Note

Money advanced by factor in factoring – a loan or not?

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February 27, 2014

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Introduction

The age old substance over form rule has been discussed in several assignment transactions over the years. The daunting question of a financing transaction being garbed as an assignment transaction or it being a true sale of receivables has been discussed in several judicial pronouncements[1] from the past in India and other countries as well.

Factoring an off spring of assignment of receivables

Factoring being an off spring of assignment of receivables has been exposed to a similar question of it being a mere financing activity or a true sale of receivables. Factoring as one understands is a financial product designed to accommodate the liquidity needs of the businesses and also render support on recovery of debtors. Over centuries, enterprises have been using factoring services to manage the debtors and account receivables in a more effective manner.

Recourse and Non-recourse factoring

Factoring from credit perspective can be of two types – with recourse or without recourse. As the name suggests in case of with recourse factoring, the factor has recourse to the seller of receivables even after the assignment of receivables may have happened. The recourse is exercisable typically where the debtor/ obligor default. Contrary to the recourse factoring, in case of non-recourse factoring the factor does not have recourse to the seller once the receivables are sold to the factor.

In terms of the exposure, the position that emerges is pretty clear. In case of recourse factoring the factor takes exposure on the seller as in case of default of the debtor, the factor may require the seller to make good the loss. Whereas in case of non-recourse factoring, the exposure is simply on the debtor and the seller is completely out of the picture after the receivables are sold to the factor. The non-recourse transaction is a transaction between the factor and the debtor as if the seller never existed in the transaction. So in essence case of non-recourse factoring the exposure is on the obligor while in case of recourse factoring the exposure is on the seller.

In a recent ruling of *M.K.J. Enterprises Ltd., Kolkata vs Department Of Income Tax*[2] , the factoring transactions were brought under the scanner from taxation perspective.

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[1] All past cases Major's Furniture Mart, Inc v. Castle Credit Corporation[1], 602 F.2d 538; 1979 U.S. App. LEXIS 13808; 26 U.C.C. Rep, Levin v. City Trust Co[1]. , 482 F.2d 937, 940 (2d Cir. 1973); Endico Potatoes, INC., McCain Foods, Qualia Clinical Service, Inc v. Inova Capital Funding, LLC. The same can be viewed at http://india-financing.com/factoring%20business-%20legal%20issues.pdf

[2] http://www.indiankanoon.org/doc/56557285/

Brief of the case

Deletion of disallowance made by AO on account of discounting/factoring charges as interest expenses for non-deduction of TDS u/s. 194A of the Act, by invoking the provisions of section 40(a)(ia) of the Act.

Ratio dicendi

The amount advanced by the factor is not a loan but a purchase price paid for assignment of receivable. Since in the transaction no loan is borrowed by the assessee therefore any charges paid in respect of the same cannot be treated as interest u/s. 2(28A) and hence no liability to deduct tax at source U/s 194A arises.

Relevant provisions of I.T.Act

Interest defined U/S 2(28A)

"Interest payable in any manner in respect of any moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) and includes 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 utilized".

Section 194A of the I.T.Act provides as follows:

"Any person, not being an individual or a Hindu undivided family, who is responsible for paying to a resident any income by way of interest other than income [by way of interest on securities], shall, at the time of credit of such income to the account of the payee or at the time of payment thereof in cash or by issue of a cheque or draft or by any other mode, whichever is earlier, deduct income-tax thereon at the rates in force".

Analysis

Non-Recourse Factoring is a true sale

Money Lenders Act of various states defines loan as an actual advance of money or in kind at interest[3]. Also every loan is a debt. Thus loan is the advancement of money or kind where the same has to be repaid after a certain period of time. In case of non-recourse factoring as explained above the client is no more liable to return the money advanced to it by the factor. Thus it does not amount to debt and is a true sale of receivables not merely a financing arrangement.

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[3] http://www.indiankanoon.org/docfragment/1558794/?formInput=definition%20of%20loan

From the definition of interest under the I.T.Act pre-requisite for interest is that it should be incurred on any ***money borrowed or debt incurred***. In relation to advance of money received by client from factor it cannot be termed as money borrowed or debt incurred. Hence discount incurred on factoring cannot be treated as an interest. Since it is not interest under the I.T.Act it is not interest income for the factor and there is no liability of the client to deduct tax at source U/S 194A – TDS on interest other than interest on securities.

Also considering the fact that it is sale of receivables will this sale be liable to sales tax? The answer is No, it will not as sales tax is levied on sale of goods and good as defined in the State VAT Act's does not include actionable claims. As per Section 3 of the Transfer of Property Act 1882, receivables are actionable claim for the client and hence not liable to sales tax.

Recourse factoring is secured lending

In most of the countries, full recourse factoring transactions of this kind are re-characterized as secured loans, with the loan being represented by the factor's advance(s). However, in Texas and Louisiana, as a matter of state law, it is the intent of the parties to make a true sale of accounts, even with full recourse, governs, and a full recourse factoring transaction is still treated as a true sale of accounts, if that is the stated intent. The view has been upheld in various judicial pronouncements as already highlighted above.

Based on these judgments recourse factoring is a loan to the extent of advance and discount charged by the factor can be termed as interest on money borrowed and treated as interest U/S 2(28A) of I.T.Act. Being interest under the Act income tax shall be deducted at source U/s 194A on such interest income.

Conclusion

Based on the type of factoring as discussed at length above factoring can be true sale or a mere financing arrangement. In case of full recourse which is a financing arrangement factoring charges is interest U/s 2(28A) of the I.T.Act and TDS shall be deducted U/s 194A on the same whereas non-recourse factoring is not covered under the ambit of these sections at all.

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