

Analysis of Section 36(1)(viii) of Income-tax Act 1961

Section 36(1)(viii) of the Income-tax Act 1961 allows deduction in respect of special reserve created and maintained by a specified entity, an amount not exceeding 20% of the profits derived from eligible business computed under the head "Profits and Gains of Business and Profession" (before making any deduction under this clause) carried to such reserve account. Provided that where the balance lying in special reserve account on the 1st day of the previous year exceeds twice the paid up capital and general reserve of the specified entity, no allowance under this clause shall be made in respect of such excess. This article analyses Section 36(1)(viii) and clarifies some critical issues relating to this section along with some case laws and clarification given by Expert Advisory Committee of ICAI in this regard.

Section 36(1)(viii) of the Income-tax Act 1961 allows deduction in respect of special reserve created and maintained by a specified entity, an amount not exceeding 20% of the profits derived from eligible business computed under the head "Profits and Gains of Business and Profession" (before making any deduction under this clause) carried to such reserve account.

Provided that where the balance lying in special reserve account on the 1st day of the previous year exceeds twice the paid up capital and general reserve of the specified entity, no allowance under this clause shall be made in respect of such excess.

It means the lower of the following will be allowed as deduction:

1. Amount transferred to special reserve account created under Section 36(1)(viii).
2. 20% of profits derived from eligible business.
3. 200% of (paid up share capital and general reserve as on the last day of the previous year) minus balance lying in special reserve account on the first of previous year.

For this purpose:--

- A) "Specified entity" means:--
- a) A financial corporation specified in section 4A of the Companies act, 1956.
 - b) A financial corporation which is a public sector company.
 - c) A banking company.
 - d) A co-operative bank other than a primary agricultural credit society or a primary co-operative agricultural and rural development bank.
 - e) A housing finance company.
 - f) Any other financial corporation including a public company.
- B) "eligible business" means:-
- a) The business of providing long-term finance for-
 - i. Industrial or agricultural development.
 - ii. Development of infrastructure facility in India.
 - iii. Development of housing in India.



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- b) The business of providing long term finance for the construction or purchase of houses in India for residential purpose.
- c) The business of providing long term finance for development of infrastructure facility in India.
- C) Banking company to which The Banking Regulation Act, 1949 applies and includes any bank or banking institution referred to in section 51 of that act.
- D) "Infrastructure facility" means:-
 - a) An infrastructure facility as defined in the Explanation to clause (i) of sub-section (4) of Section 80 or any other public facility of a similar nature as may be notified by the Board in this behalf in Official Gazette and which fulfils the conditions as may be prescribed.
 - b) An undertaking referred to in clause (ii) or clause (iii) or clause (iv) or clause (vi) of sub-section (4) of Section 80-IA; and
 - c) An undertaking referred to in sub-section (10) of Section 80-IB
- E) "Long-term finance" means any loan or advance where the terms under which money is loaned or advanced and repayment along with interest thereof during a period of not less than five years;

After study of the above section, it is clear that deduction under Section 36(1)(viii) of the Income-tax Act, 1961 can be claimed for creating and maintaining special reserve in the aforesaid section out of the profits of providing long term finance for development of infrastructure facilities in India. The deduction shall be available till the balance lying in special reserve account as on the first day of previous year does not exceed twice the amount of paid up capital and general reserve.

Now, let us clarify some critical issues relating to the aforesaid section along with some case laws and clarification given by Expert Advisory Committee of ICAI in this regard.

1. Whether maintenance of special reserve created is compulsory for availing deduction under Section 36(1)(viii)?

Before assessment year 1998-1999, deduction under Section 36(1)(viii) had been allowed on creation of special reserve. There was no such condition to maintain the reserve for a certain period. But the section has been amended w.e.f assessment year 1998-1999 intended to confer the benefit under this section only if special reserve created is to be maintained.

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2009 stated that the material variation between the provisions as they stood in the assessment year 1997-1998 and the assessment year 1998-1999 is that of insertion of word "and maintained" with effect from 1-4-1998. The amendment has been effected primarily to incorporate the condition regarding maintenance of reserve and seems to have been necessitated to overcome some deficiencies in the act, such as likely misuse of the provision.

2. Whether the amendment made in assessment year 1997-1998 will apply on the special reserve created before the amendment took place

In the case of Rural Electrification corporation Ltd., Authority for Advance Rulings (Income Tax), New Delhi vide AAR No. 759 of 2007 dated 31st March, 2009 stated that Clause (viii) of Section 36(1), as it stood before amendment, cannot be construed as to imply an obligation to maintain the special reserve intact. It would amount to reading words which were not there in pre-amended provision. The importance of difference between the expressions 'created' and 'maintained' cannot be understated. But for the amendment, the restriction against withdrawal of special reserve cannot be read into main clause. There is no doubt that the purpose of the expression 'and maintained' is obviously to impose an additional obligation and it is not merely declaratory of the existing legal provision.

In view of above, it emerges that the amendment takes effect from 01-04-1998 and shall apply in relation to the assessment year 1998-1999 and subsequent years.

3. When the amount will be withdrawn from special reserve account, what will be the tax consequences before and after amendment in assessment year 1998-1999?

The consequence of withdrawing the amount from the special reserve account in the previous year is taken care of by sub-section (4A) of Section 41.

If any deduction has been allowed in respect of any special reserve under Section 36(1)(viii) of the Income-tax Act and it is subsequently withdrawn, then it shall be deemed to have been profits and gains of the business and are chargeable to income tax. But this provision is applicable only from the assessment year 1998-1999.

The combined effect of the amendments made by the Finance act 1997 in Section 36(1)(viii) and Section 41 have been aptly analysed by a division bench of Kerala High court in *Kerala Finance Corporation Vs. CIT* and stated that the condition for availing benefit under this section is that a reserve fund should be created. In the absence of any condition that it should be continued to be maintained, there is no warrant to think that Legislature intended to confer the benefit of the provision only if it continued to maintain the reserve. Further any retrospective effect cannot be presumed to be a condition for granting the benefit as per the provision which stood prior to the amendment in question.

In view of the above, it emerges that Section 41(4A) will not apply on the amount withdrawn from the special reserve which had been transferred to special reserve before the assessment year 1998-1999.

4. **Whether Deferred Tax Liability should be created in the accounts for the amount of tax to be deferred due to availing deduction under Section 36(1)(viii)**

As we know, Accounting Standard 22 "Accounting for taxes on income" requires recognition of deferred tax for all the timing differences. Since the deduction claimed today under Section 36(1)(viii) will be taxed in the year in which the amount withdrawn from the special reserve account, it results into timing difference as per AS 22. Hence deferred tax liability should be created in the accounts.

Further, the Expert Advisory Committee of ICAI opined that in the period in which special reserve is created, the accounting income remains unaffected as the same is created below the line. However, the taxable income for the same year gets reduced by the amount of special reserve thus

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resulting into lesser tax liability. Thus, a difference arises between the accounting income and taxable income for that period. And this difference is capable of reversal in the period in which the special reserve is utilised or withdrawn as in the year of utilisation or withdrawn, it would be added to the taxable income. Hence deferred tax liability should be created.

Even if an enterprise expects that a difference between accounting and taxable income will not reverse within a reasonable period (partial provision approach), the difference should be recognised as timing difference if it is capable of reversal at any time in future. Thus, deferred tax is to be provided for all timing differences.

5. **Whether is there any condition in which full tax benefit can be availed in spite of providing deferred tax liability**

Yes, full tax benefit can be availed in spite of providing deferred tax liability only in the case where the company demonstrated by passing a resolution that it had no intention to withdraw any amount from special reserve account.

This view had been expressed by the Accounting Standards Board of the Institute of Chartered Accountants of India (ICAI) vide letter dated 02-06-2009 on representation made by "Power Finance Corporation Limited" regarding the creation of DTL on special reserve created and maintained under Section 36(1)(viii) of the Income-tax Act, 1961. Accounting Standard board stated that if the company passes a board resolution that it had no intention to withdraw any amount from special reserve account created and maintained under Section 36(1)(viii) of Income-tax Act 1961, then the company can stop creating DTL on special reserve and can also reverse the DTL on special reserve created in earlier years. And there will be no violation of the Accounting Standard 22. Further, the Comptroller and Auditor General of India vide letter No. CA-IV/80/2010 dated 09-08-2010 had also the same view that non-provision of DTL

on special reserve was acceptable, in case the company demonstrated by passing a resolution that it had no intention to withdraw from the special reserve.

6. Whether the balance lying in special reserve account will be a part of Tier-1 capital

Yes, special reserve will be a part of Tier-1 capital for banking companies. But only the net amount (net of DTL) of such special reserve should be taken into account for the purpose of Tier-1 capital. Reserve Bank of India DBOD mailbox clarification dated 23-12-2009 also stated that the balance lying in the special reserve account created and maintained under Section 36(1)(viii) net of DTL will be a part of Tier-1 capital for banking companies.

Illustrative example for accounting and tax treatment under Section 36(1)(viii) of Income-tax Act, 1961:

The following information is available for XYZ Ltd. A banking company which is eligible for deduction under Section 36(1)(viii):

- Income from activities mentioned under Section 36(1)(viii) before deduction under Section 36(1)(viii) is ₹150 lakh
- Income from other activities is ₹750 lakh
- Amount transferred to special reserve account during the previous year 2010-2011 is ₹40 lakh
- Paid up capital and general reserve as on 31-03-2011 is ₹110 lakh
- Amount standing credit in special reserve account as on 01-04-2010 is ₹200 lakh
- Deduction under Section 36(1)(viii) already claimed in earlier year ₹170 lakh
- XYZ withdraw ₹60 Lakh on 10-04-2011 (Assessment year 2012-2013)

Computation of allowable deduction under Section 36(1)(viii)

Least of the following is deductible

- Amount transferred to special reserve account = ₹40 lakh
- 20% of ₹150 Lakh = ₹30 lakh
- 200% of ₹110 lakh i.e. ₹220 Lakh minus ₹200 Lakh = ₹20 lakh

Hence, amount of deduction = ₹20 Lakh

Tax implications for the Assessment Year 2012-2013

As per accounts

Amount standing credit to special reserve account as on 01-04-2010 = ₹200 lakh

From the study of the section 36(1)(viii) along with applicable case laws and the opinion of Expert Advisory Committee in relation to creation of deferred tax liability on deduction claimed under this section, the author is of the opinion that there is only an interest benefit for the entities due to deferment of tax liability since deduction claimed today will be taxed in future on withdrawing the amount from special reserve account. ”

Add: amount transferred to Special reserve during 2010-2011 = ₹40 lakh

Amount standing credit to special reserve account as on 31-03-2011 = ₹240 lakh

As per tax laws

Deduction already claimed upto 01-04-2010 = ₹170 lakh

Deduction claimed during 2010-2011 = ₹20 lakh

Total deduction claimed upto 31-03-2011 = ₹190 lakh

Maximum amount of withdrawal permissible (on which no tax will be imposed)

₹240 lakh minus ₹190 Lakh = ₹50 lakh*

Withdrawal made on 10-04-2011 = ₹60 lakh

Amount which is chargeable to tax = (60 lakh – 50 lakh) = ₹10 lakh

*Since total deduction claimed upto 31st March, 2011 is only ₹190 Lakh i.e. on which tax had not been paid yet. The balance lying in special reserve account is ₹240 lakh. It means, tax had already been paid on ₹50 Lakh (₹240 lakh – ₹190 lakh). Hence withdrawal up to ₹50 lakh will not attract any tax.

Conclusion

From the study of the Section 36(1)(viii) along with applicable case laws and the opinion of Expert Advisory Committee in relation to creation of deferred tax liability on deduction claimed under this section, the author is of the opinion that there is only an interest benefit for the entities due to deferment of tax liability since deduction claimed today will be taxed in future on withdrawing the amount from special reserve account.

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