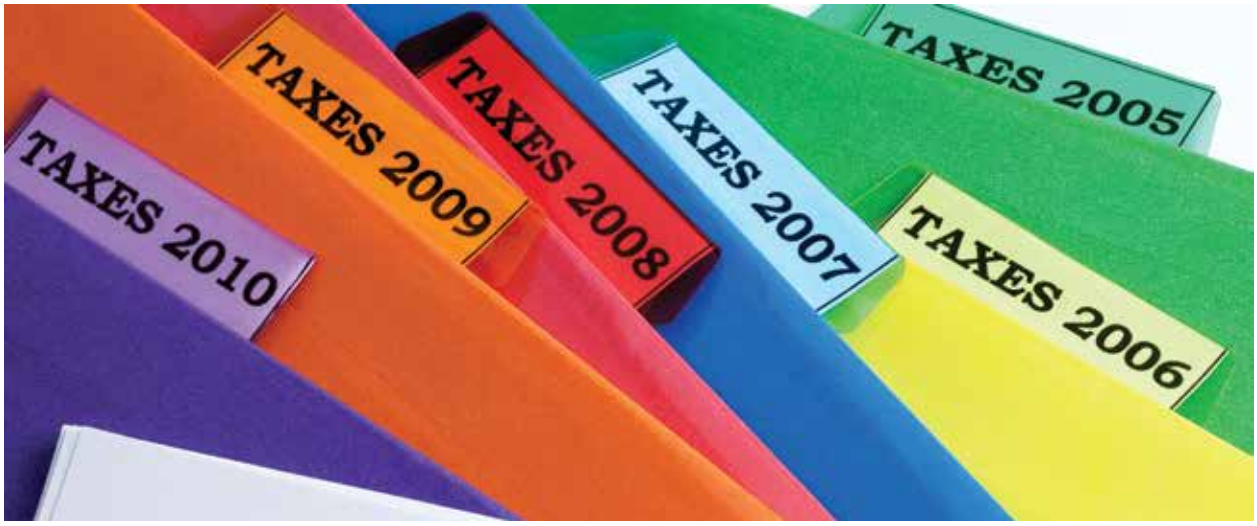
Securities Held by Banks – Treatment in Books & Taxability under Income-tax Act, 1961



Every banking company is required to hold securities for the purpose of maintaining the Statutory Liquidity Ratio (as laid down by RBI from time to time) in view of the provision of section 24(1) of the Banking Regulation Act 1949. As per Reserve Bank of India (RBI) guidelines dated 16.10.2000, the banks are required to show the securities held under 'Investment head' in Balance Sheet. On the other hand, the taxability of income is governed by the provisions of Income-tax Act, 1961 unless there is specific provision under the Income-tax Act to follow guidelines of any other act or statutory body. Now, the million dollar question is that the treatment given in the books by banks as required by RBI guidelines is conclusive for income tax purpose or any other method can be adopted by banks under the Income-tax Act, 1961. This article discusses different aspects relating to holding of securities by bank and its taxability under Income-tax Act, 1961 in the light of some important related case laws.

CA. Mudit Agarwal & Shubhi Agarwal

(*The author is a member of the Institute.
**The author is a CA Final student. They can be reached at camuditagarwal@icai.org)

Section 24(1) of the Banking Regulations Act 1949 says that after the expiry of two years from the commencement of this Act, every banking company shall maintain in cash, gold or unencumbered approved securities, valued at a price not exceeding the current market price, an amount which shall not at the close of business on any day be less than the [prescribed percentage] of the total of its demand and time liabilities in India

[Explanation.-- For the purposes of this section," unencumbered approved securities" of a banking company shall include its approved securities lodged

with another institution for an advance or any other credit arrangement to the extent to which such securities have not been drawn against or availed of.]

As per the Reserve Bank of India (RBI) guidelines dated 16.10.2000, the banks are required to show the securities held under 'Investment head' in Balance Sheet after classifying the same into following three categories:--

(a) Available for sale
(b) Held to Maturity
(c) Held for Trading

The securities held under HFT and AFS categories are required to mark to market at quarterly intervals and net depreciation under each classification is provided for and net appreciation, if any, is to be ignored. The securities held under HTM category is carried at cost. If the acquisition cost is more than the face value of security, the premium is amortised in residual maturity period by following the "constant yield method".

On the other hand, the taxability of income is governed by the provisions of Income- tax Act 1961, unless there is specific provision under the Income Tax Act to follow guidelines of any other act or statutory body.

Now the million dollar question is that the treatment given in the books by banks as required by RBI guidelines is conclusive for income tax purpose or any other method can be adopted by banks under the Income-tax Act.

Let us discuss the different aspects relating to holding of securities by bank and its taxability under Income-tax Act, 1961 along with some important case laws:--

1. **Whether treatment given in books of account is determinative of income under Income-tax Act, 1961?**

   The books of the banking company require to be maintained as per guidelines issued by the Reserve Bank of India from time to time and RBI requires that securities held by banking companies should be shown as Investment. But it is a well-known principle that under the Income-tax Act, real income is to be assessed. Section 145 of the Act says that income chargeable under the head 'Profit and gains of business or profession' or 'income from other sources' shall be computed in accordance with the method of accounting regularly followed by the assessee; provided that in a case where the accounts are correct and complete but the method employed in such that in the opinion of the Income Tax Officer (herein after referred as ITO), the income cannot properly be deduced there from, the computation shall be made in such manner and on such basis as the ITO may determine.

   In the case of ***United Commercial Bank vs. CIT*** *240 ITR 355,* the Supreme Court held that for the purpose of Income Tax, whichever method is adopted by the assessee, a true picture of profits and gains, that is to say, the real income is to be disclosed. For determining the real income, the entries in the books of account maintained in statutory form can't be decisive or conclusive. The court further held that whether the assessee is entitled to the particular deduction or not will depend upon the decision of law relating thereto and not on the view which the assessee might take of his rights nor can the existence or absence of entries in the books of account be decisive or conclusive in the matter".

In the case of ***Investment Ltd. vs. CIT*** *77* ITR 533, the Supreme court observed that in the balance sheet, it is true, the securities and shares are valued at cost but no firm conclusion can be drawn from the method of keeping accounts. A taxpayer is free to employ, for the purpose of his trade, his own method of keeping accounts.

Recently, in the case of ***Karnataka Bank Ltd. vs. ACIT*** [2013], 34 Taxmann 150 dated 11th March 2013, the High Court of Karnataka stated that even if the assessee under some misrepresentation or mistake fails to make an entry in the books of accounts, although under law, a deduction must be allowed by the Income Tax Officer, the assessee will not lose any right on claiming or will be debarred from being allowed the deduction. A method of accounting regularly adopted by the assessee cannot be discarded by the departmental

In view of the facts and legal position explained in the article, it can be concluded that the guidelines of RBI is mandatory only for the purpose of maintaining books of account of a banking company and assessee is free for adopting any other method of accounting consistently for taxing its income. Therefore, securities held by the banking companies as investment in the balance sheet as per RBI guidelines cannot be said as determinative for the purpose of income under Income-tax Act 1961.

In view of the discussion and legal position stated in this article, it is very clear that the directions/ guidelines of RBI cannot override the provisions of Income-tax Act 1961.

authorities on the view that he should have adopted a different method of keeping account or of valuation.

The same view has also been taken in the following judgements:--

- ***State Bank of India vs. CIT 157 ITR 67 (SC)***
- ***Kedar Nath Jute Manufacturing Co. Ltd. vs. CIT 82 ITR 363 (SC)***

In view of the facts and legal position explained above, it can be concluded that the guidelines of RBI is mandatory only for the purpose of maintaining books of account of a banking company and assessee is free for adopting any other method of accounting consistently for taxing its income. Therefore, securities held by the banking companies as investment in the balance sheet as per RBI guidelines cannot be said as determinative for the purpose of income under Income-tax Act 1961.

2. Whether the directions/guidelines of RBI can override the provisions of Income-tax Act, 1961?

Banking companies are required to maintain its accounts in terms of the RBI Act/Companies Act and its regulations. The form in which accounts have to be maintained is prescribed under the aforesaid legislation. The RBI Act or the Companies Act do not deal with the permissible deductions or exclusion under the Income-tax Act. In the case of ***Southern Technologies Ltd. vs. JCIT*** 320 ITR 577, the Supreme Court held that the RBI directions are only disclosure norms. They have nothing to do with the computation of total income under the Income-tax Act. The RBI directions can't override the provisions of the Income-tax Act, 1961.

Recently, in the case of ***Karnataka Bank Ltd. vs. ACIT*** [2013], 34 Taxmann 150 dated 11th March 2013, High Court of Karnataka also stated that The RBI Act, Companies Act and Income Tax Act operate altogether in different fields. The question whether the assessee is entitled to particular deduction or not, will depend upon the provision of law relating thereto and not the way, in which entries are made in the books of accounts.

The same view has also been taken in the following judgements:--

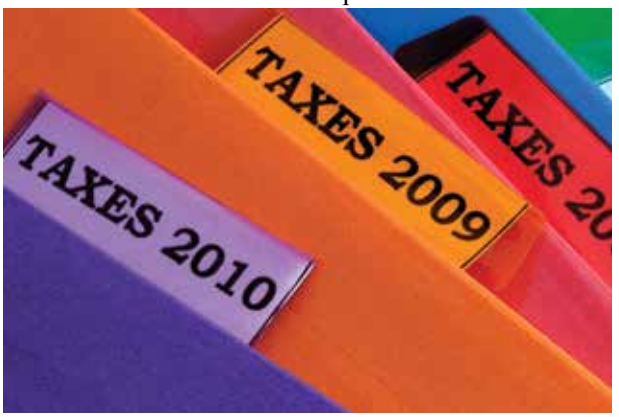
Art Leasing Ltd. vs. CIT 229 ITR 272 (Ker.)
Orissa Rural Housing Dev. Corp. Ltd. vs. ACIT 343 ITR 316 (Orissa)
TN Power Financial & Infra. Dev. Corp.Ltd. vs. JCIT 280 ITR 491 (Mad)

Further, where the intention of the Income-tax Act is to follow the RBI guidelines/circulars, the same has been specifically mentioned in the act itself. E.g., Section 43D specifically mentions that in the case of a public financial institution or a scheduled 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 or doubtful debts as may be prescribed having regard to the guidelines issued by the Reserve Bank of India in relation to such debts; shall be chargeable to tax in the previous year in which it is credited by the public financial institution or the scheduled bank or the State financial corporation or the State industrial investment corporation or the public company to its profit and loss account for that year or, as the case may be, in which it is actually received by that institution or bank or corporation or company, whichever is earlier.

In view of above discussion and legal position stated above, it is very clear that the directions/ guidelines of RBI cannot override the provisions of Income-tax Act 1961.

3. Whether securities held by banking companies are Investment or Stock in trade under Income-tax Act, 1961?

It is very clear from the above two discussions that the assessee is free to adopt different methods for



accounting and for Income Tax purpose. Banking companies require to show the securities held by them as Investments in their Balance Sheet. Now, let us discuss the real nature of securities held by banks for calculating the real income.

Investment in securities by banking companies is incidental to main banking business in view of Section 24 of the Banking Regulation Act 1949. They are bound to hold securities for maintaining its SLR requirements. Further, as per Section 6 of Banking Regulation Act 1949, there is no bar against trading of securities by banks.

In the case of ***CIT vs. Nedungadi Bank Ltd.*** [2003] 264 ITR 545 (Ker.), High Court stated that the income from such securities either on sale or on maturity is assessed as "business income", and consequently securities held by banks constitutes their stock in trade.

In the case of ***State Bank of Patiala vs. ACIT*** ITA 124 of 1979 dated 24.07.1982, the ITAT, Chandigarh held that in carrying the business of banking, the act of making investment in government securities and in trustee securities is an essential incident of the assessees' business. In fact, it is *sine qua non* in view of the provisions of Section 24 of The Banking Regulation Act 1949 for the assessee to carry on the business in a lawful manner. Therefore, these investments are made in the ordinary course of the business of the assessee and should be treated as stock-in-trade. This view is further confirmed by Punjab & Haryana High Court and Supreme Court by rejecting the reference application and the SLP (186 ITR 32) of the department.

Recently, in the case of ***Karnataka Bank Ltd. vs. ACIT*** (Supra), the High Court of Karnataka held that even though the assessee bank disclosed shares as investments in its Balance Sheet to comply with RBI Guidelines, it has not stopped from treating the same as Stock-in-trade for Income Tax and claiming valuation loss thereon where these shares have been consistently shown as stock in trade for Income Tax purpose in the past year also.

CBDT *vide* its circular no. 665 dated 05.10.1993 also stated that the Assessing Officer has to decide the issue on the basis of facts in each case, taking into consideration the guidelines issued by RBI from time to time. It is nowhere prescribed that securities are not to be treated as stock in trade in the hands of the banks. Further, it is legal position that in cases where there are contrary views of

different appellate authorities on the same issue, the circular/notification favouring the assessee can only be applied and circular/notification against the assessee, is to be ignored.

In view of the legal position explained above, the securities held by banking companies should be treated as Stock in trade and most of the banks are doing the same. However, this issue is still burning and requires more clarity from the department.

4. Taxability of securities under Income-tax Act, 1961 treated as stock in trade?

Taxability of securities treated as stock in trade for the income tax purpose can be divided into the following:--

(i) Treatment of Broken Period Interest (BPI) paid and received during purchase and sale of securities.

Interest on government securities is normally payable half-yearly. When government securities are traded, the purchaser has to pay the seller not only the purchase price of the securities but also the interest accrued on the government securities from the last due date of the interest till the date of purchase of the securities. This interest from the last due date till the date of purchase/sale is referred to as broken period interest.

In view of the legal position stated in the article, it can be concluded that valuation of securities held as stock-in-trade should be done at a lower cost or of market value at the end of financial year and resultant loss is allowable as deduction even if such loss is not actually realised.

The Supreme Court in the case of ***CIT vs. Citibank N.A.*** (Civil Appeal No.1549 of 2006) held that profit from trading of securities is to be computed u/s 28 of the Act. The interest income along with broken period interest income is required to be offered to tax and broken period interest paid on purchased is allowable as deduction.

In the case of ***American Express International Banking Corporation vs. CIT*** 258 ITR 601 (Mumbai), the High Court stated that when the BPI received was taxable as business income, the Department ought to have allowed deduction for the BPI paid on purchase of securities.

The same view has also been taken in the following judgements:--

(a) ***CIT vs. Citibank N.A.*** - 264 ITR 18 (Mumbai) HC

(b) ***CIT vs. Nedungadi Bank Limited*** 264 ITR 545 (Kerala) HC

(c) ***CIT vs. South Indian Bank Limited*** 154 Taxation 638 (Kerala) HC

(d) ***State Bank of Hyderabad vs. Joint*** CIT 95 TTJ 368 (Hyd.) ITAT

In view of legal position explained above, BPI received and paid on sale or purchase of securities should be treated as revenue expenditure.

(ii) What are the methods for Valuation of securities treated as stock in trade?

Securities held by banking companies as stock-in-trade should be valued at cost or market value whichever is lower.

The Supreme Court in the case of ***Chainrup Sampatram vs. CIT*** [1953] 24 ITR 481 held that this is the theory underlying the rule that the closing stock is to be valued at cost or market price whichever is lower, and it is now generally accepted as an established rule of commercial practice and accountancy. As profits for income tax purpose are to be computed in conformity with the ordinary principles of commercial accounting, unless of course, such principles have been superseded or modified by legislative enactments, unrealised profits in the shape of appreciated value of goods remaining unsold at the end of an accounting year and carried over to the following year's account in a business that is continuing are not brought into the charge as a matter of practice, though, as already stated, loss due to fall in price below cost is allowed even if such loss has not been actually realised.

In the case of ***State Bank of Patiala (Supra)***, ITAT held that the assessee is entitled to claim ordinary business loss arising on account of reduction of market value below cost of Government and Trustee securities at the end of the previous year.

In the case of ***Karnataka Bank (Supra)***, the High Court held that the value of stocks being closely connected with the stock market, at the end of the financial year, while valuing the assets, necessarily the bank has to take into consideration the market value of the shares. If the market value is less than the cost price, in law, they are entitled to deductions and it cannot be denied by the authorities under the pretext that it is shown as investment in the balance sheet.

In view of the legal position stated above, it can be concluded that valuation of securities held as stock-in-trade should be done at a lower cost or of market value at the end of financial year and resultant loss is allowable as deduction even if such loss is not actually realised.

Conclusion

In the light of the legal position stated by the above case laws, the author is of the view that the RBI guidelines are binding on the assessee only for the purpose of maintaining books of account and it cannot override the provisions of Income Tax. The securities held by banking companies in compliance of provision of section 24 of the Banking Regulation Act 1949 should be treated as stock-in-trade for the purpose of Income Tax because the intention of banking companies is not to earn profit by way of interest or dividend from these securities, rather the banking companies are bound to hold the portfolio as prescribed by RBI from time to time. Further, for the purpose of valuation of securities, cost or market value, whichever is lower, should be taken and the resultant loss is allowable under Income Tax. ■