Chapter I
Review on Assessments of Banks

Contents	Page

- Highlights 1
- Introduction 3
- Objective of the review 3
- Law and procedure 3
- Scope of the review 5
- Audit methodology and sample size 5
- Audit findings

System issues

- ➢ Incorrect allowance of bad debts written off 9
- ➢ Incorrect allowance of provision for bad and doubtful debts 12
- ➢ Non correlation of bad debts figures in income tax returns of banks with returns furnished to RBI 14
- ➢ Deduction towards advances given by rural branches of bank 15
- ➢ Incorrect allowance of depreciation on valuation of investments made by banks 16

Compliance issues

- ➢ Incorrect allowance of expense towards exempt income 17
- ➢ Incorrect allowance of deductions 19
- ➢ Income not offered to tax 20
- ➢ Incorrect allowance of depreciation and set off of losses 22
- ➢ Incorrect computation of tax on capital gains 23
- ➢ Incorrect allowance of provisions, capital expenditure and liabilities 24
- ➢ Incorrect allowance of expenditure on investments 25
- ➢ Incorrect deduction of income from securities 26
- ➢ Incorrect computation of income under special provisions 27
- ➢ Incorrect allowance of deduction towards head office expenses/interest relating to foreign banks 28
- ➢ Incorrect computation of income and other mistakes 29
- ➢ Non adoption of Arm's Length Price 31
- ➢ Non recognition of income 32
- ➢ Conclusion 33
- ➢ Summary of recommendations 33

Highlights

Audit reviewed the assessments of 89 banks including public sector, private and foreign banks for the assessment years 2002-03, 2003-04, 2004-05 and 2005-06 completed after scrutiny up to March 2007 with a view to (i) evaluating the compliance with the law and procedural requirements of Income Tax Act, 1961 (ii) quantify the extent of irregularities, mistakes and omissions in the assessment of banks and (iii) examine if there is any lacuna in the Act.

(Paragraphs 1.2 and 1.5.2)

Systems issues

Audit noticed mistakes in 53 percent of the scrutiny assessments of banks. Total tax effect of audit observations was nine percent of the tax payable in respect of all assessments of banks seen in audit.

(Paragraph 1.7.1)

Audit noticed mistakes in 46 assessments of banks involving tax effect of Rs. 1,719.78 crore relating to incorrect allowance of bad debts written off and incorrect allowance of provision for bad and doubtful debts. Audit also observed areas with high potential revenue impact on account of systemic issues such as differences in figures of bad and doubtful debts and non verification of advances given by rural branches of the banks.

(Paragraph 1.8.1)

There was excess allowance of bad debts written off to **M/s State Bank of India** involving short levy of tax of Rs. 1,058.70 crore.

(Paragraph 1.9.4)

Audit noticed mistakes in 12 cases involving tax effect of Rs. 164.41 crore while allowing depreciation on valuation of investments made by banks. In the case of **M/s Vijaya Bank,** incorrect depreciation allowed without considering the appreciation of investments resulted in short levy of tax of Rs. 117.08 crore.

(Paragraphs 1.14.2 and 1.14.3)

Compliance issues

Incorrect allowance of expenses towards exempt income in 20 cases involved tax effect of Rs. 164.97 crore. In the case of **M/s Canara Bank**, proportionate expenditure on exempt income was allowed incorrectly resulting in short levy of tax of Rs. 83.04 crore.

(Paragraphs 1.15.3 and 1.15.4)

Incorrect allowance of set off of losses in respect of **M/s Oriental Bank of Commerce** resulted in potential tax effect of Rs. 69.08 crore.

(Paragraph 1.18.4)

Incorrect computation of tax on capital gains made by **M/s ICICI Bank Ltd.** resulted in short levy of tax of Rs. 51.97 crore.

(Paragraph 1.19.2)

In the case of **M/s Standard Chartered Grindlays Bank**, tax was calculated on the returned income instead of assessed income resulting in short levy of tax of Rs. 63.86 crore.

(Paragraph 1.25.5)

Audit recommends that

- The Ministry may strengthen its internal controls such as ensuring regular review of assessments of banks at an appropriate level, that all such cases are checked by internal audit etc.
- The Ministry may prescribe a checklist for the assessing officers requiring them to check that the bad debts to be written off have been debited to the provision for bad and doubtful debt account and that the credit balance of provision for bad and doubtful debt account of earlier years have been considered before allowing the same.
- The Ministry may also consider devising a system where the assessing officer can take cognizance of the credit balance available in the provision for bad and doubtful debt account pertaining to earlier years in respect of banks.
- The Ministry may strengthen its internal controls so that deductions to rural branches of banks are allowed only after suitable verification by the assessing officer so as to safeguard the interests of revenue.
- The Ministry may consider introducing a suitable provision in the statute relating to valuation of investments by banks.

Review on Assessments of Banks

1.1 Introduction

Banks play a very important role in the functioning of the organised financial sector of the economy. The banking system can be broadly classified into the organised and the unorganised banking systems. The unorganized banking system comprises moneylenders, indigenous bankers, landlords, traders, etc. The organized banking system comprises scheduled banks and non-scheduled banks that are permitted by Reserve Bank of India (RBI) to undertake banking business. Scheduled banks are those banks that are included in the Second Schedule of the RBI Act, 1934, subject to certain conditions. A scheduled bank can be a public sector bank, a private bank or a foreign bank. The main sources of revenue for banks are interest from loans and advances, income from government securities and dividend, interest from private sector equity investment and debt instruments, income from trading in shares, guarantee commission, treasury and foreign exchange operations, etc. This review of the income tax assessments of banks under Income Tax Act, 1961 (the Act) has been conducted in view of the growing importance of the banking sector.

1.2 Objective of the review

The review seeks to:

1.2.1 Evaluate the degree of compliance by the public sector banks, private banks and foreign banks, with the law and procedural requirements of the Income Tax Act, 1961.

1.2.2 Quantify the extent of irregularities, mistakes and omissions in the assessment of banks made under various provisions of the Act.

1.2.3 Examine whether there is any lacuna in the Act and its application leading to evasion of tax liabilities.

1.3 Law and procedure

Banking operations are governed by the regulations/guidelines issued by the RBI from time to time. Further, deductions and exemptions available under the Income Tax Act to a company, such as depreciation, carry forward of loss, capital gains, interest income under certain circumstances, etc are applicable to banks as well. However, some of the provisions contained in sections 36(1), 41, 43D, 44C, etc. of the Act have special reference to the admissibility of deductions and exemptions relating to banking companies. These are briefly mentioned below:

1.3.1 Deduction towards bad debts under section 36(1)(vii)

Deduction relating to any bad debt or part thereof written off shall be limited to the amount by which such debt or part thereof exceeds the credit balance in the provision for bad and doubtful debts account made under that clause.

1.3.2 Deduction towards provision for bad and doubtful debts under section 36(1)(viia)

In respect of any provisions for bad and doubtful debts made by a bank, an amount not exceeding 5 percent up to 31 March 2003 and thereafter 7.5 percent of the total income (computed before making any deduction under this clause and Chapter VIA of the Act) and an amount not exceeding 10 percent of the aggregate average advances made by rural branches of such banks computed in the manner prescribed under the Income Tax Rules, 1962, shall be allowed as deduction, while computing the business income of the assessee.

1.3.3 Recovery of bad debts written off taxable under section 41(4)

Section 41(4) of the Act provides that where a deduction has been allowed under section 36(1)(vii) and if the amount subsequently recovered on any such debt or part thereof is greater than the difference between the debt or part of the debt and the amount so allowed, the excess shall be deemed to be the profits and gains of business or profession and is accordingly chargeable to income tax as income of the previous year in which it is recovered.

1.3.4 Interest accrued on bad and doubtful debts under section 43D

In the case of a scheduled bank, income by way of interest on such categories of bad and doubtful debts as may be prescribed (Rule 6EA of Income Tax Rules) 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 to the profit and loss account by the said institution for that year or in the previous year in which it is actually received by them, whichever is earlier.

1.3.5 Head office expenses in the case of foreign banks under section 44C

In the case of an assessee being a non resident, no allowance shall be made in computing the income chargeable under the head “Profits and gains of business or profession”, in respect of so much of the expenditure in the nature of head office expenditure as is in excess of the amount computed as under namely:

(a) an amount equal to 5 percent of adjusted total income[1]; or

[1] For definition refer Appendix 1.

(b) the amount of so much of the expenditure in the nature of head office expenditure incurred by the assessee, as is attributable to the business or profession of the assessee in India, whichever is the least,

provided that in a case where the adjusted total income of the assessee is a loss, the amount under clause (a) shall be computed at the rate of 5 percent of the average adjusted total income[1] of the assessee.

1.4 Scope of the review

1.4.1 The review covered all scrutiny assessments of the public sector banks, private banks and foreign banks for the assessment years 2002-03, 2003-04, 2004-05 and 2005-06 completed up to March 2007. Returns for the assessment year 2005-06, where scrutiny assessment was pending, were not included in the review. Returns for assessment years 2002-03 and 2003-04 processed in summary manner and not selected for scrutiny were also included in the scope of the review. Wherever cases of irregularities were noticed, the assessment records of the preceding years have also been examined, to the extent made available. Co-operative banks were excluded from the scope of the review.

1.5 Audit methodology and sample size

1.5.1 A list of banks was prepared from different sources such as Capitaline Plus, a private database available in the market, Reserve Bank of India, Income tax Department, Registrar of Companies etc. The assessment wards/circles where these banks were assessed were identified on the basis of records available with audit as well as with the Income tax Department. The assessment records were then requisitioned and audit checks carried out.

1.5.2 Audit requisitioned all assessments relating to 89 banks so identified pertaining to the assessment years 2002-03 to 2005-06. Two hundred ninety eight scrutiny assessments and 11 summary assessments were produced and subjected to audit scrutiny.

1.5.3 Copies of the draft review reports containing audit observations were issued to the respective Chief Commissioners of Income Tax/Commissioners of Income Tax by the Director General/Pr. Directors of Audit/Pr. Accountants General/ Accountants General during the period from June 2007 to July 2007.

1.6 Acknowledgement

1.6.1 Indian Audit and Accounts Department acknowledges the cooperation of the Income tax Department in providing the necessary records and information for audit. The draft review report was issued to the Ministry in November 2007. An exit conference was held in December 2007 with the Central Board of Direct Taxes (Board) to discuss the results of this review. The views expressed by them in the exit conference have been appropriately incorporated in this report.

1.7 Audit findings

1.7.1 Audit noticed 318 mistakes in 165 scrutiny assessments involving tax effect of Rs. 2,781.38 crore. Seventeen of these assessments had been seen by the internal audit wing of the Department but the mistakes were not noticed by them. Audit also observed cases with potential impact on levy of tax such as non correlation of figures of bad and doubtful debts, deductions towards advances given by rural branches etc.

Table no. 1.1: Tax effect of audit observations on assessments of banks

Category	No. of cases checked in audit	Taxable income assessed by the Department (Rs. crore)	Tax payable[2] (Rs. crore)	No. of assessments with mistakes	Tax effect (Rs. crore)	Tax effect as percentage of tax payable	Percentage of assessments with mistakes
1	2	3	4	5	6	7	8
Public Sector Banks	104	63988.62	22396.00	58	2216.99	9.9	55.8
Private Banks	94	13171.17	4609.91	57	317.61	6.9	60.6
Foreign Banks	111	11339.24	3968.73	50	246.78	6.2	45.0
Total	**309**	**88499.03**	**30974.64**	**165**	**2781.38**	**9.0**	**53.4**

1.7.2 It may be seen from Table no. 1.1 above that the proportion of cases with mistakes in scrutiny assessments of banks and the quantum of revenue involved are thus very high. In fact, the total tax effect of audit observations in respect of all banks was nine percent of the tax payable in respect of all assessments of banks seen in audit.

1.7.3 *Audit recommends that the Ministry may strengthen its internal controls such as ensuring regular review of assessments of banks at an appropriate level, that all such cases are checked by internal audit etc.*

1.7.4 In the exit conference, Board accepted the recommendation and stated that administrative review of assessments of banks at the level of Commissioners of Income tax is provided for and that internal audit will check all cases of banks in the new system.

1.7.5 The Department's replies have been received in 90 cases (November 2007) with tax effect of Rs. 1,772.15 crore, accepting audit observations in 39 cases with tax effect of Rs. 395.90 crore. The Department did not accept audit observations in 27 cases involving tax effect of Rs. 138.85 crore. However, it took remedial action in respect of 24 cases and raised demands totalling Rs. 1,084.46 crore. Out of this,

[2] Tax payable has been calculated at the rate of 35 percent of amount in column 3.

Rs. 1,058.70 crore has also been collected. Replies are still awaited in 228 cases (November 2007). The Department's replies have been incorporated in this report at appropriate places.

1.7.6 The audit observations included in this report catagorised by the nature of mistake are depicted in Table no. 1.2 below**:**

(Rs. in crore)

Table no. 1.2: Mistakes noticed in assessments of banks

Paragraph no.	Nature of mistake	Public Sector Banks		Private Banks		Foreign Banks		Total no. and tax effect	
		No.	Tax effect	No	Tax effect	No	Tax effect	No	Tax effect
Systems issues									
1.9	Incorrect allowance of bad debts written off	6	1499.82	10	102.96	8	44.44	24	1647.22
1.10	Incorrect allowance of provision for bad and doubtful debts	5	50.33	6	19.41	3	2.82	14	72.56
1.12	Non correlation of bad debts figures in income tax returns of banks with returns furnished to RBI	18	0	15	0	34	0	67	0
1.13	Deduction towards advances given by rural branches of bank	3	3.59	1	0	0	0	4	3.59
1.14	Incorrect allowance of depreciation on valuation of investments made by banks	3	122.29	8	39.52	1	2.60	12	164.41
Compliance issues									
1.15	Incorrect allowance of expense towards exempt income	10	140.21	10	24.76	0	0	20	164.97
1.16	Incorrect allowance of deductions	12	85.53	8	8.24	0	0	20	93.77
1.17	Income not offered to tax	9	76.65	6	2.40	0	0	15	79.05
1.18	Incorrect allowance of depreciation and set off of losses	5	78. 67	8	2.48	0	0	13	81.15
1.19	Incorrect computation of tax on capital gains	0	0	1	51.97	0	0	1	51.97
1.20	Incorrect allowance of provisions, capital expenditure & liabilities	8	36.29	10	13.46	1	1.89	19	51.64
1.21	Incorrect allowance of expenditure on investments	2	0.44	4	5.86	2	40.73	8	47.03
1.22	Incorrect deduction of income from securities	2	35.52	1	2.29	1	0.44	4	38.25
1.23	Incorrect computation of income under special provisions	6	13.54	0	0	6	24.0	12	37.54

Paragraph no.	Nature of mistake	Public Sector Banks		Private Banks		Foreign Banks		Total no. and tax effect	
		No.	Tax effect	No	Tax effect	No	Tax effect	No	Tax effect
1.24	Incorrect allowance of deduction towards head office expenses/ interest relating to foreign banks	0	0	0	0	6	27.46	6	27.46
1.25	Incorrect computation of income and other mistakes	31	74.11	29	44.26	14	102.40	74	220.77
1.26 & 1.27	Non adoption of Arm's Length Price and Non recognition of income	2	0	2	0	1	0	5	0
	Total	**122**	**2216.99**	**119**	**317.61**	**77**	**246.78**	**318**	**2781.38**

1.7.7 These audit observations are discussed in the subsequent paragraphs. Audit observations with tax effect of Rs. 50 crore and above have been discussed individually in the paragraphs, whereas those with tax effect of between Rs. 50 crore and Rs. 5 crore have been shown in the tables in the body of the review. Audit observations with tax effect of between Rs. 5 crore and Rs. 50 lakh have been shown at **Appendix 2.** The tax effect of other audit observations with money value less than Rs. 50 lakh has been included in the review, although these audit observations have not been individually highlighted. Some interesting cases without money value or with lower money value have also been discussed individually in the review report.

Systems issues

1.8 Bad debts written off and provision for bad and doubtful debts

1.8.1 Deductions allowed to banks under section 36(1)(vii) and 36(1)(vii)(a) are the most significant deductions available under the Act and aggregate deductions allowed under these provisions in the assessments of banks seen in audit were Rs. 18,163 crore and Rs. 21,809 crore respectively. Audit attempted to analyse the extent to which these deductions had been correctly allowed by assessing officers while completing the assessments of banks. Audit noticed mistakes in 46 assessments of banks involving tax effect of Rs. 1,719.78 crore which are discussed at paragraph **1.9 'Incorrect allowance of bad debts written off** and **1.10 'Incorrect allowance of provision for bad and doubtful debts'** below. Audit also observed areas with high potential revenue impact on account of systemic issues such as differences in figures of bad and doubtful debts and non verification of advances given by rural branches, which are discussed at paragraph **1.12 'Non correlation of bad debts figures in income tax returns of banks with returns furnished to RBI'** and paragraph **1.13 'Deduction towards advances given by rural branches of bank'**.

1.9 Incorrect allowance of bad debts written off

1.9.1 Section 36(1)(vii) of the Act provides that deduction on account of bad debts which are written off as irrecoverable in the accounts of the assessee can be allowed only if the assessee had debited the amount of such bad debts to the provision for bad and doubtful debt account as per the provisions of section 36(2)(v). Further, as per section 36(1)(viia), the deduction on account of bad debts shall be limited to the amount by which such debt exceeds the credit balance in the provision for bad and doubtful debts account.

1.9.2 Section 36(2)(i) also provides that no deduction shall be allowed unless such debt has been taken into account in computing the income of the previous year in which such bad debt is written off or of an earlier previous year or represents money lent in the ordinary course of business or money lending which is carried on by the assessee.

1.9.3 Audit noticed that the above provisions were not complied with while allowing deduction towards bad debts written off in 24 cases involving a tax effect of Rs. 1,647.22 crore. Four such cases are illustrated below:

1.9.4 In Maharashtra, Mumbai City 2 charge, assessments of a public sector bank, **M/s State Bank of India,** for the assessment years 2003-04 and 2004-05 were completed after scrutiny in November 2005 and March 2006 after allowing deduction of Rs. 2,309.88 crore and Rs. 2,450.87 crore for bad debts written off and deduction of Rs. 1,368.78 crore and Rs. 2,509.82 crore towards provision for bad and doubtful debts respectively. Audit scrutiny revealed that the provision for bad and doubtful debts account against which the deductions for bad debts were written off and allowed contained brought forward credit balances only and did not include the current year's provisions of Rs. 1,368.78 crore and Rs. 2,509.82 crore. Allowable deductions for bad debts written off after adding the current year's provision for bad and doubtful debts worked out to Rs. 941.10 crore and Rs. 1,276.89 crore for these two assessment years respectively. Thus, there was excess allowance of bad debts written off of Rs. 1,368.78 crore and Rs. 1,173.97 crore for the two assessment years respectively involving aggregated short levy of tax of Rs. 1,058.70 crore.

1.9.4.1 The Department did not accept the audit observation and stated that the provision allowed in the current year was meant for setting off future bad debts, and therefore could not be set off against the current year's bad debts. Department's reply is not acceptable since the provisions of clause (vii) to section 36(1) and clause (v) to section 36(2) clearly provides that only excess of bad debts over and above the provision for bad and doubtful debts account created for the purpose under clause (viia) to section 36(1) is allowable. Subsequent verification of records, however, revealed that the Department had revised the assessment under section 263 in March 2007 by disallowing excess bad debts and also recovered the entire demand of Rs. 1,058.70 crore. Further, the Department had taken the same stand as that of audit, while passing the order under section 263.

1.9.5 In Maharashtra, Mumbai City 2 charge, assessment of a public sector bank, **M/s Bank of India**, for the assessment year 2004-05 was completed after scrutiny in December 2005 allowing deduction of Rs. 132.94 crore towards bad debts written off after reducing Rs. 375.96 crore towards provision for bad and doubtful debts. Audit scrutiny revealed that no bad debts had been allowed in the assessment years 2002-03 and 2003-04 as these were only technical write offs made in the head office. However, the provision for bad and doubtful debts was allowed to the extent of Rs. 269.03 and Rs. 348.80 crore for the assessment years 2002-03 and 2003-04 respectively. Thus, at the end of assessment year 2003-04, credit balance of Rs. 617.83 crore was available in the provision for bad and doubtful debt account. While allowing bad debts of Rs. 508.90 crore for assessment 2004-05, the opening balance available in the provision for bad and doubtful debts account of Rs. 617.83 crore was not considered. This resulted in underassessment of income of Rs. 132.94 crore involving short levy of tax of Rs. 47.69 crore besides not carrying forward a credit balance of Rs. 484.89 crore (Rs. 617.83 crore –Rs. 132.94 crore) in the provision for bad and doubtful accounts involving potential tax effect of Rs. 173.95 crore.

1.9.5.1 The Department accepted (April 2007) the audit observation.

1.9.6 In Maharashtra, Mumbai City 2 charge, the assessment of a public sector bank, **M/s Bank of Baroda,** for the assessment year 2003-04 was completed after scrutiny in March 2005 by allowing a deduction of Rs. 534.68 crore for bad debts. Audit noticed that at the end of the assessment year 2002-03, credit balance of Rs. 333.67 crore was available in the provision for bad and doubtful debt account. While allowing bad debts of Rs. 534.68 crore for assessment year 2003-04, the opening balance of Rs. 333.67 crore available in the provision for bad and doubtful debt account was not considered. This resulted in underassessment of income of Rs. 333.67 crore involving potential short levy of tax of Rs. 122.62 crore.

1.9.6.1 The Department accepted (April 2007) the audit observation.

1.9.7 In West Bengal, Kolkata II charge, assessment of a public sector bank, **M/s Allahabad Bank,** for the assessment year 2003-04 was originally completed after scrutiny in March 2006 and revised in April 2006 determining a total income of Rs. 157.14 crore. Audit scrutiny revealed that the assessee had claimed Rs. 219.09 crore (Rs. 176.28 crore debited in the profit and loss account towards bad debt written off and Rs. 42.81 crore from the 'movement of provisions for NPA' as shown in the balance sheet) as deduction towards bad debt written off. The assessing officer had disallowed Rs. 42.81 crore on the ground that it did not exceed the credit balance in the provision for bad and doubtful debt account of Rs. 943.34 crore. However, bad debts of Rs. 176.28 crore also did not exceed the amount of credit balance in the provision for bad and doubtful debt account but these were not disallowed. Omission to add back Rs. 176.28 crore resulted in under assessment of income of Rs. 176.28 crore involving tax effect of Rs. 64.78 crore.

1.9.8 Five cases are shown in Table no. 1.3 below:

(Rs. in crore)

Table no. 1.3: Incorrect allowance of bad debts written off

Sl. no.	Assessee and CIT charge	Assessment year and type of assessment	Nature of mistake	Tax effect
Public Sector Banks				
1.	M/s United Bank of India, Kolkata II	2002-03 143(3)	Deductions of Rs. 130.53 crore on account of bad debts written off and Rs. 51.11 crore on account of provision for bad and doubtful debt were allowed. Deduction of bad debts should have been limited to the amount by which it exceeded the provision for bad and doubtful debt which was not done. This has resulted in excess deduction of bad debts written off to the extent of. Rs. 79.42 crore. The Department has taken remedial action under section 263 of the Act in March 2007.	18.25
2.	M/s State Bank of Saurashtra, Bhavnagar, Ahmedabad-VI	2002-03 143(3)/250	While giving effect to an appellate order, deduction of Rs. 98.53 crore on account of bad debts written off was allowed without taking into account the credit balance of Rs. 39.40 crore in the provision for bad and doubtful debts account, which resulted in excess allowance of deduction of Rs. 39.40 crore.	13.83
Private Banks				
3.	M/s ICICI Bank, Mumbai-City 3	2004-05 143(3)	While allowing bad debts written off of Rs. 492.25 crore, credit balance of Rs. 129.13 crore available in the provision for bad and doubtful debts account was not reduced.	46.32
Foreign Banks				
4.	M/s Standard Chartered Bank, Mumbai DIT(IT)	2003-04 143(3)	While allowing bad debts of Rs. 264.75 crore, credit balance of Rs. 44.21 crore available in the provision for bad and doubtful debts account was not reduced. The Department accepted (May 2006) the audit observation.	18.57
5.	M/s Citi Bank, Mumbai DIT(IT)	2004-05 143(3)	While allowing bad debts of Rs. 31.25 crore, credit balance of Rs. 59.99 crore available in the provision for doubtful debts account was not considered	17.04

1.9.9 Ten cases are featured at **serial numbers 1 to 10** of **Appendix 2.**

1.9.10 Incorrect allowance of technical write off of bad debts

1.9.10.1 Under section 36(1)(viia) of the Act, the bank shall, at its option, be allowed deduction in respect of any provision made by it for any assets classified by RBI as doubtful assets or loss assets in accordance with the guidelines issued by it in this behalf, for an amount not exceeding 5 percent of the amount of such assets shown in the books of account on the last day of the previous year. As per the RBI Circular dated 1 July 2005, banks may write-off advances at Head Office level (technical write off), even though the relative advances were still outstanding in the

books of branches of the banks. No deduction towards bad debts is, however, allowable in the Income Tax Act unless such debts are written off as irrecoverable in the books of accounts of the assessee. There is no provision in the Act to allow technical write off of bad debts.

1.9.10.2 Audit noticed that the above provisions were not complied with in one case where deduction in respect of technical write off of bad debts was allowed as shown in Table no. 1.4 below:

(Rs. in crore)

Table no. 1.4: Incorrect allowance of technical write off of bad debts

Assessee and CIT charge	Assessment year and type of assessment	Nature of mistake	Tax effect
M/s Bank of Rajasthan Ltd, Mumbai City 3	2003-04 2004-05 143(3)	Incorrect allowance of technical write off of bad debts resulted in under assessment of income of Rs. 75.89 crore and Rs. 43.12 crore for the assessment years 2003-04 and 2004-05 respectively.	43.36

1.10 Incorrect allowance of provision for bad and doubtful debts

1.10.1 Section 36(1)(viia)(a) of the Act provides that deduction on account of provision for bad and doubtful debts is allowable for an amount not exceeding 7.5 percent of the total income (computed before making any deduction under this clause and Chapter VIA of the Act). Provided that the bank shall, at its option, be allowed deduction in respect of any provision made by it for any assets classified by RBI as doubtful assets or loss assets in accordance with the guidelines issued by it in this behalf, for an amount not exceeding 5 percent of the amount of such assets shown in the books of account on the last day of the previous year.

1.10.2 In the case of foreign banks, deduction allowable under this clause is five percent of the total income computed before making any deduction under this clause and chapter VIA.

1.10.3 Audit noticed that the above provisions were not complied with while allowing deduction towards provision for bad and doubtful debts in 14 cases involving tax effect of Rs. 72.56 crore.

1.10.4 Three cases are shown in Table no. 1.5 below:

(Rs. in crore)

Table no. 1.5: Incorrect allowance of provision for bad and doubtful debts

Sl. no.	Assessee and CIT charge	Assessment year and type of assessment	Nature of mistake	Tax effect
Public Sector Bank				
1.	Indian Overseas Bank, Chennai- I	2001-02 to 2003-04 143(3)	Total income for deduction on account of provision for bad and doubtful debts was computed before set off of brought forward losses. This has resulted in under assessment of income of Rs. 78.39 crore.	28.80
2.	M/s Indian Overseas Bank, Chennai I	2004-05 143(3)	Deduction of Rs. 252.26 crore on account of provision for bad and doubtful debts was allowed which included the floating provisions of Rs. 58.10 crore towards unidentified doubtful assets. Deduction for unidentified doubtful assets was not allowable.	20.84
Private Bank				
3.	M/s ING-Vysya Bank Ltd, Bangalore- I	2004-05 143(3)	Deduction of Rs. 25.89 crore towards provision for bad and doubtful debts was allowed though the assessee had provided an amount of Rs. 10 lakh towards bad and doubtful debts only. The omission to restrict the deduction to the extent of provision created resulted in underassessment of income of Rs. 25.79 crore.	12.31

1.10.5 Four cases are featured at **serial numbers 11** to **14** of **Appendix 2.**

1.11. Thus, audit observed the maximum number of mistakes with highest revenue impact under the provisions relating to bad debts written off and provision for bad and doubtful debts. The most common mistake committed by assessing officer was that either the bad debts written off were not debited to the provision for bad and doubtful debt account of the assessee or the credit balance of provision for bad and doubtful debt account of earlier years was not considered while allowing the bad debts written off.

1.11.1 *Audit recommends that the Ministry may prescribe a checklist for the assessing officers requiring them to check that the bad debts to be written off have been debited to the provision for bad and doubtful debt account and that the credit balance of provision for bad and doubtful debt account of earlier years have been considered before allowing the same.*

1.11.2 In the exit conference, Board accepted the recommendation and stated that the concern of the checklist will be taken care of while preparing the Manual of Internal Audit.

1.11.3 *Audit recommends that the Ministry may also consider devising a system where the assessing officer can take cognizance of the credit balance available in the provision for bad and doubtful debt account pertaining to earlier years in respect of banks.*

1.11.4 In the exit conference, Board agreed to examine the issue.

1.12 Non correlation of bad debt figures in the income tax returns of banks with the returns furnished to RBI

1.12.1 The operations of the banking sector are regulated by the Reserve Bank of India under the powers given to it under the RBI Act, 1934. As per the RBI Circular dated 1 July 2005, banks are required to furnish a report on non performing assets (NPA) as on 31st March each year after the completion of audit. In this report the banks are required to show all the details about the NPAs including the amount of bad debts written off.

1.12.2 In order to verify the correctness of deductions in respect of bad debts written off and allowed in the assessment orders for the assessment years 2003-04 and 2004-05, audit called for the details of bad debts written off from RBI shown by the banks in their NPA returns. In March 2007, RBI furnished the details of NPAs written off by the banks as on March 2003 and March 2004. Audit correlated the above figures of bad debts written off in NPA returns with the corresponding figures of bad debts written off allowed in the income tax assessment orders in respect of 39 banks involving 67 assessments.

1.12.3 Audit noticed that in 64 assessments, figures of bad debts allowed in the income tax assessment orders were different from those shown by the banks in their NPA returns furnished to RBI. In 21 assessments, deductions allowed in respect of bad debts written off in the income tax assessment orders exceeded the corresponding figures furnished by the banks to RBI in their NPA returns by Rs. 1,469.74 crore. In 43 assessments, deductions allowed in respect of bad debts written off in the income tax assessment orders were lower than the corresponding figures furnished by the banks to RBI in their NPA returns by Rs. 5,157.09 crore.

1.12.4 Thus, there appears to be a wide variation in the figures of bad debts written off as furnished in NPA returns to RBI and the deductions allowed in the assessment orders.

1.12.5 *In view of the quantum of revenue involved in the deductions for bad and doubtful debts written off, audit recommends that the Ministry may examine the issue of the wide variations in the figures reported in NPA returns to RBI and the income tax returns.*

1.12.6 In the exit conference, Board stated that the issue would be examined.

1.13 Deduction towards advances given by rural branches of bank

1.13.1 Section 36(1)(viia)(a) of the Act provides that deduction in respect of provision for bad and doubtful debts not exceeding ten percent of the aggregate average advances made by the rural branches of such bank computed in the prescribed manner shall be allowed. Rural branches have been defined as the branch of the bank situated in a place which has a population of not more than ten thousand according to the last preceding census of which the relevant figures have been published before the first day of the previous year.

1.13.2 The method for computing aggregate average advances is prescribed under Rule 6ABA of the Income Tax Rules, 1962 according to which the amounts of advances made by each rural branch as outstanding at the end of the last day of each month in the previous year shall be aggregated separately and the sum so arrived at in the case of each such branch shall be divided by the number of months. The aggregate of the sums so arrived at in respect of each of the rural branches shall be the aggregate average advances made.

1.13.3 Audit observed that deductions towards advances given by rural branches of the following banks were allowed without correlating with the population figures, aggregate average advances and monthly outstanding advances as discussed in Table no. 1.6 below:

(Rs. in crore)

Table no. 1.6: Deduction towards advances given by rural branches of bank

Sl. no.	Assessee and CIT charge	Assessment year and type of assessment	Nature of mistake	Amount of deduction for rural advances claimed
1	M/s Indian Overseas Bank, Chennai I	2001-02 to 2004-05 143 (3)	Details regarding population of places where rural branches were located, aggregate average advances and monthly outstanding advances were not available.	583.82
2	M/s Indian Bank, Chennai I	2002-03 2004-05 143 (3)	Details regarding population of places where rural branches were located, aggregate average advances and monthly outstanding advances were not available.	217.92
3	M/s Tamil Nad Mercantile Bank Ltd, Madurai I	2001-02 to 2004-05 143 (3)	Details regarding population of places where rural branches were located, aggregate average advances and monthly outstanding advances were not available.	50.88
			Total	**852.62**

1.13.4 One case is shown at **serial number 15 of Appendix 2**.

1.13.5 In the absence of details regarding population of places where rural branches were located, aggregate average advances and monthly outstanding

advances, the correctness of the deductions allowed could not be ascertained in audit.

1.13.6 *Audit recommends that the Ministry may strengthen its internal controls so that such deductions are allowed only after suitable verification by the assessing officer so as to safeguard the interests of revenue.*

1.13.7 In the exit conference, Board stated that the issue would be examined.

1.14 Incorrect allowance of depreciation on valuation of investments made by banks

1.14.1 As per the RBI guidelines dated 16 October 2000, the entire investment portfolio of the banks is required to be classified under three categories viz. Held to Maturity (HTM), Held for Trading (HFT) and Available for Sale (AFS). Investments classified under HTM category need not be marked to market and are carried at acquisition cost unless these are more than the face value, in which case the premium should be amortised over the period remaining to maturity. In the case of AFS and HFT categories, the depreciation/appreciation is to be aggregated scrip wise and only net depreciation, if any, is required to be provided for in the accounts.

1.14.2 Audit noticed non-compliance of the above RBI guidelines in 12 cases involving tax effect of Rs. 164.41 crore while allowing depreciation on investments/computation of income on investments made by banks. One such case is illustrated below:

1.14.3 In Karnataka, Bangalore Large Taxpayer Unit charge, the assessments of a public sector bank, **M/s Vijaya Bank,** for the assessment years 2003-04, 2004-05 and 2005-06 were completed after scrutiny in March 2006 and August 2006 after allowing depreciation on investments under AFS and HFT category at Rs. 97.38 crore, Rs. 39.49 crore and Rs. 424.82 crore respectively. The assessment for the assessment year 2003-04 was revised after giving effect to CIT (Appeals) order in March 2007 for an income of Rs. 121.07 crore. Audit scrutiny revealed that the assessee bank has provided for only gross depreciation instead of net depreciation in the accounts in violation of the RBI guidelines, ignoring the appreciation of investments under this category. The omission to consider appreciation of investments while allowing depreciation has resulted in under assessment of income of Rs. 97.38 crore, Rs. 39.49 crore and Rs. 172.32 crore respectively for the assessment years 2003-04, 2004-05, and 2005-06 involving short levy of tax and interest aggregating Rs. 117.08 crore for these assessment years.

1.14.4 Two cases are discussed in Table no. 1.7 below:

(Rs. in crore)

Table no. 1.7: Incorrect allowance of depreciation on valuation of investments made by banks

Sl. no.	Assessee and CIT Charge	Assessment year and type of assessment	Nature of mistake	Tax effect
Private Banks				
1.	M/s J&K Bank Ltd., Jammu	2002-03 2003-04 143(3)	In the assessment year 2003-04, the assessee has ignored the appreciation of Rs. 20.77 crore on investments held for trading and claimed depreciation of Rs. 15.86 crore which was allowed. Since appreciation exceeded the depreciation figure, depreciation of Rs. 15.86 crore was not allowable as per RBI guidelines.	8.88
2.	M/s Bank of Rajasthan Ltd, City Central 3, Mumbai	2003-04 to 2005-06 143(3)	In the assessment years 2003-04 and 2004-05, while allowing depreciation in value of investments of Rs. 5.56 crore and Rs. 11.81 crore, appreciation of Rs. 12.56 crore and Rs. 9.63 crore respectively were ignored. In the assessment year 2005-06 depreciation in value of investments of Rs. 63.93 crore was allowed which included an amount of Rs. 6.77 crore being amortisation made on securities held under the HTM category. However, the net depreciation in the value of investments allowable worked out to only Rs. 29.98 core after adjusting appreciation of Rs. 15.64 crore and amortisation made on securities held under the HTM category of Rs. 6.77 crore.	23.76

1.14.5 Six cases are shown at **serial numbers 16 to 21** of **Appendix 2**.

1.14.6 Audit noticed that although the assessing officers consider the RBI guidelines relating to valuation of investments by banks at the time of processing the income tax assessment, there is no provision in the Income Tax Act or the Rules to this effect.

1.14.7 *Audit recommends that the Ministry may consider introducing a suitable provision in the statute relating to valuation of investments by banks.*

1.14.8 In the exit conference, Board agreed to examine the issue.

Compliance issues

1.15 Incorrect allowance of expense towards exempt income

1.15.1 Section 14A of the Act provides that for the purpose of computing total income under the Act, no deduction shall be allowed in respect of expenditure incurred by the assessee in relation to income, which does not form part of the total income.

1.15.2 Further, section 10(23G) of the Act provides that any income by way of dividend or interest from investments made by way of shares or long-term finance advanced to any enterprise or undertaking wholly engaged in the infrastructure business shall not be included in taxable income. Section 10(15) and 10(33) of the Act provides that income by way of interest, premium on redemption or other payment on such securities issued by Central Government or any income arising from transfer of capital assets being a unit of the Units Scheme 1964 shall not be included in the total income. Section 80M of the Act provides that where the gross total income of a domestic company in any previous year includes any income by way of dividend from another domestic company, there shall be allowed in computing the total income of such domestic company, a deduction of an amount of dividend from another domestic company.

1.15.3 Audit noticed that the above provisions were not complied with while allowing deduction on account of exempt income in 20 cases involving tax effect of Rs. 164.97 crore. One case is illustrated below:

1.15.4 In Karnataka, Bangalore Large Tax Payers Unit charge, assessments of a public sector bank, **M/s Canara Bank,** for the assessment years 2002-03 and 2004-05 were completed after scrutiny in February 2005 and March 2006 determining incomes of Rs. 1,144.89 crore and Rs. 1,675.53 crore respectively. These were revised to Rs. 946.05 crore and Rs. 1,159.12 crore while giving effect to CIT (Appeal) orders in April 2006 and November 2006 after allowing Rs. 108.91 crore and Rs. 163.47 crore on account of income exempt under section 10(23G) for the two assessment years respectively. Audit scrutiny revealed that the assessee bank earned exempt interest income through long term finance advanced to infrastructure enterprise/companies and expenditure to earn such income should have been disallowed. The omission to disallow proportionate expenditure on the interest earned on long term finance advanced to infrastructure enterprise/companies resulted in under assessment of income by Rs. 95.84 crore and Rs. 136.12 crore for the assessment years 2002-03 and 2004-05 respectively with aggregate short levy of tax of Rs. 83.04 crore.

1.15.5 Four cases are shown in Table no. 1.8 below:

(Rs. in crore)

Table no. 1.8: Incorrect allowance of expense towards exempt income

Sl. no.	Assessee and CIT charge	Assessment year and type of assessment	Nature of mistake	Tax effect
Public Sector Bank				
1.	M/s Vijaya Bank, Bangalore-I	2003-04 to 2005-06 143(3)	Proportionate expenditure on income earned on long term finance made to infrastructure enterprises was not disallowed which resulted in incorrect allowance of expense towards exempt income of Rs. 23.04 crore, Rs. 15.02 crore and Rs. 22.01 crore in the three assessment years respectively.	21.88

Sl. no.	Assessee and CIT charge	Assessment year and type of assessment	Nature of mistake	Tax effect
2.	M/s State Bank of Hyderabad, Hyderabad III	2002-03 2003-04 143(3)	Proportionate expenditure in respect of exempt income under section 10(23G) based on total exempt income to be disallowed works out to Rs. 24.35 crore and Rs. 15.76 crore against the amounts disallowed of Rs. 4.37 crore and Rs. 4.53 crore worked out by the Department on the basis of operating expenses which resulted in under assessment of income of Rs. 19.98 crore and Rs. 11.23 crore in these two assessment years respectively.	12.27
3.	M/s Syndicate Bank, Mangalore	2004-05 2005-06 143(3)	Proportionate expenditure not disallowed on income earned on long term finance made to infrastructure enterprises resulted in incorrect allowance of expense towards exempt income of Rs. 7.20 crore and Rs. 18.13 crore respectively.	9.76
Private Bank				
4.	M/s ING Vysya Bank Ltd., Bangalore-I	2003-04 2004-05 143(3)	Proportionate expenditure not disallowed on income earned on long term finance made to infrastructure enterprises resulted in incorrect allowance of expense towards exempt income of Rs. 19.47 crore and Rs. 13.16 crore respectively.	14.52

1.15.6 Eleven cases are shown at **serial numbers 22 to 32 of Appendix 2.**

1.16 Incorrect allowance of deductions

1.16.1 Section 43B(b) of the Act envisages that deduction towards contribution to any provident fund or superannuation fund or gratuity fund or any other fund for the welfare of employees is allowable in computing total income of the assessee only on actual payment basis.

1.16.2 Section 35DDA of the Act provides that where an assessee incurs any expenditure by way of payment of any sum to an employee at the time of his retirement in accordance with any scheme of voluntary retirement, one fifth of the amount so paid shall be deducted in computing the profit and gains of the business and the balance shall be deducted in equal instalments for each of the four immediately succeeding years.

1.16.3 Audit noticed that the above provisions of the Act were not complied with in 20 cases involving tax effect of Rs. 93.77 crore. Four such cases are shown in Table no. 1.9 below:

(Rs. in crore)

Table no. 1.9: Incorrect allowance of deductions

Sl. no.	Assessee and CIT charge	Assessment year and type of assessment	Nature of mistake	Tax effect
Public Sector Banks				
1.	M/s Andhra Bank, Hyderabad I	2001-02 & 2002-03 143(3)	Deduction of Rs. 59.28 crore paid through pension and gratuity fund in the assessment year 2001-02 and Rs. 20.53 crore towards pension fund in the assessment year 2002-03 covered under VRS was allowed in full instead of one fifth as required u/s section 35DDA of the Act. The Department has accepted (April 2007) the audit observation and taken remedial action.	29.06
2.	M/s Indian Overseas Bank, Chennai I	2001-02 2002-03 143(3)	Deduction of Rs. 87.26 crore towards gratuity and pension paid as a part of the benefits under VRS was allowed in full instead of one fifth as required u/s 35DDA of the Act.	23.44
3.	M/s Indian Bank, Chennai I	2001-02 143(3)	Deduction of Rs. 51.51 crore towards amount of gratuity, pension and leave encashment paid as a part of the benefits under VRS was allowed in full instead of one fifth as required u/s 35DDA of the Act.	16.29
4.	M/s State Bank of Hyderabad, Hyderabad III	2002-03 to 2004-05 143(3)	Deduction of Rs. 31.10 crore towards VRS was restricted to Rs. 26.14 crore under section 35DDA of the Act, based on actual expenditure incurred for assessment year 2001-02. However, in each of the assessment years 2002-03 to 2004-05, deduction of Rs. 31.10 crore was not restricted to Rs. 26.14 crore resulting in excess allowance of deduction of Rs. 4.96 crore in each of assessment years .	5.77

1.16.4 Twelve cases are shown at **serial numbers 33 to 44 of Appendix -2**

1.17 Income not offered to tax

1.17.1 Section 41(4) of the Act provides that where a deduction has been allowed under section 36(1)(vii) and if the amount subsequently recovered on any such debt or part thereof is greater than the difference between the debt or part of debt and the amount so allowed, the excess shall be deemed to be the profits and gains of business or profession and accordingly, chargeable to income tax as income of the previous year in which it is recovered.

1.17.2 Section 41(1) of the Act provides that where an allowance or deduction has been made in the assessment for any year in respect of loss/expenditure or trading liability incurred by the assessee and subsequently during any previous year, the amount was obtained by way of remission or cessation of liabilities thereof (in cash or any other manner), then the income realised should be treated as profits chargeable to tax.

1.17.3 Section 43D of Act, provides that income by way of interest on such categories of bad and doubtful debts as may be prescribed (Rule 6EA of Income Tax Rules, 1962) 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 to the profit and loss account by the said institution for that year or in the previous year in which it is actually received by them, whichever is earlier. As per RBI guidelines, any recovery is required to be first appropriated towards interest and then to the principal portion.

1.17.4 It has been judicially held[3] that where the assessee financial institution is following mercantile system of accounting, interest in respect of "sticky loans" debited to debtor and credited to suspense account is to be treated as the income of the assessee on accrual basis.

1.17.5 It has been judicially held[4] that if an amount was received in the course of trading transactions, even though it was not taxable in the year of receipt as being of revenue character, when the amount became assessee's own money because of limitation or by any other statutory or contractual right, the character of the amount would change. In such an event, the amount should be treated as income of the assessee.

1.17.6 Audit noticed that the above provisions were not complied with in 15 cases involving tax effect of Rs. 79.05 crore. Four cases are shown in Table no. 1.10 below:

(Rs. in crore)

Table no. 1.10: Income not offered to tax

Sl. no.	Assessee and CIT charge	Assessment year and type of assessment	Nature of mistake	Tax effect
Public Sector Bank				
1.	M/s Indian Overseas Bank, Chennai I	2001-02 143(3)	As the liability towards unclaimed balances of Rs. 37.20 crore and gulf war claims payable of Rs. 51.94 crore ceased to exist after a period of three years, it was required to be treated as income.	35.26
2.	M/s Indian Overseas Bank, Chennai I	2002-03 143(3)	A deduction of Rs. 80.48 crore towards short claim under Foreign Currency Non Resident account (FCNR) was allowed for the assessment year 2002-03. As seen from the records relevant to the assessment year 2004-05, the bank had admitted settlement of the claims under FCNR account by the Government to an extent of Rs. 36.97 crore. Consequent on the cessation of liability to the extent of Rs. 36.97 crore, this amount was required to be treated as profits under section 41(1) of the Act.	13.26

[3] Banaras State Bank vs Commissioner of Income Tax (210 ITR 129) SC
[4] M/s TV Sundaram Iyengar & Sons (222 ITR 344) SC

Sl. no.	Assessee and CIT charge	Assessment year and type of assessment	Nature of mistake	Tax effect
3.	M/s State Bank of Mysore, Bangalore III	2002-03 to 2004-05 143(3)	Recoveries of Rs. 10.44 crore, Rs. 9.10 crore and Rs. 12.63 crore received from bad debts written off in the earlier years were reduced from the net profit though the receipt from bad debts were required to be taxed under section 41(4) of the Act.	11.60
4.	M/s State Bank of Saurashtra, Ahmedabad VI	2004-05 143(3)	Interest of Rs. 13.99 crore on sticky advance was debited to the debtor's account as per mercantile system of accounting but the corresponding amount taken to suspense account was not treated as income. This is taxable based on apex court's judgment 210-ITR-129.	6.53

1.17.7 Seven cases are shown at **serial numbers 45 to 51 of Appendix 2.**

1.18 Incorrect allowance of depreciation and set off of losses

1.18.1 Section 32 of the Act provides that deduction on account of depreciation on block of 'plant and machinery' and other assets is admissible at the prescribed rates while computing the business income of the assessee, if these are owned by the assessee and used for the purpose of business during the relevant previous year.

1.18.2 Section 72 of the Act provides that where the net result of the computation under the head 'Profits and gains of the business or profession' is a loss to the assessee and such loss including depreciation cannot be wholly set off against income under any other head of the relevant year, so much of the loss as has not been set off shall be carried forward to the following assessment year/years to be set off against the 'Profits and gains of business or profession'.

1.18.3 Audit noticed that allowance of depreciation and set off of losses were allowed in excess in 13 cases involving tax effect of Rs. 81.15 crore. One case is illustrated below:

1.18.4 In Delhi V charge, the assessment of a public sector bank, **M/s Oriental Bank of Commerce,** for the assessment year 2005-06 was completed after scrutiny in March 2006 determining an income of Rs. 664.18 crore. Audit scrutiny revealed that the assessee claimed and was allowed set-off of losses of Rs. 228.52 crore of M/s. Global Trust Bank (amalgamated with M/s. Oriental Bank of Commerce) for the assessment year 2004-05. Further scrutiny of assessment records of M/s. Global Trust Bank for assessment year 2004-05 completed after scrutiny in November 2006 revealed that losses allowed to be carried forward were Rs. 35.95 crore only. The mistake resulted in underassessment of income of Rs. 192.57 crore involving potential tax effect of Rs. 69.08 crore.

1.18.4.1 The Department stated in September 2007 that remedial action has been taken.

1.18.5 One case is shown in Table no. 1.11 below**:**

Table no. 1.11: Incorrect allowance of depreciation and set off of losses			
Assessee and CIT charge	**Assessment year and type of assessment**	**Nature of mistake**	**Tax effect**
M/s Punjab National Bank, Delhi V	2003-04 143(3)	The assessee was allowed set off of losses of Rs. 18.90 crore pertaining to the assessment year 1996-97 against the assessment year 2003-04 completed after scrutiny in January 2006. Audit noticed that as per the assessment order of March 2001 pertaining to assessment year 1996-97, there was no loss which remained to be set off. The Department has taken remedial action (October 2007).	9.39

1.18.6 One case is shown at **serial number 52 of Appendix -2.**

1.19 Incorrect computation of tax on capital gains

1.19.1 As per section 112 of the Act, long term capital gain (LTCG) is taxable at the rate of twenty percent. However, as per proviso below sub section (1) to section 112, where tax payable in respect of any income arising from transfer of long term capital asset, being listed securities or unit, exceeds 10 percent of the amount of capital gains computed without taking indexation benefit, such excess shall be ignored for the purpose of computing tax payable by the assessee. In other words rate of 10 percent is applicable only if benefit of indexation is not availed.

1.19.2 In Maharashtra, Mumbai City 3 charge, assessment of a private bank, **M/s ICICI Bank Ltd.,** for the assessment year 2003-04 was completed after scrutiny in February 2006. LTCG was determined at Rs. 519.75 crore and was taxed at the rate of 10 percent. Audit scrutiny revealed that the assessee had taken the benefit of indexation while computing the long term capital loss on investments and it was reduced from LTCG computed on sale of ICICI bank shares for which indexation was not done as the acquisition cost was stated to be nil. Since assessee had taken indexation benefit while computing long term capital loss on investments, the tax rate applicable should have been 20 percent and not 10 percent as applied which resulted in short levy of tax of Rs. 51.97 crore.

1.19.3 In its reply in March 2007, the Department did not accept the audit observation stating that since the capital gain arose on the sale of ICICI bank shares for which the benefit of indexation was not availed, the rate of tax applicable was only ten percent. Reply of the Department is not tenable as the proviso below subsection (1) of section 112(1) clearly states that tax payable in respect of any income arising from transfer of long term capital asset, being listed securities or units is ten percent only if benefit of indexation is not availed of under second proviso to section 48. In other words, the rate of tax applicable is 20 percent if benefit of indexation is availed. In the instant case, assessee had availed of the

benefit of indexation while setting off the loss arising out of sale of investment and sale of leased assets against income from sale of ICICI bank shares. Hence, the rate of tax applicable is 20 percent as per the provisions of section 112.

1.20 Incorrect allowance of provisions, capital expenditure and liabilities

1.20.1 Section 37 of the Act envisages that a provision made in the accounts for an accrued or ascertained liability is an admissible deduction, while other provisions do not qualify for deduction.

1.20.2 It has been judicially held by the Supreme Court[5] that a contingent liability could not constitute expenditure for the purposes of income tax. It has been held that expenditure which is allowable for income tax purposes, is one which is towards a liability actually existing at that point of time but putting aside of money which may become expenditure on the happening of an event is not an expenditure.

1.20.3 It has also been judicially held[6] that for a loss to be deductible, it must have actually arisen and incurred and not merely anticipated as certain to occur in future.

1.20.4 Audit noticed that the above provisions were not complied with in 19 cases involving tax effect of Rs. 51.64 crore. Two cases are shown in Table no. 1.12 below:

(Rs. in crore)

Table no. 1.12: Incorrect allowance of provisions, capital expenditure & liabilities

Sl no.	Assessee and CIT charge	Assessment year and type of assessment	Nature of mistake	Tax effect
Public Sector Bank				
1.	M/s Indian Bank, Chennai I	2004-05 143(3)	The provision of Rs. 49.58 crore towards 'law charge' in respect of the earlier years, in addition to the current year's actual claim had been allowed. As the above amount represented provisions only and also related to prior period, it was required to be added back.	17.78
2.	M/s Indian Overseas Bank, Chennai I	2004-05 143(3)	Deduction of Rs. 28.40 crore was allowed towards 'loss arising out of unrecoverable investments' in respect of shares held in its wholly owned subsidiary company, which was merged with the bank during the previous year. As the investment in a subsidiary company was capital in nature, the loss allowed as revenue loss should also have been treated as capital loss only.	10.19

1.20.5 Ten cases are shown at **serial numbers 53 to 62 of Appendix 2.**

[5] 248 ITR 4 – Indian Smelting and Refining Company Ltd., 245 ITR 428- Bharat Earth Movers Ltd.
[6] CIT Vs Indian Overseas Bank (151 ITR 446) (Madras)

1.21 Incorrect allowance of expenditure on investments

1.21.1 It has been judicially held[7] that where the assessee purchases securities at a price inclusive of accrued interest, the price paid for them is in the nature of capital outlay and no part of it can be set off as expenditure against the income accruing on those securities.

1.21.2 Audit noticed that the above provisions were not complied with while allowing deduction in respect of expenditure incurred in relation to investments in eight cases involving tax effect of Rs. 47.03 crore. Two cases are discussed in Table no. 1.13 below:

(Rs. in crore)

Table no. 1.13: Incorrect allowance of expenditure on investments

Sl. no.	Assessee and CIT Charge	Assessment year and type of assessment	Nature of mistake	Tax effect
Foreign Bank				
1.	M/s Deutsche Bank AG, DIT (IT) Mumbai	2004-05 143(3)	Assessing Officer disallowed Rs. 32.00 crore towards broken period interest[8]. However, while computing the taxable income, Rs. 0.32 crore only was added back resulting in under assessment of Rs. 31.68 crore. The assessing officer replied (March 2007) that rectification proceedings had been initiated and the order under section 154 would be passed shortly.	20.88
2.	M/s Deutsche Bank AG, DIT (IT) Mumbai	2002-03 143(3)	While allowing broken period interest of Rs. 37.05 crore on purchase of securities as per CIT (A)'s order, deduction of broken period interest already allowed on the sale of such securities was not withdrawn. The Department has accepted (May 2007) and rectified the mistake by passing an order under section 154.	19.85

1.21.3 Two cases are shown at **serial numbers 63 and 64** of **Appendix 2**.

[7] Vijaya Bank vs Commissioner of Income Tax (Additional) 187 ITR 541 (Supreme Court)

[8] **Broken Period Interest (BPI)**

Interest on Government securities is payable on half-yearly basis. This interest is being paid to the holder of the security on due date. At the time of purchase of security, the buying bank pays the interest till the date of purchase (broken period) to the seller of security, debiting the same under "interest account". At the time of receipt from RBI at the end of the relevant half year, the entire half-year interest is credited to the same account.

1.22 Incorrect deduction of income from securities

1.22.1 Under the third proviso of section 36(1)(viia) of the Act, a scheduled bank or non-scheduled bank shall, at its option, be allowed a further deduction in excess of the limits specified in the preceding two provisos for an amount not exceeding the income derived from redemption of securities in accordance with a scheme framed by the Central Government. It is further provided that no deduction shall be allowed under the third proviso, unless such income has been disclosed in the return of income under the head "Profits and gains of business or profession".

1.22.2 Under section 145 of the Act, income under the heads 'profits and gains of business or profession' or 'income from other sources' shall be computed in accordance with either cash or mercantile system of accounting, regularly employed by the assessee. Under the RBI guidelines and the Indian Companies Act, 1956, banks follow the mercantile system of accounting and prepare accounts on accrual basis.

1.22.3 Audit noticed that the above provisions were not complied with in four cases involving tax effect of Rs. 38.25 crore while allowing deduction of income from redemption of securities and interest on securities. Two cases are discussed in Table no. 1.14 below:

(Rs. in crore)

Table no. 1.14: Incorrect deduction of income from securities

Sl. no.	Assessee and CIT Charge	Assessment year and type of assessment	Nature of mistake	Tax effect
Public Sector Banks				
1.	M/s Indian Bank, Chennai I	2001-02 to 2003-04 143(3)	Interest on securities credited to P&L account was deducted while computing the taxable income on the ground that the interest income accrued had not become due. Incorrect method of accounting followed in this case resulted in under assessment of income of Rs. 81.42 crore.	30.15
2.	M/s State Bank of Indore, Indore	2004-05 143(3)	A deduction of Rs. 11.75 crore on income on redemption of securities was allowed even though it was not credited to the P&L account. The Department did not accept (May 2007) the audit observation on the ground that the assessee had credited Rs. 226.22 crore being the net surplus on profit on sale of investments, where every transaction under this head had been duly accounted for. The reply is not tenable as profit of Rs. 226.22 crore was only the profit that was earned on investments other than redemption of securities and the profit of Rs. 11.75 crore earned on "redemption of securities under buy back scheme", had not been credited to the P&L account.	5.37

1.22.4 One case is shown **at serial number 65** of **Appendix 2.**

1.23 Incorrect computation of income under special provisions

1.23.1 With effect from the assessment year 2001-02, when income tax payable on total income of a company as computed under the normal provisions of the Act in respect of the relevant previous year, is less than 7.5 percent of its book profit, such book profit shall be deemed to be the total income of the assessee and the tax payable on such total income shall be the amount of income tax calculated at the rate of 7.5 percent of the book profit or total income. Book profit means the net profit as shown in the profit and loss account, prepared as per the provisions of Part II and III of Schedule VI to the Companies Act, 1956 after making certain adjustments as prescribed in the Act. As per the provisions contained in the sub section (2) of section 115JAA of the Act, no interest shall be payable on the tax credit allowed under subsection (1) of section 115JAA.

1.23.2 Audit noticed mistakes due to incorrect computation of book profits and non-adherence to the above provisions of the Act in 12 cases involving tax effect of Rs. 37.54 crore. Two cases are shown in Table no. 1.15 below:

(Rs. in crore)

Table no. 1.15: Incorrect computation of income under special provisions

Sl. no.	Assessee and CIT Charge	Assessment year and type of assessment	Nature of mistake	Tax effect
Public Sector Bank				
1	M/s Punjab National Bank, Delhi-V	2003-04 143(3)	The income for the assessment year 2003-04 should have been assessed as (-) Rs. 54.60 crore under normal provisions instead of (-) Rs. 70.43 crore under special provisions which resulted in over assessment of loss by Rs. 15.82 crore.	5.54 (P)[9]
Foreign Bank				
2	M/s Standard Chartered Bank, DIT(IT), Mumbai	2002-03 143(3)	Interest of Rs. 22.42 crore was incorrectly allowed under section 244A on MAT credit though the provisions of section 115JAA specifically prohibit allowance of interest on MAT credit. Further, as refund excluding MAT credit works out to less than 10 percent of the tax determined, the assessee was not eligible for any interest. The Department has accepted (April 2006) the audit observation.	22.42

1.23.3 Four cases are shown at **serial numbers 66 to 69 of Appendix 2**

[9] Potential

1.24 Incorrect allowance of deduction towards head office expenses/interest relating to foreign banks

1.24.1 Section 44C of the Act provides that in the case of a non resident, head office expenditure is allowable at the rate of five percent of the adjusted total income or the amount of so much of expenditure in the nature of head office expenditure incurred by the assessee as is attributable to the business of the assessee in India, whichever is less. As per explanation below sub section (1) of section 92, the allowances for any expense or interest arising from an international transaction shall be determined having regard to the arm's length price.

1.24.2 Board vide its circular no. 740 dated 17 July 1996 clarified that a branch of a foreign company /concern in India is a separate entity for the purpose of taxation. Interest paid/ payable by such branch to its head office or any branch located abroad would be liable to tax in India and would be governed by the provisions of section 115A of the Act. It has also been judicially held[10] that the interest payment made by a permanent establishment in India to its own branch outside India is not an allowable expenditure as the payment is made to self. The tribunal held that the deductibility has to be in accordance with the provisions of local law and subject to the limitations provided therein, as provided in section 44C, etc.

1.24.3 Audit noticed that the above provisions were not complied with in 6 cases involving tax effect of Rs. 27.46 crore. Three cases are shown in Table no. 1.16 below:

(Rs. in crore)

Table no. 1.16: Incorrect allowance of deduction towards head office expenses/interest relating to foreign banks

Sl. no	Assessee and CIT charge	Assessment year and type of assessment	Nature of mistake	Tax effect
Foreign Banks				
1.	M/s Bank of America, DIT(IT), Mumbai	2002-03 to 2004-05 143(3)	Interest paid to head office/overseas branches of Rs. 8.06 crore, Rs. 4.96 crore and Rs. 12.35 crore in assessment years 2002-03 to 2004-05 were allowed as deduction.	11.01
2	M/s Standard Chartered Grindlays Bank, DIT (IT) Delhi	2003-04 143(3)	Deduction of Rs. 11.61 crore on account of head office expenses was incorrectly allowed on long term capital gain.	6.71

[10] Income Tax Appellate Tribunal, Kolkata Branch, in a judgment delivered on 22-8-2005, in the case of ABN Amro Bank NV Vs Asst. Director of Income Tax, International Taxation, Calcutta

Sl. no	Assessee and CIT charge	Assessment year and type of assessment	Nature of mistake	Tax effect
3.	M/s ABN Amro Bank, DIT (IT) Kolkata	2002-03 to 2004-05 143(3)	Deductions of Rs. 13.22 crore, Rs. 15.58 crore and Rs. 19.16 crore in respect of head office expenses were calculated directly on the taxable income without adjusting the allowances under section 36(1)(viia)(b) though section 44C defines that the deduction is to be calculated on the adjusted total income.	6.23

1.24.4 Two cases are shown at **serial numbers 70 and 71 of Appendix 2.**

1.25 Incorrect computation of income and other mistakes

1.25.1 As per the provisions contained in sub section (2) of section 36, no deduction towards bad debts shall be allowed unless such debts or part thereof have been taken into account in computing the income of the assessee or such debt represents money lent in the ordinary course of the business of banking or money lending which is carried on by the assessee.

1.25.2 Section 37(1) of the Act provides that any expenditure not being in the nature of capital expenditure, laid down and expended wholly and exclusively for the purpose of business or profession shall be allowed in computing the income chargeable under the 'Profit and gains of business or profession'.

1.25.3 Section 143 of the Act provides that the assessing officer is required to determine and assess the income correctly after scrutiny assessments. The Board have issued instructions to the assessing officers and their supervising officers to ensure that the mistakes in assessments do not occur.

1.25.4 Audit noticed mistakes in computation of income and tax in 74 cases involving tax effect of Rs. 220.77 crore. One case is discussed below:

1.25.5 In Delhi, DIT (IT) charge, assessment of a foreign bank, **M/s Standard Chartered Grindlays Bank**, for the assessment year 2001-02 was completed after scrutiny in March 2004 determining an income of Rs. 433.08 crore. A rectification order under section 154 was passed in March 2005 allowing the assessee a TDS credit of Rs. 11.77 crore. Thereafter, the tax was re-calculated. Audit scrutiny revealed that tax was calculated on the returned income of Rs. 337.49 crore instead of calculating it on the total assessed income after scrutiny assessment of Rs. 433.08 crore which resulted in a refund of Rs. 10.89 crore instead of creating a demand of Rs. 52.97 crore. The mistake resulted in tax effect of Rs. 63.86 crore including interest.

1.25.6 Six cases are shown in Table no. 1.17 below:

(Rs. in crore)

Table no. 1.17: Incorrect computation of income and other mistakes

Sl. no.	Assessee and CIT charge	Assessment year and type of assessment	Nature of mistake	Tax effect
Public Sector Bank				
1	M/s Oriental Bank of Commerce, Delhi V	2003-04 143(3)	Rs. 54.01 crore being interest accrued but not due was disallowed in the assessment order of 2002-03 but an order passed under section 250 revealed that the relief was given to the assessee by the CIT(A). However, the assessing officer had again allowed deduction of Rs. 54.01 crore in the assessment year 2003-04 resulting in a double deduction of Rs. 54.01 crore. During verification, audit noticed that the Department has taken remedial action under section 154 of the Act.	24.46
2.	M/s Allahabad Bank, Kolkata II	2003-04 143(3) 115JB	The assessee had paid a contribution of Rs. 61.01 crore to pension fund over and above the 'Provision for pension (new)' debited in the profit & loss account under the head 'payment to and provisions for employees'. The assessing officer started the computation of total income from the net profit as per the profit & loss account and allowed a deduction of Rs. 61.01 crore as "Contribution to Employees' Pension Fund". Since "Contribution to Employees' Pension Fund" amounting to Rs. 61.01 crore was not routed through the profit & loss account it was not allowable as deduction.	22.42
Private Bank				
3	M/s Karnataka Bank Ltd, Mangalore	2004-05 143(3)	Refund of Rs. 19.89 crore allowed in March 2005 at the time of processing the return in summary manner was not adjusted at the time of scrutiny assessment which resulted in excess refund and interest under section 234D. The Department accepted (July 2007) the audit observation and taken remedial action.	20.97
4	M/s Federal Bank Ltd, Kochi	1996-97 143(3)	Consequent to an appellate order by the ITAT, Rs. 19.54 crore disallowed in the assessment was allowed as deduction in the revised assessment in March 2005. However, Rs. 11.84 crore already allowed as deduction while giving effect to the order by CIT (A) in February 2004 was not considered at the time of giving effect to the ITAT order. The Department accepted (February 2007) the audit observation and taken remedial action.	5.43
Foreign Bank				
5	M/s American Express Bank, DIT(IT) Mumbai	2003-04 143(3)	Refund already issued to the assessee after summary assessment was not taken into account while computing tax demand as per order passed under section 154. The Department has accepted (March 2007) the audit observation.	15.64

Sl. no.	Assessee and CIT Charge	Assessment year and type of assessment	Nature of mistake	Tax effect
6	M/s Standard Chartered Bank, DIT(IT) Mumbai	2004-05 143(3)	The assessee was allowed a deduction of Rs. 22.69 crore towards base cost of securities acquired in a slump sale from Standard Chartered Grindlays Bank (SCGB) in August 2002. It was observed from the notes to accounts that these securities were shown as acquired at book value of SCGB and additional compensation of Rs. 22.69 crore paid on its acquisition had not been included in its cost. Since the additional compensation paid on acquisition of securities had not been included in its cost, it could not be claimed as business expenditure. The Department did not accept (March 2007) the audit observation on the ground that since the securities were held as stock in trade, the deduction claimed by assessee was on revenue account and not capital outlay. Reply of the Department is not tenable as the additional compensation paid on acquisition of SCGB had not been included in the cost of acquisition of securities.	10.79

1.25.7 Thirty one cases are shown at **serial numbers 72 to 102 of Appendix -2**.

1.26 Non adoption of Arm's Length Price

1.26.1 Section 92(1) of the Act provides that, any income, allowances for any expense or interest arising from an international transaction shall be determined with reference to the arm's length price (ALP). The computation of ALP has to be done as per section 92C. Section 92CA empowers the assessing officer to refer all cases of international transaction with the associated enterprises to the Transfer Pricing Officer (TPO) for determining ALP of each transaction. The TPO shall determine the ALP after considering all relevant material gathered by him for the said purpose. On the basis of TPO's order and subsequent scrutiny, the assessing officer shall proceed with the determination of taxable income.

1.26.2 In Maharashtra, Mumbai DIT (IT) charge, assessment of a foreign bank, **M/s Standard Chartered Bank,** for the assessment year 2004-05 was completed after scrutiny in November 2006. Assessee had filed form 3CEB pertaining to international transactions which was referred to the TPO for determination of ALP. The assessee had entered into a number of international transactions involving large amounts listed in the Annexures 1 to 8C of form 3CEB. The TPO in his order of October 2006 discussed only one issue relating to head office expenses. The assessee contended that expenditure incurred by it on behalf of its associated enterprises and reimbursements towards expenses incurred by its associated enterprises would not be covered under section 92 of the Act. As per explanation below section 92(1), all allowances or expenses with regard to international

transaction is to be determined based on ALP. However, in the instant case neither the TPO nor the Assessing Officer made any comment or adjustment in this regard.

1.26.3 The assessee had sold property worth Rs. 147.71 crore to its associate enterprise SCOPE (being wholly owned subsidiary of Standard Chartered Bank UK) during the previous year but did not offer the income to tax on the ground that no transfer was involved as per section 47 (iv) of the Act. Since the assessee was a separate entity for the purpose of taxation in India, income arising from transfer of assets of Indian PE to SCOPE should have been offered to tax, based on the ALP. However, neither the TPO nor the Assessing Officer made any comment or adjustment in this regard.

1.26.4 The assessee had also provided many administrative, marketing, supervising, banking and technical services to its head office and other associated enterprises. However, no significant charges were received for providing such services. Neither the TPO nor the Assessing Officer made any comments regarding ALP of these services in their respective orders.

1.26.5 In the case of the same assessee, assessment for the assessment year 2003-04 was completed after scrutiny in December 2005. The assessee had received service charges amounting to Rs. 5.54 crore from six associated enterprises. As per the TPO's report, the Arm's length price of the transaction under Comparable Uncontrolled Price (CUP) method was the same as received by assessee. However, in the note below Annexure-11 of Form 3CEB, the property service cost received by assessee was based on the allocation made of the estimated maintenance cost for the property given/taken on lease. The TPO did not make any change in respect of the above transactions in his report. In this case, the assessee had taken the estimated maintenance cost as fair market value for the purpose of determining ALP. Since the fair market value of any property was much higher than the maintenance cost, the price declared by the assessee should have been rejected and TPO should have determined the price based on fair market value. In its reply dated May 2006, the Department stated that the matter would be referred to the TPO for his examination.

1.26.6 In the exit conference, Board agreed to examine the case.

1.27 Non recognition of income

1.27.1 Under section 145 of the Act, income under the heads 'profits and gains of business or profession' or 'income from other sources' shall be computed in accordance with either cash or mercantile system of accounting, regularly employed by the assessee.

1.27.2 In the cases of **M/s Indian Bank, M/s Indian Overseas Bank, M/s Tamil Nad Mercantile Bank Ltd. and M/s City Union Bank Ltd.,** audit observed that during the assessment years 2001-02 to 2004-05, income from locker rent, credit

card membership fees, dividend income, insurance claims and commission was accounted on realisation basis instead of on accrual basis. This was in violation of section 145 of the Act. The difference between the accrued income and income offered on cash basis in respect of the above items could not be quantified by audit.

1.27.3 In the exit conference, Board agreed to examine the case.

1.28 Conclusion

1.28.1 Banks are an important driver of growth in the national economy and are among the highest tax payers in the country. Audit noticed several mistakes with significant tax effect in the assessments of banks. A very high proportion of error was noticed in the determination of deductions available to banks for bad and doubtful debts as per the provisions of the Act. Audit findings also indicate weaknesses with potential revenue impact relating to figures of bad and doubtful debts and advances made to rural branches. Audit also observed mistakes in valuation of investments. Several cases of non compliance with specific provisions of the Act have also been included in this review. It is recommended that the Ministry should examine these issues and evolve a suitable corrective mechanism, so as to safeguard the interest of revenue.

1.29 Summary of recommendations

1.29.1 *Audit recommends that the Ministry may strengthen its internal controls such as ensuring regular review of assessments of banks at an appropriate level, that all such cases are checked by internal audit etc.*

1.29.1.1 In the exit conference, Board accepted the recommendation and stated that administrative review of assessments of banks at the level of Commissioners of Income tax is provided for and that internal audit will check all cases of banks in the new system.

1.29.2 *Audit recommends that the Ministry may prescribe a checklist for the assessing officers requiring them to check that the bad debts to be written off have been debited to the provision for bad and doubtful debt account and that the credit balance of provision for bad and doubtful debt account of earlier years have been considered before allowing the same.*

1.29.2.1 In the exit conference, Board accepted the recommendation and stated that the concern of the checklist will be taken care of while preparing the Manual of Internal Audit.

1.29.3 *Audit recommends that the Ministry may also consider devising a system where the assessing officer can take cognizance of the credit balance available in the provision for bad and doubtful debt account pertaining to earlier years in respect of banks.*

1.29.3.1 In the exit conference, Board agreed to examine the issue.

1.29.4 *In view of the quantum of revenue involved in the deductions for bad and doubtful debts written off, audit recommends that the Ministry may examine the issue of the wide variations in the figures reported in NPA returns to RBI and the income tax returns.*

1.29.4.1 In the exit conference, Board stated that the issue would be examined.

1.29.5 *Audit recommends that the Ministry may strengthen its internal controls so that deductions to rural branches of banks are allowed only after suitable verification by the assessing officer so as to safeguard the interests of revenue.*

1.29.5.1 In the exit conference, Board stated that the issue would be examined.

1.29.6 *Audit recommends that the Ministry may consider introducing a suitable provision in the statute relating to valuation of investments by banks.*

1.29.6.1 In the exit conference, Board agreed to examine the issue.