

WESTERN INDIA REGIONAL COUNCIL

Typical Tax issues in NBFCs

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Non banking Financial Company. (NBFC) 45 I (f) of RBI Act 1934

- ▶ It is a company registered under the Companies Act , 1956 and is engaged in the business of financing whether by way of making loans and advances
- ▶ Acquisition of Shares, Stocks , Bonds, Debentures, Securities issued by a Govt or local authority or other securities of like marketable nature

Non banking Financial Company. (NBFC) 45 I (f) of RBI Act 1934

- ▶ Leasing, hire purchase, insurance business, chit business but does not include any institution whose principal business is that of agricultural activity/ industrial activity /sale/purchase /construction of immovable property.
- ▶ principal business of accepting deposits or lending .

Important law regulated by RBI for NBFC.

- ▶ RBI Act 1934 particularly Chapter IIIB, IIIC and V
- ▶ The NBFC Acceptance of Public Deposit (Reserve Bank) Directions 1998
- ▶ The Non Banking Financial (Deposit accepting or holding) companies Prudential norms (Reserve Bank) Directions 2007
- ▶ The Non Banking Financial (Non-Deposit accepting or holding) companies Prudential norms (Reserve Bank) Directions 2007
- ▶ The NBFC Auditors' Report (Reserve Bank) Directions ,2008

Difference between NBFC and Bank

NBFC

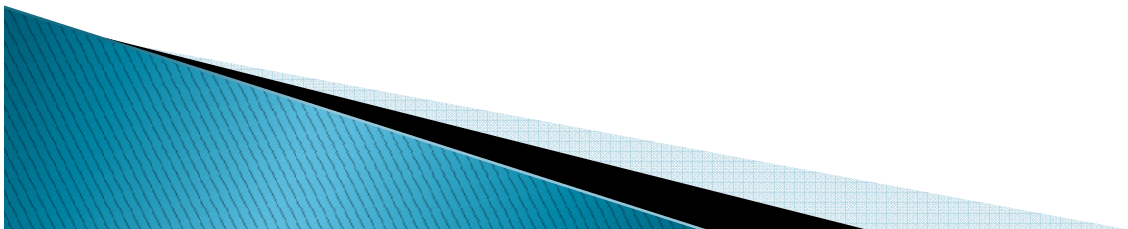
- ▶ NBFC are registered under Companies Act 1956.
- ▶ NBFC can not accept demand deposits.
- ▶ NBFC is not a part of payment and settlement system and as such , a NBFC cannot issue cheques drawn on itself.
- ▶ Deposit issuance and Credit Guarantee Corporation (DICGC) is not available for NBFC depositors unlike in case of banks.

BANK

- ▶ Banks are incorporated under Banking Regulation Act.
- ▶ Banks can accept demand deposits.
- ▶ Banks are part of payment and settlement system and can issue cheques drawn on itself.
- ▶ Deposit issuance and Credit Guarantee Corporation (DICGC) is available for bank depositors unlike in case of NBFCs.

Registration of NBFC

- ▶ It is mandatory for every NBFC to register u/s 45 of RBI Act to carry on business of Non banking financial Institution.



Taxation of NBFC

- ▶ Income Tax Act 1961 however does not contain specific provision for NBFC unlike Banking and Insurance companies
- ▶ Income of NBFC needs to be computed under each head of Income mentioned in section 14 of the Act.
- ▶ Expenditure incurred prior to set up :
Expenditure incurred prior to set up of a business are not allowable expenditure.

Taxation of NBFC

- ▶ Issues:

What should be the date of set up of the business?

- ▶ Three situation for deciding date of Setup / Commencement of Business:

- Date on which in Principle approval is granted by RBI on making an application.
- Date on which application is made to RBI to issue final approval for commencement of business.
- Date on which final Approval is granted by RBI.

- ▶ CIT v. PIEM Hotels Pvt Ltd 209 ITR 616 (Bom)

- ▶ Western India Vegetable Products Ltd V. CIT 26 ITR 151 (Bom)

Taxation of NBFC

- ▶ Interest earned prior to Setup of Business:
Interest Income that applicant might earn on placing of money in fixed deposit ought to be taxed as under the head 'Income from Other Sources'.
- ▶ Taxation of Interest income from Investment of temporary Surplus.
NBFC may have short interval between funds generated to make a particular investments and actually making investments. Funds are placed for a short period in a fixed deposits which earn some interest.

Taxation of NBFC

▶ Whether interest Income can be considered as Income from other sources or Income from business operations?

As funds otherwise used for the business have been parked for temporary period and ought not to alter the Character of these funds and make them surplus funds. Hence taxable as 'Profits and Gains of Business or Profession'

Taxation of NBFC

- ▶ Contrary View in
- ▶ ACIT Vs. Lafarge India Holding Pvt Ltd. 19 SOT 121 (Mum) (ITAT)
 - It was held that Interest earned had absolutely no relation with the business of the company. Interest Income in respect of surplus money not required for business and deposited in bank , as idle money for safe keeping would be assessable as Income from other Sources.

Provision for Doubtful debts:

- ▶ Whether provisions for doubtful debts made in accordance with RBI guidelines allowable ?
- ▶ NBFCs are required to make certain provisions for NPA as per RBI prudential norms issued by the RBI. Unlike Banks where provision for Bad and doubtful debt is specifically deductible under section 36(1)(via) of the Income Tax Act. There is no specific provision which allows deduction to NBFC.
- ▶ The Supreme Court in **Southern Technologies Ltd Vs JCIT (2010) 320 ITR 577** held that RBI directions is only the context of presentation of NPA provisions in the balance sheet of an NBFC and has nothing to do with the computation of taxable income or accounting concepts. The Income Tax Act and RBI directions operate in different field. The nature of expenditure under the Act can not be conclusively determined by the manner in which accounts are presented under RBI directions.

Provision for Doubtful debts:

- ▶ Explanations to section 36(1) (vii) of the Act clarifies that any bad debts written off as irrecoverable in the accounts of the assessee will not include any provisions for doubtful debts. Further as per section 36(2) amount of debt should have been taken into account in computing the income of the assessee in previous year. Provisions of NPA in terms of RBI directions does not constitute expense on the basis of which deduction can be claimed by NBFC under Income Tax Act.
- ▶ A provision for NPA is an expenses under RBI directions and in that sense it is notional.

Provision for Doubtful debts:

▶ Discrimination:

- NBFC are discriminated as against the Banks because of the above said judgements.
- DTC Bill 2010 seeks to remove the discrimination and place both banks and NBFC at par.

Income Recognition:

- ▶ Income on NPA or sticky loans be taxed on accrual basis i.e. as and when due date of receipt arises?
- ▶ In CIT Vs Vasisth Chay Vypar Ltd (2011) 330 ITR 440 (Del) As per the RBI Act and Directions , mandate an NBFC to declare advances as NPA when the accrued interest therein is not paid by the debtor continuously for six months.

Assessee had not received any interest income on NPA, income cannot be said to have accrued to the assessee having regard to the provisions of s. 45Q of the RBI Act and prudential norms issued by the RBI—Even under the IT Act, interest income had not accrued.

Moreover, when there is a provision in other enactment which contains a non obstante clause (45Q Of RBI Act), that would override the provisions of IT Act.

Applicability of Section 14 A:

- ▶ Investments held as stock in trade:

- Ethio Plastics Pvt. Ltd. V. DCIT (ITAT AHD)

S. 14A does not apply to shares held as stock-in-trade. As the assessee is engaged in the business of dealing in shares and the shares were held as stock-in-trade, the intention of the assessee was not to earn dividend income. As the dividend received was incidental to the business of sale of shares, no notional expenditure could be disallowed by invoking s. 14A.

- CCI LTD. vs. JOINT COMMISSIONER OF INCOME TAX (2012) 71 DTR (Kar) 141

When the assessee has not retained shares with the intention of earning dividend income and the dividend income is incidental to his business of sale of shares, which remained unsold by the assessee, it cannot be said that the expenditure incurred in acquiring the shares has to be apportioned to the extent of dividend income and that should be disallowed from deductions. Provisions of s. 14A were not applicable to the expenses incurred by the assessee in the course of its business of share dealing merely because the assessee is also having dividend income.

- Esquire Pvt Ltd Vs DCIT ITAT (mum) ITA No 5688/Mum/2011

Applicability of Section 14 A:

▶ If Investment held as Capital Asset:

- DCIT *vs.* Tata Investment Corporation Ltd. [2008] 113 TTJ 512(MUM.)

Section 14A of the Income-tax Act, 1961 – Expenditure incurred in relation to income not includible in total income.

Assessee was an investment company whose object was to invest its funds in group concerns, income from which was earned by way of dividend income and interest income, and dividend income was exempt from tax under provisions of section 10(33), expenditure incurred on salary during year under consideration, which in turn had been incurred for purpose of carrying out objects of assessee-company, had to be disallowed under section 14A.

Applicability of Section 14 A:

- ▶ Whether amount disallowed u/s. 14A can be added to the cost of Shares?
- ▶ Interest paid on Amount Borrowed for acquiring Controlling Interest whether 14A is applicable?
 - **SRISHTI SECURITIES (P.) LTD. V. JCIT [2005] 148 TAXMAN 49 (MUM.) (ITAT)**
 - if funds are borrowed by an investment company for making investment in shares which may be held as investment or as stock-in-trade or for purpose of controlling interest in other companies, interest paid on such borrowed funds will be deductible under section 36(1)(iii).

Applicability of Section 14 A:

- ▶ **Surplus / Interest free fund for investment in Shares whether 14A applicable?**
 - Reliance Utilities - (2009) 221 CTR 435 (Bom) in relation to Section 36(1)(iii)

- ▶ **NO Disallowance if no Tax Free Income.**
 - CIT vs. M/s. Delite Enterprises (Bombay High Court)
If there is no claim for tax-free income, there cannot be any disallowance u/s 14A (Walfort Shares and Stock Brokers 326 ITR 1 (SC), Godrej & Boyce 328 ITR 81 (Bom) & Winsome Textile 319 ITR 204 (P&H) referred)

- ▶ **Share Application Money**
 - Chennai ITAT case of MSA Securities
Held Share application money pending allotment since can't give any income to investor; same cannot attract section 14A at all.

Deemed Dividend

- ▶ Jayant H. Modi *vs.* JCIT [2012] 28 taxmann.com 252 (Mum.) (ITAT)

Loans and Advances given to assessee holding more than 10% of shares in a company having main object of carrying business as shares and stock brokers. Held that since the loans and advances made by the company in the ordinary course of business condition stipulated in sub-item (ii) of section 2(22)(e) were duly satisfied and amount of loan could not be regarded as a deemed dividend in hands of assessee.

Explanation to Section 73

- ▶ Where any part of the business of a company other than company whose gross total consists mainly of income under other head than business or a company the principal business of which is the business of banking or the granting of loans and advances consists in the purchase and sale of shares of other companies, such companies shall for the purpose of this section be deemed to carrying on a speculation business to the extent to which the business consists of purchase and sale of shares.

Explanation to Section 73

▶ Favourable

- CIT v Amritlal & Co 212 ITR 540 (Bom)
- PCBL Investments V CIT [2012] 20 taxmann.com 748 (Cal.)
- DCIT *vs.* Venkateswar Investment & Finance (P.) Ltd.[2005] 93 ITD 177 (KOL.) (ITAT) (SB).

▶ Adverse View

- Ganjam Trading Co. (P.) Ltd.*vs.*DCIT [2012] 25 taxmann.com 181 (Mum.)

The assessee was trading and investment company having its main business as making investment in equities and trading in shares. Therefore the argument of the assessee that the principal business of the assessee was granting loans and advances can not be accepted.

Penalty for infringement of RBI Guidelines

- ▶ Maddi Venkatraman & Co. Pvt Ltd V. CIT 229 ITR 534 (SC)

It would be against the public policy to allow deduction in a statute for payments made in contravention of another statute, however commercially expedient their payment may be

- ▶ CIT V. Catholic Syrian Bank Ltd 265 ITR 177 (Kerala)

If the levy is compensatory in nature, it should be allowed as deduction. If however, it is penal in nature, same ought to be disallowed.

Whether Directions issued by RBI for NBFC are law or an Act?

- ▶ Section 45 JA empowers RBI to determine policy and give direction to all or any of the NBFC .

Thank You