

Analysis of Section 36(1)(vii) and 36(1)(viiia) of the Income-tax Act, 1961 Read With Important Case Laws



Section 36(1)(vii) provides deductions in respect of bad debts written off as irrecoverable in the accounts of the assessee, while Section 36(1)(viiia)(a) provides the deduction merely for making provision for bad and doubtful debts up to the prescribed limit. After analysing Section 36(1)(vii) and 36(1)(viiia) along with applicable case laws and the opinion of Expert Advisory Committee of ICAI, the author is of the opinion that deduction for creating provision for bad and doubtful debts in relation to advances made by the rural advances is available under Section 36(1)(viiia), in addition to deduction for bad debts written off as irrecoverable in the accounts of the assessee under Section 36(1)(vii) subject to the provisions of Section 36(2).

Section 36(1)(vii) and Section 36(1)(viiia)

Section 36(1)(vii) of the Income-tax Act, 1961 (the Act) allows deduction in computing the income referred to in Section 28 subject to the provisions of sub-section (2), the amount of any bad debt or part thereof, which is written off as irrecoverable in the accounts of the assessee during the previous year.

Provided that in the case of an assessee to which clause (viiia) applies, the amount of the deduction relating to any such debt or part thereof shall be limited to the amount by which such debt or part thereof exceeds the credit balance in the provision for bad and doubtful debts account made under that clause.

Explanation.—For the purpose of this clause, any bad debt or part thereof written off as irrecoverable in the accounts of the assessee shall not include any provision for bad and doubtful debts made in the accounts of the assessee.



CA. Mudit Agarwal

(The author is a member of the Institute. He can be reached at camuditagarwal@icai.org.)

Section 36(1)(vii)(a) of the Act allows deduction in respect of any provision for bad and doubtful debts made by a scheduled bank [not being a bank incorporated by or under the laws of a country outside India] or a non-scheduled bank or a co-operative bank other than a primary agricultural credit society or a primary co-operative agricultural and rural development bank:-

‘An amount not exceeding seven and one-half per cent (7.5%) of the total income (computed before making any deduction under this clause and Chapter VIA) and an amount not exceeding 10% of the aggregate average advances made by the rural branches of such bank computed in the prescribed manner.’

After studying both the sections, it reveals that Section 36(1)(vii) of the Act provides deductions in respect of bad debts written off as irrecoverable in the accounts of the assessee, while Section 36(1)(vii)(a) provides the deduction merely for making provision for bad and doubtful debts up to the prescribed limit.

Critical issues relating Section 36(1)(vii) and Section 36(1)(vii)(a)

Now let us discuss some critical issues relating to these sections, along with some important case laws and opinion given by the Expert Advisory Committee of ICAI in this regard:-

1. *Whether the deduction under Section 36(1)(vii)(a) is allowed for making provision for rural advances only?*

Section 36(1)(vii)(a) has been introduced by Finance Act, 1979 in order to promote rural banking. CBDT vide its circular No. 258 dated 14th June 1979 clarified the application of the section. Circular clarified that the section was introduced in order to promote rural banking and assist the scheduled commercial banks in making adequate provision from their current profits to provide for risks in relation to their rural advances. A rural branch for the purpose of the Act meant a branch of a scheduled bank, situated in a place with a population not exceeding 10,000, according to the last preceding census.

When the Section 36(1)(vii)(a) was introduced, the limit for deduction was higher of 10% of total income or 2% of the aggregate average advances made by the rural branches of the banks. Limit

under the section has further enhanced to 5% of total income and an additional 2% of the aggregate average advances made by the rural branches. This limit was further increased by subsequent amendments in 1993 and 2001 and current limit is 7.5% of the total income (computed before making any deduction under this clause and Chapter VIA) and an amount not exceeding 10% of the aggregate average advances made by the rural branches of the bank.

In the landmark judgement of Honourable Supreme Court (*Catholic Syrian Bank Ltd Vs. CIT, Thrissur*;¹ decided on 17-02-2012), it has been laid down that the legislative intent was to encourage the rural advances and the making of provisions for bad debts in relation to such rural branches. CBDT circulars show a trend of encouraging rural business and for providing greater deductions.

It is clear from the above discussion, that the purpose of allowing mere provision of bad debts is to encourage the rural advances. Hence, Section 36(1)(vii)(a) allows deduction for the provision for bad debts in relation to rural advances only.

2. *Whether there is any double deduction of bad debts written off as irrecoverable under Section 36(1)(vii) and provision for bad and doubtful debts (36(1)(vii)(a)?*

Section 36(1)(vii) of the Act allows deduction in respect of any bad debt or part thereof, which is written off as irrecoverable in the accounts of the assessee during the previous year. The deduction is only subject to the provision of Section 36(2).

Section 36(1)(vii)(a) of the Act allows deduction in respect of provision made for bad and doubtful debts in relation to rural advances upto the specified limit.

Honourable Supreme Court in the case of *Catholic Syrian Bank (Supra)* had laid down that

Section 36(1)(vii)(a) allows deduction for the provision for bad debts in relation to rural advances only.

¹ Published in *The Chartered Accountant* (Vol. 60, Page 1569)(LD/60/104).

CBDT itself has recognised the position that a bank would be entitled to both the deductions. Hence, to prevent the double deduction, the *proviso* to clause (vii) was inserted, which says that in respect of bad debts on which clause (viia) applies, the deduction on account of actual write off would be limited to the excess of the amount written off over the amount of the provision allowed as deduction under clause (viia). Thus, the *proviso* to clause (vii) stood introduced in order to protect the revenue.

Further clause (v) in sub-section (1) of Section 36 has also been inserted, which says that where debt or part thereof relates to advances made by an assessee to which clause (viia) of sub-section (1) applies, no such deduction shall be allowed unless the assessee has debited the amount of such debt or part of debt in that previous year to the provision for bad and doubtful debts account made under that clause.

Example: In the assessment year 2010-11, an assessee got deduction for the provision made for rural advances under Section 36(1)(viia)(a) of ₹10 crore.

In the very next year (assessment year 2011-12), he wrote off bad debts relating to rural advances amounting to ₹8 crore. Then he will not get any deduction under Section 36(1)(vii) of actual write off, since the *proviso* to clause (vii) will be applicable. Further, as per the provision of clause (v) of sub-section (1) of Section 36, the amount of actual write off of bad debts relating to rural advances will be debited to provision account. Hence the balance of provision account at the end of the year will be ₹2 crore.

In assessment year 2012-13, he again wrote off bad debts relating to rural advances amounting to ₹3 crore. Now he will get the deduction only for ₹1 crore. under Section 36(1)(vii) and by virtue of Section 36(2)(v), provision account will become nil and the balance ₹1 crore will be debited to Profit & Loss account.

Deduction under Section 36 (1) (vii) is available only when the amount of bad debt is actually debited to Profit & Loss account.

In a nut shell, the author is of the opinion that deduction under clause (vii) is available only when the amount of bad debt is actually debited to Profit & Loss account. Provision for bad and doubtful debts relating to rural advances for which deduction under clause (viia) has been claimed, there will be no deduction under clause (vii) for actual write off of bad debts relating to rural advances, until or unless there is a balance lying in the provision account made under clause (viia). Hence there is no threat of double deduction.

3. Whether proviso to Section 36(1)(vii) restricts the deduction of bad debts in relation to urban branches in excess of provision made?

Proviso to Section 36(1)(vii) of the Act applies only in the case of an assessee to which clause (viia) applies. Since it is very much clear from the above discussion that deduction under Section 36(1)(viia)(a) is applicable only for the advances made by rural branches of the bank, *proviso* to Section 36(1)(vii) is applicable only for the rural advances.

Honourable Supreme Court in the case of *Catholic Syrian Bank (Supra)* stated that the schedule and non-scheduled commercial banks would continue to get the full benefit of write off of the irrecoverable debts under Section 36(1)(vii) in addition to benefit of deduction of provision for bad and doubtful debts under Section 36(1)(viia). Further, the *proviso* to Section 36(1)(vii) is self indicative in itself and its application is limited to bad debts arising out of rural advances only.

4. Whether it is necessary for an assessee to establish that the debt has become irrecoverable under Section 36(1)(vii)?

Before 01-04-1989, it was obligatory on the part of the assessee to prove that bad debts written off were indeed a bad debt. But the Section 36(1)(vii) has been amended w.e.f. 01-04-1989, to remove the obligation on the part of the assessee, to prove that bad debts written off were actually bad debt and mere writing off the bad debt is sufficient.

In the case of *CIT Vs. M/s Kohli Brothers Colour Lab (P) Ltd.*, Allahabad High Court stated that the effect of the amendment to Section 36(1)(vii) is that it is not necessary for the assessee to establish that the debt had become bad in the previous year and mere writing of the debt as

irrecoverable is sufficient. However, the said entry of write off of the bad debt in the books of accounts is not conclusive and the AO is not precluded from making inquiries as to whether the entries are genuine and not imaginary or fanciful. The AO has the power under Section 143(2) to see that the entries are not mere paper work or fake. However, at the same time, the wisdom of the assessee cannot be questioned and no demonstrative or infallible proof of bad debt having become bad is required.

In the case of *T.R.F. Ltd Vs. CIT, [2010] 190 Taxmann 391 (SC)* Honourable Supreme Court held that this position in law was well settled. After 1st April, 1989, it is not necessary for the assessee to establish that the debt, in fact, has become irrecoverable. It is enough if the bad debt is written off as irrecoverable in the accounts of the assessee.

In view of the above, it is not obligatory on the part of the assessee to prove that bad debts written off in the accounts during the previous year is actually bad debts which has become irrecoverable.

5. **Deduction under Section 36(1)(viiia)(b) and 36(1)(viiia)(c) of the Act?**

Section 36(1)(viiia)(b) allows deduction in respect of provision for bad and doubtful debts made by a bank, being a bank incorporated by or under the laws of a country outside India, an amount not exceeding five percent of the total income (computed before making any deduction under this clause and Chapter VI-A).

Section 36(1)(viiia)(c) allows deduction in respect of provision for bad and doubtful debts made by a public financial institution or a State financial corporation or a State industrial investment corporation, an amount not exceeding five percent of the total income (computed before making any deduction under this clause and Chapter VI-A).

Since the foreign banks do not have rural branches, they are not entitled to any deduction under Section 36(1)(viiia)(a). Hence the act was amended to provide the deduction upto 5% of the total income (computed before making any deduction under this clause and Chapter VI-A) to all the banks including foreign banks and public financial corporations in terms of Section 4A of the Companies Act 1956.

6. **Accounting for provision made under Section 36(1)(viiia)**

The Expert Advisory Committee of ICAI stated that merely because Section 36(1)(viiia) of the Income-tax Act, 1961 lays down the maximum limit of deduction for provision for bad and doubtful debts, is no ground for creating the same if not warranted in the facts and circumstances of the case as per the requirements of Schedule VI to the Companies Act, 1956. Section 36(1)(viiia) does not govern the preparation of financial statements for the purpose of presenting a true and fair view of the profit (loss) and the state of affairs of the company.

In view of above, Expert Advisory Committee of ICAI is of the opinion that in case the provision for bad and doubtful debts is not as per the definition of the term 'provision' given in Part III of Schedule VI to the Companies Act, 1956, the same should be treated as a reserve and where the provision for bad and doubtful debts is required to be treated as reserve, the same should be shown under 'Reserve and Surplus' in the liabilities side under a separate sub-head 'Reserve for doubtful or bad debts' as mentioned in 'Instructions in accordance with which assets should be made out' as per Part I of Schedule VI to the Companies Act, 1956. This is applicable on the companies or co-operative societies, to which deduction is allowed under Section 36(1)(viiia)(c) of the Income-tax Act, 1961. Since the banking companies prepare their financial statements as per Banking Regulation Act, 1949, this is not applicable to banking companies.

Conclusion

From the study of Section 36(1)(vii) and 36(1)(viiia) along with applicable case laws and the opinion of Expert Advisory Committee of ICAI, the author is of the opinion that deduction for creating provision for bad and doubtful debts in relation to advances made by the rural advances is available under Section 36(1)(viiia) in addition to deduction for bad debts written off as irrecoverable in the accounts of the assessee under Section 36(1)(vii) subject to the provisions of Section 36(2). Further, the *proviso* to Section 36(1)(vii) restrict the deduction only on the advances made by rural branches of the bank i.e. which is covered under Section 36(1)(viiia) and the assessee is entitled to get full deduction of bad debts written off as irrecoverable in relation to urban branches. ■