foreign bank issuing the counter guarantee, Indian branch merely provides support services in connection with processing of the guarantee.
- The transaction is in the nature of administrative / support service provided by the Indian branch requiring compensation for the same.

Recent judicial precedents

Attribution of profit to permanent establishment (PE)

The attribution of profits to PEs is the most complex subjects of the international tax arena which has been now increasingly scrutinized and challenged by the tax authorities.

OECD model convention - Profits attributable to PE shall be determined considering the below:

- Article 7 – distinct and separate enterprise in source state
- Article 23 – double tax relief in resident state

In an Italian ruling, the Supreme Court (SC) has reversed lower Court's judgment that the Italian PE's losses from sale of loan receivables to third parties should have been attributed to the US parent.

Lower court's observations

- Losses incurred on credits and commission charges on sale of loans to third parties - to be attributed to the US parent
- Transaction akin to procurement of financial resources exceeding the endowment fund of the permanent establishment – no deductibility to Italian branch

SC's observations

- Non deductibility of expenses – only if the same is attributable to the activity carried out by parent outside Italy
- Endowment Fund relating to PE – compliant as per the AOA guidance taking into consideration the FAR analysis

Key considerations

Authorised OECD Approach for capital attribution

The “Separate and Independent Enterprise” principle, under AOA, is applied to determine the profits that the PE might be expected to make if it were a separate and independent enterprise engaged in the same or similar activities under the same conditions.

A two-step approach i.e. (i) undertaking a functional and factual analysis and (ii) pricing the transaction on an arm’s length basis, is followed.

An attribution of free capital is important to determining the arm’s length amount of debt capital and the arm’s length interest expense deduction for the PE. OECD describes the follow three methods:

- Capital allocation approach
- Thin capitalisation approach
- Regulatory minimum approach

The Hong Kong Inland Revenue Department (IRD), has already, introduced the rules relating to profit attribution to PEs of the foreign MNEs.

Following the AOA approach, it requires the PEs to redraw the liability side of their balance sheet to make it consistent with that of a distinct and separate enterprise i.e., attribution of capital to the PE should be consistent with the arm’s length principle.

Few other jurisdictions like Japan, United Kingdom, Germany, etc. also have similar regulations as part of their law.

In India, there is no guidance on application of AOA , however banks are subject to the minimum regulatory capital levels set out by Reserve Bank of India (RBI). Certain instruments (Innovative Perpetual Debt Instruments (IPDI) can be construed as debt for tax purpose.

Other topical matters

Branch & HO, LIBOR

Transaction between branch and HO

- Special bench is constituted in case of M/s. TBEA Shenyang Transformer Group Company Ltd. on the issue relating to applicability of transfer pricing provisions to transactions entered between branch and HO.
- The order of the Special bench is awaited.

LIBOR transition

- LIBOR rates ceased to exist from 31 December 2021 in case of GBP, EUR, CHF, JPY and USD (1 week and 2 month), others will cease to exist from 30 June 2023
- Alternate Reference Rates ("ARR") have been replacing the LIBOR
- ARRs - robust and aligned with the market rates. However, an additional spread adjustment is required to such market rates
- Few of the ARRs typically followed in the banking sector are as below:

Currency	Leading LIBOR replacement
USDC	SOFR (Secured Overnight Financing Rate)
GBP	SONIA (Sterling Overnight Index Average)
EUR	ESTR (Euro Short-Term Rate)
CHF	SARON (Swiss Average Rate Overnight)
JPY	TONA (Tokyo Overnight Average Rate)
	Other IBOR replacements
SGD [SIBOR]	SORA [Singapore Overnight Rate Average]
INR [MIFOR]	Legacy contracts - Adjusted MIFOR [Mumbai Interbank Forward Offer Rate] New MIFOR contracts – Modified MIFOR
THB [THBFIX]	THOR [Thai Overnight Repurchase Rate]

We look forward to seeing you in the next FinTax Hour webinar!

Insurance

Date: 10 August 2022
Time: 11:30 a.m. IST
Register now

Follow the FinTax Hour page for more updates.

Deloitte.