How it should PAN out

For PAN is to be really effective, it has to be made the norm for everybody transacting in the capital market and in the banking system

Give a six-month window to all mutual fund investors to comply with PAN, as was done with demat accounts

Prithvi Haldea

Reams have been written on the market-related proposals of Budget 2007, and I won't add my 750 words to it. Instead, I will use those words allotted to me to take off from where the Budget left off on two specific proposals: single identification number for investors and higher dividend distribution tax on liquid funds.

PAN for all

Good sense has finally prevailed with the government saying that the "PAN will be the sole identification number for all participants in the securities market, with an alpha-numeric prefix or suffix to distinguish a particular kind of account". That will put a stop to multiple IDs thrust on investors in the name of regulation -- PAN, MIN, MAPIN, UIN -- and make PAN the cornerstone of identity.

But some recent damage cannot be undone. In the weeks before the Budget, nearly 200,000 investors went through the process of getting a mutual fund identification number (MIN), which was a harassing experience for many. Thankfully, MIN has now been scrapped, but the industry still wants investors to go through the entire registration process. That is questionable, at least for investors who recently submitted their PAN verification to the depositories. If the regulator is the same, as it is in this case, why go through the process again?

There is also some ambiguity over who the Budget proposal covers and who it doesn't. It is not clear if the directive means all capital market investors will need a PAN, with no exemptions on the size of investment/holding. I hope that's what it means. All those investing in the risk-driven capital market, directly or through mutual funds, are either tax payers or should at least be in a position to obtain a PAN, which is now, in any case, easy, fast and inexpensive to obtain.

The rules should be the same for all. Since January 2007, investors can sell shares held in their demat account only if they have provided their PAN verification to their depository. But for mutual funds, as per the MIN plan, only those who make a fresh investment of above Rs 50,000 have to give a PAN. That excludes the current unitholder population, which holds assets worth Rs 3,50,000 crore. Technically, an investor holding Rs 1 crore of units and not planning to invest more can exit without giving a PAN. It will also exclude investors who, by design or necessity, make applications of below Rs 50,000.

Any exemption makes the entire system ineffective. All mutual fund investors should be covered under PAN, and a six-month window should be given for compliance, as was done for demat accounts. A single ID, applicable to all, will boost tax collections and reduce frauds. Profiling of investors will lead to better targeted policies and regulations, as well as better designing of products and services by the industry.

Next, PAN should be made the norm in the banking system, another critical part of the financial markets. Presently, all payments of above Rs 20,000 have to be made by cheques only. This, however, cannot be of much help in establishing benami accounts, hidden-from-tax accounts or audit trails. Many people are known to operate multiple accounts within a bank and across banks, with many of these accounts not disclosed in their tax returns. To include a majority of investors and to prevent undue inconvenience to the poor, a savings-cum-fixed deposits threshold of, say, Rs 50,000 or bank accounts used by investors for capital market transactions can be specified for the PAN requirement. Gradually, others can be brought into the PAN fold too.

Retail funds, not corporate

The other Budget move with wider ramifications is the increase in the dividend distribution tax on liquid funds. The near-elimination of tax arbitrage between liquid funds and bank FDs might appear to just be an effort to stem the worrisome decline in bank FDs, but this move can serve another nobler objective: focus on small investors.

Today, mutual funds use their tax advantage to service corporate investors. About Rs 1,07,000 crore -- one-third of the industry's assets under management -- is in liquid funds, which is dominated by corporate investors. Mutual funds are obsessed with managing more money, for which, they pay a lot of attention to corporates, which runs contrary to their raison d'tre: small investors. With the tax advantage removed, I hope mutual funds will now focus on effectively and efficiently serving the retail market. As the next measure, corporates should be disincentivised from investing in mutual funds.

Adding depth to the market

Some other measures in Budget 2007 are long term in nature, aimed at improving the depth and efficiency of our capital market.

- Allowing institutional short-selling and creating a formal securities lending and borrowing mechanism for this purpose. Short-selling often deflates price bubbles before they grow too large, thereby lowering volatility and reducing incidences of sharp crashes.

- Exchangeable bonds are not only an additional financial instrument, but also a mechanism for unwinding interlocked corporate holdings.

- In order to improve market practices, the FM has asked Sebi to encourage various market intermediaries to form self-regulated organisations (SROs), which can lay down codes of conduct and ensure stable growth in a regulated manner. These SROs will also be able to take up various market-related issues in an organised manner and, of course, reduce the regulatory burden on Sebi and the stock exchanges.