COVID-19: an opportunity to reform the tax system and unify debt markets

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While COVID-19 has caused considerable adversity, it has also created opportunities to not only rectify long-standing pain points but reimagine the business and policy landscape. Even before the pandemic, several economies were struggling with issues of demand and liquidity. In India too, in the last few quarters of 2019 and much before the outbreak of pandemic, economic activity was faltering and sentiments were subdued.

The onset of the pandemic sent several economies into a tailspin and governments all over the world are scrambling to restart their economies, revive demand and infuse liquidity into financial systems. India also recently announced a significant stimulus package that should help reignite growth.

It has now become more important than ever to infuse liquidity into NBFCs and into the hands of retail investors. Another issue close to the heart of small and large investors is that of mutual funds (MFs), which give the common man an avenue to hedge against inflation and provide an alternative to direct investment in equities.

The case for abolishing buy-back tax

Share buy-backs are an effective way of distributing surplus cash lying with companies to their shareholders. It also provides a good exit route to investors. Buy-backs at a price higher than the market also sends a positive signal and could improve investor sentiment.

The purpose of the buy-back tax was to discourage companies from avoiding paying the dividend distribution tax (DDT) and curb non-resident shareholders from using the tax treaty network to negate their capital gains tax liability. With the abolition of the DDT and the introduction of anti-avoidance measures, claiming tax treaty benefits has however become very onerous. Given this, the fear of a buy-back escaping tax is unwarranted.

Furthermore, the tax on buy-backs is computed on the difference between the buy-back price and the issue price of the shares. Invariably, investors acquire listed shares at a price much higher than the issue price, resulting in a higher tax liability on account of a buy-back as against an on-market sale. For example, let's consider that the issue price of a share was INR50 and an investor bought the share in the secondary market at INR1800. Subsequently, if the company proposes to buy back the shares at INR1900, the investor would be required to pay tax of **INR370** i.e., 20 per cent on INR1850 (INR1900-INR50). As against this, on sale, the capital gains liability of the investor would be INR15 i.e.,15 per cent on gains of INR100 (INR1900-INR1800). Therefore, there is a disparity between the buy-back tax and the capital gains tax.

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Given the business sentiments and liquidity crunch as a result of COVID-19, the buy-back of shares by cash-rich companies could pass on some much-needed liquidity to investors. Hence, there is a compelling case for the government to consider abolishing the buy-back tax. As investors would pay capital gains tax, there would be no loss to revenue although there may be a deferment of collection of taxes.

NBFCs should be allowed to receive payments without tax being withheld at source

Another measure that would result in increasing liquidity in the system would be to remove the requirement for borrowers to withhold tax when they make payments to NBFCs. Though the government has already reduced the applicability of withholding tax rates by 25 per cent for financial year 2020-21, NBFCs would suffer tax deduction at the rate of 7.5 per cent on the amount of interest received by them. A complete exemption to systemically important NBFCs, if not all, from withholding tax requirements is likely to have a rippling effect as more money in the hands of these entities would result in more lending.

Pertinently, there is no requirement to withhold tax when borrowers make payment to banks. In fact, the government, over the past few years, has taken several steps to ensure parity between NBFCs and banks in the application of taxation laws. Allowing deduction in relation to the provision for non-performing assets (NPAs) and not taxing income in relation to NPAs are some of the measures that the government introduced under taxation laws in the last two to three years.

Therefore, it may now be only equitable that NBFCs are also provided exemption from applicability of withholding tax provisions. These measures are not likely to have any impact on the government's tax collections but may significantly improve investor sentiment.

Is all well with MFs?

With the news of closure of some open-ended MF schemes, there has been news of panic redemption pressure across the MF industry. Closure here implies that investors cannot withdraw their money on demand but will be repaid when the fund is able to realise its investments.

It is important to know that the schemes in question were designed to invest in low-rated/high-risk debt instruments and meant to offer superior returns. Such schemes are said to have done fairly well, as long as the going was good in the economy. However, with the ongoing credit crisis, the asset-liability mismatch has been amplified due to defaults by several corporates. Fund houses do resort to borrowings to meet redemption needs but it does not help that significant assets in the schemes have turned illiquid, if not bad. COVID-19 has worsened the illiquidity on the asset side while redemptions have surged, leading to a crisis. The freeze ensures that there is no advantage to exiting investors or new incoming investors at the cost of old and continuing investors.

The RBI's recent move to provide a new line of credit to MFs to tide over their liquidity issues is timely and relevant. Now, SEBI has also directed the listing of the units of closed schemes so as to give unitholders an exit route.

In the longer run, however, can fund houses afford such products or assets? SEBI has clearly directed fund houses to bring down their exposure to risky assets. On the issue of asset quality, the capital markets regulator has come down heavily on rating agencies for not having undertaken

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timely downgrades. It has also directed fund houses to do their homework rather than blame rating agencies. Perhaps the regulators need to address the long-pending need to unify the debt markets to enable wider participation so that there is better price discovery of debt instruments.

To conclude, while COVID-19 leaves a trail of destruction in its wake, agility and adaptability are crucial for survival. The support of governments and regulators will be required to create a favourable tax regime while increased global cooperation and greater resilience will also be needed to overcome the current crisis.

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