Globally, banks and financial institutions are exposed to significant business risks associated with loan portfolio and investment portfolio. The tax laws in India and the Courts also have recognized these risks. The Income Tax Act 1961, therefore, contains certain provisions specific to banks and financial institutions only. This article contains comments on the provisions along with judicial interpretations.

Barun Kumar Ghosh

Taxation of Banks and Financial Institutions

Taxation of interest on non-performing assets

The banks and financial institutions (FIs) in India had to bear with the controversy regarding the taxability of interest on sticky loans, which are doubtful of recovery which are better known as non-performing assets The issue was whether they were liable to income tax on interest on sticky loans under the mercantile system of accounting. It is the common practice to account for interest on sticky loans by debiting the customer's account and crediting interest suspense account. Thus without recognizing revenue, interest on doubtful loans and advances can be accounted for by banks to keep control on accrual of interest. The Central Board of Direct Taxes (CBDT) had clarified through a beneficent circular No 201/21 of 1984 ITA-II dated 9th October 1984 that interest credited to suspense account in respect of sticky /doubtful accounts should be excluded in computation of total income of the banks.

The problem arose for the first time when the Supreme Court dealt with the issue in the case of State Bank of Travancore vs. CIT, 158 ITR 102 (SC). While dealing with the issue of interest on sticky loans and advances, the Supreme Court took the view that circulars of CBDT would be binding on all officers and persons employed in execution of the Income Tax Act 1961 (the Act), but no instruction or circular could go against the Act. The appellant bank, while computing the total income for the relevant year, excluded interest on sticky loans and advances. The Supreme Court held that interest on sticky loans and advances, whether credited to interest suspense account or not, was liable to income tax, as the assessee followed accrual system of accounting. The Board also withdrew the circular. Later a two-judge bench of the Supreme Court in the case of Kerala Financial Corporation vs. CIT, 210 ITR 29 (SC) on identical fact also took the same view.

Earlier the Supreme Court considered the beneficent circulars issued under section 119 to be binding on the revenue authorities, even if circulars deviated from the provisions of the Act. Some landmark judgements are Navnit Lal C Javeri vs. K.K. Sen, 56 ITR 198 (SC); Ellerman Lines vs. CIT, 82 ITR 913 (SC); K.P. Varghese vs. ITO, 131 ITR 597 (SC); Keshavji Ravji & Co. vs. CIT 183 ITR 1 (SC) and CB Gautam vs. Union of India, 199

The author is a member of the Institute. He can be reached at barun66@rediffmail.com

ITR 530 (SC).

In May 1999, the Supreme Court once again had the occasion to deal with the identical issue in the case of UCO Bank vs. CIT, 237 ITR 889 (SC).

In this case, the Supreme Court has overruled its own judgement in the Kerala Financial Corporation's case (*Supra*) and has brought back the interpretation regarding beneficent circulars as per the earlier decision of the Supreme Court. The fact was that the UCO Bank in respect of assessment year 1981-82 credited certain amount by way of interest to a suspense account, because recovery of the said amount was considered doubtful and there was no recovery in those accounts in the preceding three years. The amount credited to interest suspense account was excluded by bank in computation of its total income.

of crediting interest on doubtful debts to interest suspense account and not recognising this as income before actual realisation conformed to the generally accepted accounting practice. The court felt that this particular issue might arise before several assessing officers exercising jurisdiction over different banks and the CBDT's circular was, therefore, within its powers under section 119.

The Banking Regulation Act, 1949 has prescribed the disclosure requirement of investments in a particular manner in the Balance Sheet. For the purpose of valuation, a bank classifies its entire investment portfolio under three categories viz. held-to-maturity, held-for-trading and available-for-sale.

The assessing officer completed the assessment on the basis of the beneficent circulars of the CBDT. But the commissioner invoked the revisionary power under section 263 and included the said amount in the income of the assessee. A three-member bench of the Apex court analysed the accounting practice followed by the bank in respect of interest on loans and advances. The court concluded that the accounting policy

The Supreme Court, in UCO Bank's case, analysed the history of decisions, as stated earlier and also the impact of the beneficent circulars. The court observed that in State Bank of Travancore's case (supra), the decision of the constitution bench of the court in Navnit Lal C Jhaveri vs. KK Sen (AAC), 56 ITR 198 (SC) and the decision in KP Varghese vs. ITO, 131 ITR 597 (SC) were not pointed out to the court. Even the CBDT circular dated 9th October 1984 (supra) had not been brought to the notice of the court. There was a mere submission that the interest on sticky loans was allowed to be exempted for considerable long time, the practice followed by the State Bank of Travancore had transformed itself into a law and this could not have been deviated from law. It was in this background that the court had opined that the circulars being executive in nature do not alter the decision of the law and these are in the nature of concessions, which could be withdrawn prospectively.

Their Lordships, while dealing with the case of UCO Bank, respectfully disagreed with the judgement in the case of Kerala Financial Corporation. Rather, The court in UCO Bank's case said "the question is not whether a circular can override or detract from the provisions of the Act, but the question is whether the circular seeks to mitigate the rigor of a particular section for the benefit of the assessee in certain specified circumstances". The court went on to say "so long as such a circular is in force, it would be binding on the departmental authorities in view of the provisions of section 119 to ensure a uniform and proper administration and application of the Income-tax Act".

Thus, in the UCO Bank's case (supra), the Supreme Court restored the binding nature of the beneficent circulars on the departmental authorities. Therefore, interest on sticky loans and advances need not be taxed if they fall within the purview of the beneficent circulars issued by the Board.

The same problem came up in the case of some State Industrial Investment Corporations that are incorporated under the Companies Act, 1956. The amendment in section 209 of that Act made accrual basis of accounting mandatory. However, the amendment was followed by the Notification No.GSR 550(E) dated 16th May 1989 issued by the Central Government under section 610 of the Companies Act, which requires a Government Company engaged in providing finance for industrial projects and approved under section 36(1)(viii) to account for income from interest on loans and advances on cash basis disclose such accrued income, which is not accounted for by way of a note in the annual accounts.

Therefore, the financial institutions, which are companies and engaged in providing long term finance cannot account for interest on loans and advances on accrual basis. They have to follow cash basis of accounting as far as interest on loans and advances is concerned. But a disclosure is required to be made in the accounts of the institution.

A bank can, at its option, claim deduction for provision made for doubtful assets or loss assets as per RBIs directive up to an amount calculated at 5% (10% for assessment years 2003-04 and 2004-05) of the year-end amount of such assets as per books from assessment year 2000-01 to 2004-05.

The Government's concern regarding the difficulties of the banks and financial Institutions arising out of the Supreme Court's decision in the case of State Bank of India vs. CIT (*supra*) is evidenced by insertion of section 43D to override all other provisions of the Act so that in the case of public financial institutions or a schedule bank or a state financial corporation or a state industrial investment corporation, the income by way of interest in relation to such categories of bad and doubtful debts as may be prescribed by the Reserve Bank of India in relation to such debts, shall be taxed in the previous year in which it is credited to profit and loss account or in which it is actually received, whichever is earlier. In view of section 43D, interest on sticky loans or advances (non-performing assets) shall not be taxed on accrual basis.

One may appreciate that the provision of section 43D recognises the real income concept and also the prudential norms for income recognition followed in India and abroad. The provision is also in keeping with Accounting Standard-9 (Revenue Recognition) issued by the Institute of Chartered Accountants of India.

Despite section 43D, in assessment of state industrial investments corporations following cash basis of accounting in respect of interest income on loans and advances, the department has raised the issue whether it is correct for the assessee to offer for tax interest income on cash basis when the assessee follows accrual system in respect of interest expenditure and other expenditure. In the case of West Bengal Industrial Investments Corporation Limited vs. JCIT (ITA Nos.1368/cal/2000; 987/cal/2001; 1295/kol/2001; 757/kol/2002) in respect of assessment years 1995-96 to 1998-99 the Tribunal decided the matter in favour of the assessee. However, the department has preferred appeal to the High Court under section 260A.

Though a company engaged in providing long-term finance to industries is required to follow cash system of accounting in respect of interest income on loans and advances, whether good loan or doubtful loan, as per the Government of India's Notification No.GSR 550(E) dated 16th May 1989, for tax purpose such companies should consider that section 43D permits offering for tax on cash basis in respect of interest on bad and doubtful loans only. Interest on loans, which are not sub-standard or doubtful or loss asset, shall be taxed in the year of receipt. Therefore, even if interest on loans including good loans is not accounted for on accrual basis following the aforesaid notification of the Government, the company should include interest on good loans i.e. standard assets in the computation of total income in the return.

Another interesting point is that banks and FIs account for interest on standard assets on accrual basis, while interest on non-performing assets is recorded on realisation. Thus, they follow

hybrid system of accounting as per RBI's prudential norms, which is definitely contrary to the provision of section 145 of the Act, which deals with method of accounting for computation of business income and income from other sources. Section 145 permits assessee to follow either cash system or mercantile system of accounting with effect from assessment year 1997-98. The section rules out hybrid system. If the assessee's method of accounting is not in conformity with section 145, the assessing officer can make a best judgement assessment. However, the conflict between RBI's guidelines and the provision of section 145 hardly affects the banks or FIs.

The Provisioning

Banks and financial institutions provide for non-performing assets on objective criteria laid down by RBI in its prudential guidelines. Unfortunately, the banks and financial institutions suffer an artificial disallowance by virtue of the provision of section 36(1)(viia), (viib) & (viic).

The clause (viia) was inserted by the Finance Act 1979 with effect from 1st April, 1980 and the said clause was amended from time too time. Presently section 36(1)(viia) contemplates deduction at 7.5% of total income (before allowing deduction under the said clause and Chapter VI-A) as increased by 10% of aggregate average advances made by rural branches. The provision is in two parts -one limits the deduction to 7.5% of the aggregate average advances made by the rural branches and the other allows a further deduction for provision for doubtful debts made by all banks limited to 10% of the total income.

As per the law, if a foreign company having Indian operation makes prescribed arrangement for declaration and payment within India of dividends out of its income in India, then the tax rate applicable to a domestic company shall apply to such foreign company.

A bank can, at its option, claim deduction for provision made for doubtful assets or loss assets as per RBIs directive up to an amount calculated at 5% (10% for assessment years 2003-04 and 2004-05) of the year-end amount of such assets as per books from assessment year 2000-01 to 2004-05.

Foreign banks and financial institutions can also claim such provision only up to 5% of its total income. A financial institution can, at its option, claim deduction for provision made for doubtful assets or loss assets as per RBI's norms up to 10% of the year-end amount of such assets as per books for assessment years 2003-04 and 2004-05 only. However, the section is not happily worded. The limit is 10% of total income. 'Total income' has not been defined for this purpose. Section 2(45) defines total income as the total amount of income referred to in section 5 computed in the manner laid down in the Act. As the expression 'total income' is used, it appears that the limit should be applied to the total of income under all the heads of income. Further, doubt arises as to whether limit of 5% is to be applied on total income before setting off carried forward losses or after such set off. The ITAT, Kolkata Bench, while dealing with this matter in the case of West Bengal Industrial Development Corporation Ltd. vs. Jt.CIT (ITA No.987/CAL/2001-unreported), took the view that the amount admissible under section 36(1)(viia) was to be computed before setting off brought forward business losses as the set off was the matter of chapter VI consisting of sections 70 to 80 and not falling within chapter IV-D in the manner of computation of business income as per sections 30 to 44D. The ITAT relied on the Madras High Court's decision in CIT vs. L.M. Van Moppes Diamond Tool (India) Ltd., 107 ITR 386 in connection with the

erstwhile section 80E.

There seems to be no logic to limit the allowance as indicated above while RBI desires that provision is made as per its prudential guidelines to reflect real income. This results in payment of tax on what is not real income. The Kelkar Committee has recommended that provision made as per RBI's guidelines should qualify for full deduction.

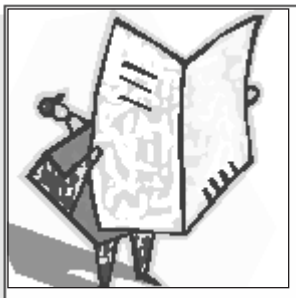
Investment valuation

The distinctive features of investments of banks are that RBI guides it and a significant portion of investments is made to maintain minimum level of liquid assets. Investments consist of Government securities, other approved securities, shares, debentures, bonds, commercial paper, the units of mutual fund and venture capital funds.

The Banking Regulation Act, 1949 has prescribed the disclosure requirement of investments in a particular manner in the Balance Sheet. For the purpose of valuation, a bank classifies its entire investment portfolio under three district categories viz. held-to-maturity (HTM), held-for-trading (HFT) and available-for-sale (AFS). HTM consists of securities acquired with the intention to hold them till maturity; HFT comprises securities acquired with the intention of trading and AFS consists of securities acquired neither for trading purpose nor for being held till maturity. HTM securities are shown at cost unless it is more than face value, in which case premium is amortised over the period till maturity. However, provision is required for any permanent diminution in the value of investments in subsidiaries or joint ventures. The AFS scrips are marked to market at year-end or at more frequent intervals. Net depreciation is recognized and fully provided for. Net appreciation is ignored. Depreciation is AFS category is debited to profit & loss Account and equivalent amount (net of tax benefit, if any) is transferred from investment fluctuation reserve account to profit & loss account. AFT scrips are revalued at monthly or at more frequent intervals and the net appreciation / depreciation is recognized in the profit & loss account. The issue is whether depreciation provided on investments held by banks as per RBI guidelines is deductible for tax purpose. In fact, the Act does not specifically provide for the same.

It may be noted that the classification of investments into HTM, AFS and HFT as per RBI guidelines is only for the purpose of compliance. For tax purpose, investments constitute stock in trade. Hence, investments can be valued at lower of cost or market value. The decision of Supreme Court in United Commercial Bank vs. CIT 106 Taxman 601 (SC) for assessment year 1982-83 is relevant here. The Bank valued stock (investments) at cost for the purpose of the balance sheet in terms of section 29 of the Banking Regulation Act, but for income tax purpose valuation was made at cost or market price whichever is lower. It was contended by the bank that the revenue had accepted the method for over last 30 years. The Apex Court made it clear that preparation of balance sheet as per statutory provision would not disentitle the bank in submitting return of income on real taxable income as per the method of accounting adopted by it consistently and regularly. For income tax purpose, what is to be taxed is the real income, which is to be deduced on the basis of accounting system regularly maintained by the assessee.

Thus, the decision of the Supreme Court sets at rest any controversy regarding depreciation on investments.



The rate of tax applicable to a foreign company on business income is 40% plus surcharge as per the Finance Act. As per section 90(2) where there is a double tax avoidance agreement ('treaty") between India and a foreign country, the provisions of the Income-tax Act applies in relation to the assessee to the extent they are more beneficial to the assessee.

Broken Period Interest

A bank purchases securities of the face value of Rs.10 lakhs at a price of Rs.11 lakhs, which includes interest, accrued on the securities till the date of purchase. The bank bifurcates the purchase price into investment in securities valued at cost Rs.10 lakhs and interest of Rs.1 lakh, which is debited to interest paid account as per accepted practice. The issue obviously is whether interest of Rs.1 lakh is allowable as deduction. The Supreme Court addressed the issue in Vijaya Bank Ltd. vs. CIT 187 ITR 541. The view of the Apex court is that the fact that securities have the face value of Rs.10 lakhs and the accrued interest as on the date of purchase is Rs.1 lakh is not relevant. The entire sum of

Rs.11lakhs is capital expenditure and portion attributable to interest for broken period is not deductible from income from securities (now assessable as income from other sources). This decision seems to be applicable to securities under HTM categories, which are intended to be held till maturity by the banks. Such securities are likely to be classified as capital assets under section 2(14) of the Act. One possible view is that interest being part of the cost of acquisition of securities is not deductible from business income of the banks but would be available for deduction for computation of capital gain on maturity. The ratio is not applicable to investments under HFT and AFS categories.

Application of Sec. 14A

Banks and FIs face problems in assessment with regard to allocation of expenditure relating to exempted income after introduction of section 14A. The section provides that expenditure incurred in relation of income, which does not form part of the total income under the Act. If there is no expenditure, which is directly attributable to earning the exempted income, the question of allocation of any

expenditure does not arise. Banks and FIs have several sources of income, some of which may be exempt (e.g. dividend). The common expenditure should not be apportioned to exempt income and taxable income for the sake of disallowance. It is felt that the Supreme Court's decisions in CIT vs. Rajasthan State Warehousing Corporation 250 ITR 218, CIT vs. Indian Bank Ltd. 56 ITR 77 and Maharashtra Sugar Mills Ltd. vs. CIT 82 ITR 452 are good law even after introduction of section 14A. Banks have started reporting segment results as per AS-17 (Segment Reporting) showing two distinct business segments – treasury operations and other banking operations. Therefore, it is possible for the department to examine the expenses allocated to treasury operations (which includes dealing in Government and other securities) in the segment reporting. It would be most appropriate to prepare a cash flow showing increase in non-interest bearing deposits i.e. balances in current account as the source for making investments generating tax free income. It is now apprehended that the section is likely to be a source of protracted litigation.

The provision of section 43D recognises the real income concept and also the prudential norms for income recognition followed in India and abroad. The provision is also in keeping with Accounting Standard-9 (Revenue Recognition) issued by ICAI.

Special reserve of FIs

Financial corporations engaged in providing long-term finance for industrial or agricultural development or development of infrastructure facility in India or by a public company engaged in providing long-term housing finance are allowed to claim deduction under section 36(1)(viii) for an amount up to 40% the profits derived from such business before making this deduction, provided such amount is carried to a special reserve. The most important aspect is that with effect from assessment year 1998-99 the assessee is required to create and maintain such special reserve. Therefore, where any amount out of special reserve is withdrawn, the assessee shall suffer taxation in the year of withdrawal in view of the provision of section of section 41(4A) of the Act. A question arises as to whether section 41(5) applies where special reserve created before assessment year 1998-99 is withdrawn. The matter is not free from doubt. However, reasonable interpretation seems to be that amount withdrawn from special reserve created in or after assessment year 1998-99 should suffer tax. Secondly, where a financial institution provides both long-term finance and short-term finance, the amount of business income derived from the business of providing long-term finance is to be ascertained for computing the eligible amount of deduction.

MERGER OF BANKS

Section 72A provides for carry forward and set off of accumulated loss and unabsorbed depreciation in amalgamation. The Finance Act, 2003 amended section 72A from assessment year 2004-05. As a result of the amendment where there is an amalgamation of a banking company referred to in section 5(c) of the Banking Regulation Act with a specified bank, then the accumulated loss and the unabsorbed depreciation of the amalgamating banking company shall be deemed to be the accumulated loss and allowance for depreciation of the amalgamated banking company for the previous year in which the amalgamation is effected. Thus the carried forward loss and unabsorbed depreciation of amalgamating bank immediately before amalgamation can be claimed by the amalgamated bank.

However, only SBI or its subsidiaries or banks constituted under Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 or under the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 are specified banks for this purpose. Therefore the amended law does not consider the cases of merger of two banks in private sector or merger of any financial institution with a bank or merger of two financial institutions. The law requires suitable amendment in view of the possibility of such mergers in India.

Foreign banks and DTAA

The rate of tax applicable to a foreign company on business income is 40% plus surcharge as per the Finance Act. As per section 90(2) where there is a double tax avoidance agreement ('treaty") between India and a foreign country, the provisions of the Income-tax Act applies in relation to the assessee to the extent they are more beneficial to the assessee. The branch of a foreign bank in India is a permanent establishment (PE) within the meaning of Article 5 of a model treaty. Article 7 (Business Profits) provide that the profits of an enterprise of one of the States shall be taxable only in that State unless the enterprise carries on business in the other State through a PE situated therein. If the enterprise carries on business in the other State, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that PE. Article 24 (Non-discrimination) provides that the taxation on a PE, which an enterprise of one of the States has in other State, shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities.

The law, finally, is that if a foreign company having Indian operation makes prescribed arrangement for declaration and payment within India of dividends out of its income in India, then the tax rate applicable to a domestic company shall apply to such foreign company. Although the word used is "prescribed", the Income-tax Rules have not prescribed any such arrangements. Further, it is not possible for a foreign company to declare dividend in India, as it does not hold annual general meeting in India. Therefore, the condition laid down in the Explanation to section 90 is not capable of being fulfilled and therefore, it would be declared as obscure and useless if the issue is taken to the Court or tribunal. Realising this impossibility an amendment has been made in the Explanation to section 90 by the Finance (No.2) Act, 2004 which has deleted the words "where such foreign company has not made the prescribed arrangement for declaration and payment within India, of the dividends (including dividends on preference shares) payable out of its income in India" once again with retrospective effect from 1st April, 2004.

It is doubtful whether Indian Government can change the terms of treaty unilaterally through amendment in domestic law, when it is one party to the treaty. The Article 51C Constitution of India that lays down directive principle states that the State shall promote respect for international law and treaty obligations. If Indian law is changed for superseding treaty rule, the foreign country may also bring in similar amendment in its law rendering it difficult for Indian resident doing business in that country. ■