

IN THE HIGH COURT OF PUNJAB & HARYANA AT CHANDIGARH

ITA-349-2017

Date of Decision: 24.9.2018

The Principal Commissioner of Income Tax-3, Ludhiana

....Appellant.

Versus

The Ludhiana Central Co-Op. Bank Ltd., Ludhiana

...Respondent.

**CORAM:- HON'BLE MR. JUSTICE AJAY KUMAR MITTAL.
HON'BLE MR. JUSTICE AVNEESH JHINGAN.**

PRESENT: Mr. Rajesh Katoch, Sr. Standing Counsel for the appellant,
in ITA-349-2017.

Mr. Vivek Sethi, Sr. Standing Counsel for the appellant,
in ITA Nos. 395, 449 and 450 of 2017.

Mr. Varun Mittal, Advocate for
Mr. Vikas Mohan Gupta, Advocate for the respondent,
in ITA-349-2017.

Mr. Aman Parti, Advocate and
Mr. Munish Kapila, Advocate for the respondent,
in ITA Nos. 395, 449 and 450 of 2017.

AJAY KUMAR MITTAL, J.

1. This order shall dispose of a bunch of four appeals bearing ITA Nos.349, 395, 449 and 450 of 2017 as according to learned counsel for the parties, similar issues are involved therein.

2. ITA-349-2017 has been preferred by the revenue under Section 260A of the Income Tax Act, 1961 (in short “the Act”) against the order dated 3.1.2017 (Annexure A-3) passed by the Income Tax Appellate Tribunal, Division Bench, Chandigarh (hereinafter referred to as “the Tribunal”) in ITA No. 526/CHD/2013, for the assessment year 2009-10, claiming the following substantial questions of law:-

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the case, the Hon'ble ITAT, Chandigarh is justified in deleting the addition of ₹ 3,02,82,000/- made by the AO on account of interest accrued on non-performing assets by ignoring the decision of the Hon'ble Supreme Court in the case of ***State Bank of Travancore Vs. Commissioner of Income Tax***, reported in (1986) 158 ITR 102?

- (ii) Whether on the facts and in the circumstances of the case, the Hon'ble ITAT erred in applying Section 43D to a cooperative society i.e. the assessee which is not specifically mentioned in Section 43D?
- iii) Whether on the facts and in the circumstances of the case, the Hon'ble ITAT has erred in following the decision in the case of ***CIT vs. Punjab State Cooperative Bank Limited*** of Assessment years 2007-08, 2008-09 reported in 143 ITD 571 (Chd) applying Section 43D, as the Punjab State Cooperative Bank Limited is a Scheduled Bank whereas the Ludhiana Central Cooperative Bank Limited is not a scheduled Bank.?"

Subsequently, vide order dated 14.11.2017 passed in CM No.23262 CII of 2017, the following amended substantial questions of law were taken on record:-

“i) Whether on the facts and in the circumstances of the case, the Hon'ble ITAT, Chandigarh is justified in deleting the addition of ₹ 3,02,82,000/- made by the Assessing Officer on account of interest accrued on non performing assets by ignoring the decision of the Hon'ble Supreme Court in the case of ***State Bank of Travancore vs. Commissioner of Income Tax***, reported in (1986) 158 ITR 102?

ii) Whether on the facts and in the circumstances of the case, the Hon'ble ITAT, Chandigarh is justified in deleting the addition of ₹ 3,02,82,000/- made by the Assessing Officer on account of interest accrued on non performing assets ignoring the finding of the Assessing Officer that the assessee who is following the mercantile system of accounting, has to show income/receipts on accrual basis but recognition of interest on NPA (Non performing Assets) accounts on receipt basis by the assessee shows that hybrid system of accounting is being followed by the assessee which is no longer permissible with effect from 1.4.1997?

3. In ITA Nos. 395, 449 and 450 of 2017, the following substantial questions of law have been raised:-

- (i) Whether on the facts and in the circumstances of the case the ITAT was correct in ignoring the fact that Section 43D of the Income-Tax Act, 1961 would not apply to a Co-operative Bank?
- (ii) Whether on the facts and in the circumstances of the case the ITAT was justified in law in holding that Section 45Q of RBI Act, 1934 is applicable in the case of the assessee, when Section 45H of the RBI Act, 1934 excludes its application to cooperative banks?
- (iii) Whether on the facts and in the circumstances of the case the ITAT has erred in law in confirming the decision of Ld. CIT(A) who had wrongly relied upon the finding of the Hon'ble Delhi High Court in the case of M/s Vasisth Chay Vyapar Ltd. [ITA Nos. 552, 565 of 2005, ITA No. 1191 of 2007, ITA Nos. 139, 466, 537 of 2008 and ITA No. 408 of 2003 date of decision 29.11.2010] which is a Non-Banking Financial Corporation, whereas the

Society?

- (iv) Whether on the facts and in the circumstances of the case, the ITAT has erred in confirming the decision of Ld. CIT(A) who deleted the addition of ₹ 2,03,46,480/- made by the AO on account of interest accrued on non-performing assets by ignoring the decision of the Hon'ble Supreme Court in the case of State Bank of Travancore (158 ITR 102)?

However, it may be noticed that the quantum of additions in ITA No.449 of 2017 and ITA No.450 of 2017 is different i.e. ₹ 2,03,76,956/- and ₹ 2,15,56,800/- respectively.

4. For brevity, the facts are being extracted from ITA-349-2017.

5. A few facts necessary for adjudication of the instant appeal as narrated therein may be noticed. The assessee filed its return of income on 30.9.2009 declaring an income of ₹ 4,15,03,450/-. The assessment was completed under Section 143(3) of the Act by the Assessing Officer vide order dated 30.11.2011 (Annexure A-1) at an income of ₹ 8,20,58,289/- with an addition of ₹ 3,02,82,000/- on account of interest due on Non-Performing Assets (NPA). Feeling aggrieved, the assessee filed an appeal before the Commissioner of Income Tax (Appeals) [for brevity "the CIT(A)"]. The CIT (A) vide order dated 28.2.2013 (Annexure A-2) deleted the addition made by the Assessing Officer. Against the order, Annexure A-2, the revenue filed an appeal before the Tribunal who vide order dated 3.1.2017 (Annexure A-3) dismissed the appeal of the revenue upholding the deletion made by the CIT(A) on account of addition of ₹ 3,02,82,000/- regarding interest accrued on NPA. Hence, the present appeals by the revenue.

6. Learned counsel for the revenue inter alia submitted that the

specified under Section 43D of the Act which provides for payment of tax on interest on bad debts or doubtful debts only in the year of receipt and, therefore, is not entitled to the benefit of Section 43D of the Act. It was argued that in view of provisions of Section 145 of the Act, the assessee is liable to pay tax on the interest income accrued to it under the mercantile system of accounting, whether or not it has been actually received. Further, it was urged that when the legislature has made a specific provision for specific entities, the same would cover only those entities and, therefore, Section 43D of the Act would not be attracted in the present case. When a specific provision in the nature of Section 43D of the Act has been made and entities like the assessee are excluded from the purview thereof, the assessee cannot indirectly claim benefit which would amount to a benefit similar to that under Section 43D of the Act. Reliance was placed upon the judgment of the Apex Court in **Southern Technologies Limited v. Joint Commissioner of Income-Tax, Coimbatore (2010) 320 ITR 527**.

7. On the other hand, learned counsel for the assessee submitted that the income accrued to the assessee is exigible to tax and the income which accrues should be real income and not hypothetical income. When an account is treated as NPA, there is hardly any likelihood of receipt of interest thereon. It was further submitted that the mercantile system of accounting can be relevant only to determine the point of time at which taxability is attracted and cannot be relied upon to determine whether the income has in fact resulted or materialized in favour of the assessee. According to the learned counsel, as per the provisions of Section 45Q of the Reserve Bank of India Act, 1934 (in short “the 1934 Act”) the provisions of Chapter III-B have an overriding effect over the provisions of all other laws

would prevail over the provisions of the Income Tax Act. Reliance was placed on the judgment of Delhi High Court in **Commissioner of Income Tax v. Vasisth Chay Vyapar Ltd. (2011) 330 ITR 440**, wherein it was held that where interest was not received on NPA, it could not be treated to have accrued in favour of the assessee or the real income in the hands of the assessee. Support was also drawn from the decisions of the Gujarat High Court in **Principal Commissioner of Income Tax-5 vs. Shri Mahila Sewa Sahakari Bank Limited**, (2017) 395 ITR 324 and Bombay High Court in **The Commissioner of Income Tax, Aurangabad vs. M/s Deogiri Nagari Sahakari Bank Limited, Aurangabad**, (2015) 379 ITR 24. Further, the learned counsel supported the order passed by the CIT(A) deleting the addition made by the Assessing Officer on account of interest due on NPA and affirmed by the Tribunal. Prayer for dismissal of the appeals was made.

8. Rebutting the arguments relating to provisions of 1934 Act and Directions/regulations formulated/issued thereunder, it was contended by learned counsel for the revenue that the RBI directions under the 1934 Act are prudential norms, but have nothing to do with the computation or taxability of the provision of the NPA under the Act. Though the RBI directions deviate from the accounting practice as provided by the Companies Act, 1956 but they do not override the provisions of the Act and they are operating in different fields. Lastly, it was pointed out that the learned Tribunal ought to have held that the assessee cooperative bank does not satisfy the conditions of CBDT circular No.F.201/81/84/ITA II dated 09.10.1984 and therefore could not avail the benefits of the said circular. On the basis of aforesaid submissions, the learned counsel further urged that the substantial issue involved in the above

Assessing Officer under section 143 (3) of the Income Tax Act be confirmed.

9. After hearing learned counsel for the parties, we do not find any merit in the appeals.

10. The core issue that arises for consideration in these appeals is whether interest on non-performing assets in the hands of the assessee-Cooperative Banks is taxable on accrual basis or not, keeping in view the guidelines of the Reserve Bank of India.

11. We proceed to examine various relevant statutory provisions essential for effective adjudication of the present controversy.

12. The legislative history of Section 43D of the Act may be noticed. Section 43D of the Act was inserted w.e.f 1.4.1991 by Finance (No.2) Act 1991. It provides for payment of tax on interest on bad debts or doubtful debts only in the year of receipt. It reads thus:-

“43D. Special provision in case of income of public financial institutions, etc.—Notwithstanding anything to the contrary contained in any other provision of this Act, in the case of a public financial institution or a scheduled bank or a State financial corporation or a State industrial investment corporation, the income by way of interest in relation to such categories of bad or doubtful debts as may be prescribed having regard to the guidelines issued by the Reserve Bank of India in relation to such debts, shall be chargeable to tax in the previous year in which it is credited by the public financial institution or the scheduled bank or the State financial corporation or the State industrial investment corporation to its profit and loss account for that year or, as the case may be, in which it is actually received by that institution or bank or corporation, whichever is earlier.

Explanation.— For the purposes of this section,—

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(a) "public financial institution" shall have the meaning assigned to it in section 4A of the Companies Act, 1956 (1 of 1956);

(b) "scheduled bank" shall have the meaning assigned to it in clause (ii) of the *Explanation* to clause (viiia) of subsection (1) of section 36;

(c) "State financial corporation" means a financial corporation established under section 3 or section 3A or an institution notified under section 46 of the State Financial Corporations Act, 1951 (63 of 1951);

(d) "State industrial investment corporation" means a Government company within the meaning of section 617 of the Companies Act, 1956 (1 of 1956), engaged in the business of providing long-term finance for industrial projects and approved by the Central Government under clause (viii) of subsection (1) of section 36.”.

13. The Circular No.621 dated 19th December, 1991 issued by the department elaborated its scope in the following portion:-

“Chargeability of income from bad or doubtful debts in the case of financial institutions and banks – 22. The Reserve Bank of India has classified advances given by banks into eight categories called Health Codes 1 to 8. Sticky advances which are doubtful of realization fall under Health Codes 4 to 8. The banks and financial institutions normally credit interest from such sticky advances to the “Interest Suspense Account” and not to the “Profit and Loss Account”. The issue whether interest on such bad and doubtful advances should be taxed in the year of accrual or of receipt has been a matter of controversy for a long time.

22.1 In view of the fact that interest from bad and doubtful debts in the case of banks and financial institutions are normally very difficult to recover, taxing such income on accrual basis reduces the liquidity of the bank without any actual generation of income.

22.2 With a view to improving the viability of banks, public financial institutions, State financial corporations and State industrial investment corporations, the Income Tax Act has been amended by inserting a new Section 43D so as to provide that interest on sticky loans shall be charged to tax only in the year in which the interest is actually received or is credited to the “Profits and Loss Account”, whichever is earlier. The category of bad and doubtful debt in respect of which the interest will qualify for this exemption, will be prescribed by the central Board of Direct Taxes, keeping in view the guidelines issued by the Reserve Bank of India in relation to such debts.

22.3 This amendment will take effect from the 1st day of April 1992 and will accordingly apply in relation to the assessment year 1992-93 and subsequent years.”

14. Finance Act, 1999 effective from 01.4.2000 substituted originally enacted Section 43D of the Act with the following:-

“43D. Special provision in case of income of public financial institutions, public companies etc. -Notwithstanding anything to the contrary contained in any other provision of this Act,—

(a) in the case of a public financial institution or a scheduled bank or a State financial corporation or a State industrial investment corporation, the income by way of interest in relation to such categories of bad or doubtful debts as may be prescribed having regard to the guidelines issued by the Reserve Bank of India in relation to such debts;

(b) in the case of a public company, the income by way of interest in relation to such categories of bad or doubtful debts as may be prescribed having regard to the guidelines issued by the National Housing Bank in relation to such debts,

shall be chargeable to tax in the previous year in which it is credited by the public financial institution or the scheduled bank or the State financial corporation or the State industrial investment corporation or the public company to its profit and

actually received by that institution or bank or corporation or company, whichever is earlier.

Explanation.—For the purposes of this section,—

(a) "National Housing Bank" means the National Housing Bank established under section 3 of the National Housing Bank Act, 1987 (53 of 1987);

(b) "public company" means a company,—

(i) which is a public company within the meaning of section of the Companies Act, 1956 (1 of 1956);

(ii) whose main object is carrying on the business of providing long-term finance for construction or purchase of houses in India for residential purposes; and

(iii) which is registered in accordance with the Housing Finance Companies (NHB) Directions, 1989 given under section 30 and section 31 of the National Housing Bank Act, 1987 (53 of 1987);

(c) "public financial institution" shall have the meaning assigned to it in section 4A of the Companies Act, 1956 (1 of 1956);

(d) "scheduled bank" shall have the meaning assigned to it in clause (ii) of the *Explanation* to clause (viia) of sub-section (1) of [section 36](#);

(e) "State financial corporation" means a financial corporation established under section 3 or section 3A or an institution notified under section 46 of the State Financial Corporations Act, 1951 (63 of 1951);

(f) "State industrial investment corporation" means a Government company within the meaning of section 617 of the Companies Act, 1956 (1 of 1956), engaged in the business of providing long-term finance for industrial projects.”

15. By virtue of the substitution, the scope and ambit of Section 43D of the Act was widened which has been explained in the departmental

Circular No.779 dated 14th September 1999 as under:-

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“25. Extension of provisions of Section 43D to the housing finance companies –

25.1 Under the existing provisions of Section 43D of the Income Tax Act, in the case of a public financial institution or a scheduled bank or a State Financial Corporation or a State Industrial Investment Corporation, income by way of interest in relation to such categories of bad or doubtful debts, as may be prescribed having regard to the guidelines issued by the Reserve Bank of India, is chargeable to tax in the previous year in which it is credited to the profit and loss account or as the case may be, in which it is actually received, whichever is earlier.

25.2. With a view to improve the viability of housing finance companies and to provide a boost to the housing sector, the Finance Act, 1999 amends Section 43D so as to extend its provisions to a public company whose main object is carrying on the business of providing long term finance for construction or purchase of houses in India for residential purposes and which is registered in accordance with the Housing Finance Companies (NHB) Directions, 1989, given under section 30 and section 31 of the National Housing Bank Act, 1987. The Finance Act, 1999 provides that in the case of such a company, the income by way of interest in relation to such categories of bad or doubtful debts, as may be prescribed having regard to the guidelines issued by the National Housing Bank in relation to such debts, shall be chargeable to tax in the previous year in which it is credited by the company to its profit and loss account or as the case may be in which it is actually received by that company, whichever is earlier.

25.3. This amendment will take effect from the 1st day of April 2000 and will accordingly apply in relation to the assessment year 2000-2001 and subsequent years. (Section 28).”

16. Rule 6EA of the Income Tax Rules, 1962 (in short, “the Rules”) relates to special provisions regarding interest on bad and doubtful debts of

financial Institutions, banks etc. It was inserted in the Rules by the Income

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Tax (Tenth Amendment) Rules, 1992 with effect from 01.04.1992 prescribing the banks/financial institutions/corporations to which provisions of Section 43D of the Act would be applicable. It is quoted below:-

“Special provision regarding interest on bad and doubtful debts of financial institutions, banks, etc.

6EA. The provisions of section 43D shall apply in the case of every public financial institution, scheduled bank, State financial corporation and State industrial investment corporation where its income by way of interest pertains to the following categories of bad and doubtful debts, namely:—

(a) (i) Non-viable or sticky advances, i.e., where irregularities of the nature specified in sub-clause (ii) are noticed in the accounts of the borrowers for a period of six months and more and there are no minimum prospects of regularisation of accounts, or where the accounts or information in relation to such accounts reflect usual signs of sickness, such as,—

- (1) apparent stagnation in the business as a result of the slow or negligible turnover;
- (2) frequent requests for overdrawing or issue of cheques without ensuring availability of funds in the account;
- (3) bills purchased or discounted remain overdue for 3 months and more or the recovery of such bills from the borrower poses difficulties;
- (4) in the case of term-loans, instalments which are overdue for 6 months or more;
- (5) unexplained delays by the borrower in submission of quarterly or half-yearly operating statements or stock statements or balance sheets and other information required by the bank;
- (6) slow movement or stagnation of stocks observed during inspections;

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inspections or suspension or closure of the business;

- (8) persistent delay in compliance with vital requirements like execution of documents, producing additional security when required or non-compliance with such requirements;
- (9) diversion of funds to sister units or acquiring capital assets not relevant to the business or large personal withdrawals by the borrowers;
- (10) intentional non-adherence to project schedules leading to substantial cost escalations and requirement of additional term-finance;
- (11) the pressure on the liquidity leading to non-payment of wages to workers or statutory dues or rents of office and factory premises;
- (12) the current liabilities exceeding current assets;
- (13) any grave irregularities observed by the auditors of the borrowers which remain to be rectified;
- (14) basic weakness revealed by the financial statements of the unit, for example, continued cash loss beyond one year.

(ii) The irregularities referred to in sub-clause (i) in the accounts of the borrowers are,—

- (1) where the accounts are overdrawn beyond the drawing power or the sanctioned limit, for a temporary period;
- (2) instalments in respect of term-loans are overdue for less than 6 months or import bills under letters of credit or instalments under deferred payment carried are overdue for less than 3 months;
- (3) bills not exceeding 10% to 15% of the total outstandings in the bills purchased or discounted account of the borrower are overdue for payment for a period of less than 3 months and refund in respect of unpaid bills is not forthcoming

- (b) Advances recalled, i.e., where the repayment is highly doubtful and revival of the unit is not considered worthwhile and a decision has been taken to recall the advances.
- (c) Suit-filed accounts, i.e., where legal action or recovery proceedings have been initiated and suits are pending for recovery of advances.
- (d) Decreed debts, i.e., where suits have been filed and decree obtained and such decree is pending for execution.
- (e) Debts recoverability whereof has become doubtful on account of shortfalls in value of security, difficulty in enforcing and realising the securities, or inability or unwillingness of the borrower to repay the banks dues, partly or wholly, and such debts have not been included in preceding clauses (a) to (d).”

17. Section 43D of the Act as inserted by Finance (No.2) Act 1991 w.e.f 1.4.1991 and substituted by Finance Act, 1999 w.e.f 1.4.2000 opens with a *non obstante* clause, namely, “Notwithstanding anything to the contrary contained in any other provisions of this Act” thus, overriding the provisions of the Act. Section 43D of the Act provides that in the case of a Public Financial Institution or a Scheduled Bank or a State Financial Corporation or a State Industrial Investment Corporation, the income by way of interest in relation to certain categories of bad or doubtful debts prescribed under Rule 6EA of the Rules, shall be chargeable to tax in the previous year in which it is credited by the Public Financial Institution or the Scheduled Bank or the State Financial Corporation or the State Industrial Investment Corporation to its profit and loss account for that year or as the case may be in which it is actually received by that institution or bank or

Corporation whichever is earlier. In other words, Section 43D of the Act is

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akin to Section 43B of the Act. The Supreme Court in ***Southern Technologies Limited vs. Joint CIT*** (2010) 320 ITR 577 (SC) elaborated the scope and reason for enacting the said provision. It was held that interest from bad and doubtful debts in the case of bank and financial institutions is difficult and onerous to recover and taxing such income on accrual basis reduces the liquidity of the Bank/financial institution without generation of any income. Thus, Section 43D of the Act was inserted with the said purpose to mitigate the circumstances of taxing income accrued from bad and doubtful debts except in the year of receipt or in the year in which it is credited to the profit and loss account, whichever is earlier.

18. Next, it would be essential to refer to relevant provisions of the 1934 Act.

Chapter III-B – Provisions relating to Non-Banking Institutions Receiving deposits and Financial Institutions:

Section 45H of the 1934 Act falling in Chapter IIIB thereof stipulates that the provisions of this Chapter shall not apply to State Bank and various Banking Companies or a Regional Rural Bank or a Cooperative Bank or a primary agricultural credit society or a primary credit society. It is in following terms:-

Section 45H:

“**45H.** Chapter IIIB not to apply in certain cases. The provisions of this Chapter shall not apply to the State Bank or a banking company as defined in Section 5 of the Banking Regulation Act, 1949 or a corresponding new bank as defined in clause (da) of Section 5 of that Act or a subsidiary bank as defined in the State Bank of India (Subsidiary Banks) Act, 1959 or a Regional Rural Bank or a co-operative bank or a primary agricultural credit society or a primary credit society:

Tamil Nadu Industrial Investment Corporation Limited
shall not be deemed to be a banking company.”

Section 45I relates to definitions in respect of expressions used in various provisions under Chapter III-B of the Act. Section 45JA empowers the RBI to determine policy and issue directions. It reads thus:-

“45JA. Power of Bank to determine policy and issue directions

(1) If the Bank is satisfied that, in the public interest or to regulate the financial system of the country to its advantage or to prevent the affairs of any non-banking financial company being conducted in manner detrimental to the interest of the depositors or in a manner prejudicial to the interest of the non-banking financial company, it is necessary or expedient so to do, it may determine the policy and give directions to all or any of the non-banking financial companies relating to income recognition, accounting standards, making of proper provision for bad and doubtful debts, capital adequacy based on risk weights for assets and credit conversion factors for off balance-sheet items and also relating to deployment of funds by a non-banking financial company or a class of non-banking financial companies or non-banking financial companies generally, as the case may be, and such non-banking financial companies shall be bound to follow the policy so determined and the direction so issued.

(2) Without prejudice to the generality of the powers vested under subsection (1), the Bank may give directions to non-banking financial companies generally or to a class of non banking financial companies or to any non-banking financial company in particular as to-

(a) the purpose for which advances or other fund based or non-fund based accommodation may not be made; and

(b) the maximum amount of advances of other financial accommodation or investment in shares and other securities

deposits of the non-banking financial company and other relevant considerations, may be made by that non-banking financial company to any person or a company or to a group of companies.”

Section 45Q postulates that Chapter III-B of the Act shall have overriding effect over other laws in the following terms:-

“45Q - Chapter IIIB to override other laws The provisions of this Chapter shall have effect notwithstanding anything inconsistent therewith contained in any other law for the time being in force or any instrument having effect by virtue of any such law.”

Reserve Bank of India has classified all assets on which there is either a default in payment of interest or in repayment of the principal sum for more than the specified period as NPA.

19. The Gujarat High Court in *Shri Mahila Sewa Sahakari Bank Limited's* case (supra), delving into the scope of Section 45Q of the 1934 Act noticed as under:-

“19. Section 45Q of the RBI Act, which is relevant for the present purpose, reads thus: “45-Q. Chapter III-B to override other laws.—The provisions of this Chapter shall have effect notwithstanding anything inconsistent therewith contained in any other law for the time being in force or any instrument having effect by virtue of any such law.”

20. Section 45Q finds place in Chapter IIIB of the RBI Act. Thus, the provisions of Chapter IIIB of the RBI Act have an overriding effect qua other enactments to the extent the same are inconsistent with the provisions contained therein. In order to reflect a bank's actual financial health in its balance sheet, the Reserve Bank has introduced prudential norms for income recognition, asset classification and provisioning for advances

thereunder are mandatory and it is incumbent upon all cooperative banks to follow the same. Insofar as income recognition is concerned, clause 4.1.1 of the circular provides that the policy of income recognition has to be objective and based on the record of recovery. Income from non-performing assets (NPA) is not recognised on accrual basis but is booked as income only when it is actually received. Therefore, banks should not take to income account interest on non-performing assets on accrual basis. Thus, in view of the mandate of the RBI Guidelines the assessee cannot recognise income from non-performing assets on accrual basis but can book such income only when it is actually received. Thus, this is a case where at the threshold, the assessee, in view of the RBI Guidelines, cannot recognise income from NPA on accrual basis. This is, therefore, a case pertaining to recognition of income and not computation of the income of the assessee.”

20. Under Section 45JA of 1934 Act, Notification No. DFC.119/DG(SPT)-98 dated 31st January, 1998 has been issued by RBI considering it necessary in public interest and being satisfied that for the purpose of enabling the Bank to regulate the credit system, to issue directions relating to Prudential Norms, given to every Non-Banking Financial Company(NBFC). The said directions are called as "NBFCs Prudential Norms (Reserve Bank) Directions, 1998"(in short, the RBI Directions, 1998).

21. Scope and applicability of RBI Directions 1998 issued under Section 45JA of 1934 Act requires consideration. RBI Directions 1998, are merely disclosure norms or norms regarding presentation of NPA provisions in the balance sheet of an NBFC. Under Section 45JA, power is given to RBI to enact a regulatory framework involving prescription of prudential

norms for NBFCs which are taking deposits to ensure that NBFCs function

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on sound and healthy lines. The primary object of the said 1998 Directions is prudence, transparency and disclosure. [Section 45JA](#) comes under Chapter IIIB which deals with provisions relating to Financial Institutions, and to non-banking Institutions receiving deposits from the public. The said 1998 Directions touch various aspects such as income recognition; asset classification; provisioning, etc. The basis of the 1998 Directions is that anticipated losses must be taken into account but expected income need not be taken note of. Therefore, these Directions ensure cash liquidity for NBFCs which are now required to state true and correct profits, without projecting inflated profits. Therefore, in our view, RBI Directions 1998 deal only with presentation of NPA provisions in the Balance Sheet of an NBFC. It has nothing to do with the computation or taxability of the provisions for NPA under the Act. It is clarified that the entire thrust of RBI Directions 1998 is on presentation of NPA provision in the Balance Sheet of an NBFC. Presentation/disclosure is different from computation/ taxability of the provision for NPA. The nature of expenditure under the Act cannot be conclusively determined by the manner in which accounts are presented in terms of 1998 Directions. If one keeps these concepts in mind, it is very clear that RBI Directions 1998 are merely prudential norms. They can also be called as disclosure norms or norms regarding presentation of NPA Provisions in the Balance Sheet. They do not touch upon the nature of income or expense which is to be decided by the Assessing Officer in the assessment proceedings.

22. The reasons for issuing RBI directions 1998 needs to be delved into. On 31.01.1998, RBI Directions 1998 introduced a new regulatory framework involving prescription of Disclosure norms for NBFCs to ensure

supervisory attention was focussed on the deposit taking NBFCs so as to enable the RBI to discharge its responsibilities to protect the interest of the depositors. These NBFCs are subjected to prudential regulations on various aspects such as income recognition; asset classification and provisioning, etc. The basis of every business is that anticipated losses must be taken into account but expected income need not be taken note of. This is the basis of the RBI Directive of 1998 as it is closer to reality of cash liquidity that prevents NBFC from collapse. The RBI Directions 1998 deal with Presentation of NPA provision in the Balance Sheet of an NBFC. Before 1998, the Balance Sheet and P&L Account of an NBFC were required to be prepared in accordance with Parts I and II of Schedule VI as provided under [Section 211](#) of the Companies Act, 1956 like any other company. Schedule VI Part I of the Companies Act, 1956 specifically provides that Provision for doubtful debts should be reduced from the gross amount of debtors and advances. NBFCs were following the same practice of disclosure in their audited financial statements as done by the Company. Vide Para 9, as noticed in ***Southern Technologies Limited's*** case (supra), RBI has mandated that every NBFC shall disclose in its Balance Sheet the Provision without netting them from the Income or from the value of the assets and that the provision shall be distinctly indicated under the separate heads of accounts as: - (i) provisions for bad and doubtful debts, and (ii) provisions for depreciation in investments in the Balance Sheet under "Current Liabilities and Provisions" and that such provision for each year shall be debited to P&L Account so that a true and correct figure of "Net Profit" gets reflected in the financial accounts of the company. The effect of such Disclosure is to increase the current liabilities by showing the provision

Para 9, "the provisions shall be distinctly indicated under separate heads of accounts" on the Liability side of the balance sheet under the caption "current liabilities and provisions".

23. Examining the applicability of Section 145 of the Act, at the outset, we may state that in essence RBI Directions 1998 are Prudential/ Provisioning Norms issued by RBI under Chapter IIIB of the 1934 Act. These Norms deal essentially with Income Recognition. They force the NBFCs to disclose the amount of NPA in their financial accounts. They force the NBFCs to reflect "true and correct" profits. By virtue of [Section 45Q](#) of the 1934 Act, an overriding effect is given to the RBI Directions 1998 vis-a-vis "income recognition" principles in the [Companies Act](#), 1956. These Directions constitute a code by itself. However, these Directions 1998 and the Act operate in different areas. These 1998 Directions have nothing to do with computation of taxable income. These Directions cannot overrule the "permissible deductions" or "their exclusion" under the Act. The inconsistency between these Directions and [Companies Act](#) is only in the matter of Income Recognition and presentation of Financial Statements. The Accounting Policies adopted by an NBFC cannot determine the taxable income. It is well settled that the Accounting Policies followed by a company can be changed unless the AO comes to the conclusion that such change would result in understatement of profits. However, in the present case, the Assessing Officer has to follow the RBI Directions 1998 in view of Section 45Q of the 1934 Act. Hence, as far as Income Recognition is concerned, [Section 145](#) of the Act has no role to play in the present dispute.

24. The Supreme Court in *Southern Technologies Limited's* case (supra) laid down as under:-

“57. At the outset, we may state that in essence RBI Directions 1998 are Prudential/ Provisioning Norms issued by RBI under Chapter IIIB of the RBI Act, 1934. These Norms deal essentially with Income Recognition. They force the NBFCs to disclose the amount of NPA in their financial accounts. They force the NBFCs to reflect "true and correct" profits. By virtue of Section 45Q, an overriding effect is given to the Directions 1998 vis-a-vis "income recognition" principles in the Companies Act, 1956. These Directions constitute a code by itself. However, these Directions 1998 and the IT Act operate in different areas. These Directions 1998 have nothing to do with computation of taxable income. These Directions cannot overrule the "permissible deductions" or "their exclusion" under the IT Act. The inconsistency between these Directions and Companies Act is only in the matter of Income Recognition and presentation of Financial Statements. The Accounting Policies adopted by an NBFC cannot determine the taxable income. It is well settled that the Accounting Policies followed by a company can be changed unless the AO comes to the conclusion that such change would result in understatement of profits. However, here is the case where the AO has to follow the RBI Directions 1998 in view of Section 45Q of the RBI Act. Hence, as far as Income Recognition is concerned, Section 145 of the IT Act has no role to play in the present dispute.”

25. It was concluded by the Apex Court in **Southern Technologies Limited's case (supra)** that the RBI directions have nothing to do with the accounting treatment or taxability of income under the Act and the two, viz. the Act and the RBI Directions, 1998 operate in different fields. The Supreme Court had clearly recognized the theory of real income and held that notwithstanding that the assessee may be following the mercantile system of accounting, it can be taxed on real income and not accrued interest which is hypothetical income.

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26. Under the Act, the charge is on profits and gains, not on gross receipts (which however, has profits embedded in it). Therefore, subject to the requirements of the Act, profits to be assessed under the Act have got to be real profits which have to be computed on ordinary principles of commercial accounting. In other words, profits have got to be computed after deducting losses/expenses incurred for business, even though such losses/expenses may not be admissible under sections 30 to 43D unless such losses/expenses are expressly or by necessary implication disallowed by the Act.

27. The Delhi High Court in **Vasisth Chay Vyapar Ltd.'s case (supra)** has in the context of a similar issue arising in the case of a non-banking financial company has held that where uncertainty prevailed in so far as recovery of interest and the principal amount of loan was concerned, it was legitimate to infer that interest on the principal amount had not “accrued”. The relevant observations read as under:-

“17. In this scenario, we have to examine the strength in the submission of learned counsel for the Revenue that whether it can still be held that income in the form of interest though not received had still accrued to the assessee under the provisions of [Income Tax Act](#) and was, therefore, exigible to tax. Our answer is in the negative and we give the following reasons in support:-

(1) First of all we would discuss the matter in the light of the provisions of [Income Tax Act](#) and to examine as to whether in the given circumstances, interest income has accrued to the assessee. It is stated at the cost of repetition that admitted position is that the assessee had not received any interest on the said ICD placed with Shaw Wallace since the assessment year 1996-97 as it had become NPAs in accordance with the Prudential norms

which was entered in the books of accounts. The assessee has further successfully demonstrated that even in the succeeding assessment years, no interest was received and the position remained the same until the assessment years 2006-07. Reason was adverse financial circumstances and the financial crunch faced by Shaw Wallace. So much so, it was facing winding up petitions which were filed by many creditors. These circumstances, led to an uncertainty in so far as recovery of interest was concerned, as a result of the aforesaid precarious financial position of Shaw Wallace. What to talk of interest, even the principal amount itself had become doubtful to recover. In this scenario it was legitimate move to infer that interest income thereupon has not "accrued". We are in agreement with the submission of Mr. Vohra on this count, supported by various decisions of different High Courts including this court which has already been referred to above.

(2) In the instant case, the assessee company being NBFC is governed by the provisions of RBI Act.

In such a case, interest income cannot be said to have accrued to the assessee having regard to the provisions of section 45Q of the RBI and Prudential Norms issued by the RBI in exercise of its statutory powers. As per these norms, the ICD had become NPA and on such NPA where the interest was not received and possibility of recovery was almost nil, it could not be treated to have been accrued in favour of the assessee.

....No doubt, in first blush, reading of the judgment gives an indication that the Court has held that RBI Act does not override the provisions of the [Income Tax Act](#). However, when we examine the issue involved therein minutely and deeply in the context in which that had

arisen and certain observations of the Apex Court

contained in that very judgment, we find that the proposition advanced by Mr. Sabharwal may not be entirely correct. In the case before the Supreme Court, the assessee a NBFC debited ₹ 81,68,516 as provision against NPA in the profit and loss account, which was claimed as deduction in terms of [Section 36\(1\) \(vii\)](#) of the Act. The assessing officer did not allow the deduction claimed as aforesaid on the ground that the provision of NPA was not in the nature of expenditure or loss but more in the nature of a reserve, and thus not deductible under [section 36\(i\)\(vii\)](#) of the Act. The assessing officer, however, did not bring to tax ₹ 20,34,605 as income (being income accrued under the mercantile system of accounting). The dispute before the Apex court centered around deductibility of provision for NPA. After analyzing the provisions of the RBI Act, their Lordships of the Apex Court observed that in so far as the permissible deductions or exclusions under the Act are concerned, the same are admissible only if such deductions/exclusions satisfy the relevant conditions stipulated therefor under the Act. To that extent, it was observed that the Prudential Norms do not override the provisions of the Act. However, the Apex Court made a distinction with regard to "Income Recognition" and held that income had to be recognized in terms of the Prudential Norms, even though the same deviated from mercantile system of accounting and/or [section 145](#) of the Income Tax Act. It can be said, therefore, that the Apex Court approved the "real income theory which is engrained in the Prudential Norms for recognition of revenue by NBFC."

The said decision was affirmed by the Supreme Court in C.A.No.5802 of 2012 dismissed on 13.12.2017.

28. Reference is now made to the judgment of *State Bank of Travancore's case (supra)* on the basis of which one of the substantial question of law has been claimed by the revenue. In *State Bank of Travancore's case (supra)* the assessee a subsidiary of the State Bank of India, used to maintain accounts on mercantile system making entries on accrual basis. The assessee adopted the calendar year as its previous year and the calendar years 1964, 1965 and 1966 were respectively the relevant previous years for Assessment Years 1965-66, 1966-67 and 1967-68 to which the question related. In the course of its banking business the assessee charged interest on advances considered doubtful of recovery otherwise called sticky advances by debiting the concerned parties but instead of carrying it to its "Profit and Loss Account" credited the same to a separate account styled 'Interest "suspense account" as the principal amounts of these sticky advances themselves had become, not bad or irrecoverable but extremely doubtful of recovery. However, in its returns the assessee disclosed such interest separately and claimed that the same was not taxable in its hands as income for the concerned years. The contention of the assessee was rejected at all levels principally on two grounds (a) since admittedly the assessee was following the mercantile system of accounting such interest had accrued to it at the end of each accounting year and (b) the assessee had itself shown the accrual of such interest by charging the same to the concerned parties by making debit entries in their accounts. The Supreme Court held that the concept of reality of the income and the actuality of the situation are relevant factors which go to the making up of the accrual of income but once accrual takes place and income accrues, the same cannot be defeated by any theory of real income. The court observed

fundamentals of the law with clarity and consistency than to be carried away by common clichés. The concept of real income certainly is well-accepted one and must be applied in appropriate cases but with circumspection and must not be called in aid to defeat the fundamental principles of law of income-tax as developed.

29. Subsequently, taking note of CBDT Circular No.F.201/81/84/ITA II dated 09.10.1984, the Supreme Court in **UCO Bank, Calcutta v. CIT (1999) 237 ITR 889 (SC)** explained its earlier decision in **State Bank of Travancore's** case (supra). In **UCO Bank's** case (supra), the Supreme Court was called upon to consider whether interest on a loan whose recovery is doubtful and which has not been recovered by the assessee-bank for the last three years but has been kept in a suspense account, can be included in the income of the assessee for the assessment year 1981-82. The Court observed that:

“10. The question whether interest earned, on what have come to be known as “sticky” loans, can be considered as income or not until actual realization, is a question which may arise before several Income Tax Officers exercising jurisdiction in different parts of the country. Under the accounting practice, interest which is transferred to the suspense account and not brought to the profit and loss account of the company is not treated as income. The question whether in a given case such “accrual” of interest is doubtful or not, may also be problematic. If, therefore, the Board has considered it necessary to lay down a general test for deciding what is a doubtful debt, and directed that all Income Tax Officers should treat such amounts as not forming part of the income of the assessee until realized, this direction by way of a circular cannot be considered as travelling beyond the powers of

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the Board under Section 119 of the Income Tax Act. Such a circular is binding under Section 119. The circular of 9-10-1984, therefore, provides a test for recognising whether a claim for interest can be treated as a doubtful claim unlikely to be recovered or not. The test provided by the said circular is to see whether at the end of three years, the amount of interest has, in fact, been recovered by the bank or not. If it is not recovered for a period of three years, then in the fourth year and onwards the claim for interest has to be treated as a doubtful claim which need not be included in the income of the assessee until it is actually recovered.

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14. There are, however, two decisions of this Court which have been strongly relied upon by the respondents in the present case. The first decision is the majority judgment in **State Bank of Travancore v. CIT** decided by a Bench of three Judges of this Court by a majority of two to one. This judgment directly deals with interest on “sticky advances” which have been debited to the customer but taken to the interest suspense account by a banking company. The majority judgment has referred to the circular of 6-10-1952 and its withdrawal by the second circular of 20-6-1978. The majority appears to have proceeded on the basis that by the second circular of 20-6-1978 the Central Board had directed that interest in the suspense account on “sticky” advances should be includible in the taxable income of the assessee and all pending cases should be disposed of keeping these instructions in view. The subsequent circular of 9-10-1984 by which, from Assessment Year 1979-80 the banking companies were given the benefit of the **circular of 9-10-1984**, does not appear to have been pointed out to the Court. What was submitted before the Court was,

that since such interest had been allowed to be exempted for more than half a century, the practice had transformed itself into law and this position should not have been deviated from. Negating this contention, the Court said that the question of how far the concept of real income enters into the question of taxability in the facts and circumstances of the case, and how far and to what extent the concept of real income should intermingle with the accrual of income, will have to be judged “in the light of the provisions of the Act, the principles of accountancy recognised and followed and the feasibility”. The Court said that the earlier circulars being executive in character cannot alter the provisions of the Act. These were in the nature of concessions which could always be prospectively withdrawn. The Court also observed that the circulars cannot detract from the Act. The decision of the Constitution Bench of this Court in **Navnit Lal C. Javeri v. K.K. Sen, (1965) 56 ITR 198** or the subsequent decision in **K.P. Varghese v. ITO, (1981) 4 SCC 172** also do not appear to have been pointed out to the Court. Since the latter circular of 9-10-1984 was not pointed out to the Court, the Court naturally proceeded on the assumption that the benefit granted under the earlier circular was no longer available to the assessee and those circulars could not be resorted to for the purpose of overcoming the provisions of the Act. Interestingly, the concurring judgment of the second Judge has not dealt with this question at all but has decided the matter on the basis of other provisions of law.

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16. In the premises the majority decision in **State Bank of Travancore v. CIT** cannot be looked upon as laying down that a circular which is properly issued under

administration of the Act and for relieving the rigour of too literal a construction of the law for the benefit of the assessee in certain situations would not be binding on the departmental authorities. This would be contrary to the ratio laid down by the Bench of five Judges in *Navnit Lal C. Javeri v. K.K. Sen.*”

30. In all fairness to learned counsel for the revenue, the contention that Section 43D of the Act itself recognises taxability of such interest and that when a specific provision in the nature of section 43D of the Act has been made, and entities like the assessee are excluded from the purview thereof, the assessee cannot indirectly claim benefit which would amount to a benefit similar to that under section 43D of the Act, requires to be discussed. In this regard, it may be noted that the benefit claimed by the assessee is not under any provision of the Act. The assessee being bound by the RBI Guidelines which are issued under the provisions of the 1934 Act has not shown the interest on NPA as income. By virtue of the provisions of section 45Q of the 1934 Act, the provisions of Chapter IIIB thereof have an overriding effect over other laws. Therefore, notwithstanding the provisions of section 43D of the Act, since the provisions of section 45Q of the 1934 Act have an overriding effect vis-à-vis income recognition principles in the Companies Act, the Assessing Officer is bound to follow the RBI Directions so far as income recognition is concerned. The interest on principal loan amount which has been classified as NPA cannot be held to have “accrued” so as to tax them under the Act. The contention that the assessee cannot indirectly claim the benefit which would amount to a benefit similar to that under section 43D of the Act, therefore, does not merit acceptance.

31. The similar issue was considered in ***Shri Mahila Sewa Sahakari Bank Ltd.'s case (supra)*** in the case of Cooperative Banks by the Gujarat High Court where the issue was decided in favour of the assessee through a detailed judgment. Against the judgment of the Gujarat High Court, the Apex Court approving the said decision dismissed the C.A.No.8977 of 2017 filed by the revenue on 13.12.2017. It may further be noticed that the Parliament has amended Section 43D of the Act by Finance Act, 2017 effective from 1.4.2018 whereby specifically including “a cooperative bank other than a primary agricultural credit society or a primary cooperative agricultural and rural development bank” in the said provision.

32. Adverting to the factual matrix, it may be noticed that the Tribunal while relying upon the various pronouncements had decided the issue regarding taxability of interest on NPA's in favour of the assessee as being taxable in the year of receipt. The Tribunal had upheld the deletion made by the CIT(A) on account of addition of ₹ 3,02,82,000/- regarding interest accrued on NPA. No illegality or perversity could be demonstrated by learned counsel for the revenue in the aforesaid findings recorded by the Tribunal.

33. Thus, substantial questions of law as claimed are answered accordingly and the appeals are dismissed.

(AJAY KUMAR MITTAL)
JUDGE

September 24, 2018
gbs/gs

(AVNEESH JHINGAN)
JUDGE

Whether Speaking/Reasoned
Whether Reportable

Yes
Yes

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