

Cash Credits - Looming Clouds of Litigation

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As we sit on the brink of witnessing the Union Budget 2023, the Hon'ble Finance Minister has a difficult task of balancing progress, controlling inflation, providing impetus to growth, increasing the taxpayer base, and to chart the growth path which sees India growing to a USD 5 trillion economy by 2024. Having said that, there are still many expectations for the Hon'ble Finance Minister to meet. Amongst many expectations, we touch upon the gamut of the provisions of section 68 (as amended by the provisions of the Finance Act, 2022) of the Income-tax Act, 1961 ('the Act').

As it may be known that the provisions of section 68 of the Act were introduced as an anti-abuse provision and has been part of the Act since its introduction. The original provisions of section 68 provided that where any amounts were found credited in the books of the taxpayer in the previous year and the taxpayer offered no explanation about the nature and source thereof, or the explanation offered was, in the opinion of the Income-tax Officer, not satisfactory, the sums so credited could be charged to income-tax as income of the taxpayer for of the relevant previous year. As time progressed and the economy expanded, seeing a large number and a variety of transactions, the provisions of section 68 of the Act too has undergone many changes. However, in this article, we would restrict ourselves to the provisions of section 68 as amended by the Finance Act, 2022.

The purpose of the above amendment is covered in the Memorandum to Finance Bill 2022 which states that it has been brought about to tackle the pernicious practice of conversion of unaccounted money by crediting it to the books of taxpayer through a masquerade of loan or borrowing. Thus, the introduction of this amendment to section 68 is to provide that the nature and source of any sum, whether in form of loan or borrowing, or any other liability credited in the books of a taxpayer shall be treated as explained only if the source of funds is also explained in the hands of the creditor or entry provider, thereby codifying the source of source principle. The only exception provided herein is if the creditor is a well-regulated entity i.e. it is a Venture Capital Fund and Venture Capital Company.

It is in this context, while the codification of the 'source of source' principle is a welcome move to address the unaccounted money problem, the satisfaction of this rule itself has some operational issues which are discussed below.

India, in the past decade, has witnessed an exponential growth in Alternative Investment Funds ('AIFs'), Non-Banking Financial Companies ('NBFCs'), Asset Reconstruction Companies ('ARCs') through

securitisation trusts ('ST'), and many other financiers which are appropriately regulated by regulators such as Securities and Exchange Board of India ('SEBI'), Reserve Bank of India ('RBI'), etc. However, these financial institutions, including Banks are regulated under the Banking Regulations, and have not been covered under the carve-out provided under section 68, which is still restricted to Venture Capital Fund and Venture Capital Company.

The country has witnessed a growth spurt including many start-ups which rely on financing options such as equity as well as debt financing, wherein AIFs and NBFCs play a major role. For the distressed sector, ARCs through STs have played a major role in turning into a favourable economic scenario for stressed assets/ businesses. For all other class of borrowers, the banks have always played a crucial role in meeting credit requirements in the country.

However, with the current provisions coming into effect from 01 April 2023 (i.e. FY 2022-23) all such start-ups, corporate entities, other entrepreneurs will now be required to justify even loans or borrowing, or temporary credit obtained from such rigorously regulated entities. In fact, RBI, SEBI, etc. mandates for quarterly, and in certain cases, monthly compliances from these regulated entities about the investments, borrowings etc. made by such entities. They are also subject to regular audits and supervision by these regulators. Given that there are millions of borrowers who have taken Bank finance, there would be a huge operational load on banks to provide details to such borrowers to satisfy the requirements of section 68 of the Act. Thus, there is a clear case to exclude such lenders from the ambit of section 68.

Even from a practical standpoint, while these regulated entities may be willing to disclose the source of source to the income-tax authorities directly, but they may not be willing to provide the justification to the borrower owing to confidentiality of the data and the risk that such data may be misused. Hence, the borrowers may find it difficult to obtain this data from the lenders. Furthermore, it may be pertinent to note that for lenders, being AIFs and STs of ARCs, the source of funds may still be linear i.e. investors holding units / security receipts in AIFs or ARCs, as the case may be. However, for lenders such as Banks, NBFCs, etc. their funds may be a mix of their own funds as well as borrowed funds and in such a scenario substantiating that the funds lent to a particular assessee has come out of specific set of funds may be a herculean task.

Part from regulated financial services entities also, even in the case of transactions between group entities, there could be a carve out so long as these are entities which falls within the definition of 'companies in which public are substantially interested' given that such entities are widely held with high standards of corporate governance (including independent directors, board level committees, etc) and under the regulatory supervision and oversight of SEBI.

Given that there are practical challenges as discussed above, it would be prudent to exclude atleast the entities engaged in regulated financial services business viz. ARCs, NBFCs, AIFs and Banks from the applicability of the amended section 68 so as to also avoid more litigation on this front. This sought-after relaxation will surely help in promoting the ease of doing business in India.