Section 185 & 186 Simplified With Examples

SECTION 185 & 186 OF COMPANIES ACT, 2013 SIMPLIFIED
PRACTICAL ASPECTS WITH EXAMPLES

The section 185 of CA,2013 was notified on 12th September 2013 and was applicable from that day itself. If there is any deviation from the conditions laid under this section then the Auditor is required to report the same in his Audit Report. A non qualified report would hold auditor in default.

The lending company and the receiver both would be liable for the penalty under the same section.

Now let us understand the basic of section 185 and 186

Section 185:- This primarily deals with the subject of person to whom company cannot give loan.

Section 186:- This section enlists the exceptions and specifies the limits up to which a company can give loan

The section 185 of CA, 2013, restrict the company on giving loans, guarantee or provide security to Directors or any other person in whom Director is interested.

The ways via which a director can be interested has been covered via 5 inclusions:-

Point 1 & 2
The inclusion in point 1 and 2 covers the **Director and his relatives too**.
It Says

1) Any Director of Lending Company.

2) Any Relative of Director.

3) Director of a Company which is its holding company.

4) Any firm in which such director is partner or relative is a partner.

5) Any partner of such Director.

Point 3,4 & 5
The inclusion in point 3,4 & 5 only include **Director but not his relatives**.
It Says

1) Any PRIVATE Limited company in which such director is a Director or member.

2) Body corporate in which such Director or Directors hold more than 25% shares.

3) Body Corporate, MD, BOD or manager accustomed to act in accordance with direction of*board or Director of lending company.*

- *A body corporate does not include a co-operative society. But it includes a foreign company.*

EXCEPTION TO SECTION 185
1) WD/WTD
a) As a part of service extended to all of its employee.

b) Any Scheme Approved by members by special resolution.

2) Given in ordinary Course of Business
How to check ordinary Course

a) Is the company engaged in lending activity regularly.

b) Lend not only to Directors and related parties but also to Arm Length Parties or unrelated parties.

KEY TAKEAWAY :- *All NBFC may not be engaged in lending activities in ordinary course.*

NOW LET US UNDERSTAND THE SECTION WITH THE HELP OF PRACTICAL EXAMPLES
EXAMPLE 1

Company A has two Directors Mr. X and Mr. Y. Both holds 50% share each of Company.

Company A wish to give loan to following and have asked for your views on same.

A) Loan to Director X.

B) Loan to a relative of Director Y.

C) Director of company D which is the holding company of A.

D) A partner of Director of Holding Company.

E) A partner of Director of company A.

F) To a firm in which Mr. X is a partner.

G) To a firm in which relative of Mr. Y is a Partner.

SOLUTION 1

S No	***Loan To***	***Whether Can***
1	Loan to Director X.	*NO*
2	Loan to a relative of Director Y.	*NO*
3	Director of company D which is the holding company of A.	*NO*
4	A partner of Director of Holding Company.	*YES*
5	A partner of Director of company A.	*NO*
6	To a firm in which Mr. X is a partner.	*NO*
7	To a firm in which relative of Mr. Y is a Partner.	*NO*

EXAMPLE 2 (PRIVATE LTD CO WITH COMMON DIRECTOR)

Particulars	**Company A (Pvt Ltd or Ltd)**	**Co**
Directors Cum share holder	A (shareholding 60.0%) B (shareholding 40.0%)	B (D (
Only Share Holder	Nil	Nil

A and B are Husband and wife. D is their Son.

Company B wish to avail loan from Company A, Whether Possible?

SOLUTION 2

Company A cannot give loan to company B as it would be in contravention of Section 185 and would attract penalty.

Planning

1) Mr B should resign from the post of Director of Company A and gift his shares to Mr A (gift of shares is tax free). They shall appoint another Director in the company.

As B resigns and transfer the shares then the provisions of section 185 wont apply and company A would be able give loan to company B.

OR

2) Converting Company A into a LLP.

OR

3) Converting Company B into a Public Limited Company and Mr B reducing his shareholding in Company B to less than 25%.

EXAMPLE 3 (Private Ltd Co To Public Ltd Co)

Particulars	Company A Pvt Ltd or Ltd	Co
	A (shareholding 60.0%) B (shareholding 20.0%)	B (A (
Directors Cum share holder	C (Shareholding 15.0%)	C (
Only Share Holder	D (Shareholding 15.0%)	Oth

Company B wish to avail loan from Company A, Whether Possible?

SOLUTION 3

No it is not possible to advance loan to company B as Director A, B and C collectively are holding 25% of shares of Company B. And hence get covered under the clause 4 of interested party to Director.

PLANNING

1) Either Mr A or Mr B or Mr C should resign from the post of Director of Company A. This would bring down the holding of shares to less than 25% and will enable the borrowing between two Companies.

OR

2) Converting Company A into a LLP.

OR

3) Either Mr A or Mr B Or Mr C should give up atleast 1% of their share held in Company B to bring down the holding under 25%.

AMOUNT ALREADY EXISTING ON 12Th SEPTEMBER 2013

Q. ***In Case any amount is outstanding on 12th September as a loan to Director or anyone in whom Director is interested.***

A. The loan can still continue to appear in the books of accounts of Company; however it can't be renewed and is to be repaid on the end of the term. If it's a loan repayable on demand then still it is suggested to make a formal agreement with tenure specified in it.

Q. Company A holds more than 5 % share of company B and have common Director. Company B has availed a loan from bank and because company A holds more than 5% of share of company B it has to be give corporate guarantee for company B to bank.

A. These types of cases are common between related private limited companies. Banks usually takes corporate Guarantee of the companies. In such a case again company cannot renew the Guarantee given to Bank.

However, the CC limits of a company are renewed each year and new Sanction ticket is issued. In such a case corporate Guarantee also gets renewed. It is advised to approach bank and get the clause of Corporate Guarantee removed.

KEY POINT

The section is applicable only at the time of granting the loan and any change in circumstances thereafter will not make the section applicable. Thus, section 185 will not be attracted in respect of a loan given to an employee, who does not fall within the ambit of specified persons as listed above, but who subsequently becomes a member of the board, because at the time of the loan, no contravention was involved.

KEY POINT IN CONVERSION OF A COMPANY INTO A LLP

As per Sec 47(xiiib) of Income tax Act, for tax neutrality of such conversion, turnover of Private Limited Company in any of last 3 years must not exceeds 60 Lakhs. So, if turnover exceeds 60 Lakhs than such conversion will be subject to income tax.

Any capital gain arising in transfer of capital asset would be taxable in hands of company.

Any Gain arising to shareholder on surrendering of shares would be taxable in hands of shareholders.

SECTION 186

Specified transactions are covered under the Section

a) Loans to any person or other body corporate;

b) Guarantee or security given in connection with a loan to any other body corporate or person; and

c) Acquisition by way of subscription, purchase or otherwise, the securities of any other body corporate.

LIMITS UPTO WHICH LOAN CAN BE GIVEN

Higher of

A) 60 % of (Share Capital + Free Reserves + Security Premium); or

B) 100% of (Free Reserves + Security Premium)

However, if company wishes to invest or give loan to a amount higher than the above then a prior approval of Shareholders is required.

Also shareholders cannot give blanket permission.

KEY POINT

If as on 1.4.2014 the company has given loan or guarantee in Excess of limits specified then it has to file a Special resolution for this by 31st March 2015.

Q. Whether various Advances would also be considered under this section?

1. Loan is lending of money with absolute promise to repay whereas advances is to be adjusted against

supply of goods and services. Genuine trade advances given to suppliers against orders for supply of goods will not be considered as loans and hence will be out of purview of Section 186. Similarly, advances given to employees against current month's salary will also not be in the nature of loans.

LOANS AND INVESTMENT BETWEEN HOLDING & SUBSIDIARY COMPANY

Section 185:- Section 185 Exempts loan between Holding Company and Subsidiary Company.

(1) Any loan made by a holding company to ***its wholly owned subsidiary company*** or any guarantee given or security provided by a holding co in respect of any loan made to its wholly owned subsidiary co is exempted from the requirements under this section; and

(2) Any guarantee given or security provided by a holding company in respect of loan made by any bank or financial institution to its ***subsidiary company*** is exempted from the requirements under this section: Provided that loans made under sub-rule (1) and (2) are utilized by the subsidiary company for its principle business activities.

SECTION 186:-

Loan or guarantee given and security provided to its wholly owned subsidiary company or a JV, exempted from calculating the limits prescribed under section 186.