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Article

Tax laws seeking to regulate NBFCs whether resulting in unintended hardships?

By **Bharathi Krishnaprasad**

Introduction:

Being regulated by the Reserve Bank of India ('RBI'), Banks and Non-Banking Finance Companies ('NBFC') are required to follow the norms for asset classification, income recognition and provisioning laid down by the Central Bank. The regulations require every NBFC to categorize assets into different buckets and create provisions for bad and doubtful debts at specified percentages.

Until 2017, only specified categories of banks were permitted to claim deduction qua provision for bad and doubtful debts. The provision to permit claim of deduction for provisions for bad and doubtful debts was first introduced vide Finance Act, 1979 to promote rural banking and the benefit was conferred only to rural advances. Subsequently, the said benefit was extended to other advances and to different categories of banks and financial institutions. However, NBFCs were not covered within the ambit of the said provision. In a case before the Hon'ble Kerala HC, the assessee therein, invoked the provisions of Section 45Q of the RBI Act and argued that deduction qua provision for bad and doubtful debts made in line with RBI guidelines was to be allowed as a deduction. However, this argument did not find favor with the Court which held that the provisions of Section 45Q would not come in the way of claiming deductions under the Income Tax Act and also that deduction under Section 36(1)(viia) of the Income Tax Act, 1961 ('IT Act') did not mention NBFCs within its ambit and hence, no deduction was allowable[1]. Despite being into the business of lending, excluding NBFCs from the purview of the Section created lot of hardships.

To bring parity with the banking sector, the benefit of claiming deduction with respect to provisions for bad and doubtful advances/debts was extended to NBFCs by the Finance Act, 2016. The necessary amendment was made in Section 36(1)(viia) of IT Act with effect from the assessment year 2017-18 onwards.

This article is intended to throw some light on and discuss few crucial aspects concerning claim of and computing deduction under the said Section 36(1)(viia). It is to be noted that the article discusses the deduction from the standpoint of an NBFC, considering that the amendment brought about is more recent and that such a discussion with a specific reference would facilitate better comprehension. However, some aspects of the discussion made herein can equally apply to claim for provisions for bad and doubtful debts by banking companies as well.

Section 36(1)(viia), Section 36(1)(vii) and Section 36(2):

Section 36(1)(viia) of the IT Act appears simple and straightforward - in that it permits deduction for claim qua provision for bad and doubtful debts for an amount 'not exceeding' 5% of total income, computed before making deduction under clause (viia) of Section 36(1) and Chapter VIA.

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[1] *Art Leasing Limited* v. *CIT, Kottayam* [2010] 229 CTR 272 (Ker.)

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It is important to read this Section in conjunction with Section 36(1)(vii) and Section 36(2) of the IT Act. Section 36(1)(vii) provides for claim of deduction for bad debts written off (as opposed to provisions for bad debts) subject to conditions specified in Section 36(2)[2]. Bad debts written off would include all instances of amounts that are, in effect reduced from the amount of debtors in the Balance Sheet.[3]

For the purposes of this article, the following provisions contained in Section 36(1)(vii) and Section 36(2) are relevant:

- *First proviso to Section 36(1)(vii)*: Inserted by Finance Act, 1985, this proviso restricts the amount of deduction claimed as bad debts to the amount by which such bad debts exceed the credit balance in provision of bad and doubtful debts account.
- *Explanation 2 to Section 36(1)(vii):* This explanation seeks to clarify that the reference to provision for bad and doubtful debts account would mean only one account of provision for bad and doubtful debts and that that such account shall relate to all advances.
- *Clause (v) to Section 36(2):*_ Inserted by Finance Act, 1985, this clause provides that no deduction for bad debts shall be made unless the assessee has debited the amount of bad debts to the provision for bad for bad and doubtful account.

The combined effect of these provisions is to ensure that the no deduction is claimed twice - once, at the stage of provisioning and again, at the stage when the bad debts are actually written off and that all provisions made for bad and doubtful debts are considered even if the Assessee maintains a separate provision account for different category of advances. As unambiguous and well-intended as this may seem, these provisions are not free from interpretational issues.

Computing deduction under Section 36(1)(viia):

It is a prerequisite that an NBFC creates a provision in its books towards bad and doubtful debts[4] for it to claim any deduction under Section 36(1)(viia). It is not necessary that this account must be named and styled as “provisions for bad & doubtful debts account”[5]. It is also not necessary that the provisions need to be identified with individual borrowers.

The intent of the statute seems to be, to give deduction for provisions created in books in line with the norms framed by the RBI, but to restrict the deduction to a percentage of taxable profits. The allowable deduction is restricted to the amount of provisions actually made or 5% of total income whichever is lower. As an example, if the provisions actually made is Rs.100 and the amount calculated at 5% of total income works to Rs.150, then, the deduction will be restricted to Rs.100. Conversely, if the provisions actually made is Rs.150 and the amount calculated at 5% of total income works to Rs.100, then, the deduction will be allowed for Rs.100. And, if the NBFC has incurred a loss, no deduction would be allowed under this section.

(i) Capping the deduction to total income:

It is interesting to note that this cap of 5% on total income is to be calculated before claim of deduction under Section 36(1)(viia) and before claim of deduction

[2] Section 36(2) inter alia provision that, to claim deduction under Section 36(1)(vii), the amount written off should have been included as income in the earlier years.
[3] *Vijaya Bank* v. *CIT* [2010] 231 CTR 209 (SC)
[4] *Kottakkal Coopoerative Urban Bank Limited* v. *ITO* [142 ITD 123] (Tri-Cochin)
[5] *Tamilnadu State Apex Cooperative Bank Limited* v. *ACIT* [2014] 62 SOT 113 (Tri-Chennai)

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under Chapter VI-A. The phrase used is 'total income' which is a defined in Section 2(45) of the IT Act. Total income essentially means the amount on which income tax is payable and is computed by giving effect to all the provisions of the IT Act. Therefore, total income will include income chargeable under all heads of income and will also take into account set off of all eligible brought forward or current period losses.

(ii) What should be claimed first and how?

To compute deduction under Section 36(1)(viia), all the provisions of the IT Act, save provisions of this section and provisions of Chapter VI-A must be given effect to. This means that provisions of Section 36(1)(vii) permitting deduction for claim of bad debts must also be given effect to before computing deduction under Section 36(1)(viia).

(iii) How to reconcile both the provisions?

The provisions of Section 36(1)(viia) and Section 36(1)(vii) require that the deduction cannot exceed the provisions for bad and doubtful debts made, that it cannot exceed the credit balance in provisions for bad and doubtful debts account. Harmoniously reading this restriction as also the requirement that deduction under Section 36(1)(vii) for bad debts must be made before Section 36(1)(viia), what ensues is that this exercise of claiming bad debts over and above the provisions must be made by comparing the opening balances in provisions for bad and doubtful debts account[6].

(iv) Provisions debited in books v. provisions allowed as deduction under IT Act:

It is also pertinent to keep in mind that, by virtue of the restriction in Section 36(1)(viia) in capping the deduction to 5% of total income, the amount of provisions appearing in the books may not correspond to the amount that is claimed as deduction in the books of accounts. If they do not so correspond, then, the amounts actually claimed and allowed as deduction for the purposes of IT Act must be considered. That is, the opening balances and closing balances in provision for bad and doubtful debts account, for the limited purpose of calculating deductions under the IT Act, must be arrived at by taking the figures of amounts actually claimed and allowed under the Act. If such an interpretation is not resorted to, then, it may ensue that for some years, no deduction at all, under Section 36(1)(vii) would be eligible, because the bad debts are less than the opening balance of provisions. A simple example would illustrate the above aspects discussed. Assume that year 1 is the first year of operations for the NBFC:

Deduction allowed under S.36(1)(viia) in Year 1	Rs.100
Actual amount of provisions created in books in Year 1	Rs.150
Bad debts debited in books in Year 2	Rs.120
Actual amount of provisions created in books in Year 2	Rs.200

[6] CBDT Instruction No. 17 of 2008

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In the above facts, the deduction under Section 36(1)(vii) for bad debts must be calculated by comparing the actual amount of bad debts debited with Rs.100 as opposed to Rs.150. In such a case, the deduction available under Section 36(1)(vii) would be Rs.20. This approach not only meets logic but also the spirit of the provisions in the IT Act in seeking to prevent an amount being claimed as deduction twice. Under this approach, if one were to devise a flow of entries for better comprehension, the same would be as under:

a. Closing balance of provisions represents amounts claimed as deduction under Section 36(1)(viia) and which are not adjusted against any amount of bad debts.

b. Against this closing balance, bad debt amounts are debited.

c. If such bad debt amounts exceed the closing balance, then, the excess is credited so as to factor the same in calculations of total income.

d. The amount for which deduction is allowable under Section 36(1)(viia) is credited and the same gets carried forward as opening balance for the subsequent year.

One practical issue could arise, if any assessee has not followed this approach right from the beginning. In such a case, rationalizing the present year calculations with this approach may be cumbersome. Further, it must be kept in mind that assessment and appellate proceedings in different assessment years can lead to change in the figures of total income assessed, thereby change in the ceiling amount eligible for deduction under Section 36(1)(viia), creating a rippling effect in the subsequent year with respect to deduction under Section 36(1)(vii).

Reversal of provisions:

A question may arise as to whether reversal of any provisions is to be offered to tax as income in the year in which the same is reversed. While the IT Act contains a specific provision to tax any recovery made with respect to bad debts, in the absence of a specific provision, reversals made to bad debts cannot be taxed. Section 41(1) of the IT Act provides for taxing any amounts earlier claimed as deduction in certain circumstances. These circumstances are: (a) if any cash or other benefit is received by assessee or (b) if there is any remission or cessation of liability. Clearly, reversal of provisions does not entail receipt of any benefit either by way of cash or otherwise. Further, provision for bad and doubtful debts cannot also be stated to be a provision for liability[7]. Be that as it may, to even seek to tax these amounts in the year of reversal, it would be incumbent on the Department to first demonstrate as to how these amounts were claimed and allowed as a deduction in any earlier year which may not be easy considering the provisions made in books and provisions for which deduction is granted, more often than not, may not match. In any case, to keep in line with the intent of these provisions, such reversals, if not offered to tax or taxed, should not be considered in calculating deduction under Section 36(1)(vii).

Congruence with RBI guidelines:

Notwithstanding the issues concerning computing claim of deduction under Section 36(1)(viia), another issue that warrants attention is the fact that the provisions of IT Act and RBI guidelines are at variance, resulting in further hardship to the Assesses. While RBI lays down

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[7] *CIT, Delhi* v. *HCL Comnet Systems & Services Ltd*. (2008) 174 Taxman 118 (SC)

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methodology to classify advances and create provisioning, the said provisions made as per RBI guidelines may not be entirely allowed as a deduction under IT Act. A similar issue exists in Section 43D with regard to taxability of interest on non-performing assets. Seeking congruence of IT provisions with RBI guidelines is, probably the best solution that could address all issues.

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Notification and Circular

Electronic payments - Installation of facility to accept payments electronically, clarified

By way of Circular No 32/2019 dated 30-12-2019, it has been clarified that business which install and operationalise the facility to receive payments electronically by 31-1-2020 would not be faced with penalty under Section 271DB. Section 269SU mandates every person carrying on a business where the turnover exceeds INR 50 crores in the immediately preceding previous year to mandatorily provide facilities for accepting payments through prescribed electronic modes. The modes specified under Rule 119AA inserted with effect from 1-1-2020 by Notification No. 105/2019, dated 26-12-2019 are, Debit Card powered by RuPay; Unified Payments Interface (UPI); and Unified Payments Interface Quick Response Code.

Ratio Decidendi

Intimation under Section 143(1) imposing liability is an appealable order

The assessee was aggrieved by the order of the CIT(A) dismissing its appeal against the intimation under Section 143(1) of the Income Tax Act and directing the assessee to file a rectification application online. The assessee argued that the intimation received by it contained various additions to the income and hence tax was demanded. It also urged that since the additions were made without any opportunity being provided to it, the additions were bad in law. The ITAT held that since the intimation under Section 143(1) did in fact impose a liability on the assessee and the same was being disputed by the assessee, the intimation was an appealable order under Section 246A and appeal would lie against order passed under Section 143(1) by the CPC. [*Dixit Rice Mill* v. *DCIT (CPC)* - I.T.A No.373/Agra/2018, Order of ITAT, Agra dated 10-1-2020]

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Draft assessment order cannot be subject to revision under Section 263

The Principal CIT issued an order under Section 263 of the Income Tax Act directing the Assessing Officer to consider various issue which had not been considered by him. The final order had not been passed on the date of issue of the revision order and the assessee had filed an appeal before the Dispute Resolution against the draft assessment order proposing certain additions on account of a transfer pricing adjustments in respect of ITES services provided by the assessee to his AE. The ITAT held that the draft assessment order is not a final order or an order which can be revised in terms of Section 263 and quashed the order holding it to be *void ab initio*. [*Louis Dreyfus Company India P. Ltd.* v. *ACIT* - ITA No. 510/Del/2018, Order of ITAT, Delhi dated 15-1-2020]

Tax is to be deducted on provisions made for ascertained expenses

At issue was the non-deduction of tax on certain provisions made at the end of the year for expenses. The assessee contended that tax had been deducted when invoices were raised by the payee(s) in the following year. Further, it contended that at the end of the year, the payee was not identified in some cases. The ITAT held that since the provisions made by the assessee were not *adhoc* provisions but based on ascertained expenses and on terms agreed with the payees, though the invoices were raised later, the assessee cannot be absolved from obligation to deduct tax. [*Interglobe Aviation Ltd.* v. *ACIT* - ITA5347/Del/2012 &ORs., Order of ITAT, Delhi dated 7-1-2020]

Buyback of shares from parent holding 99.99% shares not exempt in terms of Section 47(iv)

The shares of the assessee company were held by its parent (99.99%) and a group company. On buy back of shares, the assessee claimed that since it involved transfer of a capital assets by a company to an Indian subsidiary, the transaction was not exigible to capital gains. However, the ITAT held that in the instant case, the parent did not hold 100% of the shares either by itself or through its nominees and hence Section 47(iv) could not apply. Also, Section 46A would apply in respect of transaction of buyback and the exception under Section 47 cannot be resorted to since in the case of buyback there is no 'transfer'. [*Acciona Wind Energy P. Ltd.* v. *DCIT (International taxation)*, ITA Nos.1783 and 1784/Bang/2018, Order of ITAT, Bangalore dated 20-12-2019]

Consideration for offshore supply made under a separate contract not taxable

The revenue department contended that though separate contracts were entered into for onshore supply, offshore supply of goods and onshore supply of services, the supply was to be treated as on composite contract and the consideration for offshore supplies was taxable as per Section 44BBB of the Income Tax Act. It argued that as per the 'cross fall breach' clause, a breach in the second contract would result in breach of the other and hence the contracts were linked to each other. However, the ITAT held that property in the goods passed outside India and the payment for three supplies- offshore and onshore supply of goods, onshore supplies of services were separate and in terms of three different

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contracts. Hence, the sum paid for offshore supplies was not taxable in India. It also held that the project office and the liaison office did not constitute a PE and did not play any role in the offshore supply, no profit attribution could be made. [*DDIT* v. *Mitsui & Co. Ltd*. - ITA Nos.2801 & 4329/Del/2011, Order of ITAT, New Delhi dated 7-1-2020]

Credit of TDS deducted in subsequent year can be availed in relevant assessment year in which income is assessed

The assessee had raised invoices towards the end of the year and received payment of the same in the next previous year. Tax was therefore deducted by the payer in the subsequent year. The Assessing Officer denied the credit of the taxes deducted holding that it was not reflected in the TDS statement of the assessee and it did not related to the assessment year in question pertaining to previous year in which invoices were raised and income was offered to tax. The ITAT held that in terms of Section 199 of the Income Tax Act, credit of taxes was to be allowed in the assessment year in which income is assessable and that the claim of assessee cannot be prejudiced by the fact that the deduction was made in a different year. [*Greatship India Ltd* v. DCIT - ITA No. 5562/Mum/2018, Order of ITAT, Mumbai dated 8-1-2020]

Refund of tax wrongly withheld by employer - Employee can claim interest on delayed refund

Pursuant to tax proceedings of the employer of the petitioner, certain sum was deducted from the salary of the petitioner and paid to the government. Subsequently, in appeal proceedings (upto Supreme Court), the claim of the employer that no tax was required to be deducted was upheld. The petitioner hence, applied for refund of the tax collected from him. He obtained refund of the tax amount alone and moved a petition for grant of interest also. The High Court held that in terms of Section 244A(1)(a) and ruling of the Supreme Court in *Sandvik Asia v. CIT* holding that amount paid during pendency of appeal should be refunded with interest, the petitioner was entitled to interest on the amount refunded. [*P.R.Ganapathy* v. *CIT* - WP 8658/2014, decision of High Court of Madras, dated 13-12-2019]

Attribution of percentage of gross revenue as per revenue sharing agreement diversion at source

In terms of the revenue sharing agreement between the assessee and its partner in the bid, 25% of the gross revenue was to be given to the partner who provided financial support and also undertook commercial risk. The department contended that it was a case of application of income and what was paid was a share of the collaboration partner and hence the 25% was taxable in the hands of the assessee. It was also alleged that the agreement was a sham and the obligation was created by the parties themselves and hence was not a case of diversion of income by overriding title. The ITAT held that from the examination of the agreements, it was clear that the bid partner provided financial support at various stages and the compensation of 25% in lieu of the services was not a sham. The assessee did not have any claim over the 25% share it handed over to the partner though it was

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collected by it in the first instance. Thus, it was held that the sum representing 25% of gross revenue which was transferred to the bid partner was not taxable in the hands of the assessee. [*Emmar MGF Construction P. Ltd.* v. *ACIT* - ITA 1732/Del/2014 & Ors, Order of ITAT, Delhi dated 26-12-2019]

Negotiation on price does not alter character of acquisition as non-compulsory

The assessee(s) were aggrieved by the denial of exemption in terms of Section 10(37) of Income Tax Act to compensation received for agricultural land acquired by the Surat Municipal Corporation for construction of sewerage treatment plant. The CIT(A) upheld the denial on the ground that the assessees had negotiated the price for land with the authorities and hence the sale was voluntary. The other cause for denial of the exemption was that the assessee did not carry out agricultural operations on the land. The ITAT held that in terms of Section 10(37) the exemption would be available even where the land is situated outside municipal limits and the agricultural operations were carried out by tenants. As regards the nature of acquisition following the judgement of the Apex Court in *Balakrishnan* v. *UOI & Ors.* [Civil Appeal No. 1607/2010], it held that the fact that the assessee negotiated the price would not change the character of the acquisition being compulsory. [*Satishbhai Patel* v. *DCIT* - ITA, 1566/AHD/2016 and others, ITAT, Ahd, Order dated 13-12-2019]

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