The GST Dilemma in Co-Lending: Examining Taxability of Interest Retained by NBFCs

Jul 09, 2025

Rajat Mohan
Senior Partner, AMRG & Associates

1. Introduction

In recent years, co-lending arrangements between Banks and Non-Banking Financial Companies ('NBFCs') have emerged as a critical mechanism for enhancing credit penetration, particularly in underserved and priority sectors. Anchored by the Reserve Bank of India's guidelines issued in November 2020, the Co-Lending Model ('CLM') aims to synergize the low-cost of funds available to banks with the origination capabilities and customer reach of NBFCs.

A central feature of such arrangements is the **differential interest income retained by the NBFCs**, essentially, the difference between the total interest charged to the borrower and the interest portion passed on to the bank. This retained interest, while economically part of the lending transaction, has sparked significant debate under the Goods and Services Tax ('GST') regime.

The core question is whether this differential interest retained is purely 'interest' (and therefore exempt from GST) or whether it is, in substance, a hidden service fee or commission liable to GST. It is reported that some of the taxing agencies have been actively investigating this issue. The outcome of this discussion is critical, as it will directly impact the structure, pricing, and compliance costs of co-lending arrangements across the financial sector.

This article analyses the GST implications of such differential income earned by NBFCs under co-lending arrangements.

2. Types of Co-lending models

Co-lending arrangements, as prescribed by the Reserve Bank of India (RBI), are collaborations between regulated entities, most commonly between a Bank and an NBFC, where they jointly fund a loan portfolio, sharing both risks and rewards under a formal agreement. There are a total of 2 types of co-lending arrangement options provided by the RBI. Here is a breakdown of both:

Co-lending Model I (CLM I)

CLM I, often referred to as a co-origination or joint origination arrangement, is a collaborative lending framework where a bank and NBFC jointly provide a loan to a borrower from the very outset. A defining characteristic of this model is the simultaneous disbursement of funds: both the bank and the NBFC contribute their respective shares of the loan capital at the time of sanction. The RBI permits a maximum risk and reward sharing ratio of 80:20, meaning the bank can contribute up to 80% of the total loan, while the NBFC must contribute at least a minimum of 20%.

A key distinction of CLM I is the nature of the legal agreement. Since both the bank and the NBFC are direct lending parties from day one, a tripartite agreement is typically signed between the borrower, the bank, and the NBFC. This formalizes their joint involvement and clearly defines their roles and responsibilities to the borrower. Both institutions maintain their respective portions of the loan on their balance sheets, sharing the credit risk and rewards proportionally based on their contributions.

Co-lending Model II (CLM II)

CLM II, while also a joint lending arrangement between a bank and an NBFC, operates with a distinct operational flow compared to CLM I. In this model, the NBFC takes the lead in originating and initially disbursing the entire loan amount to the borrower. Subsequent to this, the NBFC approaches the bank, and the bank, after its own due diligence and review, decides to acquire a pre-agreed percentage of the loan from the NBFC. The maximum risk and reward sharing ratio, similar to CLM I, is typically 80:20, with the bank acquiring up to 80% and the NBFC retaining at least 20%.

The most significant operational difference in CLM II is the absence of a tripartite agreement involving the borrower at the initial stage. Instead, the primary agreement is between the bank and the NBFC, outlining their co-lending arrangements. The borrower's loan agreement is initially with the NBFC, and the bank’s involvement comes through a back-to-back acquisition of a share of that loan. This often allows for faster loan disbursement to the borrower by the NBFC, leveraging its agility and wider reach.

3. Differential Interest income

In co-lending arrangements, the interest rate charged to the borrower is typically a **blended rate** agreed upon by both the Bank and the NBFC, rather than a simple addition of their individual lending rates. The blended rate is designed keeping in mind the margins for profitability for both bank and the NBFC while also keeping the charged interest rate feasible for the borrower.

Now as per the usual arrangement, which is 80:20, the interest income is distributed amongst the two parties in a *pari passu* manner. Meaning the bank gets its fixed interest on 80% of the loan that it has either contributed to. The remaining is considered to be the interest income of the NBFC and is retained by it. As per GST laws, the Interest income is clearly exempted from being taxed.

Example:

Regarding interest income, the borrower is charged a higher interest rate/blended interest rate (e.g., 14%) on the full loan amount by the NBFC. However, the bank, having acquired its 80% share, receives a lower, preset interest rate on its portion (e.g., 8%). This arrangement results in the NBFC retaining what is termed ‘residual interest’. This residual interest comprises two parts:

- 14% on its own 20% loan component, and a
- 6% differential on the bank's 80% loan share (which is the difference between the 14% charged to the borrower and the 8% apportioned to the bank).

This **differential interest** forms part of the NBFC’s income.

4. GST Implications: Taxability of Retained Spread by NBFCs

Taxing agencies have actively investigated the issue of the extra interest retained by the NBFCs in such co-lending arrangements. Tax officers have been issuing notices and raising concerns that this differential interest amount constitutes ‘extra income’ for the NBFC and should be taxed under GST, categorizing it as a servicing fee or commission. While there is no conclusive clarification from any GST jurisprudence or the CBIC, the issue shall be clarified by CBIC at the earliest.

However, from the GST perspective, the following service is exempted from GST vide Notification No. 12/2017-Central Tax (Rate), Dated 28-06-2017:

Sl. No.	***Tariff Item***	***Description***
27	*Heading 9971*	*Services by way of:* a. ***extending deposits, loans or advances in so far as the consideration is represented by way of interest or discount (other than interest involved in credit card services);***

This exemption applies to **pure interest income** arising from lending transactions. However, where the income is viewed as arising from ancillary services, such as origination, processing, or management, a separate consideration becomes taxable. The legal uncertainty arises in determining whether the **excess interest retained** by NBFCs is merely a share of exempt interest under a joint lending transaction, or a disguised**service fee** attracting GST.

5. Legal Characterisation: Interest Income vs. Service Fee Debate

In the co-lending arrangement, the NBFC typically acts as the **primary point of contact** for the borrower. Further, it also holds the contractual right to determine and collect the 14% interest on the entire principal loan amount. While the Bank subsequently acquires an 80% share of the loan, it receives only a predetermined 8% interest rate on its share. This leaves the NBFC retaining the remaining 6% spread.

The amount which is apportioned to the Bank is also in the nature of interest. The consideration, being interest, is clearly established as per the contractual terms with the Bank, that the Bank would be charging an interest rate for extending the 80% portion of loan.

The 6% differential interest retained by the NBFC is not an ‘additional’ service fee but rather the residual interest margin. It represents the difference between the gross interest (14%) charged to the borrower on the full principal and the interest (8%) passed on to the Bank on its 80% share. Since the NBFC’s fundamental contractual obligation to the borrower is to extend credit, any margin it retains directly stems from the interest component of that credit facility, not from a distinct ancillary service. Therefore, it should be correctly characterized as interest income, not a separate fee or commission.

To provide further clarification, a **servicer fee** is what the Bank separately pays to the NBFC who performs the duties of the *servicer*. The roles and responsibilities of servicer include client dealing, liaisoning, initiating recovery measures in case of default and many more. This distinction is crucial because, in co-lending, multiple contracts are often signed, including a **servicer agreement** that typically outlines a separate fee structure for such services. **This fee is distinct from interest income and is paid separately by the parties.**

For these reasons, the differential interest should not be considered a servicer fee. Instead, it is an **interest income** and part of the NBFC's retained profit margin. Thus, GST should not be charged on this differential amount as it accrues as interest, which is exempt from GST.

Furthermore, in a co-lending arrangement, both the NBFC and the Bank are jointly entering into the arrangement to extend the loan to the borrower. The co-lending arrangement clearly sets out relevant roles and responsibilities for both parties. These roles and responsibilities are jointly performed by both parties, and no specific service is provided by one party to the other. Instead, they are collectively providing a credit facility to the borrower, and the relevant rate of interest chargeable by both the parties is mutually agreed based on the aforesaid arrangement. Accordingly, the excess interest charged by the NBFC in the context of the co-lending arrangement should not be considered a servicing fee subject to GST but merely an outcome of commercial arrangement between both parties.

Disclosure Responsibility of NBFCs in Financial Records

A critical compliance aspect arising in this context is the manner in which NBFCs disclose the retained differential interest in their books of accounts. To robustly defend the GST-exempt nature of such income, it is imperative that NBFCs explicitly classify this amount as "interest income" in line with Ind AS 109 and RBI’s prudential norms. Use of vague or alternate nomenclatures such as "spread," "excess interest," or "retained margin"—without linking it directly to the lending activity—may inadvertently expose NBFCs to tax scrutiny. Tax officers, in the absence of clear financial disclosure, may reasonably infer that the differential constitutes a separate consideration for ancillary services, thereby initiating proceedings for GST demand on the premise of a taxable supply. Therefore, the onus lies squarely on NBFCs to ensure transparent, consistent, and principle-based classification of this differential income as pure interest. Such accounting discipline not only aligns with financial reporting standards but also significantly mitigates the risk of adverse GST implications during assessments or audits.

6. Conclusion: Preserving the Tax Neutrality of Co-Lending Models

In essence, the NBFC’s spread within these co-lending arrangements, consistent with RBI regulations, represents residual interest income rather than a separate service fee. As such, it falls squarely within the statutory exemption for interest on loans and is therefore not subject to GST.