GST to be introduced in India is a fundamental change in the indirect taxation system followed up to date. It is supposed to replace certain active taxes, provide seamless input credit and reduce overall costs and prices. This is expected to translate into overall growth in Indian economy and hence the GDP of India, better use of factors of production, reduction in inflation, etc.

As mentioned before in India GST is to be introduced in the dual form as CGST and SGST, with IGST being applied for interstate transactions. Reduced input credit will be allowed to financial services and place of supply rules for financial services are specifically to be put in place for them. Thus financial services would be partially exempt.

In this research the focus is on evaluating the completeness of the provisions of law existing as on date in relation to taxing the financial services supply under the proposed GST. The reasons are the following:

1. Indirect taxes mainly service tax; especially those contributed by the financial services industry form a huge portion of the total tax revenue of the country. Hence any proposed major change in law like the GST, needs to suitably address the concerns currently faced by the financial services industry.

2. Currently, the financial services industry is facing challenges in terms of law in relation to services included in the negative list, place of provision of services, valuation of the services, unavailability of Cenvat credit, unclear exemptions available etc. These lacunas in the law need to be attended to under the anticipated GST.
3. The structure of the GST law is to have a CGST, SGST and IGST given the feudal government. Financial services are intangible in nature, and hence laws relating to the state where the taxes would become payable, the cross availability of CGST and SGST etc. are extremely important. These laws will decide the compliances to be undertaken, the state where registrations under GST need to be obtained, the Information Technology or software solutions required, the administrative process changes required, the increased cost of funds due to blockage of Cenvat credit if any, etc. These changes will have a colossal impact on the financial services industry.

In view of the above, the research is undertaken with the objectives listed below. It is likely that the objectives will address the above problems.

**Objectives of Research**

1. To comprehend the existing Indian economy and the economic policies specifically in relation to financial services supply provisions

2. To study the options existing to tax financial services supply under GST and impact thereof

3. To study the assesses / tax professionals viewpoint on the proposed provisions under GST in relation to compliances for financial services

4. To examine the viewpoint of assesses / tax professionals in relation to impact of the proposed GST on the financial services sector
Research Methodology

Region of research
In terms of the geographical area for the research, it has been restricted to Mumbai, Maharashtra. Mumbai is the financial capital of India and hence most of the financial sector companies have their headquarters in Mumbai. Thus Mumbai is a good representative for the purposes of drawing conclusions.

Research Design
The research would be descriptive, empirical as well as analytical. The design has been based on the objectives and hypothesis of the study.

Data in relation to contribution of indirect taxes to total taxes, ratio to GDP, provisions for taxing of financial services is collected from the existing law and statistical data i.e. secondary data. The data collected through the interviews and questionnaires which are primary data has been subject to further statistical methods of analysis.

Sampling
All assessees, accountants and tax professionals related to the financial sector and indirect taxes are the population. For this purpose a sample of different assessees, accountants and tax professionals are selected - around 40 in number. This sample of 40 individuals has been personally interviewed. Additionally the questionnaires were sent to them and their responses collated. The sample of persons located in Mumbai is selected based on purposive sampling. A larger sample size is not practical since the questions to be answered are technical and hence need to be answered by technical people in the financial services sector dealing regularly with indirect taxes. Such people who are available to provide the response are few and hence the sample size is restricted to 40 also based on convenient sampling.

Tools for Data collection and Source of Data
As mentioned earlier, the study involves collection of both primary and secondary data. Primary data is collected using the interview schedule and structured questionnaire. The
questionnaire before actual use was put through pilot testing. The difficulties which were identified in pilot testing were removed before finalizing the final questionnaire. This questionnaire was distributed taken personally to the selected sample of 40 people.

**Secondary data** has been collected through *existing* legislations, proposed legislations on GST floated in public domain, published/unpublished reports on the GST impact in India and globally, related articles and magazines, research papers, various websites on GST and financial services, data available online in relation to tax revenues, GDP ratios etc.

**Data Analysis**
Data collected through interviews will be analysed qualitatively. Quantitative data if any will be subjected to Z test. The primary and secondary data has been analysed using charts/graphs using MS Excel.

**Methods of reporting**
Data in relation to the above is collected and has been reported using tables, text, bar diagrams, graphs and pie diagrams for successful understanding.

**Utility of the Research**
A good tax system would ensure that the country’s resources are utilized in an most advantageous manner and the country is competitive in the global trade. When taxes are not exported, the global rates become competitive. GST is expected to ensure that with seamless ITC the costs will come down for both the business people and the consumers. It would lead to an increase in the GDP of the country and proficient use of all factors of production. Further, financial services sector supplies average 50% of the total demand in an economy and contributes to almost 20% of the indirect taxes in an economy. Hence the study of the existing system with the pros and cons, the impact of GST on the said financial sector, the difficulties in administrative compliance in the sector and examination of views of accountants in this relation is pertinent.
**Limitations of the Study**

The extent of the planned study is limited to Mumbai region with sample size of 40 only. Hence the end result of the study could differ across the country. Also, part of the study is based on secondary data which cannot be free from prejudice. Further, the primary data is collected through interviews of individuals which again would be subject to personal prejudices. Nevertheless, the study should be a good depiction of the total population.

**Scope**

The scope of the study is limited to the Mumbai region only. Of the Mumbai region, the sample size of 40 would consist of accountants and financial service industry tax professionals to whom the interviews/questionnaires would be sent. Based on the actual provisions introduced by the Government for GST, the study could be further refined and developed in future to further simplify the taxation provisions for financial services.

Collection and reporting and analysis of relevant data, keeping in mind objectives mentioned above is carried out under the following framework:

**Data for contribution by taxes to the economy**

Data is presented such as ratio of total taxes collected to Gross Domestic Product followed by breakup of the taxes into direct and indirect taxes with their ratios. Wherever possible the indirect taxes have been further analysed to trace contribution of taxes of financial services sector to the economy.

**GST Rates**

Rates of GST applied globally have been compared to existing Indian indirect tax rates and proposed GST rates.
Legislation around GST and financial services:
This has been analysed globally and within India chiefly on the following aspects:

- Treatment of the service – exempt/taxable/zero rated
- Federal system/mechanism for GST
- ITC availability
- Treatment of interchange income
- Treatment of Intermediary services
- Treatment of Correspondent Bank charges
- Place of supply rules

As mentioned, currently in India there are different types of indirect taxes applicable on transactions in goods and services. In relation to financial service industry, service tax which is a tax on services is the primary levy. Thus the financial services industry which pays VAT, excise duty etc. on multitude of its inputs/input services is able to claim Cenvat credit of service tax only. This is because the output of financial service industry is a ‘service’ and hence it can avail and use Cenvat credit of taxes paid on services only. Hence the other indirect taxes become a cost to the industry. Under the GST most of the taxes are proposed to be included in the GST. A diagrammatic representation of the different taxes to be included into the CGST and SGST is below:

D 1: Diagrammatic Representation of taxes to be replaced under GST in India
In the **budget of 2015**, the government has already taken a step in that direction by discontinuing education cess and secondary and higher education cess as separate taxes and including them in the excise and service tax itself. For this the general rates of excise and service tax have been increased.
GST Rates

GST is proposed to be a tax to replace the multitude of indirect taxes prevalent in the Indian economy. The existing rates are ranging up to 30% under excise duty and customs, 12.36% (14% as per Budget 2015) service tax rate and VAT rates up to 12.5%.

S1 : Table of current rates of chief indirect taxes to be included in CGST & SGST

<table>
<thead>
<tr>
<th>Name of tax</th>
<th>Highest Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central Excise Duty</td>
<td>30%</td>
</tr>
<tr>
<td>Additional Excise Duty</td>
<td>15%</td>
</tr>
<tr>
<td>Additional Customs Duty</td>
<td>30%</td>
</tr>
<tr>
<td>Special Customs duty</td>
<td>4%</td>
</tr>
<tr>
<td>Service Tax</td>
<td>14%</td>
</tr>
<tr>
<td>VAT</td>
<td>12.50%</td>
</tr>
</tbody>
</table>
Additional excise duty is applicable only on specific goods/products. Further in most cases additional customs duty is waived (by way of a refund) if the goods are imported for the purpose of resale. Thus the impact of excise or customs duty applicable on goods would be highest @ 30-35%, and in terms of state taxes goods are would be liable to 12.5% VAT at a maximum rate. Further services are liable at 14% - refer the chart below.

C1 – S1 : Graph of current rates of chief indirect taxes to be included in CGST & SGST

Source - Eximguru - Highest rates have been considered
Thus a GST which includes all the above taxes should ideally be between 15-20% so that the service sector does not feel a burden and the manufacturing sector a loss. However, though the earlier proposal was to keep a GST rate of 16% with 8% each to CGST and SGST, the current talks are around 23-27% of total GST rates. Of course for essentials etc. different slab rates are proposed. **If the proposed rate of 23-27% is adopted it would be one of the highest GST rates in the world. It will definitely be a huge hit to the real income of the people.**

### S2: Table of GST/VAT rates globally - 2014

<table>
<thead>
<tr>
<th>Name of Country</th>
<th>VAT/GST Rate Year - 2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>10.0</td>
</tr>
<tr>
<td>Canada</td>
<td>5.0</td>
</tr>
<tr>
<td>France</td>
<td>20.0</td>
</tr>
<tr>
<td>Germany</td>
<td>19.0</td>
</tr>
<tr>
<td>Greece</td>
<td>23.0</td>
</tr>
<tr>
<td>Hungary</td>
<td>27.0</td>
</tr>
<tr>
<td>Iceland</td>
<td>25.5</td>
</tr>
<tr>
<td>Israel</td>
<td>18.0</td>
</tr>
<tr>
<td>Italy</td>
<td>22.0</td>
</tr>
<tr>
<td>Japan</td>
<td>5.0</td>
</tr>
<tr>
<td>Korea</td>
<td>10.0</td>
</tr>
<tr>
<td>Mexico</td>
<td>16.0</td>
</tr>
<tr>
<td>Netherlands</td>
<td>21.0</td>
</tr>
<tr>
<td>New Zealand</td>
<td>15.0</td>
</tr>
<tr>
<td>Norway</td>
<td>25.0</td>
</tr>
<tr>
<td>Portugal</td>
<td>23.0</td>
</tr>
<tr>
<td>Spain</td>
<td>21.0</td>
</tr>
<tr>
<td>Switzerland</td>
<td>8.0</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>20.0</td>
</tr>
</tbody>
</table>

*Source: national delegates - position as at 1 January 2014 - OECD Tax Database
Reduced rates have not been captured - Standard rates reflecting*
Reduced rates have not been captured - Standard rates reflecting.

A look at the table and chart above and an analysis of the same i.e. geometric mean of the said rates would make it clear that globally majority of the economies have a GST rate of around **15.6%**. Geometric mean has been taken since it is a mean of percentages where arithmetic mean would be an incorrect measure of central tendency. The calculated geometric mean is 15.6% whereas the arithmetic mean is **17.5%**. Thus the global GST rate is in the range of 15-18%.

Hence the earlier proposed rate of 16% total GST in India would have been ideal. Even economies like Canada and Australia have very low GST rates like 5% and 10% respectively. **Thus India should ideally consider a GST rate (of both CGST and SGST together) of maximum 20%**.

**Contribution of taxes in economy**

**S3 : Table for Data for contribution by taxes to the economy**

<table>
<thead>
<tr>
<th>Name of Country</th>
<th>Tax to GDP Ratio - Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>25.80</td>
</tr>
</tbody>
</table>
As can be seen from the above table, tax collections form a great part of the total Gross Domestic Product – GDP in most of the global economies. The ratios range from 10.20% in Pakistan the lowest to 44.60% in France. The average ratio is 27.8% which is a considerable portion of the total revenue generated through GDP.

This indicates the importance of tax as a tool for the government to control and direct the economy, inflation, growth of a country. The above comparative percentages of tax of the total GDP are represented below in a graph form for ease of understanding.

C3 – S3: Graph for Data for contribution by taxes to the economy
In India, the said ratio is 17%. Though smaller than the global comparables, 17% is a sizeable proportion of the total GDP of the government.

**S4 : Table of Total Tax to GDP Ratio - India**

<table>
<thead>
<tr>
<th>Year</th>
<th>Tax as % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009-10</td>
<td>15.45</td>
</tr>
<tr>
<td>2010-11</td>
<td>16.31</td>
</tr>
<tr>
<td>2011-12</td>
<td>16.44</td>
</tr>
<tr>
<td>2012-13</td>
<td>17.23</td>
</tr>
</tbody>
</table>

*Source - Indian Public Finance Statistics - 2012-13*
GST, the proposed new reform for the Indian economy, is a culmination of all indirect taxes into one tax on both goods and services. It is expected to be a game changer for the Indian economy.

As mentioned above, tax in itself is a good portion of the total GDP of all economies and government revenues - approx. 27% globally and 17.5% in India. Hence it is called as a ‘fiscal tool’ to help the government boost economy, growth etc. Hence it is obvious that the proportion of indirect taxes to the total tax collections would be an important parameter to gauge how much impact any change in indirect taxes or GST would have on the economy.

Below is a breakup of direct and indirect taxes to GDP in India. As can be seen indirect taxes form a larger part – 11% of GDP of the two taxes. Thus GST would have a major impact on the total economy.

### Table for Ratio of Direct and Indirect taxes to GDP - India

<table>
<thead>
<tr>
<th>Year</th>
<th>Direct tax</th>
<th>Indirect tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009-10</td>
<td>5.82</td>
<td>9.63</td>
</tr>
<tr>
<td>2010-11</td>
<td>5.78</td>
<td>10.53</td>
</tr>
<tr>
<td>2011-12</td>
<td>5.66</td>
<td>10.78</td>
</tr>
<tr>
<td>2012-13</td>
<td>5.69</td>
<td>11.54</td>
</tr>
</tbody>
</table>

Source - Indian Public Finance Statistics - 2012-13
### S6 : Table of Percentage Share of direct and indirect taxes in total tax collections - Global

<table>
<thead>
<tr>
<th>Country</th>
<th>Direct Tax</th>
<th>Indirect Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>72.00</td>
<td>28.00</td>
</tr>
<tr>
<td>Canada</td>
<td>75.50</td>
<td>24.50</td>
</tr>
<tr>
<td>France</td>
<td>72.80</td>
<td>27.20</td>
</tr>
<tr>
<td>Germany</td>
<td>71.10</td>
<td>28.90</td>
</tr>
<tr>
<td>Netherlands</td>
<td>69.50</td>
<td>30.50</td>
</tr>
<tr>
<td>New Zealand</td>
<td>61.70</td>
<td>38.30</td>
</tr>
<tr>
<td>Spain</td>
<td>71.90</td>
<td>28.10</td>
</tr>
<tr>
<td>Switzerland</td>
<td>77.10</td>
<td>22.90</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>66.60</td>
<td>33.40</td>
</tr>
<tr>
<td>United States</td>
<td>82.10</td>
<td>17.90</td>
</tr>
</tbody>
</table>

*Source - OECD Tax Policy Analysis, 2012*
The table above now captures data globally of the proportion of indirect taxes to the total tax collections which is around 27% of total tax collections.

**C6 –S6: Graph of Percentage Share of direct and indirect taxes in total tax collections – Global**

![Graph of Percentage Share of direct and indirect taxes in total tax collections – Global](image)

*Source - OECD Tax Policy Analysis, 2012*

The individual breakup of tax collections for Australia and Brazil are shown below in the form of a table and chart to understand how important indirect tax or GST as it is called in these economies a contributor to the country’s growth is. This is relevant for India which is a federal economy about to launch GST.

**S7 : Table of Percentage Share of direct and indirect taxes in total tax collections - Australia**

<table>
<thead>
<tr>
<th>Year</th>
<th>Direct Tax</th>
<th>Indirect Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009-10</td>
<td>70</td>
<td>30</td>
</tr>
<tr>
<td>2010-11</td>
<td>72</td>
<td>28</td>
</tr>
<tr>
<td>2011-12</td>
<td>71</td>
<td>29</td>
</tr>
<tr>
<td>2012-13</td>
<td>71</td>
<td>29</td>
</tr>
</tbody>
</table>

*Source - Taxation Revenue, Australia, 2012-13*
As can be seen above, indirect taxes form approximately 30% of the total tax collections in Australia. GST is 12% of the same.

**C7 – S7: Graph of Percentage Share of direct and indirect taxes in total tax collections - Australia**

Source - *Taxation Revenue, Australia, 2012-13*

**S8: Table of Percentage Share of direct and indirect taxes in total tax collections - Brazil**

<table>
<thead>
<tr>
<th>Year</th>
<th>Direct Tax</th>
<th>Indirect Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009-10</td>
<td>50.3</td>
<td>49.7</td>
</tr>
<tr>
<td>2010-11</td>
<td>50.3</td>
<td>49.7</td>
</tr>
<tr>
<td>2011-12</td>
<td>50.3</td>
<td>49.7</td>
</tr>
<tr>
<td>2012-13</td>
<td>50.3</td>
<td>49.7</td>
</tr>
</tbody>
</table>

Source - *The Brazil Business, Tax Revenue in Brazil, 2014*

In Brazil indirect taxes form a huge proportion of the total taxes. It is almost half of the total tax collections in Brazil.
In India too like Brazil, the proportion of indirect taxes has almost touched 50%. Thus any reform in relation to indirect taxes like a GST in India is bound to have a massive impact on the Indian economy. The expectations from GST are so high because in India, indirect taxes form 50% of the total tax collection.

### S9 : Table of Percentage Share of direct and indirect taxes in total tax collections - India

<table>
<thead>
<tr>
<th>Year</th>
<th>Direct tax</th>
<th>Indirect tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009-10</td>
<td>60</td>
<td>40</td>
</tr>
<tr>
<td>2010-11</td>
<td>55</td>
<td>45</td>
</tr>
<tr>
<td>2011-12</td>
<td>55</td>
<td>45</td>
</tr>
<tr>
<td>2012-13</td>
<td>52</td>
<td>48</td>
</tr>
</tbody>
</table>

*Source - Indian Public Finance Statistics - 2012-13*
As can be seen from the table above and the pie chart below, contribution of the service sector to the total GDP in India is more than that of the other sectors. Hence any change in the taxation of service sector is bound to have an impact on the entire economy.
C10 –S10: Pie chart for Contribution of service sector in total GDP - India

Source - IBEF - 2015

S11 : Table for Increase in contribution of service sector to total GDP - India

<table>
<thead>
<tr>
<th>Year</th>
<th>% Contribution of financial services to total GDP - India</th>
</tr>
</thead>
<tbody>
<tr>
<td>1950-51</td>
<td>30.5</td>
</tr>
<tr>
<td>2009-10</td>
<td>55.2</td>
</tr>
</tbody>
</table>

Source - Indiabudget - Economic Survey 2010-11
It is evident from the above table and the line graph below that the contribution of the service sector to the Indian GDP is on the rise. Hence it is very important to be very careful whilst changing laws impacting the service sector.

**C11 – S11 : Line Graph for Increase in contribution of service sector to total GDP - India**

% Contribution of financial services to total GDP - India

Source - Indiabudget - Economic Survey 2010-11

**S12 : Table for Share of banking & insurance sector in total GDP - India**

<table>
<thead>
<tr>
<th>Year</th>
<th>% Contribution of banking &amp; insurance services to total GDP - India</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004-05</td>
<td>5.8</td>
</tr>
<tr>
<td>2005-06</td>
<td>5.4</td>
</tr>
<tr>
<td>2006-07</td>
<td>5.5</td>
</tr>
<tr>
<td>2007-08</td>
<td>5.5</td>
</tr>
<tr>
<td>2008-09</td>
<td>5.7</td>
</tr>
<tr>
<td>2009-10</td>
<td>5.4</td>
</tr>
</tbody>
</table>
The table above and the line graph below depicts the share of banking and insurance sector the subject matter of this research paper in the total GDP. The said share is around 5.5% (geometric mean has been found since the data is in percentages) which is a reasonable share having an impact on the economy. Hence the laws under GST in relation to this sector, the place of supply rules etc. need to be abundantly clear to ensure positive impact for both the sector and the economy.

C12 – S12 : Line graph for Share of banking & insurance sector in total GDP - India

Source - Indiabudget - Economic Survey 2010-11
Legislation around GST and financial services:

Treatment of the service – exempt/taxable/zero rated

It is a well known fact world over that financial service provider provides basically two services. One is that they accept funds from public in return for payment of interest and make the said funds available to borrowers. The other is they recover the time cost of these funds. However they charge a single amount to the borrowers. Thus the entire consideration received in the form of interest is not for one service rendered. A portion of the consideration is for the service of bringing a lender and borrower together and the balance is for the use of funds. However apportioning the consideration between the two services provided is not possible due to the complexities of the services. Hence it would be highly cumbersome, complex and costly to identify the considerations for each type of service and as a matter of easier option, the services end up being treated as ‘exempt’.

The providers also provide other services like advisory services, portfolio management services, leasing, credit card services etc. For these services generally the consideration is in the form of fees. Further these services are a smaller proportion of their income. Majority of the income of financial service providers comes from interest/discount on monies lent and fees in relation to such lending.
Hence, the general practice is to make the financial services either exempt from GST/VAT or zero rated. In either case no GST/VAT/indirect tax is levied on the service provided on the output side.

Few of the economies require the financial service providers to charge GST/VAT where the income is in the form of fees. Some give an option to the service provider to charge the said tax on the entire service. In such case, the customer can avail ITC of the taxes so charged.

Thus the treatment of the financial services is different. The treatment of the service provided on the output side is very relevant since it determines the ITC available.

There is a huge difference in the ITC available and the final costing depending on whether the service is exempt or zero rated. The same has been explained below in detail.

**Zero rating v/s Exempt status for financial services**

Financial services are treated as exempt as interest is income for time value of money and is not payment towards a consumed service. However this leads to higher cost of tax as ITC is not available to Banks. However, in the case of zero rating of financial services, ITC on inputs became available and hence services provided by Banks will be cheaper since their input costs come down.

**D3: Diagrammatic representation of scenario before zero rating of financial services i.e. when they were exempt – NO ITC for Bank and hence costs increase.**
An option can be to zero rate taxable supplies to GST registered businesses and exempt taxable supplies to non GST registered consumers. This will limit the cascading effect of taxes to the B2B financial transactions and B2C will be under taxed. Further B2B financial transactions became tax neutral like other transactions.

**Treatment of financial service – Globally**

The various treatments accorded to financial services generally around the world are depicted below.

**D5 : Diagrammatic Representation of treatment of financial services globally**
Financial service ‘exempt’: Globally, in most economies, financial services where income is interest or discount are treated as ‘exempt’. Thus ITC on input services is not available at all, and the costs of the same get included in the amounts charged by the service providers as an imbedded cost. Further, since the output service is not liable to any type of indirect taxes, the customer cannot avail any ITC of the tax included in the charge. Thus in these economies there is a tax cost in the financial service cost which is irrecoverable. This pushes the costs up.

Financial service both ‘taxable’ and ‘exempt’: In a few economies to reduce this tax cost impact, the services where fees are separately charged are made ‘taxable’ and liable to GST/VAT. The portion which is earning interest/discount remains exempt.

Thus the ITC on input services used for providing ‘taxable’ services is available 100% whereas the ITC on input services used to provide ‘exempt’ services is not available at all. Thus financial service providers in such economies get proportionate credit in ratio of their incomes. In such economies the service providers need to take the additional effort of tracking their incomes as fees and interest/discounts. Further they need to bifurcate their input services into those related to fee incomes and those related to interest/discounts. If that is not possible then an alternative would be to take ITC in proportion of the taxable output services.
**Financial service ‘zero rated’:** Few economies treat the financial services as ‘zero rated’. Thus though the service provider does not charge GST/VAT on the output side, he can avail 100% ITC of input services used. This model ensures that the costs of the service provider are lower since the ITC is available and his charge to customer does not have any imbedded tax costs. However, since the output service is not liable to GST/VAT, the customer cannot avail any ITC. This does not impact much as the cost of the service will be lower as the service provider has availed 100% ITC. In most economies exports of financial services are zero rated in this manner.

There are a few other types of treatment of financial services with related ITC impact globally also shown below:

**D6: Diagrammatic Representation of other treatment of financial services globally**

Few economies keep the entire gamut of financial services within the ‘taxable’ classification and require the service provider to charge GST/VAT on all types of services irrespective of the consideration received. This means that whether the income is in the nature of interest or discount or fees the same are liable to GST/VAT. In such cases of course, ITC is available 100% to the financial service provider and the customer also avails ITC of 100% for GST/VAT charged by service provider.
Another treatment is to treat services provided to customers not registered for GST/VAT – generally B2C cases as ‘exempt’ and the ones rendered to GST/VAT registered customers – B2B cases as ‘zero rated’. That way though B2C customers would have a higher cost of procuring financial services (since ITC is a cost to the service provider) their proportion is small. In B2B cases zero rating would ensure lower costs as explained earlier. Again under this system, the service provider needs to track the GST/VAT registration status of the customer. The service provider would avail proportionate ITC for services to B2B customers. However the B2B customer would not get ITC.

An alternative to this approach which is prevalent is to keep B2C services ‘exempt’ and tax B2B customers. This does not drastically change things from the service provider perspective but will further bring down the cascading effect of GST/VAT as the B2B customers can avail ITC of GST/VAT paid.

In the European Union all financial services are exempt and hence ITC availability is 0%. There is a proposal to tax the financial services provided to B2B customers whereby ITC will be proportionately available to the service provider and 100% ITC to B2B customers.

In Canada currently financial services are exempt and ITC is 0%. There is a proposal to zero rate the financial services provided to B2B customers whereby ITC will be proportionately available to the service provider. However, B2B customers will not get any ITC. Even in New Zealand all financial services are exempt and those to B2B customers are zero rated.

Singapore exempts all financial services with 0% ITC. Exports are zero rated. Malaysia follows a system like India where services with fee income are taxable and those with interest/discount income are exempt. Thus ITC is available proportionately.

Australia has a unique system of treating financial services employing a “reduced ITC” system. Firstly in Australia instead of the terms exempt and zero rated the terms are input taxed and
GST-free respectively. Effectively they have the same impact in terms of chargeability of output GST/VAT and availability of ITC.

However, the term financial supply which covers financial services is defined based on the nature of the service itself and whether the service provider is the owner of the financial supply or the generator of the said supply. Thus specific supplies depending on their nature and the status of the service provider are covered as financial supplies/services.

A review of the legislation shows that supplies like opening of an account, debts, annuities, charges/mortgages etc. are financial supplies. Certain services which are incidental to these are also covered under financial supplies. However services like cheque book issues, professional services, advisory service etc. are not covered under financial services at all. Thus effectively through definition certain supplies get excluded and hence can avail 100% ITC. The method of the classification is similar to India where the services where income if interest/discount would be out of the taxable net and the services with fee incomes would become taxable.

Further there is a financial acquisition threshold – FAT in Australia to keep businesses with very small turnovers of financial services of their total turnover out of the need to get input taxed. Thus if FAT is not exceeded they can avail full ITC. The threshold is calculated based on the proportion of ITC on financial acquisitions to the total ITC and only if a certain limit is crossed then the person gets covered as a financial supplier. It helps businesses for whom financial supply is a very small portion of the business to remain out of the issues caused by non availability of ITC.

Lastly Australia follows the system of Reduced ITC for service providers who get covered as financial suppliers. Makers of financial supplies are allowed a reduced ITC almost 75% on their inputs/input services. However the inherent issues in the Australian system are that firstly the service providers need to analyze their supplies to decide whether they are financial supplies as per law. Then they need to categorize their output according to definition and based on whether they exceed the prescribed norms of FAT. Separately they need to bifurcate their input services
as per their categories of output financial supplies so that they get benefit of reduced input tax credit.

Thus as can be seen above, the issue of how to tax financial services, the value to be taxed, the treatment to be given, the ITC to be allowed etc. are all major issues. There is no consensus on the same. Each country applies its own norms.

When India is posed on the anvil of GST, it is important to device stringent, clear laws on what should be included in financial services, how should the value to be taxed under GST be determined, the treatment of ITC etc.

The current treatment of financial services in India under the negative list regime is shown below:

**D7 : Diagrammatic Representation of treatment of financial services in India**

In India under the current negative list regime the following treatment is given to the various types of incomes received by financial services providers. The major income streams of a bank
with its service tax applicability are provided below since currently the financial service industry in India are liable to service tax which going forward would be GST.

It is relevant to note that India is the only country which in few cases like foreign exchange conversion is making margins liable to indirect tax.

**Fees received for any activity** – Includes fees/charges for operation of accounts, issuing of cheque books, demand drafts, Letter of credit, providing of any loan facility like term loan, cash credit etc., - Thus any types of fees received by banks are considered as ‘taxable’ and hence are liable to service tax.

**Interest/ Discount** – All types of income of banks which are in the nature of interest and discount are under the negative list and hence not liable to service tax. This includes interest on all types of facilities granted by financial service providers like cash credit, overdraft, term loan, vehicle finance, etc. Discount income earned through bill discounting, factoring, etc. is also covered. Thus any income received as time value of money is not liable to service tax.

**Activity of foreign exchange conversion** – The service of sale/purchase and conversion of foreign exchange is not liable to service tax directly. There is a slab system to calculate and pay service tax on foreign exchange conversion. The fees for the same are of course charged directly to service tax separately.

Sale and/or purchase of foreign exchange between banks/authorized dealers is out of the service tax cover.

**Credit Card income** – All income received in relation to credit card service is taxable. This is an exception to the general rule that interest is under the negative list and hence not liable to service tax.

Interest on credit cards is specifically carved out and made liable to service tax in India. Fees for credit card services are of course taxable.
**Interchange Income**: Further interchange income received by both the acquiring and issuing bank is liable to service tax. – Interchange income is discussed further in detail.

**Other types of interest incomes** – Income from repos and reverse repos, are out of the purview of service tax as the nature of income under the activity is in the nature of interest for lending and borrowing. Similarly Collateral borrowing and lending income is also out of the purview of service tax for the same reasons.

**Transactions in securities** – Trading in goods is included in the negative list and hence is not liable to service tax. Further goods include securities as per definition of goods and securities have been defined as per the Securities Contracts (Regulation) Act, 1956. Under the said Act, securities include shares, scrips, stocks, derivatives, units etc. Hence by implication all transactions in shares, scrips, derivatives, units, government securities are out of the service tax net so far as the transaction is of transfer of title of the securities. Derivatives include interest rate swaps, foreign exchange swaps and hence they too are out of service tax cover. Any related services like broker, commission agent would of course continue to be liable to service tax.

Forward and future contracts are in the nature of derivatives and hence trading in them is not liable to service tax. In case the contract relates to transactions in money even then since it is only a transaction in money it would not be liable to service tax.

**Transactions in money and actionable claims** These transactions are similarly not liable to service tax as definition of service excludes activities that are only transactions in money and/or actionable claims. Money is defined to include cheques, drafts, pay orders etc. and hence transactions in these are not liable to service tax.

Thus even commercial paper, certificate of deposit; letters of credit are also not liable to service tax for the value of these instruments and transactions therein as it is a transaction in money (*certificate of deposit and commercial paper should be in the format of a promissory note*). Further, income from commercial paper/certificate of deposit is in the form of discount income
and even due to that is not liable to service tax. Any fees charged for the transaction separately continue to be liable to service tax.

**Export Income of Banks not liable to service tax - Export Rules:**

Rule 6A of the Service Tax Rules, 1994 provides the conditions to be met for services provided by anybody to qualify as exports. Export of services is not liable to service tax. The main conditions to qualify as export are as under:

1. The service provider has to be located in India
2. The service recipient has to be located out of India
3. The service should not be one which is covered under the negative list since then it would anyway not be liable to service tax.
4. The payment or consideration for the service needs to be received in convertible foreign exchange
5. The service needs to be provided outside India as per the current Place of Provision of Services Rules, 2012 (POPS).
6. A new condition is that a service is not considered as export even if all the conditions mentioned above are satisfied if both service provider and service recipient are branch and head office.

Under the earlier regime services provided by branch situated in India to a head office located outside India were treated as export if they satisfied the other conditions as provided in the erstwhile export rules. However, by introducing point 6 in the current Export rules, services between head office and branch, will not be export even though they satisfy all the other conditions.

These services will continue to not be liable to service tax since the place of provision of service would be outside India. Services provided by branch to head office are not those provided to an ‘account holder’ in the normal course of business and hence based on the current provisions Rule 3 of POPS would apply. Currently since there is no proportionate reversal based on the ‘exempt’
service, this classification has no impact. However, this could cause issues in case availment of ITC is made proportionate and the Export Rules are maintained the way they are.

Further, a term “intermediary” has been introduced in the POPS where services provided by intermediary are taxable at location of service provider. Thus a lot of foreign banks acting as agents and procuring loans from their offshore counterparts for their Indian customers are facing issues. Earlier income received on account of these services qualified as export but now it is ‘taxable’. This has also caused lots of issues in context of the Indian banking scenario which is discussed in detail later in the paper.

Whilst most of the explanations provided in the education guide on the types of income and their taxability (discussed above) are in line with global practices, a clear concise and explicit law would help reduce litigation and provide clarity to industry. Further the industry will become globally competitive.

Federal system/mechanism for GST

India has a federal system of government, which means that the power is distributed at two levels – Centre and State. The GST proposal is to cover various indirect taxes charged by each level into CGST and SGST respectively and have a common tax across levels of government and in place of different taxes. This is expected to reduce costs due to ITC and increase the GDP since the base for taxation for both state and centre will be bigger.

However, such a federal or dual structure has its own challenges. This challenge is majorly in the area of taxing interstate transactions.

Firstly the paper captures the methods applied globally in similar situations and then proceeds to the proposed model to be adopted in India.

D8 - Diagrammatic Representation of federal system of GST/VAT globally
Globally as discussed earlier there are two main models for applying GST/VAT on interstate transactions.

1. Centre to charge tax on all interstate transactions and then distribute the same between various states on an agreed basis. In Australia this is done based on the contribution of the various provinces, and in Papua New Guinea based on an agreed proportion.

2. Provinces to incorporate the central tax with their province tax and administer and apply both. The centre portion to be given to the centre. This works like the CST currently works in India. This system is followed by some provinces in Canada. Else if the province does not incorporate the centre tax each manage their taxes and administration separately – This system is followed by other provinces in Canada.

3. EU follows a system similar to one proposed in India – discussed separately below. In EU the common EU VAT is applied separately along with the member state VAT. The assesses are expected to carry out compliances at both levels.

Each system has its own drawbacks and good points.
As can be seen from the diagram, India proposes to follow the following taxation system under dual structure:

**CGST** – This includes all the central level indirect taxes like excise duty, service tax etc. It would be levied on all transactions within the state along with the SGST but the revenue of CGST would go to the centre. Input CGST can be set off against output CGST.

**SGST** – This includes all the state level indirect taxes like VAT etc. It would be levied on all transactions within the state along with the CGST but the revenue of SGST would go to the state. Input SGST could be set off against output SGST.

**IGST** – This is a combination of CGST and SGST and is levied when the transaction is interstate. Thus it includes all the central level and state level indirect taxes as explained above. The CGST portion would go to the centre and the SGST portion would be transferred to the state of destination (unless as per place of supply rules the transaction is taxable in state of origination).
For IGST administration the government would either need a bank or an institution to administer the transfer of credits between states so that the states get the benefits and assesses can get appropriate setoffs.

IGST input can be set off against IGST output. Further clarifications on the set off rules are awaited.

**Recovery of ITC**

**D10 : Diagrammatic Representation of Recovery of Input Tax Credit - ITC in relation to Financial Services (FS) (Global)**

| Special Recovery Method - Supplies to taxable entity zero rated - B2B | Fixed Recovery Method - Fixed proportion of ITC allowed | Proportionate Recovery method - Ratio based on composition of output services |
The entire mechanism of GST or VAT is based on the principle that a service provider or manufacturer etc. can avail input credit of taxes paid on the input side and set the same off against the output liability of taxes. GST is one step further with fungibility of taxes on both goods and services and set off of the said taxes both on the input and output side.

However, the availability of ITC depends on the taxability of the output service. Thus financial services industry and more specifically banks can avail input tax credit or ITC of various taxes paid on the input side and set it off against their output liability of taxes. However the proportion of the ITC to be availed would depend on the nature of their output services.

From a banking industry perspective, the income earned by Banks is majorly in the form of interest and discount and partly in the form of fees. Thus income of Banks is partly taxable and partly exempt. Further, each country defines financial services differently and also differs in what they include. Also each country has its parameters to define whether the financial service is ‘exempt’, ‘non taxable’ or ‘zero rated’. Due to these differences the availability of the ITC in each country differs greatly.

The major positions for ITC recovery by financial service providers adopted globally are discussed below:
Globally, in most economies, income from financial services is treated as ‘exempt’. Thus ITC on input services is not available at all leading to higher costs of financial services. Financial service providers provide basically two types of services one of lending the money and the other of bringing a borrower and lender together. However, it is technically and administratively costly and cumbersome to identify and apportion the income received between these two functions. Hence unless the financial service provider charges fees, the income is treated as exempt or zero rated.

**0% and 100% ITC** – Where the output service is treated as exempt or ‘input taxed’, 0% ITC is available and where it is treated as zero rated or ‘GST free’, 100% ITC is available.
In the European Union all financial services are exempt (unless fees are charged) and hence ITC availability is 0%.

In Canada currently financial services are exempt and ITC is 0%.

Singapore exempts all financial services with 0% ITC.

Very few economies keep the entire gamut of financial services within the ‘taxable’ classification and require the service provider to charge GST/VAT on all types of services irrespective of the consideration received. This means that whether the income is in the nature of interest or discount or fees the same are liable to GST/VAT. In such cases of course, ITC is available 100% to the financial service provider as well as the customer.

EU is proposing to tax the financial services provided to B2B customers. Hence the services will become taxable and ITC on inputs will become available to service provider proportionately (since services to B2C customers continue to be ‘exempt’).

Brazil levies a nominal tax on financial services and those become ‘taxable’ services.

Based on the broad correlation mentioned above between the output service and availability of ITC, the various recovery methods of ITC are as under:

**Special recovery method** – Under this method ITC on input services used for providing ‘exempt’ services is not allowed and ITC on inputs/input services used for providing ‘zero rated’ and ‘taxable’ services is allowed. Under this method the service provider needs to track the input services separately for the ‘exempt’ and ‘taxable/zero rated’ services.

**Proportionate method** – An alternative to the special recovery method, under this the service provider tracks his output services as ‘exempt’ and ‘taxable/zero rated’ services and avails ITC in proportion of the taxable and zero rated services to total services.

For this some economies treat services provided to customers not registered for GST/VAT – generally B2C cases as ‘exempt’ and the ones rendered to GST/VAT registered customers – B2B
cases as ‘zero rated’. An alternative to this approach which is prevalent is to keep B2C services ‘exempt’ and tax B2B customers.

- In New Zealand all financial services are exempt and those to B2B customers are zero rated. Thus the ITC is available in proportion.

- EU is also proposing to tax the financial services provided to B2B customers. Thus ITC will become proportionately available to the service provider and the customer will get 100% ITC.

- Canada is proposing to zero rate the financial services provided to B2B customers. Thus financial service providers will get proportionate ITC. However, obviously B2B customers will not get any ITC.

- Malaysia follows a system like India where services with fee income are taxable and those with interest/discount income are exempt. Thus proportionate ITC is available.

**Fixed Recovery method** – Under this method based on the study of the proportion of taxable and zero rated service income to total income of financial service providers, the taxation authorities determine a fixed ratio or percentage of ITC which the service providers may avail. Under this method neither do the service providers have to track correlation between inputs/input services and output services nor the breakup of their output services into exempt/taxable/zero rated. Directly a fixed portion of ITC is allowed. For this the definition of service provider/institution/financial service etc. differs from country to country.

- Singapore exempts all financial services with 0% ITC. Specifically for Banks 76% ITC recovery is allowed since their income is exempt and taxable.

- Australia has a unique system of treating financial services employing a “reduced ITC’ system. Under this system, the financial service and financial institution is defined and specific service providers are allowed 75% reduced ITC recovery.
India has picked up the best from all the existing economies in the world and adopted the following system for ITC recovery. The system discussed is for the applicability of the current service tax laws on the banking industry:

- **Interest/Discount income** - Services provided by Banks where the income is in the form of interest and/or discount is covered under the negative list and hence are not liable to service tax.

- **Fee income** - Services provided by Banks where the income is in the form of fees is not covered under the negative list and hence are is liable to service tax.

- **Exempt Income** - Services provided by Banks to certain specified customers like those who are SEZs, or the UN, embassy etc. fee incomes from such customers is “exempt”. Interest and discount income continue to be covered under the negative list and hence are not liable to service tax.

- **ITC recovery** - Thus for the purpose of ITC recovery banks are required to follow the following method:
• Capture inputs/input services used specifically to provide exempt services and not avail credit for the same.
• Separately ITC on certain services like those in relation to employee welfare like canteen services, ones like rent a cab etc. are excluded from definition of input services. Hence ITC on such services needs to be excluded.
• Of the balance ITC, 50% is written off and 50% is available to banks. Non banking financial companies have to follow the same method. For insurance the fixed write off is different.

The Indian method of writing off a fixed percentage of the ITC post exclusions appears to be the easiest method of claiming ITC. However the fixed write off percentage may be revised to 60-70% so that the ITC write off costs for financial services industry go down.

**Intermediary services and Interchange Income**

**D12 : Diagrammatic Representation of Treatment of intermediary services and interchange income globally and India**
**Intermediary services** – These services in relation to financial services cover services such as broker, agent etc. services. Broker, agent etc. are providing the services of getting the borrower and lender together. Other than that they do not provide any services. It means that their service is incidental to the main financial service of lending. These services are those which enable availability of funds to various customers. For providing these services they earn income.

In most global economies since these services are solely related to financial services which are exempt, by association they are also exempt. Australia, EU, Singapore, Malaysia, New Zealand exempt financial intermediary’s services similar to the main financial services. Thus no GST/VAT is leviable on their services. In Canada and Brazil these services are partially exempt based on certain criterion. Thus there is no tax cost to the financial service provider since the input service received from the financial intermediary is exempt from GST/VAT. This is particularly helpful in a case where the final output service is exempt and hence ITC is 0%.

**India** – In India, intermediary services are explained in the education guide. There is no definition etc. in the main law. Intermediary has been explained as a person who arranges or facilitates a supply of goods or a provision of service or both between two persons without material alteration or further processing. By definition, intermediary in respect of goods was kept out of the purview of this rule till 1 October 2014. Thus banks which ‘arrange’ loans for their Indian customers like external commercial borrowings, term loans, letter of credit etc. would be liable to pay service tax in India on income received for such services.

Other than exemption to business facilitator or business correspondent to a banking company ………….area in a rural area provided under the Mega Exemption Notification 25/2012 dated 20 June, 2012 (as amended from time to time), there is no special exemption to financial intermediaries. Obviously the said exemption cannot be availed by Banks providing intermediation service in obtaining funds for their clients/ arranging any services for their clients. Hence the tax becomes a cost since only 50% ITC as explained earlier is allowed.
Further, as per POPS, the place of provision of service by an intermediary is the location of the service provider. Hence the following issues arose specially in cases of external commercial borrowings where banks in India ‘arranged’ the borrowing from outside India for a customer located in India.

Under the earlier laws, the income received due to such services qualified as exports since they conditions of the erstwhile export rules were met. However, given the current Export Rules and the POPS, the impact is that services of financial intermediaries in such cases are said to be provided in India - location of service provider i.e. the Indian bank being in India. Thus till now income earned by the Indian banks from the foreign banks qualified as exports. However from July 2012 the same has become taxable. This is contrary to the global position of exempting financial intermediation.

Further by definition, from July 2012, intermediation of goods was out of the service tax net. Goods include securities as defined under SCRA. Thus intermediary services in relation to issue of bonds/shares/derivatives were out of the service tax net.

However effective 1st October 2014, even intermediation of goods is bought within the services of an intermediary. Hence even those services become liable to service tax. Thus banks would effective 1st October 2014 would have to pay service tax even on income received for arranging for issuance of bonds/shares etc.

This has not only impacted Indian Banks obtaining ECB loans for their client from foreign banks but also branches or subsidiaries of foreign banks operating in India. Such branches/subsidiaries receive transfer pricing allocations in India as income for a bouquet of services they provide to their offshore head office/group companies. Till July 2012, this income was qualifying as export. With the introduction of ‘intermediary’ the same has become liable to service tax as explained above. This increases the costs of doing business in India as the Indian banks cannot recover the service tax from their foreign counterparts and neither can they claim ITC of the same since the tax is on the income i.e. output liability. Further of the total inward allocation that these banks receive it is difficult to identify the portion which is for pure intermediation and
the portion for the other services that they do like due diligence, KYC norms, documentation of
the loan etc. Hence with introduction of this term and the POPS, the banks are facing issues in
terms of identifying the value attributable to intermediation and higher costs due to the tax they
have to pay from their pocket on this income. **Given that globally intermediation linked to
financial services is considered as ‘exempt/zero rated’ since it is linked to a exempt/zero
rated service, India can rethink on keeping financial intermediation out of the taxable net
at the time of introducing GST.**

**Interchange Income** – This income is an income earned by Banks in the credit card business.
This income is earned by both the acquiring bank and the issuing bank. In the credit card
business there are 5 parties - the customer, the acquiring bank, the issuing bank, the merchant
and the enabler i.e. the entity like VISA/Mastercard providing the platform and IT support for
credit card transactions.

- **The customer** is the one who has been issued the credit card and uses it to pay for
goods/services. For this usage he pays fees to the bank who has issued the credit card
and interest if the amount due on the credit card is not paid.

- **The issuing bank** is the one who has issued the credit card to the customer. It receives
fee for issuing the card and interest for late payment of amount due on the card. All
credit card related incomes are taxable specifically as explained earlier. Thus all income
in the form of interest/fees received by the issuing banks from the customer is liable to
service tax currently.

- **The acquiring bank** is the one who owns the point of sales terminal – POS terminal
which is the machine located in a merchant establishment on which a credit card is
swiped. The acquiring bank has nothing to do with the customer.
• **The merchant** is the one who has sold goods/services to the customer and accepts the payment for the same from the customer by swiping the credit card at the POS located in his establishment.

• **VISA/Mastercard** – These are global entities having the knowledge, IT infrastructure etc. whereby they provide the platform for these credit card transactions. They help in settlement of monies in credit card transactions between the merchant, the acquiring bank and the issuing bank. For this they take a separate commission which is not the subject matter over here.

Interchange income is the income earned by the acquiring bank from the merchant on swiping of the credit card which it shares with the issuing bank.

---

**D13 : Diagrammatic representation of interchange income**

The above diagram is explained with a numerical example below:
• Customer swipes card for Rs. 100 with merchant
  Acquiring bank who owns the POS pays merchant Rs. 97 – Thus interchange income of acquiring bank is Rs. 3
• Acquiring Bank pays Rs. 97 to merchant and pays service tax on the interchange income
  Acquiring Bank shares Rs. 2 from the Rs. 3 interchange income with the Issuing Bank
• Issuing Bank receives its share of Rs. 2 of interchange income from Acquiring Bank
  Issuing Bank recovers the Rs. 100 from customer

Note – From the Rs. 3 interchange a charge is paid to VISA/MasterCard by either or Acquirer or Issuing Bank – The payer pays service tax under reverse charge on payment to VISA/MasterCard. This is not dealt with here.

The interchange income and the amount to be shared between the acquiring and issuing bank depends on the type of card, type of customer, the settling platform, the transaction volume, the reason for swiping i.e. sector etc.

Globally interchange income is taxable in the hands of the acquiring Bank. – In Canada, no ITC of the service tax recovered by the acquiring bank from the merchant is available to the merchant. Even Australia and New Zealand tax the interchange income in the hands of the acquirer bank. However, the sharing of the said income with the issuing bank is not taxed again in the hands of the issuing bank.

In India, till 1 July 2012, interchange income was taxable only in the hands of the acquiring bank like the global practice. However with the introduction of the negative list, the way the law was worded by implication the interchange income received by the issuing bank became liable to service tax again. Thus the interchange income suffered double service tax.

Though this is a regressive practice, as on date the banks are required to pay the service tax. GST needs to address such issues of double taxation on income like the interchange income as they lead to inflationary pressure due to hidden sunk tax costs.

**Correspondent Bank Charges**

**D 14 - Diagrammatic representation of flow of Correspondent bank charges**
Customers in India who export goods/services need to receive funds from outside India towards services rendered. For this they approach their Bank in India with a request to process their export documents.

The Bank in India – say Indian Bank agrees to process these documents for a fee. The Indian bank charges service tax on the fee, collects it from the customer and pays it to the Government. Customer takes ITC of the said service tax. The issue under consideration is not the said service tax.

The bank outside India – say Foreign Bank receives the export documents and processes them on behalf of the offshore importer (client of the customer in India). For this service the Foreign Bank charges fees to the client outside India. Whether service tax is collected on the same is again not an issue since the Foreign Bank, client and services all are outside India.
The Foreign Bank then processes the documents and sends the proceeds to India after deduction of its charges for sending the proceeds to India. Indian Bank receives the net consideration from the Foreign Bank on behalf of its customer and credits proceeds of the same to the customer’s account in India.

The issue under consideration is of the service tax on the charges of the Foreign Bank for sending the proceeds to India.

These are charges of a foreign entity liable to service tax under reverse charge. The issue is as under:

- The customer claims that he is not liable to pay the service tax under reverse charge since there is no privity of contract between him and the Foreign Bank. He many times is not aware of the identity of the Foreign Bank. Thus he is not a service recipient and is not liable to pay the service tax as he has not ‘received’ the service.

- The Indian Bank claims that most of the times customer is aware of the identity of the Foreign Bank and that the Indian Bank is providing the service of clearing and processing of the export documents to the customer for which services of Foreign Bank are used. However, the Indian Bank is acting only as an agent and the charges of the Foreign Bank are not its expense, are not paid by Indian Bank are not charged to expense account of Indian Bank and hence Indian Bank is not the “service recipient” liable to pay service tax under reverse charge on the said charges.

- The department has tried to recover the said service tax from the customer and failed as the courts have held that the customer is not the ‘service recipient’. Hence now the authorities are trying to recover the said service tax from the Indian Bank.

- The banks in India feel that they are not liable to pay and at the most seek a clarification from the department stating that they are not liable to pay and in the alternative state that the Banks are liable to pay prospectively. If such a clarification is issued then Banks will
device a system where in they recover the said service tax from the customer in India and pay the same to the government.

Globally banks are not required to pay VAT/GST on such charges. If at all the customers may pay service tax under reverse charge.

Thus GST needs to address such issues of double taxation on correspondent bank charges as they lead to inflationary pressure due to hidden sunk tax costs.

**Place of Supply Rules**

**D15 – Diagrammatic Representation of Comparative place of supply rules for financial services in federal economies – globally**
The Place of provision of services rules or POPS as they are currently called in India or the Place of Supply Rules as they are globally known are very relevant for the proposed GST in India. This is because currently the VAT on goods is state administered and service tax is a central tax. Further for the financial services industry for which service tax is majorly applicable it is centrally administered. Hence currently at least for domestic transactions compliance is not an issue. However, with the advent of GST, the issue will achieve high importance since these rules will determine compliance of a tax which will be both state and central level.

Further for this it is necessary to understand and define the terms service provider, service recipient, location of service provider and location of service recipient clearly.

Globally the thumb rule for place of supply rules is that the supply is taxable at the place of service recipient since it is supposed to be a destination based tax.

However in the case of intangible services like financial services some countries apply the rule that for B2B customers i.e. where the service recipient is VAT/GST registered the place of supply should be location of service recipient. For other customers it should be location of service provider. This is irrespective of where the service is destined or consumed. These rules are made in this manner because service being an intangible it is anyway quite difficult to determine its movement unlike goods.

The implication of the above rules is that a service provider needs to track the status of his service recipient and then ensure compliance in the location of his service recipient irrespective of whether he has a place of business in that location. On a practically level it can raise a lot of issues. This rule has been introduced for telecommunication services, ecommerce services etc. in the EU from 1 January, 2015. It is posing challenges of multi province compliance. An alternative in the EU is the mini one stop shop where the service provider can choose a province and do the compliances in that province for the entire EU.

In Brazil the place of supply is the location of service provider whereas in Australia and Canada the general rule is location of service recipient.
In India currently the POPS are operational. For applying POPS it is first necessary to understand the definition and meaning of account holder, services provided in the ordinary course of banking business and non account holder and services not provided in the ordinary course of business. This is because the rules of POPS are applicable based on the meaning of the same. These terms are not defined/explained in the main law or rules. They form a part of the education guide which can lead to litigation.

For banking services in the ordinary course of business provided to an account holder the applicable rule is Rule 9. Thus in such cases wherever service tax is applicable it is payable at the location of the service provider which would be the location where the bank is located.

In case of services either not in the ordinary course of business or provided to a non account holder, the place of provision is location of service recipient. Thus in the current scenario in cases where the service recipient is located out of the taxable territory i.e. out of India, the place of provision of the service would be out of India and hence not liable to service tax.
In a GST scenario these rules become even more important since the ‘taxable territory’ is not restricted to within and outside India but also to which state.

The proposed Place of Supply rules have changed the location where the service is taxable. Once more they mention normal banking services and linked to the account of the account holder and other services or services not linked to the account of the account holder. These terms need to be specifically defined to avoid litigation since currently the litigation is restricted to whether the service is within India or outside India but going forward it would be on which state is the one which would receive the tax.

Even the basis of the taxability has been changed. Currently normal banking services provided to accountholder are taxable at location of service provider. Going forward under the GST regime they are proposed to be taxed at the location of the service recipient. Further non banking services/not in the ordinary course of business or not provided to the account holder which were taxable at location of service recipient will now be taxable at location of service provider. Whilst the reasoning for this paradigm shift is not provided the logical answer seems to be

1. To follow the global rules of GST becoming a destination based tax as a thumb rule – Hence normal banking services or services linked to account to be taxed at location of service recipient

2. If the current rules of location of service provider are followed then given that most of the financial institutions have their central offices in Mumbai, the Maharashtra state would get most of the financial services industry GST revenue. Not only would this be an issue for the states but in cases where the customer is claiming ITC, there could be an issue of blocked ITC in Maharashtra if the customer has operations through India

3. The other non banking services or services not linked to the account would be smaller proportion of the total service income and hence would continue to be taxable at location of service provider.
4. Another reason could be the basis that generally customer receiving banking services or services linked to their account is B2B type customers i.e. they would be GST registered customers. Hence like the global shift in practice of taxing services to B2B customers at location of service recipient even in India the same would be followed. An again like mentioned earlier the customer being registered would be able to utilize the ITC against his output if the ITC is received in his resident state.

5. For the other non registered customers the rule of location of service provider makes sense since anyway the customer is indifferent and tracking of addresses and location of such customers for compliances would become a humungous task for the banks.