

Query No. 23

Subject: *Clarification regarding recognition of Deferred Tax Liability in respect of Special Reserve created for the purpose of deduction u/s 36(1)(viii) of the Income Tax Act, 1961.*¹

A. Facts of the Case

1. In order to encourage the Banks to undertake long term funding to specified sectors, Section 36(1)(viii) of the Income Tax Act has facilitated tax exemption to the extent of 20% of profit derived from long term finance to infrastructure, industrial, agriculture and housing development sectors - provided equivalent amount is transferred to special reserve.

Section 36(1) (viii) of the Income Tax Act reads as follows:

“in respect of any special reserve created and maintained by a specified entity, an amount not exceeding twenty per cent of the profits derived from eligible business computed under the head profits and gains of business or profession (before making any deduction under this clause) carried to such reserve account”.

2. The Querist has stated that Accounting Standard (AS) 22, ‘Accounting for Taxes on Income’ (hereinafter referred as AS 22) envisages recognition of deferred tax assets/deferred tax liabilities for the timing differences. As per the said Standard:

“Timing differences are the differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods.”

“Permanent differences are the differences between taxable income and accounting income for a period that originate in one period and do not reverse subsequently.”

3. The Querist has also stated that section 41(4A) of the Income Tax Act reads as follows:

“Where a deduction has been allowed in respect of any special reserve created and maintained under clause (viii) of sub-section (1) of section 36, any amount subsequently withdrawn from such special reserve shall be deemed to be the profits and gains of business or profession and accordingly be chargeable to income-tax as the income of the previous year in which such amount is withdrawn”.

4. The Querist has informed that Reserve Bank of India (RBI), vide its circular dated 20th December 2013 advised all the banks to recognize deferred tax liability (DTL) on special reserve. The extract of the Circular is as follows:

“The matter regarding creating of DTL on special reserve has been examined and banks are advised that, as a matter of prudence, DTL should be created on special reserve”.

Accordingly, the Bank has recognised the deferred tax liability (DTL) on the outstanding balance of special reserve. The RBI Circular on recognition of DTL has been supplied separately by the querist. .

5. According to the querist, the above presumption of treating the creation of special reserve as timing difference holds good when there is a liberty to withdraw the special

¹ Opinion finalised by the Committee on 4.1.2018.

reserve. The Reserve Bank of India (RBI) vide circular dated 20th September 2006, has instructed the banks that without prior permission of RBI, no reserve can be withdrawn which includes special reserve also. The RBI circular in this regard has been supplied separately by the querist. The relevant extract of the RBI Circular is as follows:

“In order to ensure that their recourse to drawing down the Statutory Reserve is done prudently and is not in violation of any of the regulatory prescriptions, banks are advised in their own interest to take prior approval from the Reserve Bank before any appropriation is made from the statutory reserve or any **other reserves.**” (Emphasis supplied by the querist.)

6. The querist informed that as the advances made to specified sectors viz Industrial, Infrastructure, Housing and Agriculture purposes are under stress and banks are required to make huge amount of provisions, the bank had requested RBI for utilisation of special reserve by banks but the request has been turned down. The querist has separately provided a copy of the request made by the bank to RBI and the communication received from the RBI in this regard.

According to the querist, since RBI has denied withdrawal of special reserve and Banks are not allowed to withdraw any reserve without prior permission of the Reserve Bank of India, in terms of Accounting Standard (AS) 22, transfer of special reserve and claiming tax benefit have become ‘Permanent Difference’.

B. Query

7. The Querist has requested the Expert Advisory Committee to clarify whether transfer of special reserve could be considered as “permanent difference” in terms of the Accounting Standard 22.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised in the query relates to whether transfer to special reserve created under section 36(1)(viii) of the Income –tax Act, 1961 could be treated as ‘permanent difference’ for the purpose of accounting treatment under AS 22 and has not considered any other issue that may arise from the facts of the case. The Committee also wishes to point out that since AS 22 has been referred to in the facts of the case, the Committee has expressed its views, hereinafter in the context of Accounting Standards, notified under the Companies (Accounting Standards) Rules, 2006 and not in the context of Indian Accounting Standards (Ind ASs) Companies (Indian Accounting Standards) Rules 2015.

9. The Committee notes section 36(1)(viii) of the Income-tax Act, 1961, as reproduced in paragraph 1 above and the definition of the term ‘timing differences’, as reproduced in paragraph 2 above.

10. The Committee notes that there are two essentialities for timing differences to arise:

- (i) There should be difference between taxable income and accounting income originating in one period; and
- (ii) The difference so originated should be capable of reversal in one or more subsequent periods.

The Committee notes that there is no condition of any limitation of the period for reversal of such differences, i.e., as per the definition of ‘timing differences’, the reversal of the

difference can take place at any time in future.

11. The Committee notes that in the period in which special reserve is created, the accounting income remains unaffected as the same is created below the line. However, the taxable income for the same year gets reduced by the amount of the special reserve thus, resulting into lesser tax liability. Thus, a difference arises between the accounting income and the taxable income for that period. The Committee also notes that this difference is *capable of reversal* in the period in which the special reserve is utilised or withdrawn as in the year of utilisation or withdrawal, the amount of special reserve would be added to taxable income (Section 41(4A) of the Income-tax Act, 1961) thus, resulting into a higher taxable income than the accounting income of that period (emphasis supplied by the Committee). Therefore, the Committee is of the view that the creation of special reserve results into timing differences as per AS 22. Accordingly, a deferred tax liability is required to be created in this regard.

12. The Committee also notes paragraph 14 of AS 22 which states as below:

“14. This Standard requires recognition of deferred tax for *all* the timing differences. This is based on the principle that the financial statements for a period should recognise the tax effect, whether current or deferred, of all the transactions occurring in that period.” (Emphasis supplied by the Committee.)

13. From the above, the Committee notes that the difference between the accounting income and the taxable income for that period should be recognised as timing difference if it is capable of reversal at any time in future. Thus, deferred tax is to be provided for *all* timing differences. Accordingly, the Committee is of the view that in the present case, as long as the utilisation/withdrawal is *capable* of taking place, the creation of special reserve results into timing differences for which deferred tax liability should be provided.

14. With regard to the arguments advanced by the querist in paragraphs 5 and 6 above, the Committee is of the view that RBI's rejection of the querist's request to utilise the special reserve, does not necessary imply that it is permanent policy.

D. Opinion

15. On the basis of the above, the Committee is of the opinion that the transfer to special reserve created and maintained under section 36(1)(viii) of the Income-tax Act, 1961 cannot be considered as 'permanent difference' since the same is capable of reversal resulting into the difference between accounting income and taxable income (i.e., timing difference).
