Potential GST Implications vis-a-vis 'First Loan Default Guarantees' – is FinTech Sector Ready?

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1. Introduction and backdrop

Evolution of technology has not left any aspect of our lives untouched. Our habits, from eating to mobility have witnessed paradigm transformation with technology and have evolved to be managed with a click. Embracing digitisation, the banking and financial services industry has been at the forefront to adopt technology, both for efficiency and security of transactions.

'*Fintech*', which has become a buzzword in recent times, is an amalgamation coined from 'finance' and 'technology' to represent businesses that employ technology to enhance or automate its finance related products and/or service offerings. New age fintech players have taken the industry by storm to create a niche for themselves despite the complex regulatory framework.

Amongst these fintech startups, those in digital loan aggregation found favour from the banking or non-banking financial ("NBFC") institutions for helping them efficiently improve their loan books in a short span of time. However, with certain sectors of the economy staring at a downturn accelerated by the impact of the pandemic, these stakeholders will face stress on their balance sheets given the potentially sharp rise in loan defaulters triggering the invocation of 'First Loan Default Guarantee' ("FLDG") clause by the partnering banks or NBFCs.

Conceptually, FLDG is a contractual arrangement whereby a third party effectively compensates the lenders if the borrower defaults. It is effectively a protection against a potential loss owing to a loan default[1].

FLDGs have become immensely popular in the fintech space since the time the fintech players have sought to collaborate with banks to lend to hitherto underserved sections like freelancers, blue-collar workers, micro businesses etc[2]. FLDG provides some sense of security to the banks / financial institutions against losses from potential loan defaults and ensures that the fintech players "*sourcing loans have some skin in the game and aims to ensure that borrower quality is not diluted*"[3]. While newspaper reports suggest that the extent of FLDG by fintech players is typically around 5%[4] of the total quantum of loans sourced through them, the now infamous Chinese fintech players / loan apps apparently used to offer an incredible 100% FLDG

to their collaborator financial institutions in India[5]. Typically, FLDG clauses are built into the contracts between the fintech players and banks / NBFCs / financial institutions[6].

Given the COVID induced economic downturn in many sectors, there is apprehension that a sizable percentage of loans sourced through fintech players may default in the coming months leading to invocation of the FLDGs given by many of these fintech players. It is in this backdrop that FLDGs as a transaction need to be evaluated from a contract law as well as GST perspective.

2. Key FLDG models and their classification under the Indian Contract Act, 1872

Typically, the following models are used by fintech players vis a vis FLDGs:

i. **Model 1** ("Model 1"): Bi-partite transactions where the FLDG clause exists in the contract between the bank / NBFC and the fintech entity covering the entire portfolio of loans sourced through the fintech entity. This is predominantly the model used by fintech players.

ii. **Model 2** ("Model 2"): Occasionally, one also hears about tri-partite transactions where the FLDG clause exists in each loan agreement to be entered into between the bank / NBFC, the borrower (sourced through the fintech entity) and the fintech entity.

At this juncture, it is pertinent to look at the above models from the prism of the Indian Contract Act, 1872 ("ICA") – two concepts under the ICA appear to be relevant in this regard: indemnity and guarantee.

- Section 124 of the ICA defines indemnity as "*A contract by which one party promises to save the other from loss caused to him by the contract of the promisor himself, or by the conduct of any other person....*"

- Section 126 of the ICA defines a contract of guarantee as "....*a contract to perform the promise, or discharge the liability, of a third person in case of his default. The person who gives the guarantee is called the "surety"; the person in respect of whose default the guarantee is given is called the "principal debtor", and the person to whom the guarantee is given is called the "creditor"*."

Clearly, a contract of guarantee entails three parties, principal debtor, creditor and surety. In fact, even though indemnity and guarantees often appear to very similar at a macro level, the foregoing point has been consistently highlighted as the key difference between indemnity and guarantees – i.e., a contract of guarantee always has three parties (the creditor, the principal debtor and the surety) whereas a contract of indemnity has two parties, the indemnifier and the indemnity holder. In a contract of indemnity, the indemnifier assumes primary liability, whereas in a contract of guarantee, the debtor is primarily liable, and the surety assumes secondary liability[7].

Extrapolating the above in the context of Model 1, bi-partite transactions where the FLDG clause exists in the contract between bank / NBFC and the fintech entity, the FLDG obligation appears to be in the nature of an indemnity.

Similarly, in Model 2, the tri-partite transactions where the FLDG clause exists in each loan agreement to be entered into between the bank / NBFC, the borrower (sourced through the fintech entity) and the fintech entity, the FLDG clause is likely to qualify as a contract of guarantee – with bank / NBFC as the 'creditor', the borrower as 'principal debtor' and the

fintech entity as the 'surety'.

GST implications can be examined in the context of the foregoing discussion apropos contract laws.

3. Key FLDG models and their potential GST implications

In terms of the extant GST framework, tax is chargeable on '*supply*' of any goods and/or services. Notably, the expression '*supply*' has been defined in broad terms to inter alia include:

a. sale, transfer, barter, exchange, licence, rental, lease or disposal i.e., any transaction falling within generic understanding of term supply when undertaken by one person for another, for consideration;
b. certain activities listed in Schedule I of the Central Goods and Service Tax Act, 2017 ("CGST Act") even when undertaken without consideration (like related party transactions); and
c. certain transactions referred in Schedule II of the CGST Act which are deemed to be a supply of goods or services.

In this context it will be pertinent to note that in terms of Schedule II of the CGST Act, any arrangement entailing agreement to "*the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act*"**,** is also construed as **"***service***"** and is covered within the ambit of supply.

This clause has been attempted to be invoked by the GST authorities in the context of a wide variety of contractual protections / conditions / clauses to try and demand GST – liquidated damages, non-compete restrictions, notice pay clauses in employment contracts, minimum-take-or-pay clauses, to name a few. It is probably only a matter of time before the all-pervasive interpretation accorded to this clause is also invoked by GST authorities in the context of FLDG clauses. When that happens, it will be interesting to observe how any so-called 'service' extracted out of an FLDG obligation is valued by the GST authorities, especially when the banks / NBFCs, fintech companies and borrowers are unrelated (as is most often the case) – some notional consideration is likely to get attributed in order to demand recovery of GST. The valuation will get murkier still, if fintech companies start acquiring stakes in their collaborator banks / NBFCs in a manner that triggers 'related party valuation' provisions under GST.

Nevertheless, rebuttal may be attempted against any such demand of GST on the basis of the argument that conditions in a contract are different from consideration in the context of GST [8] and that an FLDG obligation is nothing but a 'condition of the contract' as opposed to being part consideration for any activity by the bank / NBFC or an independent supply by the fintech to the bank / NBFC. Also, an argument that any payment by the fintech entity under an FLDG clause is nothing but in the nature of damages / compensation (and thus outside GST) may also be explored.

However, such a rebuttal will have a much stronger legal footing in Model I of FLDGs (bi-partite transaction) where the FLDG clause appears as a condition of the larger contract between the banks / NBFCs and fintech companies.

Apropos Model II, which qualifies as a contract of guarantee, the tax authorities may try to argue that since a contract of guarantee has often been recognized as an independent contractual obligation, the argument based on '*condition of contract versus consideration*' will be inapplicable. In this regard, it is pertinent to take note of the Government's position as clarified under Circular No. 34/8/2018-GST (dated 1.3.2018) apropos a specific transaction involving guaranteeing loans – "….*service provided by Central Government / State Government to any business entity including PSUs by way of guaranteeing the loans taken by them from financial institutions against consideration in any form including Guarantee Commission is taxable*".

Rebuttals can also be explored based on exclusion for 'actionable claims' from GST. Section 2(1) of the CGST Act read with section 3 of the Transfer of Property Act define 'actionable claim'

to envisage two scenarios: (i) an enforceable claim to an unsecured debt, and (b) an enforceable claim to a beneficial interest in a movable property which is not in possession of the claimant.

4. Concluding remarks

In light of the above discussion, as invocation of FLDGs become more frequent (and newsworthy) in the coming days, the aspect of GST applicability thereon is a battle that the budding fintech sector in India might have to endure.

While certain arguments, as briefly alluded to above, do exist for the fintech companies to contest demand of GST on such FLDG obligations, any concrete determination in this regard will necessitate a deep dive into several aspects including understanding the manner of transactions and relevant underlying documents to gather the true intent of the parties. It would be prudent for fintech companies to commence such analysis soon in order to be better prepared to deal with investigations / inquiries / notices targeting GST collection apropos FLDG obligations.

The views of the authors in this article are personal and do not constitute legal / professional advice of Khaitan & Co. For any further queries or follow up please contact us at editors@khaitanco.com.

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[1] See “First loss guarantee system helps borrowers indirectly”, *The Mint*, available here.

[2] See “FLDG, once popular among fintech lenders, could haunt them as defaults loom”, *Moneycontrol*, available here.

[3] *Ibid*

[4] *Ibid*

[5] See “Inside the scramble to cut off Chinese loan apps” at *The Morning Context*, available here.

[6] *Ibid*

[7] See “Indemnity and guarantee” at https://www.lawctopus.com/academike/indemnity-and-guarantee/

[8] This argument has been upheld in multiple judgments by now, especially to quash GST demand on things like liquidated damages. Reference may be made to the recent CESTAT decision in South Eastern Coalfields Ltd. (Service Tax Appeal No. 50567 of 2019): - "*It should also be remembered that* ***there is marked distinction between "conditions to a contract" and "considerations for the contract"****. A service recipient may be required to fulfil certain conditions contained in the contract but that would not necessarily mean that this value would form part of the value of taxable services that are provided*."