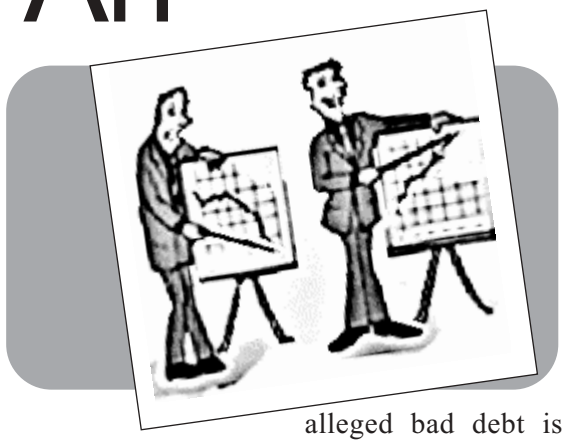
Bad Debt -- An unresolved controversy



Pradip Kedia

> Section 36(1)(vii) of the Income Tax Act, 1996 enables the Assessee to claim deduction on account of Bad-debt while determining its profit and gains of the business or profession.

Onus of proving debt as 'bad':

Before the amendment by the Finance Act, 1987 with effect from 1-4-1989 in section 36(1)(vii), the words used were any debt or part thereof which is **established to have become a bad debt** in the previous year". The words "**any bad debt** or part thereof which is written off as irrecoverable in the accounts of the Assessee for the previous year" have been inserted by the amendment.

Now the question arises whether there is still an obligation on the Assessee to prove that the debt has become bad despite the fact that he has written off the same as irrecoverable in his books of account. The question is whether the amendment brought about in section 36(1)(vii) and section 36(2) has taken away the power of the Assessing officer (AO) to question the claim when made by the Assessee on the basis of entries in the books of account.

Proposition in favour of the Assessee:

One school of thought is that with the amendment, the AO has no option but to allow the claim in respect of a debt when a claim is made by the Assessee. The Assessee is entitled to deduction in respect of any debt, which is claimed to be a bad debt by the Assessee and the AO has no power to question the claim. The arguments to support such a view are narrated as under:

1. While the onus of establishing that the write-off of the alleged bad debt is proper and permissible in the circumstances of the case is undoubtedly upon the Assessee, the AO cannot insist on the demonstrative proof, which is quite infallible. [*Jethabhai Hirji & Jethabahi Ramdas [120 ITR 792 (Bom.)*]

2. Such bad debts were necessarily allowable as deduction grounds of first principles of accountancy. What are chargeable to income-tax in respect of a business under Sec. 28 are the profits and gains of an year and in determining the amount of the profits and gains of an year and not gross receipts. Therefore, account must necessarily be taken of all losses incurred to arrive at net gains.

3. The Board echoed the intention of the amended provisions at para 6.6 of the Circular No. 551 dated 23.01.1990 as follows:

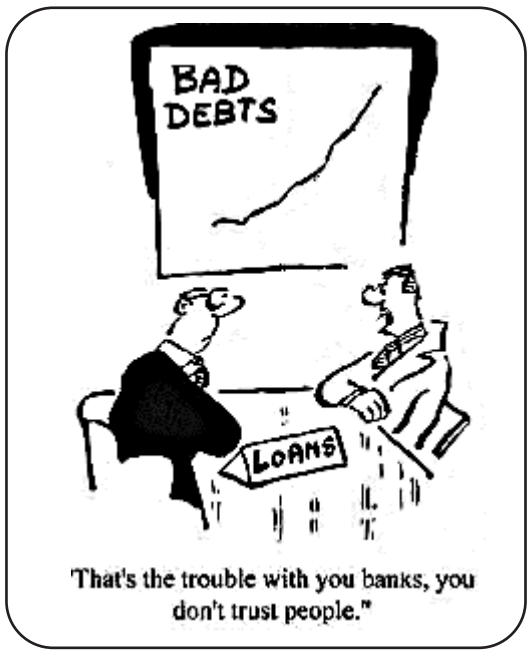
"*6.6 Amendments to sections 36(1)(vii) and 36(2) to rationalise provisions regarding allowability of bad debts. The old provisions of clause (vii) of sub-section (1) read with sub-section (2) of the section laid down conditions necessary for*

The author is a member of the Institute. He can be reached at pkedia@vsnl.net

While the onus of establishing that the write-off of the alleged bad debt is proper and permissible in the circumstances of the case is undoubtedly upon the Assessee, the AO cannot insist on the demonstrative proof, which is quite infallible. ***[Jethabhai Hirji & Jethabahi Ramdas [120 ITR 792 (Bom.)]***

allowability of bad debts. It was provided that the debt must be established to have become bad in the previous year. This led to enormous litigation on the question of allowability of bad debt in a particular year, because the bad debt was not necessarily allowed by the AO in the year in which the same had been written off on the ground that the debt was not established to have become bad in that year. In order to eliminate the disputes in the matter of determining the year in which a bad debt can be allowed and also to rationalise the provisions, the Amending Act, 1987, has amended clause (vii) of sub-section (1) and clause (i) of sub-section (2) of the section to provide that the claim for bad debt will be allowed in the year in which such a bad debt has been written off as irrecoverable in the accounts of the Assessees."

4. In CIT v. Girish Bhagwatprasad [2002] 256 ITR 772, the Gujarat High Court has also taken a similar view. In that case, the Assessee had written off certain amount on account of its having become a bad debt. The AO held that the Assessee could not prove that the debt had become bad and that the Assessee did not try to recover the amount and further that mere delay in recovery did not convert the debt into a bad debt. On appeal, the CIT(A) found that the amended provisions of section 36(1)(vii) of the Act were applicable under which the Assessee was not required to establish that the debt had become bad in the previous year and mere writing off of the amount as bad debt was sufficient. Even on merits, the first appellate authority found that there was no chance for the Assessee to recover the amount and hence, the debt really became bad. The Tribunal also upheld the contention of the Assessee on the basis of the amended provisions of section 36(1)(vii) of the Act. On an application filed under section 256(2) of the Act, the High Court held that prior to the amendment, the allowance under this clause was confined to the debts and loans which had become irrecoverable in the accounting year. However, as per amended provisions, all that the Assessee had to show was that the bad debt was written off as irrecoverable. The Court further observed that genuineness of such a claim made by the Assessee was not in doubt and therefore no question of law arose for reference.



"That's the trouble with you banks, you don't trust people."

5. A simple comparison of sub-clause (vii) as it existed before amendment and as it exists today would clearly show that the phrase "which is established to have become a bad debt in the previous year" is conspicuously absent in the post-amended sub-clause. As a logical corollary, it is not for the Assessee now to establish that the debt had become bad in the previous year. On the other hand, if it has been written off as irrecoverable in the accounts of the Assessee for the previous year, it will suffice for claiming it as bad debt, as per the post-amended clause. In such situation, it is not for the AO to decide about writing off of the debt as bad in the accounts of the relevant previous year. The best judge in deciding a matter on the commercial aspects of the business is the Assessee itself and not the AO. Once the Assessee was satisfied that the debt had become bad and it had passed the necessary entry for writing off the debt as bad in the profit and loss account, it is allowable deduction. Even before the

If the Assessing Officer is of the view that the debt has become bad in any of the subsequent years, Assessee would be denied deduction thereof because he can not write off the bad debt in that year since he had already written it off earlier.

amendment, the Hon'ble Madras High Court in the case of Devi Films Ltd. v. CIT [1963] 49 ITR 874 observed that while the onus of establishing that the write off of the alleged debt is proper and permissible is undoubtedly on the Assessee, the department cannot insist on demonstrative proof which is quite infallible. When such is the situation, for writing off of a debt in the books of account as bad debt, after the post-amendment period, the Assessee can never be called upon to prove that the debt had become bad.

6. It is also worth considering the consequences that may follow if the Assessee is not allowed deduction in the year of write off. Prior to its omission by the Direct Tax Laws Amendment Act, 1987, clauses (iii) and (iv) of sub-section (2) of section 36 were relevant in certain situations.

Clause (iii) dealt with the situation where the Assessee had written off a debt but the same was not allowed as a deduction on the ground that it had not become bad in that year and that the claim was premature. In such an event it enabled the Assessee to claim and obliged the AO to allow the deduction for the debt in such year as it was accepted to have become bad.

Clause (iv) dealt with the situation where the Assessee had written off and claimed a bad debt in a particular previous year but the officer took the view that it had become bad even in an earlier year.

It enabled the AO to reopen the assessment of the earlier year in question and give the Assessee the benefit of the deduction for the bad debt in that year. Both these clauses have been omitted by the Amending Act of 1987. The effect of

omission has been explained by the Board in Circular No. 551 referred to earlier. Para 6.7 of the said Circular is reproduced below:

"*6.7 Clauses (iii) and (iv) of section 36(2) provided for allowing deduction for a bad debt in an earlier or later previous year, if the Income-tax Officer was satisfied that the debt did not become bad in the year in which it was written off by the Assessee. These clauses have become redundant, as the bad debts are now being straightaway allowed in the year of write-off. The Amending Act, 1987, has, therefore, amended these clauses to withdraw them after the assessment year 1988-89.*"

Thus, the effect would be that if the Assessee is not given deduction in the year of write off, then in no other year it would be possible for the AO to give deduction to the Assessee. If the AO is of the view that the debt has become bad in any of the subsequent years, Assessee would be denied deduction thereof because he can not write off the bad debt in that year since he had already written it off earlier. Thus, by denying the deduction in the year of write off, Assessee would be denied the deduction under section 36(1)(vii) forever. Simultaneously, sub-section (6) of section 155 has also been omitted by the Amending Act 1987. This provisions enabled the AO to allow deduction for the earlier previous year.

It therefore follows that by not allowing the deduction in the year of write off, the Assessee is permanently deprived of the deduction. On the other hand, by allowing the deduction, the revenue is not permanently prejudiced. If the Assessee recovers any debt of which he had claimed deduction earlier, it will be brought to tax by virtue of section 41(1) of the Act.

Contrary proposition:

The Assessing Officer has the power to enquire into the genuineness of the claim and unless the claim is established to be genuine the Assessee is not entitled to deduction. It is still necessary to prove the debt as bad while claiming the deduction under section 36(1)(vii) of the Act. The arguments advanced to support this proposition are as under:

1. The pre-amended provisions used the words '**any debt**'.

Now the amended provision has been incorporated to use the words '**any bad debt**'. Therefore, it is necessary that the Assessee has to prove the debt as a bad debt.

2. The Delhi Bench of ITAT in the case of Dy. CIT v. India Thermit Corpn. Ltd [1996] 56 ITD 307 held that the debt written off has to be bad debt. It is the prior condition for allowability of the deduction under section 36(1)(vii) even after the amended provision. Once the debt is established to be bad, deduction will have to be allowed for the year in which the Assessee writes off the same. AO cannot question the year in which the debt becomes bad.

3. The view that the amendment with effect from 1-4-1989 has made it obligatory upon the AO to allow the claim of write off merely on the basis of an entry in the books of account of the Assessee and the AO has no power to enquire about the genuineness of the claim has no legally sound basis. If that is so, the Assessee in order to reduce the profits may write off any debt as on the close of the previous year. It is well settled principle of law that when a return of income is filed by the Assessee, the AO has the power to gather material from the Assessee as well as from any other sources. The correctness of the return and the claims made can be subjected to scrutiny and in this connection the power of the AO is unfettered by the amendment of section 36(1)(vii). Keeping in view the scheme of assessment, it is difficult to perceive that the Legislature would have intended to give a tool in the hands of the Assessee for getting a deduction in respect of the amounts written off without it being required to be supported by evidence. Such an interpretation would produce wholly undesirable and absurd results.

4. It is well settled principle that an interpretation which gives rise to absurd results is to be avoided. [*K.P. Varghese v. ITO [1981] 131 ITR 597 (SC)*].

5. The amendment made in section 36(1)(vii) and section 36(2) was with a definite purpose of curtailing litigation in respect of year of allowability of a bad debt. It is well known that there was lot of litigation in regard to the year of allowability of deduction on account of bad debts. It is clear from the language of the section that the law required the Assessee to establish that a debt had become bad in the previous year in which the claim was made. In several cases through the Assessee was able to establish that a debt had become bad, yet the claim was not allowed as in the opinion of the AO the debt had become bad in some other previous year. In order to obviate the difficulty, the law was amended.

6. The amendment has specifically used the words "bad debt" instead of the word "debt". It is well settled principle of interpretation that the Legislature does not use the words unnecessarily and superfluously. The very fact that instead of the word "debt" the Legislature in its wisdom has used the words "bad debt" would support the view that the intention of the Legislature was not to allow a deduction in respect of any debt but only in respect of bad debts relating to business of the Assessee. Section 139(1) makes it obligatory upon the Assessee to file the return of income. The AO has the option to accept the return or to issue a notice to the Assessee for supporting the return. The AO is required to make the assessment on the basis of the material filed before him and the material gathered by him. The law empowers the AO to gather material. The AO has the power to scrutinize the evidence produced by the Assessee. When the claim of deduction is made, it is open to the AO to verify the correctness of the claim.

As per a contrary proposition, the Assessing Officer has the power to enquire into the genuineness of the claim and unless the claim is established to be genuine the Assessee is not entitled to deduction. It is still necessary to prove the debt as bad while claiming the deduction under section 36(1)(vii) of the Act.

7. Whereas the judicial pronouncements have recognized the fact that there need not be infallible evidence to show that the write off is proper and permissible in the circumstances of the case, it can not support the proposition that the Assessee is not required to give any evidence whatsoever. The disputes

relating to bad debts prior to amendment in section 36(1)(vii) were of two types. One was as to whether the debt had become bad and the second type of dispute was the year in which the debt had actually become bad. The deduction of a bad debt was permissible only in the year in which such debt had become bad. Therefore, in some cases deduction was not allowed to the Assessee in the year in which a deduction was claimed not because the debt had not become bad but because it had not become bad in that year. In other words, the disputes extended to, the year of allowability. With the amendment in section 36(1)(vii) the dispute relating to the year of allowability will no longer arise as a deduction which is allowable in law will be allowed in the year the Assessee has written off that amount. The requirement of law to support the deduction has not been given a go-bye.

8. It is further contended that whether a debt has become a bad debt or not is a question of fact. The Assessee must satisfy the AO that in fact the debt has become irrecoverable. In this connection, reliance is placed on the decision of Raja Bahadur Mukundlal Bansilal v. CIT [1952] 22 ITR 94(Bom.).

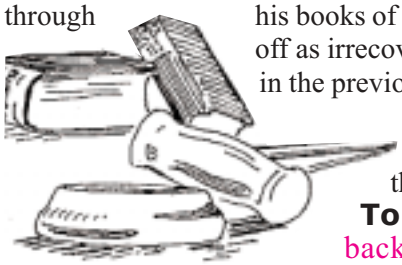
9. The decision of the India Thermit Corpn. Ltd. [1996] 56 ITD 307(Del.); Gobind Glass Industries Ltd. [2000] 110 Taxman 109 (Ahd.); Newdeal Finance & Investment Ltd v. Dy. CIT [2000] 74 ITD 469(Chennai) supports this view.

Whereas judicial pronouncements have recognized the fact that there need not be infallible evidence to show that the write off is proper and permissible in the circumstances of the case, it can't support the proposition that Assessee is not required to give any evidence whatsoever. The disputes relating to bad debts prior to amendment in section 36(1)(vii) were of two types. One was as to whether the debt had become bad and the second type of dispute was the year in which the debt had actually become bad.

10. The decision of Girish Bhagwatprasad supra is based on its peculiar facts. It does not lay down the law that the debt need not be proved to be 'bad'.

Mumbai Tribunal view:

While the controversy is continuing to rage and yet to be conclusively settled by the Courts, the matter was referred to the Third Member in Anil H. Rastogi. 86 ITD 193(Mum) owing to difference of opinion. The Third Member in his brief order heavily relied upon legislative intent and pronounced that if one goes through the intention of the Legislature in substituting these words, it will be clear from the substitution itself that the intention of the Legislature was to leave it to the prudence of the businessman to judge himself as to whether a particular debt has become irrecoverable or not. Previously, the words used were "any debt or part thereof which is established to have become bad". It is significant in the sense that it was obligatory for the Assessee to prove or show with demonstration that such a debt has become bad. By taking away the words "which is established to have become bad", the intention of the Legislature is clear that it did not want to burden the Assessee to prove that the debt has become bad. It is now left to the prudence and judgment of the businessman to consider it as a bad and irrecoverable debt and write off the same in his books of account. If he writes it off as irrecoverable in his accounts in the previous year, it is sufficient compliance of the provisions to claim the deduction.



To sum up: In the backdrop of blurred position of law in this regard, it is only advisable to write-off the debt on some cogent evidence pending development of law in this regard.