



**VERITA MANAGEMENT ADVISORS
PVT LTD**

**DEMONETIZATION
EFFECTS AND IMPLICATIONS
A REPORT**

November 2016

Contents:

1. Introduction and Sector wise effects of Demonetization
2. Important Guidelines by RBI on Demonetization
3. Income Tax implications of Demonetization
4. Disclaimer & Contact Information

India has demonetized its currency of Rs.500 and Rs.1000 that has shaken, stirred and awakened her masses. This is an unprecedented and bold move by the Union Government to unearth Black money and deter hoarders in a single stroke, being a cash-based economy; the menace of illegal cash is very large in India. The move by the Union Government is a monumental step against corruption, hoarding of unaccounted money and terror funding. However, such moves also generate incidental laundering opportunities such as mushrooming of commission shops across the country that accept the banned currency note at a discount, bullion and commodity investment avenues at premium exploited by traders, conversion schemes run by commission agents, etc.

India had also previously demonetized its currency of Rs.500, Rs.1000 and Rs.10,000 in 1978 with little success as these notes were reintroduced subsequently and there was no element of surprise in demonetization.

Though the primary objective is eradication of black money, combat and terror financing, it has resulted in various **implications for common people and the various sectors of economy** that are vulnerable to laundering schemes as enumerated below:-

Sector: Banking - Possibly the largest sector to be affected by demonetization	
Risk	Increased vulnerability to money laundering activities
Modus Operandi	People are flocking to the bank branches for depositing or exchanging their old currency notes for new ones. This phenomenon opens the avenue for exchange of unaccounted higher denomination notes with the lower ones by any unscrupulous bank official by charging a commission.

Alleviation measure - This risk can be avoided by attaching accountability and incorporating checks on existing bank customers for deposit or exchange of cash.

Sector: Hospitals – Increase in number of cash transactions	
Risk	Since hospitals are allowed to accept cash up to November 11, they will be afflicted by a large inflow of cash.
Modus Operandi	Many people will look at hospitals now as an avenue to get rid of their excess cash holdings. They would try to dispose of their extra illegal cash at hospitals by insisting on paying even huge amounts in cash. Booking registrations and cancellation resulting in refund in new currency.

Alleviation measure - All the cash transactions during this period should be carefully scrutinized to determine their genuine need.

Sector: Petrol/diesel/gas stations	
Risk	Avenue for conversion of higher denomination into lower
Modus Operandi	People will try to use the above places as exchange centers for converting their higher denomination currency into lower ones. Since these places are not subject to much scrutiny, it is easier to get rid of unwanted notes at these places.

Alleviation measure - A strict policy can be adopted at these places for non-acceptance of high denomination notes unless absolutely necessary.

Sector: Gold/Jewelry and Gems – New source of generation of black money	
Risk	Investment Avenue to turn unaccounted cash into legal form
Modus Operandi	People will buy gold and jewelry back-dated in order to dispose of their excess unaccounted cash and in the process evade taxes and disclosure of income.

Alleviation measure - Genuine buyers need to be identified for sale. Proper documentation to be followed for sale. It should be established that no dealer enters into any money laundering activity by charging any commission.

Sector: Agriculture	
Risk	Disclosure of undisclosed income as agricultural income
Modus Operandi	Agriculture is a largely unorganized sector with majority of its income and expense dealings happening in cash. Therefore, it is relatively easy to pass of undisclosed income as agricultural income thereby availing tax benefits as well as converting black money into white.

Alleviation measure - Trend analysis of particular crop should be undertaken and any huge variation should be carefully scrutinized.

Sector: Government Transport services	
Risk	Mass bookings and cancellations to obtain currency exchange
Modus Operandi	Bookings for travel will be done in huge numbers which will lead to massive payments being done in old tender. Subsequently, these bookings will be cancelled and refund obtained by cash in lower tender.

Alleviation measure – Any sudden bookings and cancellations should be reported and audited for foul play.

Sector: Foreign Exchange Dealers	
Risk	Money laundering by conversion into foreign currency
Modus Operandi	Cash hoarders will approach foreign exchange dealers for conversion of their cash into foreign currency which is often obliged by charge of a hefty commission.

Sector: Retail Outlets – Discretionary spending reduced	
Risk	Cash intensive retail outlets would be affected by lower sales due to reduced currency in circulation.

Sources:

1. Wikipedia:
https://en.wikipedia.org/wiki/Indian_500_and_1000_rupee_currency_demonetization
2. Quora: <https://www.quora.com/How-will-scrapping-currency-notes-of-INR-500-and-INR-1000-affect-the-daily-lives-of-Indians>

Important Guidelines by RBI on Demonetization and Exchange of currency:

1. The legal tender character of the notes in denominations of Rs500 and Rs1000 stands withdrawn.
2. These notes can be exchanged for value at any of the 19 offices of the Reserve Bank of India or at any of the bank branches or at any Head Post Office or Sub-Post Office.
3. Value will be received for the entire volume of notes tendered at the bank branches / RBI offices up to Rs.4000 and the rest credited in bank a/c of holder.
4. You can withdraw from ATMs up to a maximum of Rs.2,000/- per card per day up to 18th November, 2016. The limit will be raised to Rs.4000/- per day per card from 19th November 2016 onwards.
5. You can withdraw cash against withdrawal slip or cheque subject to ceiling of Rs10,000/- in a day within an overall limit of Rs.20,000/- in a week (including withdrawals from ATMs) for the first fortnight i.e. up to 24th November 2016.
6. The old banknotes can be exchanged at branches of commercial banks, Regional Rural Banks, Urban Cooperative banks, State Cooperative Banks and RBI till 30th December 2016.
7. If a person outside India has old banknotes in India, he may authorize in writing enabling another person in India to deposit the notes into his bank account.
8. Old banknotes can be deposited in NRO account of the bank customer.
9. A foreign tourist can purchase foreign exchange equivalent to Rs5000 using these old notes at airport exchange counters within 72 hours after the notification, provided he presents proof of purchasing the OHD notes.

Note: - Above rules has created unique challenges for the banking sector in terms of time and limit configuration in core banking and ATMs.

Source:

Economic Times: <http://economictimes.indiatimes.com/news/politics-and-nation/rs-500-and-rs-1000-notes-banned-your-questions-answered-by-the-rbi/articleshow/55320904.cms>

Income-Tax Implications on Demonetization and Deposits of old currency:

1. High-value transactions will come under the tax department's scanner and there will be no immunity for cash deposits made.
2. All cash deposits of more than Rs2.5 lakh made till 30 December in a bank account will be reported to the tax department by banks which will be matched with the depositor's income tax returns and suitable action taken in case of discrepancy.
3. Smaller deposits made by housewives, small businesses and artisans that fall below the taxable income threshold will not come under the department's scrutiny.
4. In case of large cash deposits of more than Rs10 lakh that are not explained by the income declared in the income tax returns, it will be treated as tax evasion and the tax amount plus a penalty of 200% of the tax payable would be levied.
5. The tax department had issued instructions to field officers to ensure jewelers are verifying the permanent account number (PAN) of the buyers.
6. Farmers should not be worried about making cash deposits in banks as their genuine income is not taxable provided the farmers' income should not be disproportionately high compared to the yield expected from the land owned by him.

Note: - These measures suggest an aggressive and proactive stand of the Government as well as the Income Tax Department to track down and recover black money.

These measures will create challenges for assesses if they are unable to explain the sources of their income/cash deposited. These measures, if undertaken promptly in real time, can lead to major eradication of black money in the country.

Source:

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