

# GST on Financial Transactions



**Vinod Kothari, FCS**  
 Managing Partner  
 Vinod Kothari & Company  
 Company Secretaries  
 Kolkata  
[vinod@vinodkothari.com](mailto:vinod@vinodkothari.com)

**F**inancial transactions are at the very center of economic activity as investment in assets, goods and productive activity is funded by financial transactions. These transactions take various forms – from equity, to loans, to investment in various types of securities. Besides primary financing transactions, there are numerous secondary market transactions – including trades in securities, assignment and securitization of

The introduction of Goods and Services Tax (GST) is, admittedly, one of the most outstanding tax reforms since Independence, and therefore, it is very important to unravel the implications of GST on financial transactions. This article is limited to GST on basic financial transactions excluding insurance, stock broking services, etc.

loans, etc.

The introduction of Goods and Services Tax (GST) is, admittedly, one of the most outstanding tax reforms since Independence, and therefore, it is very important to unravel the implications of GST on financial transactions. This article is limited to GST on basic financial transactions excluding insurance, stock broking services, etc.

## GST ON LENDING TRANSACTIONS

One of the primary facts one should note while evaluating the applicability of GST is the nearly-all-pervasive nature of the levy. The charging section [Sec 9 of the CGST Act] imposes the tax on any “supply”. Exclusions are items like non-taxable supplies [for example, alcohol for human consumption], or exempt supplies, or supplies which are zero-rated. Hence, the focus shifts to the ambit of the word “supply”, which consists of all forms of supply of goods and services [sec 7 (1) of CGST Act]. Since the word is intrinsically connected with the words “goods” and “services”, one needs to examine the meaning of those terms.

“Goods” are defined in sec. 2 (52) to include any movable property, other than money and securities. “Services” are defined in sec. 2 (102) to mean “anything other than goods, money and securities but includes activities relating to the use of money or its conversion by cash or by any other mode, from one form, currency or denomination, to another form, currency or denomination for which a separate consideration is charged.”

Mere money is excluded from both “goods” as well as “services”. When read with the word “supply”, supply of money is neither a supply of goods, nor a supply of services. However, sec. 2 (102) includes, in the definition of “service”, any activity relating to use of money, even though supply of money itself is not a service. Mere supply of money could be settlement of a transaction – for instance, making a payment for goods and services. It could not have been argued that the person making the payment itself is making a supply. Therefore, the intent of the law excluding supply of money, but including any activity pertaining to the use of money becomes intriguing. This conundrum was faced by the Delhi High Court in Delhi Chit Fund Association vs Union of India<sup>1</sup> while interpreting similar expression used in sec 65B (44) of the Finance Act, 1994 – the High court expressed its perplexity in the following words: “The Explanation, therefore, seems to offer a clue to the problem which appears to us to be a creation of the very confounding manner in which the definition is found to have been drafted. However, we have to make sense of what we have”.

Can it, therefore, be argued that lending of money is an activity pertaining to use of money? If the settlement of a supply in form of a monetary payment cannot itself be taken to be a supply, then, what else could be the exclusion of monetary transactions

<sup>1</sup> <https://indiankanoon.org/doc/110893075/>. An SLP against the decision was rejected by the Supreme Court – therefore, the ruling has the authority of the Apex court.

There is an elaborate definition of “location of supplier of services” in sec. 2 (71) of the CGST Act, but the definition does not address the crucial question of the place from where the supply is being made. The determination of the place at which the supply is made, that place of supply, is done as per principles laid in the IGST Act, that Act does not provide guidance in fixing the place of the supplier.

in both the definition of “goods” as well as “services”, except lending or deposit of money?

The discussion may seem academic because the list of exempted services [item 8- extending deposits, loans or advances in so far as the consideration is represented by way of interest or discount (other than interest involved in credit card services)]. That is to say, there is a clear exemption for extending of deposits, loans or advances, insofar as the consideration is interest or discount. Therefore, it does not practically matter whether lending of money is a supply of services or not. However, the question becomes crucial from at least 2 viewpoints:

- Lending of money is a supply of service, but an exempt service in terms of Item 8 of Exemption list;
- Interest involved in credit cards is not a fully exempt service

The essence of the Delhi High court ruling in Delhi Chit Fund Association was that exempting something that was not even included in the ambit of the law does not have much meaning. However, the question whether moneylending is itself a supply of service at all, will continue to engage courts for some time to come.

The exemption for financial transactions in India is quite narrow – it is only the interest/discount earned or paid for loans, deposits or advances<sup>2</sup>. Therefore, if the transaction deviates from a plain vanilla structure and therefore, fails the test of being a “loan”, “deposit” or “advance”, or the consideration is not an interest or discount, the exemption is lost. As a result:

- All earnings and charges other than interest or discount<sup>3</sup> will be chargeable to GST. This includes any upfront or regular charges such as processing fees, documentation charges, service charges, collection charges, inspection charges, repossession charges, foreclosure or prepayment charges<sup>4</sup>, and so on.
- If the transaction does not fit into the meaning of “loan”, “deposit” or “advance”, even if the transaction is intrinsically

<sup>2</sup> This may be compared to global practices. Singapore GST Act exempts a whole range of financial transactions – Fourth Schedule to GST Act. Australian law also exempts “financial supplies”, which terms includes a range of financial transactions. The same is the position in New Zealand.

<sup>3</sup> The expression “discount” will be relevant to transactions such as discounting of bills, commercial paper, etc.

<sup>4</sup> See ruling of CESTAT in the case of HDFC Limited: <http://www.cbec.gov.in/resources/htdocs-servicetax/ecs-st/exemption/2013-1-158-triahm.pdf>

a financial transaction, it does not seem that the supply will be exempt from GST. Thus, if an inventory repurchase transaction or a financial lease transaction may have the substance of a financial transaction, but it will be difficult to contend that they avail the exemption given in Item 8 of the Exemption list.

- Nevertheless, if the transaction is a loan transaction, there is no question of GST on the recovery of principal lent, as the tax can only be on the consideration, and not for principal recovery.

## REGISTRATION REQUIREMENTS

Loan transactions are currently originated, besides banks, by thousands of non-banking financial entities, thousands of money-lenders and entities occasionally engaged in lending activities. Therefore, a pertinent question is, is registration under GST law relevant for an entity, even though the entity may be earning income by way of interest.

Notably, interest on loans is exempt as per the exemption discussed above; however, the registration requirement is based on (a) aggregate turnover in a financial year exceeding Rs 20 lacs; and (b) the supplier making a taxable supply. The term “aggregate turnover” as defined in sec. 2 (6) includes value of all exempt supplies as well. Thus, while there is no GST on interest on loans, but the same is still captured in while computing aggregate turnover. Thus:

- If the aggregate amount of turnover (note that this is all-India turnover), including interest, in a year exceeds Rs 20 lacs; AND
- The entity has received any consideration other than interest (any amount whatsoever) or made any other taxable supply (for example, even sale of scrap in the office), the entity will require registration.

As may be well-known, GST law requires registration in every state where a taxable supply is being offered from. In context of lending activities, a pertinent question is – what is the place from where the supplier is rendering the service? There is an elaborate definition of “location of supplier of services” in sec. 2 (71) of the CGST Act, but the definition does not address the



crucial question of the place from where the supply is being made. The determination of the place at which the supply is made, that place of supply, is done as per principles laid in the IGST Act, that Act does not provide guidance in fixing the place of the supplier.

Section 2 (71) refers to a fixed establishment, or the establishment most directly concerned with the provision of the supply. In case of a lending transaction, there are various facets – sourcing of the loan, servicing of the loan, legal documentation, refinancing of the loan, etc. Each of these may be done from different places – therefore, lenders will continue to ask which is the place from where the lending service is being provided.

One wonders why did the law leave such a crucial question open to interpretation? One potential answer is that eventually, GST law is destination-based, and therefore, the benefit of the levy will anyway travel to the state where the recipient of the service is registered. However, it will be too optimistic to expect that the States will care about whether the eventual benefit has been passed on to the state by way of inter-state transfer of credits, if the transaction otherwise falls in their primary taxing jurisdiction.

In terms of practical advice, if the lender has a “fixed establishment” [defined in sec. 2 (50) with reference to “sufficient degree of permanence and suitable structure in terms of human and technical resources to supply services”], it should generally be advisable for the lender to get registration in that state. Notably, the draft of the law is inspired, to quite an extent, by the EU VAT regime, and the rulings under EU VAT Directive seem to favour the above interpretation.

## AVAILING INPUT TAX CREDITS

One of the most critical issues for lenders will be the manner of seeking input tax credits. As a general rule, the credit for input services is allowed, if such inputs are used in course of or in furtherance of the business of the supplier [sec 16 of CGST Act]. Sec. 17 (1) puts a restriction to the aforesaid general rule, stating that if the inputs are used partly for

business purposes, and partly for other purposes, then the input credit will be restricted to so much input tax as is attributable to business purpose. Sec. 17 (2) makes a similar rule for use of inputs for making exempt supplies, providing that the claims for input tax credit will be restricted to so much of the input tax as it used for making taxable and zero-rated supplies.

In case of banks and financial institutions, the output is mostly in form of loans, which is exempt. So, there will only be a small fraction of taxable output. As regards inputs, once again, large part of the inputs are in the form of interest, or manpower cost – most of which are non-taxable. Hence, there is an option, in sec. 17 (4), to banks, financial institutions and NBFCs, to take a thumb rule of 50% set-off – that is, on a monthly basis, 50% of the available input tax credits are set-off against output tax liability.

Many lenders often have activities or business segments which have distinctly taxable outputs. For example, agency functions, brokerages, leasing, etc have taxable outputs. Therefore, a lender may like to evaluate whether to put for the segment or business-silo computation, or to opt for the 50% set off. In case of the former option, Rule 42 of the Central Goods and Services Tax Rules, 2017 provides the detailed manner of apportionment of inputs to the respective silos. The inputs explicitly attributable to the taxable outputs are taken off, after deducting the explicitly disallowable inputs [those for non-business use, those specifically attributable to exempt turnover, and those which are blocked credits under sec. 17 (5)], and the remaining credits are apportioned on the basis of the contribution of exempt turnover to total turnover.

If a lender has a business segment which can be regarded as a “business vertical” in terms of the definition given in sec. 2 (18), on considerations of risks and returns, the lender may also elect to register the business vertical as a “distinct person”, that is, a separate GST entity, though within the same legal and income-tax entity. Therefore, there are as many as 4 options with lenders: (a) opt for 50% set-off under sec. 17 (4); (b) make a segment-wise computation by identifying inputs explicitly attributable to exempt and taxable turnover respectively and appropriating the rest of the inputs in proportion of turnover; (c) opting for a separate vertical registration for the taxable activity, though within the same legal entity; and (d) option for a separate legal entity for the taxable activity.

**Table 1: Input tax credit options for lenders**

	Sec. 17 (2) – silo-wise computation	Sec. 17 (4) – 50% set-off	Separate business vertical	Separate legal entity
Extent of set-off available	Inputs directly attributable to taxable output to be allowed fully; remaining inputs to be split proportionately based on turnover	50% of the inputs on a monthly basis	Inputs used in the taxable vertical to be allowed fully; inputs used for the other vertical may be subject to 50% set-off u/s 17 (4)	Two separate entities – hence, same as for separate vertical



GST registrations	One for each relevant state	One for each relevant state	Two for each relevant state where separate vertical option exercised	Two for each relevant state
Legal and income-tax entities	One	One	One	Two
Cross-offset of excess of input taxes over output taxes between different silos	Possible, after restricting and apportioning the inputs	Question does not arise	Not possible	Not possible
Compliance burden	+, since segment-wise attribution of input taxes to be done	Minimal	++, not only segment-wise attribution, but two distinct persons for GST purposes	+++; two separate corporate entities – leading to duplication of all corporate, legal and GST compliances
Flexibility of the option	Option opted once will be valid for the financial year	Option opted once will be valid for the financial year	Opting out will amount to de-registration for GST purposes	Opting out will require corporate merger formalities as well

The election of one out of the 4 options above is a tricky choice, as there are numerous factors to be considered. Table 1 compares the 4 options. In practice, the choice is based on a mix of quantitative factors (numerical impact based on the size of the taxable activity), as well as qualitative factors.

## TAX ON SALE OF REPOSSESSED ASSETS

In sales-tax and VAT regime, there has been inconclusive litigation on whether sale of repossessed goods by lenders is liable to be taxed in the hands of banks/financial institutions, who are not otherwise engaged in the business of buying/selling goods. One of the early rulings in this regard is the ruling of Federal Bank Ltd vs State of Kerala (2007) 6 VST 736 (SC); [2007] 4 SCC 188. However, since the ruling depended on the text of the law in the State, there have been multiple cases on this issue. Calcutta High court ruling in Tata Motors Finance vs Asst Commissioner of Sales tax<sup>5</sup> is presently pending before the Supreme Court. However, in the meantime, several courts have ruled in favour of taxability of sale of repossessed goods: Madras High court in HDFC Bank Ltd vs State of Tamil Nadu [2016] 60 NTN DX 62 holding that lack of title with the seller does not affect tax liability in case of sale of repossessed goods; Delhi High court in Citibank vs Commissioner of Sales tax<sup>6</sup> - Delhi High court relying on the Calcutta and Madras rulings above. In addition, the Supreme court has ruled in Karnataka

Under GST law, the ambit of taxability expands substantially, as we move from “sale” to “supply”. While one may await the answer from the Supreme court on taxability of repossessed goods as a “sale”, but the word “supply” used in GST law, in relation to goods, includes sale, transfer, barter, exchange, license, rental, lease or disposal, leaving little doubt that the disposition of repossessed goods by lenders will be liable to GST.

*Pawn Brokers vs State of Karnataka*<sup>7</sup> that existence of title with the lender is not necessary for taxability for sales-tax/VAT purposes.

Under GST law, the ambit of taxability expands substantially, as we move from “sale” to “supply”. While one may await the answer from the Supreme court on taxability of repossessed goods as a “sale”, but the word “supply” used in GST law, in relation to goods, includes sale, transfer, barter, exchange, license, rental, lease or disposal, leaving little doubt that the disposition of repossessed goods by lenders will be liable to GST.

The real issue, in sale of repossessed goods, is the potential for cascading tax. Assume a bank repossesses a car for a defaulted loan. The car has an element of GST in its price (as the borrower bought the car with GST). On repossession, the bank does not get benefit of GST, and the price charged by the bank on sale will be subject to GST, thus leading to a duplication of GST.

This problem is sought to be resolved by proviso to Rule 32 (5) of the Central Goods and Services Tax Rule, 2017 which says that in case of sale of repossessed goods from a defaulting borrower, who is not registered, the value of the output will be the difference between (a) actual sale price; or (b) depreciated purchase price, taking a depreciation of 5% per quarter or part thereof, from the date of purchase till disposal. The value of the output will be taken as nil, if (a) is less than (b).

The real problem arises in case of repossession of goods from registered dealers – admittedly, most of the defaulted loans in the country are accounted for by registered dealers, rather than unregistered ones, and post-GST implementation, in any case, there will be a strong demotivation for businesses to remain unregistered. Therefore, the relief given by proviso to Rule 32 (5) is only in case of retail lending, which is just a fraction of the mammoth NPA problem in the country. So, if the bank, or for that matter, an asset reconstruction company, uses its powers under the SARFAESI Act or similar law, and repossesses and sells movable property, is it to charge GST on the entire sale price, even though the price includes GST paid originally on the purchase?

<sup>5</sup> <https://indiankanoon.org/doc/40291817/>

<sup>6</sup> <http://lobis.nic.in/dhir/dhc/SMD/judgement/14-12-2015/SMD-14122015STR12003.pdf>

<sup>7</sup> <https://indiankanoon.org/doc/369962/>

What could have been the motivation of the law-maker in restricting the benefit of Rule 32 (5) only to repossessions from unregistered dealers? There may be two potential answers:

- Going forward, in case of credit facilities to registered suppliers, lenders may like to keep their loan-to-value (LTV) ratio limited to the pre-GST value of the asset, as the GST is something which the borrower avails as a credit from the government. In such a case, if repossession happens, the lender will credit only for the pre-GST value of the asset, and pay GST to the government.
- Alternatively, a legal issue that arises is – is repossession itself a case of “supply” by the borrower, and therefore, on repossession, a registered dealer should reverse his own input tax credit in favour of the lender? Note that the definition of “supply” includes several elements – including broadly-construed words such as “transfer” and “disposal”. The word “disposal” has been interpreted by the Supreme Court in *Deputy Commissioner of Sales-tax vs. Thomas Stephen & Co . Ltd 1988 AIR 997* as follows: “Disposal means transfer of title in the goods to any other person. The expression “dispose” means to transfer or alienate. It was formerly an essential word in any conveyance of land. (See Jowitt “The Dictionary of English Law” and also Webster Comprehensive Dictionary (International Edn.)- Vol. 1, page 368). There is no transfer of title as between the borrower and lender, but there surely is a transfer of title by the lender to the buyer. In many cases, the lender may retain the asset himself, and use the same for hiring. Hence, whether the repossession is merely a pro-tem measure amounting to protection of the asset, or it amounts to transfer of proprietary interest to the lender, depends on the terms of the security document.

It would take quite some time of the law to get settled on repossessions from registered dealers; however, lenders are strongly advised to realign their lending policies to restrict lending to the pre-GST price of the asset.

## IMPLICATION FOR TRANSFER OF RECEIVABLES AND SECURITIZATION

In lending business, transfer of receivables arising out of loan transactions happens quite commonly. This may happen in multiple scenarios, inclusively:

- Sale of loan portfolios on exit from a business
- Assignment of loan portfolios among lenders (so-called direct assignments)
- Securitization of receivables through SPVs
- Purchase and sale of non-performing loans
- Factoring of receivables, etc

The GST implications on sale of receivables become intriguing because of the definition of “goods”, which is made to include all movable property including actionable claims, but exclude actionable claims by way of Schedule III. A receivable is also an actionable claim, and hence the question. The GST law imports the meaning of the term “actionable claims” from the Transfer of Property Act. Under the definition of Transfer of Property Act, receivables backed by mortgages, hypothecations and pledges are excluded. This would, prima facie, give rise to an impression that the GST law excludes only unsecured



receivables, since secured receivables, being movable property, are not a part of the exclusion referencing the Transfer of Property Act.

However, the proper view to take in this regard is that an actionable claim representing a claim on money is excluded from the purview of both “goods” and “services”, as money is neither. If an actionable claim is nothing but a right to receive money, then it is money itself, and therefore, excluded from the GST law. The position would not change if the receivable was backed by any tangible or intangible property, because the property is just a collateral to back up a monetary claim. The lender’s primary right is on money – if the money is not paid, the lender may enforce the claim on the underlying asset. The loan itself is not a claim on the asset – hence, the receivable still remains a monetary asset.

Hence, the primary sale of the receivables, in any of the transactions mentioned above, will not itself be liable to GST.

In many transactions, the transfer of receivables is followed by servicing –for example, in case of direct assignments and securitization, the seller typically acts as the servicer. In case of transfer of non-performing loans, the ARC charges management fees for managing the pool of the loans. Each of these servicing or management fees become subject to GST, at the residual rate of 18%.

Securitisation and ARC transactions are worst-affected, because here, the fees are charged to the SPV or the trust, which is not an entity registered for GST purposes. Hence, the GST levy reaches its dead-end, and becomes a burden on the transaction.

Transaction structures in future may also have to bear in mind that sweep out of residual profits also has to be structured either as interest, or as servicing of a “security” – otherwise, this may well come into the wide sweep of the GST law.

## CONCLUSION

GST law marks a major change. Financial transactions are catalysts for economic activity and the exemption in India for financial transactions is very narrow – interest on loans and purchase/sale and servicing of securities. It is, therefore, imperative that transactions are structured carefully to avoid unhappy results.