Article

Conditional Sale and Credit Sale – thin line distinguishing security interest and absolute sale

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Introduction:

Financial instruments more often than not borrow their framework from existing instruments and at times transgress into one another's territories. Over the years, the judiciary has done abundant discussion on the implicit understanding of the parties in a transaction and what is conveyed face apparent to determine the nature of the contract. In the constant tug of war of substance vs. form some lines of distinction have evolved over a period of time that defines the periphery of each of the financial products. One such thin line of distinction that we discuss in this article is between conditional sale as a financial instrument and credit sale made by a trader/ seller. While in the financial markets the two jargons may be inter-changeably used but they certainly are not the same.

Understanding the products:

Before we discuss the line of distinction it is pertinent to understand the features of the two products and the intent behind each of these. A credit sale is "sale" with an element of deferred consideration for such sale. The Sale of Goods Act, 1930, refers to "*sale*" as a "*contract whereby the seller transfers or agrees to transfer the property in goods to the buyer for a price*." Therefore, the essence of sale is that the property in goods must pass on from one person to another. A sale may be one where the payment is made in instalments.

A conditional sale or mortgage by conditional sale on the other hand is a sale conditional upon occurrence of certain events. As per Transfer of Property Act, 1882, *mortgage by conditional sale* has been defined under Section 58 (c) of the Transfer of Property Act, 1882 defines *mortgage by conditional sale* as –

> *Where a mortgagor ostensibly sells the mortgaged property –*
>
> *a) On condition that on default of payment of the mortgage-money on a certain date the sale shall become absolute or,*
>
> *b) On condition that on such payment being made the sale shall become void, or*
>
> *c) On condition that on such payment being made the buyer shall transfer the property to the seller,*
>
> *the transaction is called mortgage by conditional sale and the mortgagee a mortgagee by conditional sale.*
>
> *Provided that no such transaction shall be deemed to be a mortgage, unless the condition is embodied in the document which effects or purports to effect the sale.*

The existence of the "*condition*" is quintessential to mortgage by conditional sale. The definition covers 3 probable aspects which give out the intent of a conditional sale transaction.

a. Where the default in payment happens the sale shall become absolute in favour of the mortgagee;

b. Where the payments have been made as agreed, the sale to the mortgagee shall be void; or

c. Where the payments have been made the buyer (mortgagee) shall transfer the property back to the seller (mortgagor).

The property in the goods does not pass to the borrower until payment of the purchase price or performance of other conditions specified in the agreement is performed. In essence title is retained with the financier-lender and is passed or reversed to the borrower on the satisfaction of the conditions which typically is payment of instalments. The essence of mortgage by conditional sale is title retention for the purpose of mere financing.

Substance over form: age old rule:

The question of mortgage by conditional sale (conditional sale) or sale (credit sale) is that of intention. Where the transferee became entitled to all the rights of the transferor on the date of execution of the document, the document would be sale; but if absolute right were intended to be postponed so as to take effect in a future date, the transaction would be by way of mortgage[1].

Intention is the prime factor determining whether the transaction is a sale or a mortgage. This intention is to be gathered from the language of the documents but not the nomenclature of the documents. The nomenclature of the documents is not conclusive in determining the intent of the parties, the substance of the transaction is. The intention of the parties is the real test of the transaction. In case of mortgage there is a debtor, creditor relationship. That is in case of mortgage the title of ownership is deferred, whereas in case of sale the title of ownership is transferred at the inception. Where the relationship between debtor and creditor subsists it is a mortgage prototype.

Indicative tests:

Some of the tests that would distinguish conditional sale from credit sale are laid down below. While these tests are not independently indicator of the product being credit sale

[1] *Veeravuni Haji* vs *Koyammu*, AIR 1957 Ker 169 (170)

or conditional sale but when read with the substance of the transaction do indicate the color of the transaction.

The indicia of credit sale are:

a. The transferor is normally dealing in goods;

b. There are expressed or implied representations and warranties with regard to quality and fitness or the goods;

c. The credit seller jad the title before making the credit.

The indicia of conditional sale or mortgage by conditional sale are:

a. The transferor of the goods is normally a financial company;

b. The transferor rules out the representations and warranties of the goods, on the contrary expressly indicates that it does not ascertain or provide for the fitness, quality or merchantability of the goods;
c. The finance company acquires the title of the goods for the purpose of the transaction either from the seller or from the buyer.

Implications of the distinction:

The distinction between conditional sale and credit sale has several legal, regulatory and tax implications in India which include title retention, regulatory permissibility etc. However the key difference between the two products is the sales tax treatment. Sale as defined under section 2(g) of the Central Sales Tax Act, 1956 states that –

> *"sale", with its grammatical variations and cognate expressions, means any transfer of property in goods by one person to another for cash or deferred payment or for any other valuable consideration, and includes,–*
>
> i. *a transfer, otherwise than in pursuance of a contract, of property in any goods for cash, deferred payment or other valuable consideration;*
>
> ii. *a transfer of property in goods (whether as goods or in some other form) involved in the execution of a works contract;*
>
> iii. *a delivery of goods on hire-purchase* ***or any system of payment by instalments (empahsis ours);***

iv. *a transfer of the right to use any goods for any purpose (whether or not for a specified period) for cash, deferred payment or other valuable consideration;*

v. *a supply of goods by any unincorporated association or body of persons to a member thereof for cash, deferred payment or other valuable consideration;*

vi. *a supply, by way of or as part of any service or in any other manner whatsoever, of goods, being food or any other article for human consumption or any drink (whether or not intoxicating), where such supply or service, is for cash, deferred payment or other valuable consideration,* ***but does not include a mortgage or hypothecation of or a charge or pledge on goods (empahsis ours)****;*

As per the definition, a sale includes any sale made by any system of payment by instalments. When there is a credit sale from the seller to the buyer, the instalment payments made to the seller is nothing but consideration to purchase the goods spread over a period of time. Hence, sales tax will be applicable on the consideration amount; this ofcourse is subject to the local sales tax laws.

In case of conditional sale, the sale occurs between the vendor and the financier. However, between the financer and the borrower-buyer there is no sale. The financier merely retains the title of the goods as security of the financial arrangement. As the relationship between the financier and the borrower is that of a mortgagor-mortgagee and by the very definition of sale, it excludes any mortgage or hypothecation of or a charge or pledge of goods. The fact that sale does not include mere financing transactions was also discussed at length in the Supreme Court ruling of *Sundaram Finance Ltd* vs. *State of Kerala and Another*[2], whereby the Apex Court discussed the issue of sale, mortgage and title retention for security. The relevant extracts are reproduced below –

> *"If the real transaction is a loan of money secured by a right of seizure of the goods, the property ostensibly passes under the documents em. bodying, the transaction, but subject to the terms of the hiring agreement, which become part of the buyer's title, and confer a licence to seize. When a person desiring to purchase goods and not having sufficient money on hand borrows the amount needed from a third person and pays it over to the vendor, the transaction between the customer and the lender will unquestionably be a loan transaction. The real character of the transaction would not be altered if the lender himself is the owner of the goods and the owner accepts the promise of the purchaser to pay the price or the balance remaining due against delivery of goods. ……*

[2] http://indiankanoon.org/doc/1331666/

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> *……As Lord Esher, M.R., said (1891) 1 Q.B. 2341 in Madell v. Thomas & Co. : the court is to look through or behind the documents, and to get at the reality; and, if in reality the documents are only given as a security for money, then they are bills of sale."*

The Apex Court held that when one looks through or behind the documents to the intent of the parties and the intent of the parties is to secure the return of the loan advanced to the customer and no real sale was intended, the transaction will be a mere financing transaction.

Hence there will be no sales in case of conditional sale or mortgage by conditional sale and hence no sales tax applicable on the re-payment from the borrower to the financier. The table below indicates the various distinguishing aspects of conditional sale and credit sale.

Sl. No	PARAMETERS	CREDIT SALE	CONDITIONAL SALE
1	**Retention of Title**	Buyer	Financier
2	**Transfer of title at end of funding period**	NA	Automatic upon payment of all instalments
3	**IT Depreciation**	Buyer entitled to claim depreciation	Buyer entitled to claim depreciation
4	**Capitalisation of asset in books of**	Buyer	Buyer
5	**Financial activity for RBI regulations**	No	Yes
6	**Warranty**	Seller will provide warranty on the goods	No warranty since financial activity
7	**VAT implications**	Applicable - on principal / principal + interest depending on the State in which the sale takes place	One time VAT on the transaction - instalment payments made to financier are not liable to VAT

Conclusion:

While we understand that the line of distinction between conditional sale and credit sale is very blurred and more often than not in commercial parlance we encroach into each others territories yet the two are not the same. There is no clear cut demarcation between the two, while one is used as a financing transaction the other is a selling device. One needs to look at the substance over form as the transaction does not face apparent exhibit the nature of the transaction. Hence it remains a smell test where one needs to look through the transaction, determine the intent and fall in either ambit..

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