

Digitally
signed by
NIKITA
YOGESH
GADGIL
Date:
2022.07.18
15:31:41
+0530

IN THE HIGH COURT OF JUDICATURE AT BOMBAY

ORDINARY ORIGINAL CIVIL JURISDICTION

INCOME TAX APPEAL NO. 70 OF 2004

M/s. L.K.P. Merchant Financing Ltd.
203, Embassy Center, Nariman Point,
Mumbai - 400 021.

... Appellant

V/s.

The Dy. Commissioner of Income Tax,
Special Range - 34, Mumbai.

... Respondent

Ms.Dinkle Hariya a/w Ms.Rashmi Vyas i/b. Mr.Vipul B. Joshi for the
Appellant.

Mr.Vikas T. Khanchandani for the Respondent.

**CORAM : DHIRAJ SINGH THAKUR &
ABHAY AHUJA, JJ.**

RESERVED ON : 6th JULY 2022

PRONOUNCED ON : 18th JULY 2022

JUDGMENT : (PER ABHAY AHUJA, J.)

1. This is an Appeal, filed under Section 260A of the Income Tax Act, 1961 ("the Act") by M/s. L.K.P. Merchant Financing Ltd., being aggrieved by an order dated 28th July, 2003, passed by the Income Tax Appellate Tribunal, Mumbai in Income Tax Appeal No.5403/M/97 for Assessment Year 1991-92.

2. The Appeal came to be admitted on 29th November, 2004 on the following substantial question of law:

“Whether, in the facts and circumstances of the case and in law, the order of the Tribunal confirming the action of the Assessing Officer in rejecting the claim of the appellant for deduction of bad debt written off u/s. 36(i) (vii) of the Act, is bad in law?”

3. The Appellant statedly is a Public Limited Company registered as a Non Banking Finance Company engaged in the business *inter alia* of lease finance.

4. For the Assessment Year 1991-92, the Appellant Company filed a return showing “nil” income. The return was processed under Section 143(1)(a) of the Act. Subsequently, proceedings under Section 147 of the Act were initiated by issuance of a notice under Section 148 of the Act as the Assessing Officer had reason to believe that income chargeable to tax had escaped assessment. In the re-assessment proceedings, the assessee was assessed to a sum of Rs.20,69,805/- which is the dispute having given rise to the question of law in this Appeal.

5. Earlier, on December 19th, 1987, a lease agreement was entered into between the Appellant and one M/s.Orson Electronics

Ltd., as lessee to transfer the right to use of certain equipments by way of lease. As per the terms of the lease deed, order for manufacturing and supply of the equipment was placed on three concerns to whom, the Appellant-assessee made payments on behalf of lessee. The first installment of lease amount was received by the Assessee. Further installments due were also accounted for as income in the respective years, as per the mercantile system of accounting although the lessee defaulted in payment of further installments. The following lease incomes were offered for assessment:

Assessment Year	Amount (Rs.)
1987-88	5,86,139.60 (out of this Rs.2,93,069.80 was received on the first installment)
1988-89	10,62,377.96
1989-90	7,14,357.54
	<u>23,62,875.10</u>

6. It is the case of the Appellant that in view of the defaults in payment of the balance installments, the assessee approached this Court seeking winding up of M/s.Orson Electronics Ltd., and appointment of Official Liquidator to safeguard the interest of the creditors. That in view of the dispute that arose, the assessee

company wrote off the amount of Rs.20,69,805.30 (23,62,875.10 minus 2,93,069.80) as bad debt during the previous year relevant to A.Y.1991-92.

7. In the re-assessment, the Assessing Officer held that as per the mercantile system of accounting followed by the assessee, the accrued lease incomes were taxable in the respective years. The writing off was not allowed by the Assessing Officer observing that in view of the pendency of the dispute of the assessee before the High Court, the assessee had not foregone its right to claim the lease rentals and that the write off was premature.

8. The assessee filed an Appeal before the Commissioner of Income Tax (Appeals) and vide order dated 21st May, 1997, the Commissioner of Income Tax (Appeals) partly allowed the Appeal of the assessee directing the Assessing Officer to allow deduction of an amount of Rs.20,69,805/- to be written off by the assessee in its books of account for the Assessment Year 1991-92 observing that the lease rentals offered as income on mercantile basis can be definitely said to have become bad from the business point of view of the assessee and the assessee's subsisting right to recover the

amount and the pendency of the matter before the High Court were not valid grounds to postpone writing off of the amounts in question which had been offered for taxation in the earlier years.

9. Aggrieved by the said order, the Revenue carried the order of the Commissioner of Income - Tax (Appeals) - II, Mumbai in appeal, before the Income Tax Appellate Tribunal, Mumbai. The Income Tax Appellate Tribunal allowed the Revenue's Appeal and reversed the order of the Commissioner of Income - Tax (Appeals). It was held that the assessee's attempt to reverse the entry to claim bad debt, was against the established principle of accountancy. Further, it was observed that since the assessee was maintaining mercantile system of accounting and if such reversal was allowed, then it would be a clear violation of the method of accounting adopted by the assessee and even if the claim of the assessee in respect of bad debt may be correct, the same could not be considered as the assessee had accounted for lease rentals and has also claimed depreciation.

10. Aggrieved by the aforesaid order of the Tribunal, the assessee has approached this Court by filing this Appeal impugning

the Tribunal order on *inter alia* the aforementioned substantial question of law.

11. Ms.Dinkle Hariya, learned Counsel for the Appellant submits that since the Assessment Year in question is 1991-92 and as per the amended Section 36(1)(vii), after 1st April, 1989, it is not necessary for the assessee to establish that the debt has in fact become irrecoverable, it is enough if the bad debt is written off as irrecoverable in the accounts of the assessee. Learned Counsel draws the attention of this Court to the decision of the Hon'ble Supreme Court in the case of *T.R.F. Ltd. V/s. Commissioner of Income-tax [(2010) 190 Taxman 391 (SC)]* in support of her contentions.

12. On the other hand, Mr.Vikas Khanchandani-learned Standing Counsel for the Revenue would submit that the very fact that the assessee has reversed the entry to the claim of bad debt as can be seen from Note - 5 to the Notes to the Accounts in Schedule - 17 forming part of the accounts as on 31st March, 1991 of the assessee, there has been a violation of the mercantile method of accounting adopted by the assessee and therefore, the Tribunal has

rightly rejected the assessee's claim. He submits that the Assessing Officer has disallowed the debt as a bad debt after arriving at a conclusion that the decision of the assessee to write off the debt as irrecoverable was not *bona fide* inasmuch as the assessee had sought to reverse the entry to the claim of bad debt. He submits that the Tribunal has also rightly set aside the decision of the Commissioner (Appeals). He further submits that the written off debt has to be a bad debt and not any kind of debt can be written off as can be seen from the language of the said provision. In support of his contention, learned Standing Counsel refers to a decision of this Court in the case of ***Director of Income Tax V/s. Oman International Bank SOAG [2009(5) Bom.C.R.416]***. He however fairly states that notwithstanding the aforesaid objection, the requirement of Section 36(1)(vii) of the Act after the amendment only requires the writing off of the bad debt as irrecoverable as it is not necessary for the assessee to establish that in fact the debt has become irrecoverable.

13. We have heard Ms.Dinkle Hariya, learned Counsel for the Appellant and Mr.Vikas Khanchandani learned Standing Counsel for the Revenue and with their able assistance, we have perused the papers and proceedings in the matter.

14. Facts being undisputed, the only issue that arises for our consideration is whether the Tribunal was right in rejecting the claim of the assessee for deduction of bad debt written off under Section 36 (1)(vii) of the Act.

15. Section 36(1)(vii) of the Act is quoted as under:

Other deductions.

36. (1) *The deductions provided for in the following clauses shall be allowed in respect of the matters dealt with therein, in computing the income referred to in section 28-*

(i) to (vi).....

(vii) subject to the provisions of sub-section (2), the amount of any bad debt or part thereof which is written off as irrecoverable in the accounts of the assessee for the previous year:

Provided *that in the case of an assessee to which clause (vii) applies, the amount of the deduction relating to any such debt or part thereof 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:*

Provided further *that where the amount of such debt or part thereof has been taken into account in computing the income of the assessee of the previous year in which the amount of such debt or part thereof becomes irrecoverable or of an earlier previous year on the basis of income computation and disclosure standards notified under sub-section (2) of section 145 without recording the same in the accounts, then, such debt or part thereof shall be allowed in the previous year in which such debt or part thereof becomes irrecoverable and it shall be deemed that such debt or part thereof has been written off as irrecoverable in the accounts for the purposes of this clause.*

[Explanation 1.]—For the purposes of this clause, any bad debt or part thereof written off as irrecoverable in

the accounts of the assessee shall not include any provision for bad and doubtful debts made in the accounts of the assessee.

[Explanation 2.]—For the removal of doubts, it is hereby clarified that for the purposes of the proviso to clause (vii) of this sub-section and clause (v) of sub-section (2), the account referred to therein shall be only one account in respect of provision for bad and doubtful debts under clause (vii) and such account shall relate to all types of advances, including advances made by rural branches;”

16. The above provision was brought into effect from 1st April, 1989 by the Direct Tax Laws (Amendment) Act, 1987. Prior to the amendment, any debt which is established to have become a bad debt in the previous year could be allowed as a deduction. However, after 1st April, 1989, it is not necessary for an assessee to establish that the debt has become irrecoverable. Paragraph 4 of the decision of the Hon’ble Supreme Court in the case of ***T.R.F. Ltd. V/s. Commissioner of Income-tax (supra)*** is apt and is quoted as under:

“4. This position in law is well-settled. After 1-4-1989, it is not necessary for the assessee to establish that the debt, in fact, has become irrecoverable. It is enough if the bad debt is written off as irrecoverable in the accounts of the assessee. However, in the present case, the Assessing Officer has not examined whether the debt has, in fact, been written off in accounts of the assessee. When bad debt occurs, the bad debt account is debited and the customer's account is credited, thus, closing the account of the customer. In the case of companies, the provision is deducted from sundry debtors. As stated above, the Assessing Officer has not examined whether,

in fact, the bad debt or part thereof is written off in the accounts of the assessee. This exercise has not been undertaken by the Assessing Officer. Hence, the matter is remitted to the Assessing Officer for de novo consideration of the above-mentioned aspect only and that too only to the extent of the write off."

17. This Court in the case of ***Director of Income Tax V/s. Oman International Bank SOAG (supra)*** had the occasion to consider what is 'bad debt'. Paragraph 10 of the said decision describes bad debt to be a debt that cannot be recovered. A debt becomes bad debt when the creditor has no reasonable chance of recovering it from the debtor. It is a debt which cannot reasonably be collected nor is there any reasonable expectation of recovery. Expanding further with respect to the provisions of Section 36(1) (vii), in Paragraph 11, this Court observed that when the assessee treats the debt as a bad debt in his books, the decision has to be a business or a commercial decision and cannot be whimsical or fanciful. The decision must be based on material that the debt is not recoverable. The decision must be *bona fide*. This Court observed that the difference between the position, pre-amendment and post amendment would be that the burden is no longer on the assessee and can be claimed in the year it is written off in the books of account as irrecoverable. If the A.O. is to disallow a debt as a bad

debt, he must arrive at a conclusion that the decision to treat a debt as bad debt was not *bona fide*. The obligation on the assessee is that he must be *prima facie* satisfied based on information available that the debt is bad and that would be sufficient requirement of the amended provisions. Paragraphs 10 and 11 of the said decision are usefully quoted as under:

10. *Let us refer to some Dictionary meanings of the word "bad debt". Chambers 20th Century Dictionary refers to bad debt as "A debt that cannot be recovered". Mitra's Legal & Commercial Dictionary refers to bad debt as "A debt becomes bad debt when the Creditor has no reasonable chance of recovering it from the debtor as held in (Deoniti Prasad Vs. Commissioner of Income Tax), A.I.R. 1953 Pat. 360. The Law Lexicon refers to bad debt as "Debt which cannot reasonably be collected. A debt about which there is no reasonable expectation of recovery; A debt believed to be unrecoverable." Reference may also be made to page 878 of the "Law and Practice of Income Tax Law by Kanga, Palkhiwala and Vyas, 9th Edition, where the learned Jurist opined as under:-*

"Under the amended clause, the requirement of "establishing" that the debt had become bad in the relevant accounting year is dispensed with; all that the assessee has to show is that the bad debt has been written off as irrecoverable. But the subject-matter of the Clause is still "any bad debt" and "not any debt". The consequences of the amendment are mainly three:

(ii) The assessee cannot arbitrarily, irrationally or mala fide treat a good debt as bad write it off in his accounts.,(iii) Where the assessee has acted bona fide and reasonable, the Assessing Officer cannot substitute his own subjective judgment, but must

accept the assessee's decision, as to the quality of the debt.

(iv) The assessee is not obliged to write off and claim the debt in the very year in which it becomes bad. He can write it off and claim it in a subsequent year in which the debt continues to remain bad.

11. All this would indicate that when the assessee treats the debt as a bad debt in his books the decision which has to be a business ors commercial decision and not whimsical or fanciful. The decision must be based on material that the debt is not recoverable. The decision must be bona fide. The difference between the position, pre-amendment and post amendment would be that the burden is no longer on the assessee and can be claimed in the year it is written off in the books of account irrecoverable. The A.O. if he is to disallow the debt as a bad debt must arrive at a conclusion that the decision was not bona fide. The A.O. only in those circumstances and to that extent may interfere. All that the assessee must do is to be prima facie satisfied based on the information available that the debt is bad and that would be sufficient requirement of the amended provisions."

18. With the above prefatory discussion on the settled principles with regard to Section 36(1)(vii), post amendment, let us examine the facts of this case with reference to these principles.

19. The assessee had entered into a lease agreement with M/s.Orson Electronics Ltd., the lessee, to transfer the right to use by way of lease of certain equipment for which, it had already made payments to the suppliers. It received one installment from the lessee but did not receive payment of the further installments on

which, lessee had defaulted. The assessee following the mercantile system of accounting offered these incomes totaling to Rs.23,62,815.10 as set out earlier in the Assessment Years 1987-88, 1988-89 and 1989-90. However, in view of the dispute with the lessee, the assessee filed a winding up petition against the lessee in the Bombay High Court. It is not in dispute that the assessee had entered into a *bona fide* lease agreement with the lessee or that it had paid amounts to the suppliers of the equipment on behalf of the lessee. The first installment of the lease amount was received by the assessee. Further installments due were also accounted for in view of the mercantile system of accounting followed by the assessee. The depreciation was also claimed by the assessee on the equipment which was not disallowed by the Assessing Officer. The legal dispute between the assessee and the lessee was pending in the Bombay High Court. It is recorded in the order of the Commissioner of Appeals that the lessee company had become a sick company. Obviously, the prospects of recovery of lease rentals were quite bleak and the assessee considering that the same could not be recovered in the foreseeable future decided to write off a debt of Rs.20,69,859.30 as bad debt during the previous year relevant to the Assessment Year 1991-92. It is nobody's case that the assessee

had not complied with the provisions of Section 36(2) of the Act. The assessee took a business decision to write off the debt as a bad debt. Wise businessman would not want to spend good money in litigating for a bad bargain especially in the light of the facts noted above. Having taken the commercial decision to write off the debt as a bad debt based on the material, cannot lead to a conclusion that the decision was not *bona fide*. The lease rentals of Rs.20,69,805.30/- offered as income by the Appellant on mercantile basis had become bad and the Appellant decided to write it off and did write off the same in its books of accounts in the previous year in relation to A.Y. 1991-92 in terms of the amended Section 36(1)(vii). In our view, no fault can be found with the same.

20. Coming to the issue of reversal of lease rentals totaling to Rs.20.69 lakhs, that may be a change of the method of accounting by the assessee from mercantile to cash and may even be a breach of the accounting principles. However, that in our view is not a requirement of Section 36(1)(vii) of the Income Tax Act for allowing a debt as a bad debt. In fact, what emerges from Note-5 of making a special mention is that a prudent practice has been adopted by a limited company of informing its shareholders about

the remote possibility of recovery of the said amounts and the decision to reverse and that the same would be accounted for as and when received.

21. The reliance by the Tribunal on the decision of *Commissioner of Income - Tax V/s. Coates of India Ltd. [1998 232 ITR 324 Cal]*, in our view is also misplaced. We observe that the said decision was rendered with respect to the facts of a case relating to the pre-amended Section 36(1)(vii) and not to the post amended situation and is therefore distinguishable. Moreover, in view of what we have already observed with respect to the *bona fide* nature of the decision by the assessee to write off the debt as irrecoverable, the said decision would not further the case of the Revenue.

22. In our view, the finding of the Tribunal that the claim of the assessee in respect of bad debt cannot be considered, is without any basis. Once, a business decision has been taken to write off a debt as a bad debt in its books which decision as discussed above, is *bona fide*, that in our view, should be sufficient to allow the claim of the assessee. The method of accounting has no relevance to the issue. In our view, the Tribunal has misdirected itself in proceeding to give precedence to accounting principles over clear statutory

provisions. Evidently, the written off lease rental amount has not been reversed from the income entry in Schedule-16. This is a clear case of writing off a bad debt in accordance with the provision of Section 36(1)(vii) of the Income Tax Act. The Tribunal has erred in rejecting the claim of the assessee for deduction of bad debt written off under Section 36(1)(vii) of the Act. The substantial question of law framed in this Appeal is accordingly answered in favour of the Appellant Assessee and against the Revenue.

23. The order of the Tribunal dated 28th July, 2003 passed in Income Tax Appeal No.5403/M/97 is hereby set aside. The Assessing Officer is directed to allow the claim of bad debt of Rs.20,69,805/- and pass an appropriate Assessment Order in accordance with the aforesaid decision.

24. The Appeal is allowed in the above terms. No costs.

(ABHAY AHUJA, J.)

(DHIRAJ SINGH THAKUR J.)