



Writing-off of **Bad Debts** in Urban Co-operative Banks

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In the co-operative banking sector, it is commonly believed that writing-off of bad debts is a failure of the Management. Hence, the Board of Directors (BOD) does not want to take decision regarding the writing-off of bad debts. As per the Co-operative Societies Act, the BOD has to recommend such decisions in their Annual General Meeting (AGM) and the AGM should accept the recommendation and pass a resolution to that effect. But the members generally do not agree with such recommendations. The members feel that the debts become bad because of wrong sanctioning of loans by the BOD and hence it is the duty of the BOD to recover the same. They are also of the opinion that the BOD should be held responsible for such bad debts. In this backdrop, the BOD generally hesitate to take such decision, even if it is in the interest of the bank. Because of such an attitude of the board as well as members, the quantum of irrecoverable loans shown in the balance sheet of every urban co-operative bank (UCB) is very large and, therefore, they have to make large provision. Thus, their CD ratio, gross NPA level and other financial parameters are affected and the balance sheet does not present an attractive financial position. In fact, it is the duty of every management to prepare the balance sheet in a way that attracts its members as well as investors. If the management does not do so, we must say that the management has failed in its duty and they are not conducting banking in a professional way.

In the current scenario, when the exemption under Sec. 80-P of Income Tax Act has been withdrawn, it is always advisable to write-off bad debts and get tax benefit as well as clean the balance sheet.

In this context, the Supreme Court of India gave a landmark decision in a civil appeal No. 675/2004, dated May 1, 2005 (Salim Akabarali Nanji Vs. Govt. of India) which stimulates thinking about new concepts in cooperative banking for modern times.

In the instant case, Development Credit Bank proposed in its AGM to write - off the long-standing unproductive and irrecoverable debts to the tune of Rs. 120 crore from its reserves for the following reasons:

1. even after writing off the debts of Rs. 120 crore from the reserve fund, the CRAR of the bank exceeds the necessary ratio decided by the RBI i.e. 9%.

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2. the bank has raised its share capital from Rs. 21 crore to Rs. 75 crore.
3. the said debts are unproductive for quite a long time and hence difficult to recover, as per the bank's auditor's report.
4. it is necessary to clean the balance sheet for the prestige of the bank.
5. the bank will get the deduction under Sec. 43 -D of Income Tax Act.

The AGM passed the resolution with a condition that the Reserve Bank approves it. Accordingly, the bank obtained RBI permission.

According to the petitioner, who is a member of the bank, the bank should have taken action against the said debtor and his sureties under the Securitisation Act, and it was necessary to take the custody for the recovery. In the same way, the RBI has authority only to control the banks. As per the Sec. 17(2) of the B.R. Act grant of such permission doesn't come under the jurisdiction of the RBI. Due to this permission, the bank and its members had come into losses, and so the said permission given by the RBI should be dismissed.

While dismissing the appeal, the Supreme Court stated the following points.

- 1) To write - off the debts is an internal matter of the bank that doesn't prevent the bank from recovering the outstanding debt. Though the account of the debtor is closed in the banks ledger, it doesn't mean that the bank has given up the debt. The bank can recover it any time.
- 2) It is the need of the bank to have such a clean balance sheet in order to attract the investors and its members.
- 3) Such an action enables banks to avail of deduction of income tax and the said written off bad debts when recovered in a particular financial year are included in the income of that financial year and so it is the right step of the bank to get the deduction in income tax.
- 4) Though, under the Banking Regulation Act, it is not necessary to have the permission of the RBI, the bank has asked for it as per the long practice and the RBI has approved it. Though it may be a technical mistake, the objective of the bank and the RBI is bona fide and good.
- 5) Banking is a business and when it becomes impossible to recover the debts, it becomes necessary to take such a step for the bank.
- 6) The decision taken by the bank to write - off the said debts from its reserve fund is quite right.

In the above case, the decision taken by the bank to keep its operational profit of the current year intact and to write- off the debts from the reserve fund is totally a professional decision. According to the Supreme Court, writing-off the debts in this way is an internal accounting procedure to clean-up the balance sheet of the bank.

In this background, it is the prime duty of every bank management to study the changes taking place in the banking arena, and the decisions of the courts and accordingly modify its functioning and working.

Hon'ble Finance Minister in his budget speech on 28th February 2006, while withdrawing the concession under 80-P of the income tax has said, "co-operative banks like any other banks are lending institutions and should pay tax on their profits. I propose to exclude all co-operative banks from the scope of section 80-P".

Naturally, urban co-operative banks will have to pay the income tax for the financial year 2006-07 i.e. Assessment Year 2007-08 and in that context, all the banks will have to follow all the provisions of the Income Tax Act, including advance tax. At the same time, it is possible for every bank management to avail of the exemptions within the frame work of the law and post higher profits. It is, therefore, essential to study the provisions of Income Tax Act and available deductions u/s. 36(1) (vii), 36(1) (vii a), and 43-D of the Income Tax Act, as also the definitions of the bad debts.

'PROFIT' in the banking business and 'INCOME' of that business are two different concepts. The income tax is not calculated on the profit but on the income only and while calculating the taxable income, every tax payer will try to take advantage of the deductions available under the Act. Therefore, if the UCBs write-off the irrecoverable bad debts, they will have to pay less income tax as well as their balance sheet will become attractive.

It is necessary to have a collective discussion on the point raised by the experts in the field and there must be a common policy in all the UCBs. Every bank should take its own decision after consulting its advisors but in the interest of co-operative banks, discussion on these points is very necessary.

Can the Income Tax Act and the State Co-operative Act be complementary to each other ?

The Income Tax Act is a Central subject from

the Central list as per Article 246 and 7th Schedule of the Constitution, whereas the Co-operative Societies Act, is a state subject in the State list. Income Tax Act, is an independent act and has its own rules and regulation for its execution. In the same way, the Co-operative Act also is independent and under the relevant provisions, independent rules and regulations are framed. Moreover, independent courts are instituted under this State Act for getting justice. So, the said two Acts cannot be complementary to each other and to get the concession under the Income Tax Act, it is subsidiary to complete the rules under the Co-operative Act. Assessors have full right to take the deductions of bad debts under the Income Tax Act. While doing so, it is not the responsibility of the bank to prove whether the said debts are really bad debts or to convince the government what efforts are made to recover the said debts. The debts as and when recovered will be considered as income in that particular year. To decide whether the debts are bad or not is the sole right of the bank under the Income Tax Act. There are rules in the Income Tax Act regarding how much deduction one can avail. On the contrary, the bank under the Co-operative Societies Act has to convince the statutory auditors about what efforts were taken to recover the same and why they are irrecoverable and if the auditors are satisfied, and certify it, then the bank can declare the debts as bad debts. Thus, the rules under the two Acts are different and the banks are expected to follow the rules made under the two Acts separately. It is, therefore, obvious that the two Acts are not complementary to each other. Some of the decisions of the courts require that the debtors must admit these debts and hence it would be quite proper to write-off the debts which are not disputed and the bank cannot take decision to write-off debts where adjudication is pending,

Is it necessary to follow the provisions of the co-operative act while calculating the deductions of the bad debts according to the Income Tax Act?

It is compulsory to follow the provisions of the Co-operative Societies Act, if the bad debts are to be written - off. It is necessary to have the certificate of the statutory auditors, the recommendation of the BOD, the approval of the AGM and lastly permission of the Commissioner of the Co-operative Department. It is also necessary to fulfill all the conditions under all the sub-sections from No. 1 to 5 of the section 36(2) of the Income Tax Act. If the deductions of the bad debts are to be taken under the section 36(1)(vii), while calculating the tax under Income Tax Act, the Income Tax Officer will only see whether the bank has strictly followed the section 36(2). He need not see whether the bank has followed the procedure under of the Co-operative Act. But, according to the Income Tax Act, banks will have to write-off such bad debts in their books in the financial year if they want to take the concession for the Assessment Year 2007-08. It is simply impossible if the banks want to follow both the Acts, because the statutory auditors are appointed only after March and it is impossible to follow the procedures laid down under Co-operative Societies Act.

The way out is for banks to call for a list of such bad debts from their branches and give those lists to their internal auditors for certifying under a special resolution of the board of directors. The board may sanction and recommend the write-off to Annual / Special General Meeting, and such approval of the proposal is required to be sent to the Co-operative Department with a resolution passed in the Annual / Special General Meeting. The banks should pass the accounting entry in their books before March 31, as well as a guarantee should be given to get those debts certified from the statutory auditors when appointed, and if the statutory auditors do not certify some of the debts they would be reversed. So, to avail the deduction under Income Tax Act, it is not necessary to fulfill the provisions of the Co-operative Act, but it is better to have a compromise between the two Acts.

Even after the writing – off of such bad debts, banks have every right to recover the same, so can it be called as ‘Notional write-off’?

In the case of Salim Akabarali Nanji, the Hon’ble Supreme Court has clearly stated that, write-off does not mean that the banks have given up their right to recover such debts. It does not mean that the banks have waived such amount. In fact, the Court says that this is nothing but a contractual relationship and the bank has every right to recover the said bad debts by adopting every recovery measure. The Court also says that if the bank has taken deduction in the current year they can add the amount in the year in which the said debts are recovered. So when by writing – off such debts, banks are not surrendering their rights of recovery, then why not such writing off of debts is to be called as ‘Notional’ write-off? Commercial banks are maintaining a separate register for such accounts and also keeping the recovery records. Such books are not a

part of books of accounts and from the record of recovery, they pass the accounting entry in that respective year. So the important question is, when it is a 'Notional' write-off, why the bank should follow the procedure mentioned in the Co-operative Act of the respective States?

How to take the aggregate deduction u/s 36(1) (vii) & sec. 36(1) (vii a) of the Income Tax Act?

For availing the deduction u/s 36(1)(vii) and 36(1)(vii a) of Income Tax Act, one should take into account the principal outstanding plus the amount of interest charged but not recovered. It means that while fixing the amount of bad debts, one should not consider the interest receivable. As per the RBI guidelines, we are not supposed to charge any interest on NPA accounts. It means that the ledger balance of the NPA account would be the balance to be written off as bad debts. When the bank wants to write-off such debts, they have to debit their profit and loss account by such amount. The bank can avail of the deduction u/s 36(1)(vii) only after fulfilling the conditions mentioned u/s 36(2) of the Income Tax Act. As per the condition laid down u/s 36(2) (v), whenever Sec. 36(1) (vii a) is applicable to an assessee, the deduction available u/s 36(1) (vii) is restricted upto the amount which exceeds the balance in provision for bad & doubtful debts made as per the Sec. 36(1) (Vii a) of Income Tax Act. As per the Sec. 36(1)(Vii a), the bank can get deduction of 7.5% of its total income, and 10% of the average loans and advances made by its rural branches (rural branches means branches situated in a rural area, having a total population of less than 10,000).

The following example will explain this:

Provision for Bad and Doubtful Debt Account			
March 31.2007 To debtors A/c. (being bad debts the bank wants to write - off)	204.00	By P&L Account (7.5% of Rs.10 crore as per Sec. 36(i) (vii a))	(Rs. In lakh) 75.00
		By P & L Account Being deduction available under Sec. 36(i)(vii)	129.00
	204.00		204.00

But the Sec. 36 (1) (vii) and 36 (1) (vii a) are independent. So, if the bank has not taken the deduction under Sec.36 (1) (vii a) it can get the whole deduction under section 36(1) (vii). In this back ground, if the amount of bad debt written off is more than the deductions got under section 36(1)(vii a), only then it would be beneficial to the bank.

Will the extra provision regarding the doubtful and bad debts, if reversed, included in the bank's income?

Many a time, provisions made for unproductive debts of the banks are more than necessary. The said provisions are not treated as expenses during the last year, and if it is reversed, it cannot be included in the income. But to get the concession under the Income Tax Act, if it is necessary to show the bad debts to debit side under the provision of Sec. 36(1)(vii a) and if the previous provision is more than necessary and if the only excess provision is reversed and again that much or more than that provision is made during this year, then the bank is not getting any profit by reversing previous provision. The Reserve Bank of India will not take any objection to that e.g. the bank reverses the provisions of Rs. 1 crore and makes the provision of that much or more than that amount this year, it will do.

Can the co-operative banks get the deduction on accumulated loss?

Previously the co-operative banks were getting exemption under Section 80P of Income Tax Act. This means if the banks have filed their return every year and have declared their loss they can get the exemption for their accumulated losses from this year's income.

Whether Sec. 72 A is not applicable to co-operative banks?

At present, the RBI does not allow UCBs to open new branches. Instead, stronger UCBs are encouraged to get the financially weak banks merged with them and in this way they can expand their branches. But, Section 72 A (i) of Income Tax Act doesn't allow the merged banks to get the said exemption because the UCBs do not come under the definition of specified banks. As

the co-operative banks do not get exemption under Sec. 72A, it has become a great stumbling block in the process of merger.

About the deduction regarding the writing - off of the amount of depreciation and premium in the investment.

The banks are classifying their investments under three categories i.e. (a) Held to Maturity (HTM) (b) Available for Sale (AFS) and (c) Held for Trading (HFT). But generally the banks are classifying their investments into only two categories (i.e. HTM & AFS). In the HTM category, RBI allows write-off of the premium amount given at the time of purchase in equal installments till the due date of the bonds and the said amount is debited to the Profit & Loss account. In the AFS category, every year on the 31st March, it is to be evaluated as per the market value and if the market value is less than the book value, the depreciation should be provided for. The

investment made in AFS category is stock in trade according to Income Tax department and so the regular system for evaluation is accepted by the Income Tax department. So the provision made for such depreciation is considered as admitted expenditure according to Income Tax Act. But the investment made in HTM category is supposed to be the capital investment and the banks cannot get the deduction for the premium amount written - off. The amount of income on the due date for the investment made HTM category is not considered as capital income and taxed accordingly.

Is the concession under the Section 43-D of the Income Tax Act applicable to the UCBs?

In the recent budget, the Hon'ble Finance Minister has included only scheduled co-operative banks in the list of scheduled banks. So prima-facie, it seems that the non-scheduled urban co-operative banks are not eligible for the deduction available u/s 43-D of the Income Tax Act. It is a fact that the urban co-operative banks are following accrual accounting system by crediting the interest only on realisation/accrual basis and they are doing this because of the specific guidelines from the RBI. When it is mandatory for any assessee to adopt two different accounting policies - one for the performing advances and other for the non - performing advances - then, such hybrid system can be accepted for two different kinds of advances subject to its disclosure. In this background, the unrecovered interest cannot be taken in banks income and one can enjoy the benefit u/s 43-D of the Income Tax Act. ■

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