Key Income-tax issues that challenge the banking sector

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Financial services play a vital role in any economy. Banking industry, easily, fits in as the backbone of the financial service sector. Focus and attention on the banking industry have grown immensely in the recent past on the back of actions launched by regulatory agencies against some of the banks. It is a matter of time for the tax regulators, including Income-tax department, to turn their focus on the positions taken by banks on various intricate tax issues. Through this article, an attempt has been made to identify and discuss some of the key direct tax issues specific to the banking sector.

1. **Income Computation Disclosure Standards (ICDS)**
   1.1 ICDS - I – All the disclosure requirements warranted under this standard shall be taken care.
   1.2 ICDS – II - Valuation of Inventories – Section 8 of The Banking Regulation Act prohibits banks from trading in goods. Thus, ICDS II becomes insignificant for the banking sector. However, many banks trade in gold and bullions, which needs to be taken care.
   1.3 ICDS – VI – Effects of changes in forex rates – For banks, this may be in the form of monetary and non-monetary items. Besides, the balances held by foreign branches or foreign subsidiaries of the banks require compliance of ICDS VI. While the exchange gain or loss on monetary items shall be treated as revenue, non-monetary items do not require any adjustments. This has been made clear in para 5.1 of the ICDS VI. Again, any foreign currency translation amounts of a bank having branches outside India shall be treated as revenue. Reference may be drawn to FAQ No.16 in the CBDT Circular no. 10/2017 dated 23.3.2017.
   1.4 ICDS – VII – Government grants – Though this ICDS has limited relevance to banks, caution needs to be exercised on certain grants, namely, setting up and operating of Aadhar enrolment centres, debit card swipe-up concession of Rs.2,000 etc and their tax treatments.

2. Disallowance under section 14A

2.1 The Finance Act, 2020 has amended taxation of dividend and by virtue of the same, we are moving back from the DDT model to the classical model of taxation of dividend in the hands of shareholders. Expenditure relating to earning of dividend income was subject matter of disallowance u/s.14A in view of exemption in the hands of shareholders. Since the new dividend taxation regime has taken effect only from 1st April, 2020, the issue of disallowance under sec.14A in the context of dividend income shall continue to apply for FY 2019-20 relevant to AY 20-21.

2.2 In a case where a bank had used its own funds for investment which derives exempt income and borrowed funds for the purpose of business, no disallowance u/s. 14A could be made since there was no nexus between the investment and the borrowing. This view was endorsed by the Supreme Court in its landmark pronouncement in the case of ***Maxopp Investment Ltd. vs. CIT*** **(2018) 402 ITR 640 (SC).** How far this principle holds good for banking sector needs to be understood in the context of disallowance under section 14A.

2.3 We are aware that banks possess large CASA (proportion of current account and savings account) funds. Needless to mention that a low CASA ratio means the bank relies heavily on costlier wholesale funding, which eventually hurt its margin, in view of higher interest pay-outs. While Kotak Mahindra Bank holds the best CASA ratio of 53.7%, DCB Bank performed poorly in CASA management with a ratio of 23% (source: data analytics report from Capitaline).

2.4 While computing disallowance u/s.14A, one needs to take into account the interest on savings account as it carries interest cost. On the other hand, funds in current account may not be an issue as it does not carry any interest cost. Utilisation of large pool of current account balances by the bank in tax free investments would raise an issue of fungibility of own funds and borrowed

funds. Even though it is a tough task, it is highly important for the banks to demonstrate the nexus test on usage of funds, to successfully contest on the disallowance u/s.14A.

2.5 Again, sec. 14A applies irrespective of whether the shares are held to gain control (as investment) or as stock-in-trade (for trading/business purpose) as held in the case of ***Maxopp Investment Ltd. vs. CIT*** **(2018) 402 ITR 640 (SC).** In view of this decision, even if the Bank claims that the investment in shares has been made as a strategic investment, disallowance u/s.14A would be made by the tax department.

3. **Broken period interest**

3.1 As part of treasury operations, banks keep investing in various securities. Debt securities are unique in nature as the interest accrues from one coupon date to another. The portion of interest on debt securities between 2 coupon dates is known as 'broken period interest'. When a bank acquires debt securities between its coupon dates, the purchase consideration invariably embedded with interest up to the date of purchase, apart from the cost of securities. In such eventuality, treatment of interest as revenue expenditure or otherwise is a contentious issue.

3.2 It may be noted that the banks generally hold such securities as stock-in-trade and not as investments and thus, the interest income, if any, shall be chargeable under the head business income. CBDT endorsed such treatment vide its circular no. 665 dated 5.10.1993.

3.3 While the banks consider such broken period interest as revenue expenditure, the department considers the same as part of cost of acquisition of securities and thus, declines to allow the same as deduction until the securities are sold. This issue was settled in favour of the assessee-bank in the case of **CIT Vs. Citibank N.A. 264 ITR 18,** wherein the Bombay High Court has held that the broken period interest on the purchase of debt securities shall not be treated as cost of purchase of securities but was fully deductible in the year of

purchase itself. The Supreme Court has dismissed the SLP filed by the Department in Citibank's case (Civil Appeal no. 1549 /2006).

3.4 Recently, the Department has again raised this issue before the Supreme Court in State Bank of India's case claiming that the principles laid down in Citibank's case need reconsideration. It is understood that the Supreme Court has admitted the SLP and in view of this, allowability of broken period interest as deduction is subject matter of debate once again till the SBI's case is concluded.

4. **Deduction for provision for doubtful debts & bad debts**

4.1 Banks are eligible for deduction in respect of their provision for bad and doubtful debts as well in respect of bad debts written off, subject to the condition that there should not be a double deduction in respect of the same account. Section 36(2)(i) provides a condition that in order to claim a debt as bad, the same should have been offered as income in a previous year. However, this condition shall not apply to a debt of a bank, which represent money lent in the ordinary course of business. Few issues that need to be taken care of are discussed hereunder:

4.2 **Credit card dues**: Whether the write-off of credit card dues of customers are eligible for deduction as bad debts? The Department is of the view that the credit card dues are not money lent in the course of banking business and thus, not entitled for deduction under section 28 as well under section 37(1). Assessee-banks are of the view that credit card balances, which are outstanding, are integral part of banking business. Further, the Master Directions of RBI treats such dues as 'unsecured loans' and accordingly, revenue recognition principles shall apply. Though it appears to have reached clarity in view of RBI directions, Department still makes a case out of this seemingly simple deduction.

4.3 **Adjustment of bad debts against the provisions**: Section 36(1)(vii) provides that claim for bad debts written off in any year is to be reduced to the extent of the balance in the provision for bad and doubtful debts account. The intention of this adjustment is to ensure that there is no double deduction for the same account. Sec.36(2)(v) provides further that banks are required to adjust the bad debts against the provisions deductible u/s.36(1)(viia). There may be an issue as to whether the opening balance or the closing balance of the provision for bad and doubtful debts account are to be adjusted for claiming bad debts written off as deduction. As the statutory provisions are silent, the Department has, in a few cases, contended that the adjustment should be made to the closing balance in the provision account. Whereas the assessee claims that the same should be done on the opening balance. There are ongoing cases on this subject being dealt at different Tribunals. Reference may be drawn to the decision of the Gujarat High Court in the case of ***CIT Vs. UTI Bank Ltd., (2013) 212 Taxman 296*** wherein it is held that the adjustment shall be done to the opening balance of provision account as the closing balance is arrived at only after write offs are done. Readers may take note of ***CBDT Instruction No. 17/2008 dated 26-11-2008***, wherein it is clarified that the opening balance alone shall be considered for adjustment. Relevant portion of the instruction is reproduced hereunder:

> *…(ii) While considering the claim for bad debts under section 36(1)(vii), the Assessing Officer should allow only such amount of bad debts written off as exceeds the credit balance available in the provision for bad and doubtful debt account created under section 36(1)(viia). The credit balance for this purpose will be the opening credit balance, i.e., the balance brought forward as on 1st April of the relevant accounting year…"*

Banks shall keep in mind the above clarification and decision of the Gujarat High Court while computing the amount of provision deductible u/s.36(1)(viia).

4.4 **Rural branches**: Sec.36(1)(viia) defines 'rural branch' for the purpose of allowing deduction to the extent of 10% of aggregate average rural advances. Sec.36(1)(viia) defines rural branch to mean a branch located at a place which has a population of not more than 10,000 according to the last preceding census for which the data have been published before the 1st day of the previous year. In few instances where the final population census is not made available, the Department relied on the provisional population data to determine whether the branch is located in rural area. In a situation where such provisional census shows population in a village exceeds 10,000, it becomes a contentious issue whether the branch is eligible for the deduction. The Karnataka High Court in the case of ***State Bank of Mysore Vs. ACIT (2015) 231 Taxman 319*** has held that the department could rely on such provisional population census to decide on whether the branch is a rural branch. In view of this, banks should pay attention to the provisional population data where the final statistics are not available.

4.5 Further, in many cases, Department seeks to rely on the data available at the stage of assessment. This issue is more challenging in the 2 to 4 years after a census has been done. Further, sometimes RBI's classification of rural advances may be at variance causing tax issues. Caution needs to be exercised in this area.

4.6 **Manner of computation of advances**: Another issue that has frequently been raised by the Department is on the manner of computing aggregate average advances made by the rural branches for the purpose of deduction under section 36(1)(viia). Rule 6ABA prescribes the procedure as follows:

(i) the amounts of advances made by each rural branch as outstanding at the end of the last day of each month comprised in the previous year shall be aggregated separately;

(ii) the sum so arrived at in the case of each such branch shall be divided by the number of months for which the outstanding advances have been taken into account for the purposes of clause (i) above;

(iii) the aggregate of the sums so arrived at in respect of each of the rural branches shall be the aggregate average advances made by the rural branches of the scheduled bank.

The Calcutta High Court in the case of ***PCIT Vs. Uttarbanga Kshetriya Gramin Bank (2018) 256 Taxman 72*** has validated the manner prescribed in Rule 6ABA for the purpose of section 36(1)(viia). As there are no other divergent judicial pronouncements on this issue, adopting any other method would be contentious.

4.7 **Deduction based on advances made – double deduction**: Deduction under section 36(1)(viia) was first introduced by the Finance Act, 1979. Presently, the deduction is prescribed at 10% of the aggregate average *advances made by the rural branches of a bank*. The intention of this deduction could be seen as a measure to: (a) encourage more rural advances by banks; and (b) to cover the higher risk of non-recovery in respect of such rural advances on the part of the banks. Accordingly, there is no second thought on the intention of section 36(1)(viia), which is beneficial in nature to the banking sector.

4.8 There are instances where the Department is interpreting that the deduction u/s.36(1)(viia) shall be limited to the advance made by the branch during the year. Some of the assessment orders highlight the language used in the section that it is on the 'advances made'. Armed with this interpretation, some AOs are disregarding the amount of provision that are attributable to advances made in the earlier period. The assessment orders also point out that by allowing deduction on the year end provision, it would result in double deduction as the year end outstanding comprise of provision for bad and doubtful debts of advances pertaining to current as well the previous years.

4.9 It may be noted that the Supreme Court in the case of ***Escorts Ltd. Vs. Union of India (1993) 199 ITR 43*** has held that:

'…it is impossible to conceive of the legislature having envisages a double deduction in respect of the same expenditure. There is a fundamental though unwritten axiom that no legislature could have at all

intended a double deduction in regard to the same outgoing; and if it is intended, it will be clearly expressed…'

In view of this, the Department is correct in its approach towards not allowing double deduction for the same item.

4.10 Having said that, such interpretation could be unfair if the deduction is allowed strictly to the extent of provision for advances made during the year alone. We will be failing in our duty to understand the intention of the law as well facts of a particular case. There could be a possibility that a bank has provided for bad and doubtful debts of say, year I based on the advances made in that year. In the subsequent year - II, the bank could have made provision based on advances made during year II as well additional provision for year I based on a fresh estimate of doubtful debts of year I. In this scenario, it appears that the bank is correct in claiming the aggregate provision made for year II and year I (based on fresh assessment). Of course, where there is double claim for the same provision, the same shall be disallowed in view of the decision in case of Escorts Ltd.

4.11 **Bad debts**: Deduction for bad debts u/s.36(1)(vii) does not require a bank to establish that the debt has, in fact, become irrecoverable and it is enough if bad debt is written off as irrecoverable in the books of account of the assessee. This principle found favour from the decision of the Supreme Court in the case ***TRF Ltd. Vs. CIT (2010) 190 Taxman 391.***

4.12 Of course, one cannot easily take away the powers of the AO. The AO is empowered to make enquiry as to whether the write off entry is genuine and not an imaginary and fanciful entry. However, while making such enquiry the AO should not question the wisdom of the bank, nor should he demand demonstrative or infallible proof of the debt having become bad. Commercial expediency from the point of view of the bank, the nature of transactions and period during which the write-off decision has been taken should be looked into for determining the allowability of bad debts.

4.13 There are instances wherein the AO has questioned the validity of claim of bad debts based on the reasoning that legal recourses have not been pursued before such write off of debt. The CBDT vide its Letter: F.No.10/66/61-IT(A-I) as early as 16-01-1962 has clarified that the claim for deduction by a bank in respect of irrecoverable loans will not be rejected by the Department merely for the reason that legal proceedings have not been taken by the banks in respect of advances to customers affected by natural calamities. In the present context, the country and the rest of the world are experiencing the unprecedented Covid-19 attack which is even more dangerous and disastrous than a natural calamity. Banks would be experiencing unprecedented write-offs as the entire economy is in standstill mode. Debts written off as bad for the fiscal year 2019-20 and 2020-21 would run the test of law and the banks may look out for a liberal approach by the Department in allowing such write-off as deduction, without much litigation.

4.14 **Netting off of provisions**: The decision of a bank to create a provision for bad and doubtful debts is taken on the basis of the quality of 'Advances and debts' as are available at the end of a particular year. Similarly, the decision to write back the provision or reverse the provisions that were created in earlier years is taken on the basis of the recovery pattern of the 'Advances and debts', against which the provision was created in earlier years. Thus, both the decisions are taken on the basis of different set of facts and hence both the decisions constitute independent decisions, which are not related to each other. Hence it may be contended that the provision for bad and doubtful debts newly created during the year under consideration should not be netted against the amount written back or reversed. The Cochin Bench of the ITAT in the case of **Kannur Dist. Co-op Bank Ltd. Vs. ACIT** I.T.A. No. 323/Coch/2010 has endorsed this view, which the banks could make use of.

5. **Specified Domestic Transactions**

5.1 While international transfer pricing may have limited impact on Indian banks, applicability of specified domestic transaction (SDT) as prescribed under

section 92BA is gaining importance in view of the emergence of International Financial Service Centres (IFSC), which are enjoying tax neutrality. Section 92BA(v) provides that any transaction referred to in any sections under Chapter VI-A relating to deduction for specified income shall be considered to be a SDT. Here, it may be mentioned that section 80LA of the Income-tax Act provides a 5-year tax holiday to a unit located in an IFSC. This indicates that any transaction between a unit in an IFSC and a non-IFSC unit of an assessee shall be tested for SDT. Relevant provisions of section 80LA are reproduced in Appendix 1 for ready reference.

5.2 Gujarat International Finance Tec City (GIFT City) at Gandhinagar is one such example of IFSC. Presently, some of the leading banks in India, namely, SBI, Bank of Baroda, Bank of India are operating branches at GIFT City and many more banks have applied for setting up their branches there. A banking unit set up and operating at IFSC is known as IFSC Banking Unit (IBU). The IBUs would operate and maintain balance sheet only in foreign currency and would not be allowed to deal in INR except for administrative and statutory expenses using a special rupee account. The details of IBU in GIFT city may be understood from the FAQ's posted at http://www.giftgujarat.in/faq.aspx.

5.3 Now, any services between a GIFT City branch of a Bank and non-GIFT City branch should meet with the arms' length price (ALP) standards stipulated under section 92BA. Readers may note that the safe harbour rules for specified domestic transactions are covered under Rules 10THB and 10THC. Unlike the exhaustive list prescribed for international transactions as safe harbour provisions under Rules 10TC and 10TD, the list for specified domestic transactions are limited in number, thus, posing a challenge for the banks to figure out ALP with certain degree of accuracy and certainty.

6. Withholding tax provisions

6.1 TDS and TCS provisions have emerged as a major source of collection of taxes for the Government and thus, one could always witness a spike in the number of sections and the procedures there to. Presently, there are over 40

active sections dealing with various payments/receipts including the recently added items through the Finance Acts, 2019 and 2020. Few of the challenges arising out of TDS/TCS provisions are discussed hereunder:

6.2 **TDS on cash withdrawals**: Section 194N applicable from 1st September, 2019 provides for 2% TDS by certain payers, including banks, where the aggregate cash withdrawals by any person through one or more accounts maintained by the recipient account holder exceeds Rs. 1 crore during the previous year. It needs mention that the account holder withdraws cash not only from the bank branches but also from ATMs. It is pertinent to note that the withdrawal may happen from ATMs operated by any other banks too. As the language used in section 194N reads as 'at the time of payment of such sum', it would be a challenging task for the banks to adhere to deduction of tax on a real time basis. Besides, this may lead to overlapping of deduction of tax, adding to more compliances. For example, an account(s) of a customer, which earns interest (say, SB,FD or RD accounts) would be subject to TDS u/s.194A and there will be a repeat of TDS u/s.194N, when the cash withdrawal is effected from the same account.

6.3 **TDS on immovable property transactions**: Section 194IA deals with deduction of tax at source @ 1% by the purchaser on acquisition of immovable property. It is common knowledge that banks lend to customers based on the security of immovable properties. Where there is a default or failure on the part of the customer in adhering to the terms of loan, banks invoke auctioning powers of the security to recover the loan. The amount of TDS reduces the cash flow for adjustment against defaulting loan account as there is no specific exemption to bank auction process from the applicability of TDS u/s.194IA. Further, instances are noticed where the purchaser inadvertently deducts tax in the name of the bank instead of the actual owner of the immovable property, resulting in complications on claiming credit for TDS.

6.4 Though it is not on TDS related provisions, there could be an instance of application of section 56(2)(x) where shares/securities are held by the bank by way of a pledge. It is possible that the Department may charge to tax the difference between the book value of the shares computed in accordance with Rule 11UA of the Income-tax Rules and the amount of loan outstanding in the hands of the lending bank at time of invocation of pledge against the defaulting loan account. Though the intention of section 56(2)(x) is altogether different, the banks have to face this contentious issue in view of lack of specific exemption.

6.5 **TCS on LRS**: On the TCS front, the Finance Act, 2020 has cast upon banks the onerous task of collecting tax on overseas remittances. Section 206C provides that an Authorized Dealer receiving an amount or an aggregate of amounts of seven lakh rupees or more in a financial year for remittance out of India under the LRS of RBI, shall be liable to collect TCS, if he receives sum in excess of said amount from a buyer being a person remitting such amount out of India, at the rate of 5%.

7. Tax aspects on merger on banks

7.1 An important milestone was achieved on 1st April, 2020 in the annals of state owned banks in India with the merger of certain banks with anchor banks. While the merger would certainly provide the much-needed synergy and open the floodgates for international pitch, it also would provide certain tax challenges post-merger. Amalgamating and amalgamated banks will need to focus on identifying and capturing all the merger related expenses and carry out a tax accounting for 5 years of staggered deduction under section 35DD. It may be noted that the amalgamation expenses are not allowed as revenue expenditure in entirety in the year of amalgamation.

7.2 Further, the carry forward and set-off of losses of the amalgamating banking company shall be subject to the rigor of section 72AA so that the amalgamated banking company could derive the benefit of losses, if any. By virtue of the

overriding provision contained in section 72AA, the conditions prescribed under section 2(1B) relating to transfer of all assets/liabilities etc. shall not apply to amalgamation of banking companies.

Conclusion

As we have seen in the foregoing discussions, there are many compliances and open litigation issues which banks are grappling with. There are many other issues not discussed in this article including but not limited to compliance under Foreign Account Tax Compliance Act (FATCA), Place of Effective management (POEM) etc., which pose a greater challenge similar to the issues specifically discussed.

The banking sector acts as a central nervous system of the economy and the tax issues and consequent prolonged litigations may create an uncertainty and may dislodge the banking cycle. It is time that the law is amended to incorporate a mechanism to negotiate in advance on the major issues that are potentially litigative. Such mechanism could be similar to the Advance Pricing Agreement available for transfer pricing cases, to bring in certainty to major tax issues specific to the banking sector.

Appendix -I

Offshore banking units and International Financial Services Centre - Sec. 80LA

Eligible assessee : The deduction under this section is available to an assessee being:

(a) A Scheduled bank, having an offshore banking unit in a SEZ; or (b) A foreign bank having an offshore banking unit in a SEZ; or (c) **A unit of an International Financial Services Centre (IFSC).**

Quantum and period of deduction

For assesses mentioned in (a) & (b) above - Explanation 1 to Sec. 80LA:

i. First 5 consecutive AYs beginning from the AY in which permission to operate or registration of such unit has been obtained under Banking Regulation Act or SEBI Act or any other Statute- deduction @ 100% of such income; and

ii. Thereafter for next 5 consecutive AYs – deduction @ 50% of such income.

For assesses mentioned above in Point (c) - Explanation 1A to Sec. 80LA:

i. 100% of such income for any 10 consecutive AYs at the option of the assesse, out of 15 years, beginning from the AY in which permission to operate or registration of such unit has been obtained under Banking Regulation Act or SEBI Act or any other Statute.

Eligible income

The deduction shall be allowed on account of the following income included in the gross total income of the assessee:

(i) Any income from an Offshore Banking Unit in a Special Economic Zone; or

(ii) Income from the business referred to in Sec. 6(1) of the Banking Regulation Act, 1949 (activities a banking company may engage apart from the business of banking), with an undertaking located in a Special Economic Zone or any other undertaking which develops, develops and operates or develops, operates and maintains a Special Economic Zone; or

(iii) Income from any Unit of the International Financial Services Centre from its business for which it has been approved for setting up in such a Centre in a Special Economic Zone.

Other Points

The deduction shall be allowed to such assessee in respect of their income received from the above mentioned Units subject to the furnishing of the following, along with the return of income:

(a) report from a CA about the correctness of the claim of deduction in the prescribed form; and

(b) a copy of the permission obtained u/s. 23(1)(a) of Banking Regulation Act, 1949.