

Legal Updates

Vinod Kothari & Company

Treatment of Provision for NPAs in case of NBFCs

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The Supreme Court of India has recently pronounced a remarkable judgement on the treatment of 'Provision for NPAs in case of NBFCs'. The said ruling was given in the case of *Southern Technologies limited vs JCIT*, on 11th January 2010.

An Analysis of the Ruling

In the case cited above, the Assessee claimed deduction under Section 36(1)(vii) of the Income Tax Act, 1961 on Provision for NPA created in terms of RBI Directions 1998 on the ground that Assessee had debited the said amount to P&L Account reducing its Profits, contending it to be 'write off'. In the alternative, Assessee submitted that consequent upon RBI Directions 1998 there has been diminution in the value of its assets for which Assessee was entitled to deduction under Section 37 of the IT Act as a trading loss. It was also claimed that the RBI Directions override the IT Act. The Tribunal allowed the claim but the High Court rejected it. On appeal, the Apex Court observed the following:

Mere Presentation and Disclosure Norms

The Supreme Court observed that the appellant had to follow the method of accounting prescribed by RBI, the regulatory authority, in terms of the Prudential Norms 1998, though the same was inconsistent with the accounting practices under the Companies Act, 1956.

But the entire thrust of RBI Directions is on the Presentation and Disclosure only. It never intended to govern the computation and taxability of the income and, hence, there was no inconsistency between the two. For the protection of investor interests, the Directions require NBFCs to make a provision for a possible loss to be made and disclosed to the public. Such debits are only notional for purposes of disclosure; hence, they cannot be treated as an 'expense' for claiming deduction under the IT Act.

The Court observed that a statutory debit or a statutory charge under RBI Directions 1998 cannot form part of the "real income" and, consequently, it cannot be subjected to tax under the IT Act. In the case of *Poona Electric Supply Co. Ltd. v. Commissioner of Income-Tax*, Bombay City I, 57 ITR 521 at page 530 the Supreme Court observed:

"Income Tax is a tax on the "real income", i.e., the profits arrived at on commercial principles subject to the provisions of the Income Tax Act. The real profit can be ascertained only by making the permissible deductions under the provisions of the Income Tax Act. There is a clear distinction between the real profits and statutory profits. The latter are statutorily fixed for a specified purpose".

Provision for NPAs - Taxability issues

Section 36(1)(vii) provides for a deduction in the computation of taxable profits for the debt established to be a bad debt.

Section 36(1)(viia) provides for a deduction in respect of any provision for bad and doubtful debt made by a Scheduled Bank or Non- Scheduled Bank in relation to advances made by its rural branches, of a sum not exceeding the limit specified therein.

Section 43D provides that interest from bad and doubtful debts in the case of bank and financial institutions shall be charged to tax only in the year of receipt or the year in which it is credited to the P&L Account, whichever is earlier.

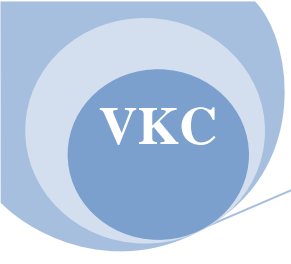
Such benefits of deduction are available only to the banks only, and are not extended to NBFCs. Further the NBFCs cannot take recourse of section 37 also. Section 37 is a residuary section for the expenses which are not expressly covered by other permissible deductions or exclusions.

Banks not treated at par with NBFCs

The Apex Court held that neither Section 36(1)(viia) nor Section 43D violates Article 14 of the Constitution of India. It further held that the test of intelligible differentia stands complied with.

“NBFCs accept deposits from the public for which transparency is the key; hence, we have RBI directions/norms. On the other hand, for banks, weightage must be placed on liquidity. These two concepts, namely, risk and liquidity bring out the basic difference between NBFCs and banks”, the Bench added.

The business operations of NBFCs and banks are quite different. As regards Art 19 (1), keeping in mind the important role assigned to banks in the economy and the fact that NBFCs are vulnerable to economic and financial uncertainties, the restriction placed on



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NBFC by not giving them the benefit of deduction satisfies the principle of “reasonable justification”.

The issues relating to treatment of provision for NBFCs, now, stand resolved.