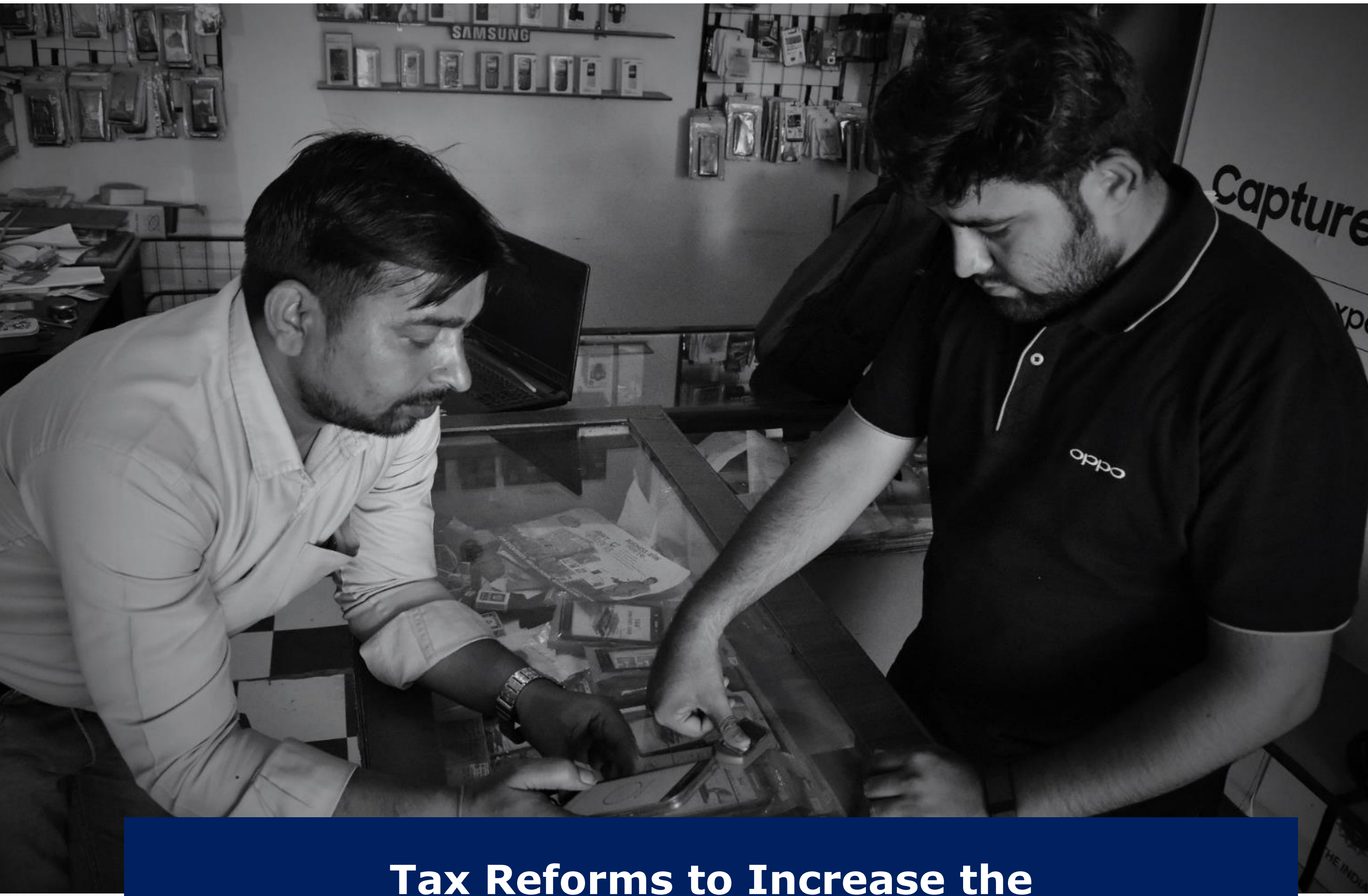

Tax Reforms to Increase the Viability of Business Correspondents

Policy Note

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Key Recommendations:

The current interpretation and wording of regulations on Tax Deducted at Source (TDS) and Goods and Services Tax (GST) limit the viability of the Business Correspondent model. The following policy changes can fix this issue:

- The Central Board of Direct Taxes (CBDT) should issue a clarification stating that the exemption of the TDS deduction applies to all BCs regardless of the bank for which they operate.
- The Central Board of Indirect taxes and Customs (CBIC) should issue a notification to extend the application of a NIL GST rate to *all* banking services offered at BC Agent outlets, irrespective of whether they pertain to accounts from rural/urban areas or PMJDY.
- RBI should examine whether current modes of GST collection on transactions performed at BC points follow the principles of value-added taxation. This note shows that, currently, GST is being overcharged on such transaction, an issue that could be resolved allowing BC agents to charge fees, within, of course, the limits prescribed by their sponsor bank.

Background

The Reserve Bank of India's (RBI) model to bring banking to the last mile through Business Correspondents (BC) has achieved important results. During the COVID-19 pandemic, BCs brought essential banking services to under-banked and unbanked citizens and played a vital role in simplifying access to COVID-19 relief packages. As of March 2020, over 1.1 million BCs provide services to their communities, constituting 87% of all banking outlets in the country[1]. The transformative potential of such last-mile facilitators is evident from the high-level statistics reported in Table 1 below. Consider the case of rural India. With 649,481 villages[2], bank branches and ATMs in rural areas leave a significant gap in access to financial services which 541,000 rural BCs[3] are contributing to address. The fundamental role played by BC agents was further acknowledged during the ongoing COVID-19 pandemic. First, in April 2020 BC agents were recognized to provide essential services and thus were allowed to operate while lockdown measures were in effect. Subsequently, in April 2021, they have also been recognized as "front-line COVID warriors" - to be prioritized for vaccination. Evidently, ensuring the sustainability and expansion of the BC model is crucial to increase access to financial services, integrate all population segments with the formal financial system, and contribute to the nation's transition to a less-cash economy.

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[1] Microsave (2020). The Rise of New Age BCNMs

[2] 2011 Census Data.

[3] Microsave (2020). The Rise of New Age BCNMs

Table 1: Number and regional distribution of Commercial Bank Branches and ATMs (RBI data, December 2020)

	Total	Rural Areas	Semi-urban Centres	Urban Centres	Metro Centres
Commercial Bank Branches	**160,827**	52,632 (33%)	43,492 (27%)	31,326 (19%)	33,377 (21%)
ATMs	**233,066**	46,103 (20%)	65,822 (28%)	60,306 (26%)	60,835 (26%)

Policy Framework

The Reserve Bank of India (RBI) explicitly recognizes the important role that BCs play to provide financial services to the poor in its 2020-2024 Financial Inclusion Strategy and through the numerous policies implemented since 2006 to support and expand their role. The Strategy identifies the "*number of BCs per 100,000 citizens*" as a key metric for "*access to financial services"* and notes that they should receive further support to enhance their role in offering a basic bouquet of financial services[4] to citizens.

RBI has adopted a policy direction that clearly demarcates an intent to strengthen, expand, and support the BC model. Essential policies in this regard include the relaxation of Domestic Money Transfer rules (2011 - Permitting non-banks to charge appropriate fee), the introduction of interoperability among banks (2012 - Permitting BC Agents to serve customers of any Bank), and the waiver of the *distance criteria* for BCs (2014 - Recognising the significance of operative convenience and technology advancement).

Considering the above directives, ensuring the sustainability of the BC model is essential to achieve RBI's vision to "*make financial services available, accessible, and affordable to all the citizens in a safe and transparent manner to support inclusive and resilient multi-stakeholder led growth*". To achieve sustainability and scale up the model further, it is critical to make it attractive for the highest possible number of potential BCs and ensure their continued engagement.

To this end, this note focuses on two key taxation issues that are hindering the sustainability and attractiveness of the BC model, namely the application of Tax Deducted at Source (TDS) on cash withdrawals and of the Goods and Services Tax (GST) on financial transactions conducted by BCs. Specifically, this note argues that flawed implementations certain regulations lead to significant entry barriers and friction, i.e., that BCs are subject to taxes and deductions which erode their already thin revenue margins.

The Profile of BC Agents

In areas where banks have not opened a branch or set up an ATM, local shop owners are trained to offer the services of Banking Agents, which typically earns them, based on field insights[5], rupees 250 - 5,000 a month. The revenue that these individuals earn as a BC can thus supplement their main source of income, but it is not high enough to push them past the threshold required to pay income taxes or collect GST, unless they are already over or close to this limit.

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[4] This basic bouquet of financial services identified by RBI in the Financial Inclusion Strategy includes a Basic Savings Bank Deposit Account, credit, a micro life and non-life insurance product, a pension product, and a suitable investment product.

[5] Data collected through members of the Banking Correspondent Federation of India.

Tax Deducted at Source (TDS)

In 2019 and 2020 the Central Board of Direct Taxes under the Ministry of Finance introduced two amendments of Section 194N of the Income Tax Act with the clear intent of discouraging the use of cash and accelerating India's transition to a *less-cash* economy. Specifically, the Act mandates the deduction of TDS on cash withdrawals at the rate of 2% if, at the time of withdrawal, the aggregate amount of cash withdrawn by any individual exceeds one crore rupees during the previous year. In case of a recipient who has not filed income returns every year for at least three years, which is rather common among low-income citizens, the act becomes even more stringent. It states that for this group of people the deduction of 2% TDS on cash withdrawals will apply if the aggregate amount withdrawn by the recipient in the previous year is between 20 lakh and 1 crore rupees. On the other hand, if that amount exceeds 1 crore rupees, the TDS deduction rate would increase to 5%.

Recognising that this would create an unfair burden on individuals and institutions *who are involved in the handling of substantial amounts of cash as a part of their business operation*[6], the act makes explicit provisions stating that these regulations would not apply to "any business correspondent of a banking company".

Yet, many BCs are not being recognized as such by the banks from which they withdraw cash and are being subject to TDS deduction. This practice is observed in instances where the BC is affiliated to a bank that is different from the one where the cash withdrawal is conducted, which is quite common in rural areas where BC have personal bank accounts with local Banks and serve as BC Agent on behalf of other banks through which, for example, migrants send remittances or citizens access their government subsidies. Even when the BC produces proof of her/his status (through a letter from the BC sponsor Bank), most local banks refuse to exempt the BC Agents from TDS deduction, implementing a flawed interpretation of the law, i.e., that the TDS deduction does not apply only to BCs of the same bank where the withdrawal occurs, rather than of any bank. A clarification from the Ministry of Finance to make this provision more explicit is required to ensure that the intent of the legislator is applied to its full extent. If this issue is not resolved, BC Agents may stop serving the customers once they hit the first TDS ceiling of Rs. 20 lakh or suffer a significant capital blockage. This can be as high as 400% or 1,000% of their income as illustrated in Table 2 below.

Table 2: Example of capital blockage for a BC following TDS deduction

Transaction Amount	Fee levied by BC		TDS (2%)		TDS (5%)	
	Fee (percent)	Fee (rupees)	TDS (rupees)	TDS / Fee (percent)	TDS (rupees)	TDS / Fee (percent)
1,000	0.5%	5	20	400%	50	1,000%

In the unlikely scenario of a BC agent that (a) files income taxes (many are not required to do so), and (b) fiscally savvy enough to know how to apply for a refund when filing taxes, the capital blockage caused from the TDS deduction is proportionally so high that, considering the opportunity cost of having access to these resources blocked till Income Tax refunds are received in the next year, conducting such transactions would make very little business sense for any BC agent.

[6] As clearly stated in the Memorandum to Finance (No.2) Bill of 2019, which suggests introducing the exemptions to the application of the TDS deduction on cash withdrawals, which were adopted by the Finance Bill, 2020.

Goods and Services Tax (GST)

The introduction of GST in 2017 marked a significant advancement in India's tax mobilization capacity. At the same time, the regulator intended to create a system that did not create an unfair burden on the poorer population segments, an intent that is demonstrated by several amendments and provisions, some of which relate to financial inclusion and the BC model and will be detailed in this note. To begin with, it is worth mentioning that services provided by a business correspondent with respect to accounts from rural areas[7] and PMJDY accounts are subject to a NIL GST rate. However, for all intents and purposes it is virtually impossible for a BC to adequately avail the benefit of this provision. This is because a BC cannot determine whether the bank accounts that they service are rural or urban, since transactions conducted through IMPS only require the IFSC of the banking institution, which is unique for each financial institution, regardless of whether the client's account is hosted at a rural or urban branch. This leads to an unintended *inclusion* error[8]: as the IMPS system is blind to whether an account is rural or urban, GST is charged on all transactions, directly contradicting the policy intent.

The inclusion of interoperable services[9] has greatly increased the potential of BC agents to advance financial inclusion, but also created some new challenges. In fact, while for certain interoperable services, like AEPS, NPCI charges fees directly to the issuer bank, for others, like remittances, such back-end reconciliation of fees is not possible. In these cases, banks collect fees from customers via BC agents[10] that are channelled directly to the banks, inclusive of GST. Subsequently, banks will pay a fee on the same service, also susceptible to GST, to the Corporate Business Correspondents (CBC) to which the BC agent that processed the initial transaction belongs, and, again, the CBC will pay a commission to the agents, which will also have a GST component. This system leads to several issues. First, it can be observed that the fee paid by the customer includes the value added to the transaction, not only by the bank, but also by the CBC and the BC agent. This is obvious considering that the fee is divided between these three actors. In this light, it can be argued that GST is being charged multiple times on the same value addition as it is levied on the overall fee paid by the citizen and then again on the fee paid by the bank to the CBC, and from the CBC to the BC agent. Finally, indirectly this system forces citizens to pay GST on services that in most instances should be GST exempt, in this case the service rendered by the BC agent. This is because, again, the overall fee paid by the citizen includes the agent's value added as well.

An example can help clarify the arguments above. Consider a situation in which a citizen submits INR 1,000 in remittances, paying INR 10 in fees. This includes INR 8.47 of fees and INR 1.53 of GST. Suppose the bank pays 95% of the net fee it receives to the CBC and the CBC pays 90% of the net fees it receives to the BC agent. Noting that both transactions are also subject to GST, it follows that the BC agent receives INR 5.2, the CBC INR 0.68, and the bank INR 0.42, while the cumulative GST remitted is equal to INR 3.69 (1.53 collected by the BC agent from the citizen, 1.23 collected by the CBC from the bank, and .95 collected by the CBC from the BC agent). Evidently, if the net fees collected by the CBC and the bank are representative of their value addition and considering that the

[7] Notification No.12/2017 – Central Tax (Rate) Serial No. 39, Heading 9971.

[8] Please note that accurately measuring this inclusion error is virtually impossible for the same reasons causing it: the IMPS system is unable to distinguish between transactions conducted on accounts belonging to rural or urban branches. However, considering rural-to-urban migration patterns and the general composition of the Indian population, it is reasonable to assume that this is a non-negligible issue.

[9] DBOD.No.BL.BC.82/22.01.009/2011-12

[10] Please note that this is in line with an RBI circular which allows Bank/non-Bank to charge an appropriate fee to Domestic Money Transfers (Para 4 e) of RBI/2011-12/213 DPSS.PD.CO No. 622/02.27.019/2011-2012), which partially supersedes another circular from 2010 which stated that "The banks (and not BCs) are permitted to collect reasonable service charges from the customers in a transparent manner".

service provided by the BC agent should not be subject to GST, the current system clearly leads to significantly overcharge GST, mostly at the detriment of the citizens and the BC agents, whose potential earnings are eroded significantly. Considering that both BC agents and BC clients tend to be low-income citizens, it is evident how this directly violates the Government's intent to ensure a proportional tax burden and greater financial inclusion for the lowest income levels.

Conclusions and Recommendations

This brief note demonstrates how gaps in the interpretation of tax laws have implications for the tax burden and revenue margins of Business Correspondents. It is thus essential to issue policy clarifications and amendments to ensure that the law is applied according to its true intent and, consequently, the BC model is made as attractive and profitable as possible. Specifically, it is suggested that:

1. A clarification on section 194N of the Income Tax Act should be issued by the Central Board of Direct Taxes (CBDT) stating that the exemption of the TDS deduction applies to all BCs regardless of the bank for which they operate. Alternatively, the text of the act could be changed to "*any business correspondent of* <u>*any*</u> *banking company or co-operative…*" to prevent any confusion.
2. A notification to extend the provisions of Notification 12/2017, Heading 9971 may be issued by the Central Board of Indirect Taxes and Customs, to apply a NIL GST rate to *all* banking services offered at BC Agent outlets, irrespective of whether they pertain to accounts from rural/urban areas or PMJDY, since, as explained above, the distinction between rural and urban branches cannot be made on transaction performed on NPCI platforms and the fact that BC Agent services are normally used by the poorer strata of the society. This could be seen as an interim measure while a technical solution is sought to allow the identification of rural and PMJDY accounts on transactions performed on NPCI platforms, which would permit the intended implementation of notification 12/2017.
3. There is a need for RBI to examine whether the current implementation of GST regulations duly follows the principles of value-added taxation since, as highlighted in this note, it appears that GST is currently being overcharged on certain transactions performed by BC agents. A potential solution might come from allowing agents to directly charge fees, within, obviously, limits prescribed by RBI.

Business Correspondents play an essential role to bring financial services to the poorest citizens and underbanked regions of the country. Ensuring their viability is, thus, imperative to support the scale up and sustainability of their operations and thus meet the government's priorities on financial inclusion. Ensuring the correct implementation of TDS and GST regulations is a low-hanging fruit to take an important step in that direction to which the recommendations presented in this note, if adopted, would contribute.

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