Deduction of Bad Debts - Law is now settled

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Section 36(1)(vii) read with section 37(1) of the Income Tax Act, 1961 empowers an assessee to claim deduction of any bad debt or part thereof which is written off as irrecoverable.

Thus the Act provides for deduction of debt which is bad and written off as irrecoverable i.e. twin conditions of the debt being bad and write off as irrecoverable is required to be established.

However, earlier law was not clear and the courts took a narrow view regarding deduction of bad debts.

The Madras High Court in the case of South India Surgical Co. Ltd. v/s. Asstt. CIT (Mad) reported in 287 ITR 62 has observed as under:

"It is not sufficient for the assessee to say that he became pessimistic about the prospect of recovery of the debt in question. He must feel honestly convinced that the financial position of the debtor was so precarious and shaky and that it would be impossible to collect any money from him. The question is really one of fact depending upon the various facts and diverse circumstances bearing on the debtor's pecuniary position, his commitments and obligations. The judgment of the assessee regarding the debt as bad debt must be an honest judgment and not a convenient judgment. The judgment of the assessee must be established to have been taken on relevant facts and circumstances, which should show that the debt is not realisable for some fault on the part of the debtor or some supervening impossibility on the part of the debtor to pay, but not possible difficulties or hurdles the assessee may have to incur to compel the recalcitrant debtor to pay. The assessee for his convenience may decide that the debt is too small and it is not worthwhile to pursue the debtor but that judgment would not be a honest judgment, which would establish that the debt has become a bad debt. A time-barred debt can be assumed to be bad, but is not necessarily bad because of expiry of limitation for recovery of the same."

With the above observations the Madras High Court has held as under:

"Except the unilateral act of the assessee to write off the debts as bad debts in the books of account for the previous year relevant to the assessment year in question, the assessee has not made out any case regarding the debts as irrecoverable. The judgment of the assessee in regarding the debts as bad debts was not an honest judgment having regard to the financial position of the hospitals. The Tribunal was right in law in holding that the debt claimed by the appellant as bad had not become bad and thus not allowable as deduction under Section 36(1)(vii)."

Under the scheme as provided for under the Income-tax Act, the entries which were made, as to whether the same were genuine entry and not imaginary and fanciful entry, qua the same the Assessing Officer was fully empowered to make inquiry. However, wisdom of the assessee could not be in such manner questioned and no demonstrative or infallible proof of bad debt having become bad was required, and commercial expediency was to be seen from the point of view of the assessee, depending on the nature of the transactions, capacity of debtor, etc., but qua entry, semblance of genuineness was there and the same should not be mere paper work. The High Court was of the view that under section 143(2) of the I.T. Act, the Assessing Officer was empowered to require the assessee to produce the evidence in support of the return, as such where the assessee had claimed as bad debt or part thereof, written off as irrecoverable in the accounts of the assessee under the provisions of sec. 36(1)(vii) of the I.T. Act, 1961, then on the strength of the amendment made on 1.4.1989, it could not be said that an inquiry was not permissible under the provisions of the Income-tax Act to see and satisfy that there was some semblance of the genuineness in the entry, which had been made, the same was not at all totally

fake entry as the assessee would be entitled for deduction only if it was bad debt, or part thereof.

Now let me refer to the judgement of the Supreme Court in the case of Travancore Tea Estates Co. Ltd. v. CIT (1998) 233 ITR 203 (SC). In this case the Supreme Court had taken the view, that as to whether a debt had become bad or at what point of time it became bad, were all questions of fact. Though standard of proof of proving the same as bad debt, is not r·equired to be adopted and is to be decided on the wisdom of the assessee and not on the wisdom of the Assessing Officer, but to show that entry which had been made as bad debt there was some material in support of the same,. Giving some semblance of genuineness and truthfulness to the same in the direction of forming opinion, that said debt was arising out of trading activity, there was relationship of debtor or creditor, the same was irrecoverable. Thus, it was held that in this case on the substantial question of law posed, the provision of section 143(2) of the I.T. Act vis-a-vis section 36(1)((vii) of the I.T. Act, read with section 36(1) of the I.T. Act both would be harmonized to give purposeful meaning to both the statutory provisions, as one extends benefits to the assessee of deduction for their debt or part thereof becoming bad and to other authorizes the Assessing Officer to see that the provision of the Income -Tax Act are not flouted by any means.

In the case of DCIT v/s. Oman International Bank, the Allahabad High Court held that the order passed in the case of Oman International Bank dated 4.08.06 is quashed and set aside with an observation that u/s. 143(2) of the Income Tax Act 1961, the AO is empowered to require the assessee to produce the evidence in support of the claim of a bad debt.

We should also not loose sight of on the decision of Dhal Enterprise and Engineers Pvt. Ltd. v/s. CIT 295 ITR 481 where their Lordships of GujMat High Court has held that the assessee has to prove that debt as a bad debt ir1 view of the language of law used in section 3G(1)(vii) of the Income Tax Act, 1961.

However let me now focus on recent Judicial developments regarding claim of deduction of bad debts.

The Ahmedabad Bench of the IT AT in the case **of** Asstt. **CIT Baroda v/s. M/s. TDW.India Ltd.** has held as under:

"I have considered the submissions of the ld. A.R. and the facts of the case. The rule of evidence regarding the writing off of bad debts u/s 36(1)(vii) has undergone change with the amendment of the section with effect from 1-4-1989. In the pre-amended section, the expression used was "any debt or part thereof, which is established to have become a bad debt in the previous year." This has been omitted by the amendment and substituted by the expression "written off as irrecoverable". Thus, the intention of the Legislature appears to be that, whereas earlier it was incumbent upon the assessee to establish that the debt had become bad during the previous year, after the said amendment, it was sufficient that the assessee had merely written off the debt as irrecoverable however, there continued to prevail an opinion that since the word "debt" was preceded by the word "bad", not every debt written off was allowable but only a debt which was "bad" was allowed to be written off. In this view, there still remained a duty cast upon the assessee to establish that the debt had become bad during the previous year.

In order to resolve the divergent judicial opinion the, Special bench of the IT AT was constituted to look into the issue. The Special Bench has held in the case of DCIT vs. Oman International Bank, 100 ITO 285 (Mum.SB) that prior to the amendment, assessee had to establish that the debt had become bad during the previous year and the AO could allow or disallow the claim on the basis whether the debt had become bad during the said previous year or not. In other words, irrespective of the write-off claimed by the assessee, the deduction was still dependent on the finding of the A.O. regarding the previous year in which the debt has become bad, based on which, the A.O. would allow the deduction either in an earlier assessment year or in a later assessment year, which was different from the assessment year in which the assessee had written off the debt as bad. Referring to the CBDT Circular No, 551 dated 23.1.1990, the Special Bench observed that the amendment was brought to do away with all the complications involved in determining the issue of deductibility of

bad debts as well as the year in which the deduction was to be allowed. The dispute regarding the year in which the debt has to be allowed as deduction was held to be resolved by the clear statement of the amended law that the deduction was allowable in the year in which the debt has been written off as irrecoverable. Thus, the wording of the law and the legislative intent were clear in as much as the earlier rule of establishing that the debt had become bad was omitted from the provisions of law. It was further held that "the act of writing off a debt as irrecoverable in the accounts of the assessee, is deemed to be discharging the onus of the assessee in holding a debt as bad. When the statute has provided the mode of discharging the onus of proof by writing off the debt as bad, it is not incumbent on the revenue to call for further evidence. The rule regarding the deductibility of bad debt provided in section 36(1)(vii) after the amendment is a statutory rule by itself and, there is no need of insisting on any other proof. The statutory rule itself declares the rule of deduction of bad debt. If it is again necessary to prove by demonstrative proof that the debt has become bad, then there was no necessity to insert a statutory rule. The onus of proving the debt as bad debt has been prescribed by the statutory rule. Once that statutory rule is satisfied by following the prescribed method, no further obligations remain on the assessee to be discharged."

In view of the decision of the Special Bench, which is squarely applicable on the facts of the present case, I am of the opinion that the AO was not justified in asking for demonstrative proof regarding the irrecoverability of the debts. The above view is reinforced by the decision of the Gujarat High Court in CIT vs. Girish Bhagwat Prasad 256 ITR 772. Following the above cited decisions, the disallowance of bad debts amounting to Rs.10,11,966/- is directed to be deleted."

Also in the case of T.R.F. Ltd. v/s. CIT reported in 230 CTR 14(SC) has held as under:

"This position in law is well-settled, after l't April, 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."

Finally:

It is submitted that once a debt is written off as a bad debt, the same has to be allowed as deduction u/s. 36(1)(vii) of the Income Tax Act, 1961, unless the write off is not genuine and is proved by the AO that the same is not genuine.

The Central Board of Direct Taxes, in its Circular No. 551 dated 23-1-1990 [183 ITR St.) 37)] , has explained the object and the ambit of the amendment in the following manner:

Amendments to section 36(1)(vii) and 36(2) to rationalize 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 allowability of bad debt. It was provided that the debt must be established to have become bad in the previous year. This lead to enormous litigation on the question of allowability of bad debt in a particular 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 rationalize 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 the debt will be allowed in the year in which such a bad debt has been written off as irrecoverable in the accounts of the assessee."

Prior to the amendment explained above, an assessee had to establish that the debt has become bad during the previous year and the Assessing Officer may allow or disallow the claim in terms of section 36(2) on the basis of his observation whether· the debt has become bad during the. said previous year or not. In other· words, irrespective of the write off claimed by the assessee, the deduction was still dependent on the finding of the Assessing officer· that in which previous year the debt has become bad and based on which the Assessing Officer could allow the deduction either in an earlier assessment year or in a later assessment year which is different from the assessment year in which the assessee has written off the debt as bad debt. As explained by the above circular, the

amendment has been brought to do away with all the complications involved in determining the issue of deductibility of bad debts under section 36(1)(vii). The amendment decided the year in which the deduction has to be allowed; as the year in which the *assessee* has written off the debt as bad debt in the books of account. The amendment has also done away with the requirement of establishing that the debt has become bad.

This is clear from the circular of the Board where it is stated that the amendment has been brought to eliminate the disputes in the matter of determining the year in which a bad debt can be allowed and also to rationalize the provisions. Even after the amendment, if the *assessee* is again called upon to establish that the debt has become bad, the true spirit of the amendment will not be fulfilled. The intent and purpose of the amendment is to avoid litigations and do away with all sorts of disputes regarding the allowability of bad debts as a deduction in computing the income of an *assessee*.

The dispute regarding the year in which the debt has to be allowed as a deduction has been resolved by the clear statement of the amended law that the deduction shall be allowed in the year in which the debt has been written off as irrecoverable. It is very important to note that the earlier expression" any debt, or part thereof, which is established to have become a bad debt in the previous year "has been conspicuously omitted by the amendment and substituted by the expression" written off as irrecoverable".

The words of the law are clear and the intent and purpose of the amendment are manifest. The earlier rule of establishing that the debt has become bad is omitted from the provisions of law. Therefore, there is no occasion or provocation to consider whether the assessee has again to establish that the debt has become bad. In fact, there is no provocation at all to go to that extent of discussion because the amendment has omitted the expression "debt which is established to have become a bad debt."

I am of the view that when the amendment has been brought to cure a defect and the amendment has omitted the expression which has made way for such defect there is no reason to ponder over the past and to decide the matter still under the law as it stood prior to the amendment.

CBDT Circular No. 551, dated 23rd January, 1990 inter alia clarifies the rationale for amending section 36(1)(vii) by stating that the section was being amended, so that the claim for Bad Debts would be allowed in the year in which such a bad debt is written off as irrecoverable in the accounts of the *assessee.* The Hon'ble Gujarat High Court has in the *case* of CIT V/s Girish Bhagwatprasad (256 ITR 772) observed that with effect from 1st April, 1989 all that the assessee had to show was that the bad debt was written off as irrecoverable and the veracity of the doubtful debts cannot be gone into by the Department. An assessee would be the best judge from the commercial perspective as to whether the debt has become bad and the Department could not go behind it. The reliance on the judgment of the Hon'ble Gujarat High Court in the case of Dhall Enterprises (295 ITR 481) is misconceived since the said judgment pertains to the assessment year prior to the amendment dated 1.4.1989. Thus, the said judgment is not applicable in view of the amended provisions and the settled legal position with regard to the effect of the amendment to the section w.e.f. 1.4.1989.

The Delhi High Court also extensively relied on this circular in the case of **CIT v. Morgan Securities and Credit Pvt. ltd.** and held that this circular clearly left no scope for debate and that a bad debt was allowable in the year as write-off in the accounts. The said view is also supported by the decision in the case of **Dy. CIT** v/s **Patidar Ginning and Pressing Co.** (157 **CTR 177)** where the issue before the Hon'ble Gujarat High Court was whether it was sufficient for the assessee to write off as bad debts and he need not establish that the same had become bad. The High Court affirmed the view of the Tribunal relying upon the amendment to the section w.e.f. 1.4.1989.

It is respectfully submitted that after the amendment to section 36(1)(vii) of the Act with effect from 01.04.89 and in view of the decision of the Supreme Court in this case of TRF Ltd. once the debt is written off as bad debt, the same has to be allowed as deduction u/s. 36(1)(vii) of the Income Tax Act 1961 unless this write off is not genuine.

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