Tax implications for Banks & NBFCs

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Perpetual Debt Instruments (PDIs)
PDIs – General aspects

• Permitted by RBI as Additional Tier – 1 (AT-1) capital base.

• Fixed rate of return but no fixed tenure for repayment.

• **Subscribers have no right to enforce repayment of principal.**

• YES bank – INR 8,400 crores of PDI.

• Restructuring pack – suggests permanent write-down of PDI.

• Tax issues in the hands of the issuer.

• Tax issues in the hands of the subscriber.
• Deduction for interest – 3 prerequisites.
  - *Bazpur Co-op.’s case* – 177 ITR 469 (SC).

• Write-down of PDI – constitutes income?

• Application of sec.41(1).
  - *Mahindra & Mahindra Ltd.’s case* – 404 ITR 1 (SC).
  - *Compaq Electric Ltd.’s case* – 261 Taxman 71 (SC).
PDIs – Tax issues for Investor

• Stock-in-trade vs Capital asset.

• Write-down results in ‘transfer’ u/s.2(47)?
  - Grace Collis’s case – 248 ITR 323 (SC).

• Conversion of PDI in to equity – constitutes income?
  - Sec. 2(47) triggers.
  - Applicability of sec.47(x).
Section 36(1)(viia)

Special deduction for Provisions
Tracing the history – 1979 to 2020

- Introduced by the Finance Act, 1979.
- Non-schedule banks; **NBFCs** & Co-op societies covered.
- **Foreign banks** added for special benefits.
- PFIs, SFIs, SIICs found their way for deduction.
- Deduction for **Non-rural advances** included.
- Approval from CG – done away.
- 1.5% deduction moved to 8.5% over these years.
- 5% of asset amount – to strengthen the financials of Banks.
- Definition of ‘rural branch’.
Interlocking sections

S.36(1)(viia)

S.36(1)(vii)

S.36(2)(v)

S. 36(2)(i)
• S.36(1)(vii) – Allows bad debts written-off.

• S.36(2)(i) – Income Vs. money lent.

• S.36(1)(viia) – Provision for BDDs.

• S.36(2)(v) – Set-off against provision.
<table>
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<tr>
<th>Banks/ institutions</th>
<th>% of PBDD</th>
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<td>Banks incorporated in India</td>
<td>(i) Rural branches – <strong>10%</strong> of the AAAs; and</td>
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<td>(ii) Other branches – <strong>8.5%</strong> of Gross Total Income.</td>
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<tr>
<td>Foreign Banks; NBFCs; and Public/State financial institutions.</td>
<td><strong>5%</strong> of Gross Total Income.</td>
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Adjustment of provision for bad debts
Adjustment of Bad debts

- Provision made vs. Actually allowed as deduction.
  - State Bank of Patiala’s case 272 ITR 54 (P&H).

- Aggregate provision vs. Account wise provisions.

- RBI stipulated provision vs. Debited to books.
  - Syndicate Bank’s case 26 ITR-Tribunal 501 (Bang.).
Adjustment of bad debts

• B/F provision balance vs. closing balance.

• “…bad debt exceed credit balance in PBBD…”

• C&AG’s view & reopening of cases.


• *UTI’s case – 212 Taxman 269.*
Write-off of bad debts
Write-off of bad debts – Sec.36(1)(vii)

• Requirement to prove – a debt as bad?

• *TRF Ltd’s case* – 323 *ITR 397*(SC).

• Technical Vs. actual write-off.

• Bad debts – IT Returns Vs. RBI Returns.

• Benefit to anchor banks, post merger.
Deduction for Rural advances
• Rural area - Population ≤ 10,000.

• Deduction up to 10% of the advances.

• Aggregate out standing balance of Branch wise, month wise advances – Rule 6ABA.
• Provisional Vs. final population data.

• State Bank of Mysore, 246 Taxman 58.

• ‘situated in a place’ - sec.2(1A) & 2(14).

• Federal Bank, 417 ITR 694; Lord Krishna Bank, 339 ITR 606.
• Provision on standard assets – Whether allowable?

• Might turnout to be sub-standard later.

• No definition for Bad & Doubtful Debts.

• Analogy from warranty claims.

• Treatment under Ind-AS scenario.
Disallowance under Section 14A
- 14A(2) - AO not satisfied with the claim.
- 14A(3) - Bank claims no expenditure is incurred.

**Disallow**

- (i) direct actual expenditure relating to exempt income;
  &
- (ii) 1% of the AAMA of such investments.
Sec.14A – CRITICAL CONDITIONS

- There must be an income.
- Such income shall be exempt from tax.
- There must be expenditure incurred.
- Such expenditure is relating to exempt income.
• Restrictions on disallowance.
  - limiting to expenditure incurred
  - limiting to income earned

• Earning of exempt income during the year.

• Availability of Interest-free sources.

• Investment held as stock or capital asset.
Broken period interest
Broken period interest

- Interest on debt securities between 2 coupon dates.


- Treatment of capital vs. Revenue.


- SLP in Citi Banks’s case – Civil Appeal # 1549/2006.
Miscellaneous issues
• Accounting system Vs. Income recognition.
  

• Unreconciled balances in branch – Income?
  

• Pension Fund Trust – a charity?
  
  - GCDA employees pension Trust 419 ITR 343 (Ker).
Thank you..

BCAS & participants

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