



## EMBEZZLEMENT LOSS

Whether loss on account of embezzlement by an employee can be allowed as deduction while computing business income?

### Issue

When embezzlement takes place in a business organization it is allowable as a business loss.

### Proposition

Loss caused due to embezzlement by employee or agent is allowable as deduction. However, there is no specific section allowing such deduction and hence it is proposed that the loss caused to the employer by the embezzlement by the employee is incidental to business and the same is allowable as deduction.

### View against the proposition

It is submitted that there is no provision in the Income tax Act for deduction of embezzlement loss. It can not be claimed as expenditure incurred for the purpose of business. However, the Hon Madras High Court in the case of Gothamchand Galada vs. CIT (1961) 42 ITR 418, has laid down exclusive tests for allowability of the said loss.

“The test to apply in deciding whether a loss sustained by a businessman, when an employee of his embezzled funds left in the charge of that employee, constitutes a trading loss of the business of the employer is whether the loss was incidental to the carrying on of that business. Was the employment of the employee in the normal course of that business and was it a normal incidental of the conduct of that business? Was the entrustment of the funds of the employer to that employee in the normal course of the conduct of that business?

Was the loss caused to the employer by the embezzlement by the employee incidental to that entrustment? These questions have to be answered from the view point of a prudent man of business. If these tests are satisfied then the loss would be a trading loss.”

Thus, as per this decision it is very clear that the assessee will have to prove that the embezzlement loss is in the normal course of business and it is normal incidental of the conduct of that business. The entrustment of the funds of the employer to the employee must be in the normal course of the conduct of that business. It is debatable whether when employee drawing salary of Rs. 10,000/- is handed over blank signed cheques is normal conduct of the business? In my opinion it is not and hence it can not be claimed as normal trading loss.

Further it is submitted that if embezzlement is done by the partner of the partnership firm then also the loss can not be claimed as incidental to the carrying on the business. Further if the funds are made available to an agent and embezzlement loss is caused which is not normal incidence of the business then also such loss can not be allowed as deduction.

It is further submitted that if no proceeding have been initiated against the defaulting employee then the assessee will have to establish that the embezzlement loss have been incurred by leading strong evidences.

The assessee should have made necessary attempt to recover the loss from the persons concerned and had failed or he has not made such attempt because it was useless in view of the financial position of the person concerned. But where, the assessee did

not make attempt to recover the amount and the financial position of the person was not bad, the amount cannot be allowed to be deducted as loss. [CIT vs. Ashwani Kumar Liladhar (1997) 143 CTR 449 (All)].

### **View in favor of the Assessee**

Loss caused due to embezzlement by employee or agent is allowable as deduction. It has been held by the hon'ble Supreme Court in the case of Badridas Daga vs. CIT 34 ITR 10, as follows:

“A business especially such as is calculated to yield taxable profits has to be carried on through agents, cashiers, clerks and peons. If employment of agents is incidental to the carrying on of business, it must logically follow that losses which are incidental to such employment are also incidental to the carrying on of the business. Human nature being what it is, is impossible to rule out the possibility of an employee taking advantage of his position as such employee and misappropriating the funds of his employer, and the loss arising from such misappropriation must be held to arise out of the carrying on of business and to be incidental to it.”

### **Summation**

Is it the year in which deduction for loss on account of embezzlement is the year in which took place, or it was discovered, or it was quantified? Courts have not taken a uniform view on the matter. It is agreed that embezzlement in the course of business is deductible, as decided in Badridas Daga vs. CIT [1958] 34 ITR 10 (SC), though there is no specific provision in law for allowing the same. The year in which the amount could be allowed is generally taken to be the year in which embezzlement took place. In Associated Banking Corporation of India Ltd. Vs. CIT [1965] 56 ITR 1 (SC), it was pointed out that embezzlement results in trading loss, when the embezzlement takes place, whether the employer was aware or not. It is in this context

that it was decided in Shitla Prasad Shyamlal vs. CIT [1991] 188 ITR 514 (All) that deduction need not await final outcome of the criminal proceedings taken against the embezzler.

In the case of Bombay Forgings Pvt. Ltd. Vs. CIT 206 ITR 562 where it was pointed out that the quantification at the time of preparation of final accounts can be taken as the basis and be allowed in the year of embezzlement. Where the extent of embezzlement was not ascertainable during the year, the claim in the year in which it was ascertained by the Chartered Accountant after examination of accounts and receipt of report by the assessee was not accepted, as the Tribunal found that it should have been claimed in the earlier year, when the embezzlement took place. With respect this decision does not appear to have laid down the correct position of law. It is submitted that Loss due to embezzlement does not necessarily arise the moment embezzlement takes place. If the assessee detects or become aware of the loss later, then it is only on such detection that the loss can be said to have incurred. Also, in case the proceedings for recovery of the amount are initiated, the loss “matures” only when there is reasonable cause to conclude that the amount cannot be recovered. It is also useful to refer to the decision of their lordships in the case of Dinesh Mills Ltd. vs. CIT 254 ITR 673, where it was decided that the embezzlement loss claimed shall be admissible if it is not possible to recover the loss from the person responsible for the same.

However, the CBDT Circular No. 35-D (XLVII-20) of 1965, F.No. 10/48/65 – IT (AI), dated 24.11.1965 directs the assessing officer to allow loss arising due to embezzlement by employees in the year in which it was discovered.

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