Depreciation on Investments by Banks— Its Allowability in Income Tax

In the early eighties almost all the banks in the country realised that their investments in securities are its stock in trade and thereby started evaluating these securities at cost or market value whichever is less. The resultant depreciation was booked and claimed in return of income. The Apex Court confirmed this action of banks in the case: United Commercial Bank vs. Commissioner of Income Tax (1999) 240 ITR 355(SC). This article takes stock of various other circulars issued in this regard by the CBDT and RBI and elaborates that from A.Y. 1993-94, the depreciation is allowable as per the directions of Board given in Circular 665 issued on 5-10-1993.

Real Income Concept

Prior to 1980, almost all the Banks were not following the real income concept while filing their Income Tax Returns so far as the valuation of its investments was concerned and had been reflecting such investments in securities at cost by ignoring the real market value. Only in early eighties such banks realised that these investments in securities are its stock in trade and thereby started evaluating it at cost or market value whichever is less and the resultant depreciation was booked and claimed in their return of income. The Income Tax authorities objected to this concept and also to this change in method of valuation from "cost" to "cost or market value which ever is less" and accordingly disallowed the entire amount of depreciation on the plea that this depreciation on valuation of securities is nothing but depreciation on valuation of investments which is a capital asset and thereby cannot be allowed by giving it a treatment as stock in trade.

The matter remained under litigation till the apex court finally put it to rest by deciding the case: *United Commercial Bank vs. Commissioner of Income Tax (1999) 240 ITR 355(SC)* pertaining to A.Y. 1982-83. The apex court set aside the case *CIT vs. UCO Bank (1993) 200 ITR 68(Cal)* and *Applied Investment Ltd. vs. CIT (1970) 77 ITR 533(SC)* and *Chainrup Sampatram vs. CIT (1953) 24 ITR 481(SC)* by holding that *"For the purpose of income tax what is to be taxed is the real income."* The apex court distinguished the case of *CIT vs. British Paints India Ltd. (1991) 188 ITR 44 (SC)* and *State Bank of Travancore vs. CIT (1986) 158 ITR 102 (SC).* The ITAT Jodhpur in the case of *Bank of Rajasthan Ltd. vs. Inspecting Assistant Commissioner (2004) 88ITD 577(Jodh),* which had earlier disallowed the assessee's claim for loss on account for difference between market price and book value of such investment by holding that such loss was in nature of notional loss, subsequently amended its order u/s 254(2) of the Income Tax Act, 1961 based on the ratio as held by Supreme Court in the case of *United Commercial Bank vs. Commissioner of Income Tax* and concluded as under:

"As per Banking Regulation Act, 1949, a banking company cannot show shares and securities as stock in trade and the same has to be shown as investment. This investment represents stock in trade because the entire shares and securities are stock in trade and banks deal in shares and securities as per said Act as well as memorandum of association of the company. Thus shares and securities are stock in trade. In case of applicant bank, the investment represented in its balance sheet, in fact, was stock in trade for all practical purposes."

The view had also been confirmed by the Supreme Court in the case of UCO Bank (supra). Therefore, it was admittedly, a mistake of law. It has also been held in a plethora of judgments of

— CA. R.K. Gupta

(The author is a member of the Institute. He can be reached at ggajmu@yahoo.com)

various High Courts and Benches of the Tribunal that the subsequent decision of the Supreme Court overruling the decision of the Tribunal would render that decision as a mistake apparent from records. Thus, it was to be held that the order of the Tribunal suffered from an apparent mistake of law as per subsequent judgment of the Supreme Court, in the case of UCO Bank (supra). Therefore, the order of the Tribunal was to be rectified on the issue of valuation of investment (stock in trade). The assessing officer was to be directed to allow the losses claimed for the relevant assessment years.

The recent judgement of Bombay High Court in the case of *Commissioner of Income Tax vs. Bank of Baroda ((2003) 262 ITR 334(BOM))* has also followed the same. Lot many benches of Income Tax Tribunals have allowed the claim of banks on this score and the Revenue is not in further litigation against such orders in Courts.

CBDT Clarification

When the matter was under litigation, the Banks had also approached Central Board of Direct Taxes for clarification on this issue. The Board clarified the matter by issuing Circular No. 599 on 24-04-1991:

Treatment of securities – Stock in trade or investment

BUSINESS INCOME, INCOME, INTEREST ON SECURITIES

SECTIONS 18, 28, 29

Clarifications on the following issues have been sought by banks from the Central Board of Direct Taxes:

i) Whether the securities held by the banks constitute their stock in trade or investment, and consequently whether the loss claimed by the banks on the valuation of their securities should be allowed as a deduction in computing their taxable profits?

ii) Whether deduction claimed in respect of interest paid for broken period on the purchase of securities should be allowed as a deduction from the taxable profits?

The matter has been considered by the Board and it has been decided that the securities must be regarded as stock in trade by the banks. Therefore, the claim of loss, if debited in the books of account, would be given the same treatment as is normally given to the stock in trade. As far as the second issue is concerned, both the interest payments and receipts must be regarded as revenue payments/ receipts, and only the net interest on securities shall be brought to tax as business income.

Later on 31-07-1991 the Board withdrew this circular in toto by circular No. 610 putting reliance on the ratio held by Supreme Court in the case of Vijaya Bank. Although the intention of the Board was to withdraw the clarification regarding another issue of interest paid for broken period interest on the purchase of securities yet by mistake it has withdrawn the whole circular 599. Aggrieved by it the Banks through IBA again approached the Board and represented that the withdrawal of Circular No.599 dated 24-04-1991 in toto was not correct.

The Board reconsidered the treatment to be accorded to securities held by banks and issued the following directions by its Circular No. 665 on 5-10-1993:

"The question whether a particular item of investment in securities constitutes stock in trade or a capital asset is a question of fact. In fact, the banks are generally governed by the instructions of the Reserve Bank of India from time to time with regard to the classification of assets and also the accounting standards for investments. The board has, therefore, decided that the Assessing Officers should determine on the facts and circumstances of each case as to whether any particular security constitutes stock in trade or investment taking into account the guidelines issued by the Reserve Bank of India in this regard from time to time".

RBI Guidelines

Over the years, the Reserve Bank of India has issued a number of circulars on valuation of investments by banks. Many of these circulars are no longer relevant because they have been

superseded by subsequent circulars. The relevant circulars under consideration give the following position to the valuation of securities.

From the year 1992, The Reserve Bank of India has required banks to classify investments into two categories for purposes of valuation: permanent and current. The Reserve Bank of India has also laid down detailed guidelines for valuation of investments falling under these categories. While the depreciation in respect of permanent investments is not likely to affect their realisable value and therefore need not be provided for, the depreciation in the current investments should be fully provided for. Permanent investments could be valued at cost unless it is more than the face value, in which case the premium has to be amortised over the period remaining for maturity of the security. Banks are not excpected to sell securities in the permanent category freely, but if they do so any loss on such transactions in securities in this category has to be written off. Besides, any gain should be taken to capital reserve account.

These guidelines were superseded by Circular DBOD No.BP.BC.32/21.04.048/2000-2001 dated October 16, 2000. The revised guidelines contained in this circular require classification of investments into three categories: held-to-maturity, available-for-sale and held-for-trading. The Circular also lays down guidelines to be followed in case a bank desires to shift certain investments from one category to another.

The revised guidelines are effective from the half-year ended September 30, 2000. According to the circular, the classification of existing investments of banks among the three categories may be done at the book value of the respective securities as on September 30, 2000. The circular states that securities under the held-for-trading category may be revalued as on September 30, 2000. Securities under the available-for-sale category may also be revalued as on that date if the bank proposes to revalue this category at intervals more frequent than annual intervals.

The guidelines require every bank to formulate an 'Investment Policy' with the approval of its Board of Directors to take care of the requirements relating to classification, shifting and valuation of investments as per the guidelines. Besides, the policy should adequately address risk management aspects and should also ensure that the procedures to be adopted by the bank under the guidelines are consistent, transparent and well documented to facilitate easy verification by inspectors and statutory auditors.

It has been clarified that the above categorisation is only for purposes of valuation. For purposes of balance sheet presentation, the investments will continue to be disclosed under the following six categories as required by the Third Schedule to the Banking Regulation Act, 1949.

- Government securities
- Other approved securities
- Shares
- Debentures and bonds
- Subsidiaries/joint ventures
- Others (Commercial paper, mutual fund units, etc.)

Valuation

Held to maturity securities: Investments classified under held to maturity category need not be marked to market. They are required to be carried at acquisition cost unless it is more than the face value, in which case the premium should be amortised over the period remaining to maturity.

Any diminution in the value of investments in subsidiaries/joint ventures included under held to maturity category is to be provided for if such diminution is other than temporary in nature. Such depreciation is to be determined and provided for each investment individually.

Available for sale securities: The individual scrips available for sale category are to be marked to market at quarterly or at more frequent intervals. While the net depreciation under each of the categories referred to above is to be recognised and fully provided for, the net

appreciation under any of the aforesaid categories above is to be ignored. The guidelines state that the book value of the individual securities would not undergo any change after the revaluation. In other words, the depreciation or appreciation in value of individual's scrips in accordance with the above methodology would not be credited to individual scrip accounts but would be held collectively in a separate account.

Held for trading securities: The individual scrips in the held for trading category are to be marked to market at monthly or at more frequent intervals as in the case of those in the available for sale category. The book value of the individual securities in this category would not undergo any change after marking to market.

Conclusion

The case law *United Commercial Bank vs. CIT (1999) 240 ITR 355 (SC)* is relevant to assessment year 1982-83. At that point of time there was no specific Accounting Standard issued by Reserve Bank of India on valuation of Investments. Although the CBDT circular no. 599 dated 24-04-1991 supports that in case of banks, securities must be regarded as stock in trade of banks and the loss if any on its valuation would be given the same treatment as is normally given to the stock in trade but this circular stands withdrawn by another CBDT circular no. 610 dated 31- 07-1991.

The most important point which is relevant for consideration is CBDT circular no. 665 dated 05-10-1993 which has been issued by the Board on the insistent of Indian Banks' Association after the withdrawal of CBDT circular no. 599 in toto because the confusion resolved by CBDT circular no. 599 on treatment of securities as stock in trade in case of banks has emerged again by CBDT circular no. 610.

Now, the question is whether CBDT circular no. 665 is binding on assessing officer with effect from assessment year 1993-94 or the judgement of apex court which is relevant to assessment year 1982-83 only.

The matter has been studied in view of section 145(2) of the Income Tax Act, 1961 keeping into consideration the CBDT circular no. 665. In fact, no other treatment can be given for valuation of securities than what is prescribed by Reserve Bank of India from time to time. Even the banks may provide for excess depreciation on its securities by following a more prudent and conservative approach but for its allowability in income tax what is prescribed in the guidelines of Reserve Bank of India is required to be followed and the income tax authorities are bound to adhere to these guidelines by virtue of CBDT circular 665.

The case of United Commercial Bank holds good up to that assessment year in which the CBDT Circular No. 665 came directing to follow RBI guidelines. Reserve Bank of India has laid down a clear policy for banks with effect from 1992 to bifurcate its investments in securities which are to be held till its maturity or for a longer period as Permanent Investments (Later on defined as Investments categorised as Held to Maturity Securities) and which are to be held with the intention to trade or for sale as Current Investments (Later on defined as Investments categorised as Held for Trading and Available for Sale category).

From the aforesaid discussion, it is crystal clear that up to the A.Y. 1992-93 all the Investments in Securities by Banks are to be treated as its stock in trade and any diminution in the cost in the value is allowable by following the ratio as held by The Supreme Court in the case of *United Commercial Bank vs. Commissioner of I. Tax* (Supra). But from A.Y. 1993-94, the depreciation is allowable only on those investments which are allowable to be marked to market by RBI and not on all investments. In other words, depreciation is not allowable on Permanent Investments, (Later on defined as Investments categorised as Held to Maturity Securities) but allowable on Current Investments (Later on defined as Investments categorised as Held for Trading and Available for Sale category). ❐