COMPLETE ANALYSIS OF GST APPLICABILITY ON NON-BANKING FINANCIAL COMPANIES (NBFCS) IN INDIA

TABLE OF CONTENTS

NBFC SECTOR IN INDIA

The banking and finance sector in India has witnessed a tremendous growth curve since the advent of Non-Banking Financial Companies in India. While the sector was heavily dominated by banking institutions for the good 50 years, the past decade has seen a shift in the consumer preference for their financial requirements towards private lending players viz. NBFCs.

Non-Banking Financial Companies or NBFCs in India are companies registered to perform activities that are similar in nature to the activities carried on by banks, with some exceptions.

Section 45I(f) of the Reserve Bank of India Act, 1934[1] defines a Non-Banking Financial Company as:

i. A financial institution which is a company;
ii. A non-banking institution which is a company and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner;
iii. Such other non-banking institution or class of such institutions, as the Bank may, with the previous approval of the Central Government and by notification in the Official Gazette, specify.

[1] https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/RBIAM_230609.pdf

The RBI has further clarified that a NBFC is any company which is engaged in the business of loans and advances, acquisition of shares, stocks, bonds, debentures, or securities issued by the Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale, purchase, or construction of an immovable property. A non-banking institution which is a company and has principal business of receiving deposits under any scheme or arrangement in one lump sum or in instalments by way of contributions or in any other manner, is also a non-banking financial company[2].

The general classification of NBFCs in India divide them into two categories based on whether they accept public deposits:

1. NBFC-Deposit-Taking (NBFC-D)
2. NBFCs-Non-Deposit-Taking (NBFC-ND)

Non-Banking Financial Companies are slowly climbing up the ladder in the financial system of the country, taking place as the third largest financial segment after commercial banks in India.

[2] https://www.rbi.org.in/Scripts/FAQView.aspx?Id=92

Non-Banking Financial Companies are also contributing significantly towards streamlining of credit for the marginalised section in India, which has remained deprived of quality financial services under the existing banking sector. The major factor that has led to this, is the Financial Inclusivity approach that NBFCs have taken while extending their services in the country's rural, semi-urban, urban and metropolitan regions alike.

With more lenient credit assessment criteria as compared to the banking institutions, NBFCs are not only supporting an increase in credit flow and financial assistance to businesses and individuals in India, but also contributing to an increase in entrepreneurial and employment opportunities.

These private entities also hold in-depth understanding of their targeted customer profiles and their latent credit demand, which allows them to create a robust market segmentation strategy to run a profitable venture while extending credit to the underserved market.

The success of NBFCs in India also stems from the fact that they are able to incorporate state-of-the-art technologies, innovative product lines, and strong risk management and planning strategies, while still providing affordable credit to their customers.

Additionally, the Indian banking system has been lagging behind private lenders in terms of reaching out to the market that resides in remote regions, or the segment that does not meet the strict requirements of a credit background implemented by banks.

NBFCs are slowly becoming the go-to credit source for businesses and individuals, and supporting the entrepreneurial talent that remains hidden due to the lack of financial resources.

Like all other major industries in India, the NBFC sector was also affected by the implementation of Goods and Services Tax, that redefined the indirect tax regime in India. In order to grasp the extent of GST's impact on NBFCs, it is important to analyse in detail the meaning of the new tax and the scope of its applicability on the NBFC sector.

GOODS AND SERVICES TAX (GST)

The old Indian indirect taxation system caused lower productivity and higher operational costs across the supply and production chains in the country. This also restricted the economic development and international trade in India, causing the country to fall behind many others in terms of fiscal growth.

The old tax regime with multiple indirect taxes had the following drawbacks:

- ✓ Affected end consumption due to high tax incidence.
- ✓ Inefficiency in the tax system due to multiplicity.

- ✓ High production and supply costs for businesses.
- ✓ Cascading tax effect due to tax on tax.

This led to the realisation that the indirect tax regime in India needs a makeover, and thus, the Goods and Services Tax was introduced in 2017.

GST is the new indirect tax that has subsumed different indirect taxes which were earlier implemented in India, such as Central Excise duty, Service Tax, VAT, Purchase Tax, Central Sales Tax, Entry Tax, Local Body Taxes, Octroi, Luxury Tax, etc. The primary goal of introducing GST was to create a uniform, single-tax that covered the manufacturing, sales, and service sector under one umbrella.

GST is a destination-based consumption tax, which is collected at every stage of the movement of goods and services. The tax paid at one stage can be claimed back as credit when it is paid at the next stage of the supply chain. This has allowed the government to ease the tax burden of businesses by eliminating the cascading effect of taxes.

The GST model in India consists of three components:

1) ***Central GST***: Central Goods and Service Tax to be levied at the Centre.
2) ***State/UT GST***: GST levied at the state or Union Territory level.
3) ***Dual GST***: Integrated GST to be levied at the State and Centre concurrently.

The GST has had a positive impact on the economy as a whole. But when it comes to sectoral-wise classification, the GST has brought both advantages as well as disadvantages for each of the primary sectors in India. Non-Banking Financial Companies have also been impacted by the implementation of GST in India, with both positive and negative effects on the sector.

APPLICABILITY OF GST ON NBFC SECTOR

To a large extent, GST is not applicable on NBFC Sector due to the nature of its transactions being loans and advances. However, there are certain transactions which are not considered as part of the transaction relating to a loan, deposit or advance.

Under the previous indirect tax regime in India, the service tax on such transactions was 15%, but after the implementation GST, the tax rate has been increased to 18%.

The implementation of GST has further made it mandatory for NBFCs to obtain separate GST registration in India for each state in which it will operate.

Additionally, the NBFC is required to file its GST returns for all the GSTINs it holds, with the requirement to maintain invoices, details of all its purchases and supplies, etc. in order to upload the same digitally for filing its monthly, quarterly and yearly GST returns.

When it comes to supplies between the different branches of a NBFC, the same are liable for taxation under the Integrated Goods and Services Tax (IGST) and no Input Tax Credit can be availed for such supplies.

GST REGISTRATION FOR NBFCS IN INDIA

A Non-Banking Financial Company is liable to obtain GST registration in India in the following cases:

- Its annual aggregate turnover is more than INR 20 lakh, being a service provider.
- Any part of its services falls under the category of taxable supplies.

While the loan transactions and interest thereon are exempted from GST, when it comes to the calculation of the aggregate turnover of its business, Section 2(6) of the CGST Act would be applicable, making the value of all the exempt supplies a part of the annual turnover as well.

NOTE: The limit of an aggregate annual turnover of INR 20 lakh is only applicable for service providers. In case of businesses that deal in goods, the limit for annual turnover for the purposes of GST registration eligibility has been increased to INR 40 lakhs.

A Non-Banking Financial Company is also required to obtain GST registration for all the states it wishes to operate and establish a branch in. This requirement for multiple GST registrations has caused an additional step when it comes to NBFC registration in India since a company that plans to operate in multiple cities, or even PAN-India would require to obtain separate registrations in each state.

PLACE OF SUPPLY

Due to multiple GST registrations, a critical question with regards to NBFCs is the place of supplies from where the lending business is supplying its different services arises.

Section 2(71) of the CGST Act, 2017 defines a place of supply as a fixed establishment, or an establishment most directly concerned with the provision of the supply.

In case of a NBFC that operates from multiple branches, the place of supply of services relating to client acquisition, loan processing, loan disbursement, loan documentation, and collection of loan may be different.

The multiplicity of places of supplies is not an issue when the place of the recipient of services is known and recorded by the NBFC since GST is a destination-based tax.

However, when the location of the recipient is not known, the place of supply would be considered as the location of the supplier as per Section 12(12) of the CGST Act, 2017, leading to problems in identifying the exact place of supply.

GST RETURN FILING FOR NBFCS

The compliance requirement for filing the different monthly, quarterly and annual GST Returns is applicable on NBFCs similar to any regular business. Section 39 of the CGST Act, 2017 requires every registered person, other than an Input Service Distributor or a non-resident taxable person or a person paying GST to furnish the details of its inward and outward supplies of goods or services or both, input tax credit availed, tax payable, tax paid and such other particulars as may be prescribed, for every month, quarter and year.

When the NBFC holds multiple GST registrations, the lending business would be required to file GST returns for all the GSTINs it holds.

This would require the NBFC to have in place a state-of-the-art technology framework, including integrations and software to manage its bulk taxation information and file its GST returns efficiently.

EXEMPTIONS UNDER GST FOR NBFCS

Any form of loan, advance or deposit is considered as a money transaction, and as per Section 2 of the CGST Act, money or money transaction is not taxable under GST. Within the meaning of this definition, the primary activity of lending falls outside the ambit of GST. Additionally, there are certain other components of a NBFC's income that are not subject to GST. These include:

i. **Interest income on advances is exempted from GST:** Heading 9971 under Notification No. 12/2017 dated June 28, 2017[3] also provides GST exemption to interest on loans and advances. It states that the following services would have Nil GST taxability:
    a. Extension of 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.
    b. Inter se sale or purchase of foreign currency amongst banks or authorised dealers of foreign exchange or amongst banks and such dealers.

[3] https://www.cbic.gov.in/resources//htdocs-cbec/gst/Notification12-CGST.pdf

Clause 2(zk) of the Notification further defines '***interest***' as the *interest payable in any manner in respect of any moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) but does not include any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilised.*

ii. **Any additional interest income in the nature of penalty or additional penalty for delay in repayment of the loan is exempted from GST**: Circular No. 102/21/2019-GST[4] has cleared the confusion that prevailed regarding the applicability of GST on additional income interest in the form of penalty or any penalty for delay in repayment of the loan earned by a NBFC with regards to the Notification No. 12/2017-Central Tax (Rate) dated June 28 2017.

    The circular has also made it clear whether such penal interest would fall under the category of liquidated damages that constitute a separate taxable supply of services under GST covered under Entry 5(e) of Schedule II of the Central Goods and Services Tax Act, 2017.

    The circular has stated that any such additional income interest or penalty on delay will not be liable for GST. The circular has clarified that within the meaning of Section 15(2)(d) of the CGST Act, the value of supply shall include any interest or late fee or penalty for delayed payment of any consideration for any supply.

iii. **Discounting income on loans is also kept outside the purview of GST**: GST is also not applicable on any income earned based on the calculation of the present and future value of the loans or advances by the way of discounting.

iv. **Gain on sale of investment is exempted**: Another component which has been kept outside the ambit of GST is the any gain on the sale of investments.

v. **Interest income from investments**: Any interest income from such investments that may be generated is also exempted from GST.

NBFC TRANSACTIONS NOT EXEMPTED UNDER GST

If any transaction fails to check the criteria of being a loan, deposit or advance transaction, interest or discount on such loan even if it is essentially a financial transaction, then it will not be exempted from applicability of GST.

I. **Processing Fees**: The fees applicable for processing loan application, documentation, collection, etc. is subject to 18% GST applicability. The previous rate of tax on processing of loan applications was 15%.

[4] https://www.cbic.gov.in/resources//htdocs-cbec/gst/circular-cgst-102.pdf

II. **Syndication or Arranger Fees**: Any fees earned on loan syndication would be liable for GST at 18%.

III. **Foreclosure and Swap Charges:** If the applicant wishes to foreclose the loan before the completion of his/her loan cycle, the company can levy foreclosure charges and GST would be chargeable on it.

IV. **Referral and Commission Income**: Referral or commission income earned from reference to other would be taxable at 18%.

INPUT TAX CREDIT

One of the most critical issues for NBFC is the manner of availing Input Tax Credit on their inward supplies. As a general rule under Section 16 of the CGST Act, 2017, the credit for input services is allowed only if such inputs are used in course of or in furtherance of the business of the supplier.

Further, Input Tax Credit can only be claimed for eligible credit. Credit for food and beverage, travelling, etc., is not available with regards to ITC claim of a NBFC.

To be eligible to claim Input Tax Credit, the NBFC needs to fulfil the following conditions:

1. The company should have the tax invoices, debit notes or any such documents to prove their input tax.
2. The NBFC should have received any goods, services or both.
3. The supplier of such goods or services has paid GST in respect to such supplies.
4. The NBFC should have filed their return under Section 39 of the CGST Act.

TAXABLE SUPPLIES METHOD

Section 17(2) of the CGST Act states that "*where the goods or services or both are used by the registered person partly for effecting taxable supplies including zero-rated supplies under this Act or under the Integrated Goods and Services Tax Act and partly for effecting exempt supplies under the said Acts, the amount of credit* *shall be restricted to so much of the input tax as is attributable to the said taxable supplies including zero-rated supplies".*[5]

The provision lays down the method for claiming Input Tax Credit by a NBFC for its taxable supplies, putting a condition that the claim for input tax credit is restricted only to the amount of input tax used on making taxable and zero-rated supplies.

The method of claiming Input Tax Credit under Section 17(2) is not applicable to exempted supplies.

FLAT 50% INPUT TAX CREDIT METHOD

In the case of Non-Banking Financial Companies, the output supplies are in the form of loans, and therefore, mostly fall outside the ambit of GST.

However, when it comes to input, input supplies and capital goods, another method to claim Input Credit Tax is available to the NBFCs.

Under Section 17(4) of the CGST Act, Input Tax Credit can be claimed at a flat rate of 50%. This rule allows a NBFC business to claim 50% ITC of its total credit each month, while relinquishing the rest.

The provision states that:

[5] http://gstcouncil.gov.in/sites/default/files/CGST.pdf

"A banking company or a financial institution including a non-banking financial company, engaged in supplying services by way of accepting deposits, extending loans or advances shall have the option to either comply with the provisions of sub-section (2), or avail of, every month, an amount equal to fifty per cent. of the eligible input tax credit on inputs, capital goods and input services in that month and the rest shall lapse:

Provided that the option once exercised shall not be withdrawn during the remaining part of the financial year:

Provided further that the restriction of fifty per cent. shall not apply to the tax paid on supplies made by one registered person to another registered person having the same Permanent Account Number."[6]

Once the 50% Input Tax Credit is claimed, it cannot be withdrawn later by the NBFC during the financial year.

Also, if the NBFC holds multiple GST registrations within the same entity (i.e. under the same Permanent Account Number), for its different branches, then the 50% ITC option will not be available for any supplies made between the two GSTINs.

While the NBFC has the option to claim Input Tax Credit through any of the above-mentioned two methods, it is suggested by NBFC experts to opt for the

[6] http://gstcouncil.gov.in/sites/default/files/CGST.pdf

50% Method under Section 17(4), since a NBFC may have a large amount of transactional data and this method allows the business to calculate its total Input Tax Credit without the need to identify its every taxable/ zero-rated supply.

Moreover, the NBFC gets an option to claim a flat 50% of its total Input Tax Credit, instead of relying on the limited Input Tax Credit attributable to its taxable supplies including zero-rated supplies.

PROS AND CONS OF APPLICABILITY OF GST ON NBFCS

PROS OF GST

1. ***Overall reduction in costs***: With most of the financial transactions performed by a NBFC falling outside the ambit of GST and ability to claim Input Tax Credit for inward supplies available, the overall operational costs of a NBFC business have reduced, allowing businesses to further offer affordable lending solutions to its customers.
2. ***Removal of Cascading Effect of old indirect taxes***: With the implementation of GST, the old indirect taxes have been subsumed, eliminating the 'tax-on-tax' effect they had, which has also led to a decrease in the costs of financial services.
3. ***GST Registration Threshold***: A high threshold of annual turnover set as INR 20 lakh in case of service providers allows small-scale NBFCs to operate without a GST registration in case their operations are limited to only one state.
4. ***Digital GST Return Filing***: The GST return filing system is digital, which allows businesses to easily manage their GST returns online after uploading the requisite invoices and transactional information. Since most NBFCs operate on a hybrid model or digital model, it makes it easier to integrate digital GST filing in their operations.

CONS OF GST FOR NON-BANKING FINANCIAL COMPANIES

1. ***Intricate GST Return Filing***: After the introduction of GST, requirements relating accounting, administration and recording financial transactions need to be restructured and carefully managed, since NBFCs are now required to maintain records for its state-wise operations in case it operates in different states. This is required in order to fulfil the requirement of filing multiple GST returns for each registration and perform audits and assessments for each of its GST registration.

2. ***Issues Relating to Place of Supply***: In case the location of recipient is unknown, i.e. in the case of Non-Account Linked Services, it would become difficult for the NBFC to define a place of supply when it operates from multiple branches.
3. ***Detailed Invoicing***: In case the NBFC operates from different locations, the business would require to maintain a detailed archive of all its transactions and invoices, both outwards and inwards, in order to become eligible for claiming Input Tax Credit and filing its GST returns.
4. ***Data Recording and Invoicing***: As per Section 25, a NBFC business would be required to keep a detailed record of its transaction and invoices for any inward or outward supplies for its GST return filing compliances. This requirement would lead to additional administration for the NBFC that operates on a large scale, and manages bulk loan applications.
5. ***Carry-forward of additional duties***: Additional duties of cess such as Krishi Kalyan Cess, Secondary and Higher Education Cess may impact the Cash Flow of the NBFC if it gets involved in any legal matters for the same.
6. ***Assessment and Adjudication***: In case of multiple GST registrations, the NBFC would be subject to multiple GST Authorities. This may lead to confusion and disagreement regarding the assessment of the legal matter and adjudication over the case.

CONCLUSION

The old tax regime in India with multiple tax implications was complex. It caused an array of difficulties for businesses and consumers alike due to the cascading tax effect and the constant change in prices of goods and services. With Goods and Services Tax combining more than a dozen indirect taxes, it has simplified tax registration as well as compliance requirements for businesses.

GST has also simplified the tax structure for businesses across the supply chain by laying down the fixed rates for different goods and services at 0%, 5%, 12%, 18% and 28%.

While this has led to a positive impact on certain goods and service sectors by reducing their overall price, it has also led to certain negative effects by leading to an increase in price of products and services, and increasing certain tax compliance requirements for businesses.

The NBFC sector has also gained on account of increase in the overall pull of ITC due to availability of credit on inward supplies of goods and services used for business purposes. This has led to a positive impact on the revenue of NBFC sector.

Financial transactions and lending services are key to maintain a healthy credit flow in the country and boost economic activities across the country. Exempting the transactions of NBFCs have given them more freedom and made the country a viable business market to start a NBFC in India.

However, in taxation terms, there is only a thin line between exempted financial transactions related to loans and advances extended by banks as well as Non-Banking Financial Companies. This has made it important for NBFCs to maintain a clear record of its transactions and identify the taxable and exempted inward and outward supplies.

There is a lot of room left for amendments to the implications of GST on Non-Banking Financial Company (NBFC) sector, and with the Reserve Bank of India's encouragement and the Indian government's supports, the NBFC sector remains a profitable business option for local as well as international players who wish to enter the lending sector in the country.

ABOUT ENTERSLICE

Enterslice is a globally acclaimed Management Consulting Firm - a leading Legal Tech and CPA Firm which has achieved numerous accolades for its services to entrepreneurs and business houses for their business setup across the globe.

Enterslice has helped number of entrepreneurs in setting up their business outside India and number of global players to setup their business in India. Be it starting a new venture or management of an existing enterprise, Enterslice is known for its customer-centric, personalised and prompt services to its esteemed clients.

With a large team of subject matters experts - Chartered Accountants, CPAs, Company Secretaries, Lawyers and other professionals and offices around the world, Enterslice Advisory acts the all-in-one solution that helps its clients in achieving unparallel heights of success irrespective of their current size and structure. Enterslice's experts can help you with defining and executing key growth milestones, product development and launch in the market, Venture Capital Funding, to name a few.

At Enterslice, you can avail customised solutions and advisory services for:

- ❖ Finance business specialised in NBFC registration, compliances, takeovers, collaborations.
- ❖ Virtual CFO Services
- ❖ FEMA Advisory
- ❖ Audit matters Specialised Sectors are NBFC, Civil, e-commerce and other entities.
- ❖ Tax advisory and appeal
- ❖ Business registration and Start-up Advisory
- ❖ Business Management for all type of companies.
- ❖ Legal Matters, dealing in all types of civil and criminal matters.
- ❖ Regulatory licenses.