

A COMMISSIONER OF INCOME TAX, A.P.

v.

M/S. T.VEERABHADRA RAO, K. KOTESWARA RAO & CO.

JULY 8, 1985

B [R.S. PATHAK AND E.S. VENKATARAMIAH JJ.]

Income Tax Act, 1961, Sec. 36(1)(vii)- Business of a predecessor firm with assets and liabilities taken over by the assessee-Assessee paying income tax on interest income accruing on debt - Part of debt written off as a bad debt - Whether it could be allowed as a deduction.

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D The assessee, a partnership firm, took over the running business of an earlier firm with all the assets and liabilities including a debt of Rs.23,577. The assessee paid income tax on the interest income accruing on the aforesaid amount of debt for the assessment year 1963-64. On March 31, 1965 the assessee and the debtor entered into a settlement whereby a sum of Rs.25,000 was accepted by the assessee in satisfaction of the debt and the amount of interest due thereon. The balance of Rs. 15,100 was written off by the assessee as irrecoverable. The assessee also incurred a sum of Rs. 6,880 as legal expenses on filing an appeal which arose out of a suit already instituted by the predecessor firm for recovering a sum due from the Central Government.

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F In assessment proceedings for the assessment year 1965-66, the assessee claimed deduction of the aforesaid two amounts written off as bad debts. The Income Tax Officer disallowed both the claims. On appeal, the Appellate Assistant Commissioner of Income Tax allowed the claims of the assessee-firm holding that the business transferred from the predecessor firm to the assessee continued uninterrupted, and the change of ownership was no bar to the bad debt being allowed. The Income Tax Appellate Tribunal and the High Court confirmed the view taken by the Appellate Assistant Commissioner. Hence this appeal.

G Dismissing the appeal,

H HELD: (1) The money owed by a debtor under a transaction with a predecessor firm can be written off as irrecoverable in the accounts of the successor, the assessee, in a subsequent year and could be claimed as a bad debt under clause (vii) of sub-s.(1) of s.36 of the Income Tax Act, 1961. [24 A-B]

(2) When a business along with its assets and liabilities is transferred by one owner to another, there is no reason why a debt so transferred should not be entitled to the same treatment in the hands of the successor. The recovery of the debt is a right transferred along with the numerous other rights comprising the subject of the transfer. If the law permits the transferor to treat the whole or part of the debt as irrecoverable and to claim a deduction on that account, it seems difficult to accept that the same right should not be recognised in the transferee. It is merely an incident flowing from the transfer of the business, together with its assets and liabilities, from the previous owner to the transferee. It is a right which should, on a proper appreciation of all that is implied in the transfer of a business, be regarded as belonging to the new owner. [25 E-H]

(3) Even if the debt had been taken into account in computing the income of the predecessor firm only and had subsequently been written off as irrecoverable in the accounts of the assessee, the assessee would still have been entitled to a deduction of the amount written off as a bad debt. It is not imperative that the assessee referred to in sub-clause (a) must necessarily mean the identical assessee referred to in sub-clause (b). A successor to the pertinent interest of a previous assessee would be covered within the terms of sub-clause (b). The successor assessee, in effect, steps into the shoes of his predecessor. [26 E-F]

In the present case, the debt was taken into account in the income of the assessee for the assessment year 1963-64 when the interest income accruing thereon was taxed in the hands of the assessee. It is the same assessee who has subsequently, pursuant to a settlement, accepted part payment of the debt in full satisfaction and has written off the balance of the debt as irrecoverable in his accounts. Therefore the conditions in both sub-clause (a) and (b) of Clause (1) of sub-s.(2) of s.36 are satisfied. The same test has to be applied for acknowledging the claim to deduction of Rs. 6,880. [26 B-D]

CIVIL APPELLATE JURISDICTION : Civil Appeal No. 114 (NT) of 1975.

From the Judgment and Order dated 16.1.1974 of the Andhra Pradesh High Court in Case Referred No. 9 of 1972.

B.B. Ahuja and Miss A. Subhashini for the Appellant.

A A. Subba Rao for the Respondent.

The Judgment of the Court was delivered by

B PATHAK, J. This appeal by special leave is directed against the judgment of the High Court of Andhra Pradesh disposing of a reference made under sub-s.(1) of s.256 of the Indian Income Tax Act, 1961 for its opinion on the following question of law.

C "Whether on the facts and in the circumstances of the case the bad debt of Rs.15,100 and the legal expenses of Rs.6,880 were allowable deductions in the assessment of the assessee firm for the assessment year 1965-66?"

D The assessee is a partnership firm. It took over the business of an earlier firm. All the assets and liabilities of the predecessor firm passed on to the assessee firm. These included a debt of Rs.23,577 due from Laxmi Trading Company to the predecessor firm. The total amount due in the account relating to Laxmi Trading Company was Rs.40,549 comprising an outstanding amount of Rs. 29,200 and interest thereon in the sum of Rs. 11,349 for the period April 31, 1960 to March 31, 1961. The amount of interest was taxed in the hands of the assessee for the assessment year 1963-64. On March 31, 1965 the parties effected a settlement under which a sum of Rs.25,000 was accepted by the assessee in full settlement of the said debt. The balance of Rs.15,100 was written off as irrecoverable.

F In assessment proceedings for the assessment year 1965-66, for which the previous year was the year ending March 31, 1965 the assessee claimed a deduction of the aforesaid sum of Rs. 15,100 written off as a bad debt. The Income-tax Officer disallowed the claim on the ground that the debt was due originally to the predecessor firm, that there was no reason to take over the loan by the assessee firm and further that it was not proved that the debtor was so financially embarrassed that he was unable to pay the debt. On appeal, the Appellate Assistant Commissioner of Income Tax held that the business transferred from the predecessor firm to the assessee continued uninterrupted, and the change of ownership was no bar to the bad debt being allowed. He also noted that the assessee had paid income-tax on the interest of Rs.11,349, in an earlier assessment year, and held that the assessee's bonafides stood established. Holding that there was

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justification for writing off the bad debt in the measure claimed by the assessee, the Appellate Assistant Commissioner allowed the appeal.

It may be mentioned that the assessee had also claimed a deduction of a sum of Rs. 6,880 before the Income-tax Officer on the ground that the assessee had incurred legal expenses in that amount in connection with an appeal filed in the Supreme Court for the purpose of recovering a sum due from the Central Government. The transaction related to the predecessor firm and the suit instituted by it had been continued by the assessee on taking over the assets and liabilities of the predecessor firm. The Income Tax Officer disallowed this claim also, but in appeal the Appellate Assistant Commissioner upheld the claim.

The Income-tax Department appealed to the Income-tax Appellate Tribunal against the order of the Appellate Assistant Commissioner and urged that cl.(i) of sub-s.(2) of s.36 of the Income Tax Act, 1961 did not permit such an allowance because it did not satisfy the requirement mentioned in cl.(a) and cl.(b) of that provision, and therefore it was not open to the assessee to claim a deduction of Rs.15,100 as a bad debt nor the legal expenses of Rs.6,880. The Appellate Tribunal dismissed the appeal, holding that where a business was succeeded to by an assessee, it was entitled to write off the bad debts of the business taken over. The Appellate Tribunal observed that whenever a business was succeeded to as a whole and as a running enterprise the assets and liabilities so taken over became the assets and liabilities of the successor and, therefore, the assessee was entitled to write off the bad debts. It noted that the assessee had not only treated the amount a debt owed to it but had allowed the interest accrued thereon to be assessed in its hand as the interest constituted part of the debt. At the instance of the Commissioner of Income-tax, a reference was made to the High Court of Andhra Pradesh for its opinion on the question set forth earlier. The High Court answered the question in the affirmative and against the Department.

It is not disputed that the assessee succeeded to the business of the predecessor firm and took over all its assets and liabilities, including the debt due from Laxmi Trading Company. The business carried on by the predecessor firm was now carried on by the assessee. The facts also show that the assessee paid income tax on the interest income accruing on the debt for the assessment year 1963-64. It is also not disputed that the parties effected a settlement on March 31, 1965 whereby a sum of

A Rs. 25,000 was accepted by the assessee in satisfaction of the debt and that the balance of Rs.15,100 was written off by the assessee as irrecoverable. The question is whether money owed by a debtor under a transaction with a predecessor firm can be written off as irrecoverable in the accounts of its successor, the assessee, in a subsequent year and could be claimed as a bad debt under cl.(vii) of sub-s.(1) of s.36 of the Income Tax Act, 1961.

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Cl.(vii) of sub-s.(1) of s.36 of the Income Tax Act, 1961 provides :

C "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 -

(vii) subject to the provisions of sub-s.(2), the amount of any debt, or part thereof, which is established to have become a bad debt in the previous year".

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Sub-s.(2) of s.36 declares :-

E "(2). In making any deduction for a bad debt or part thereof, the following provisions shall apply :-

(i) no such deduction shall be allowed unless such debt or part thereof -

(a) has been taken into account in computing the income of the assessee of the previous year or of an earlier previous year, or represents money lent in the ordinary course of the business of banking or money-lending which is carried on by the assessee, and

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(b) has been written off as irrecoverable in the accounts of the assessee for that previous year;

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(ii) if the amount ultimately recovered on any such debt or part of debt is less than the difference between the debt or part and the amount so deducted, the deficiency shall be deductible in the previous year in which the ultimate recovery is made;

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(iii) any such debt or part of debt may be deducted if it has already been written off as irrecoverable in the accounts of an earlier previous year, but the Income-tax Officer had not allowed it to be deducted on the ground that it had not been established to have become a bad debt in that year;

(iv) where any such debt or part of debt is written off as irrecoverable in the accounts of the previous year and the Income-tax Officer is satisfied that such debt or part became a bad debt in any earlier previous year not falling beyond a period of four previous years immediately preceding the previous year in which such debt or part is written off, the provisions of sub-section (6) of section 155 shall apply".

S.28, referred to in sub-s.(1) of s.36, provides that income under the head "Profits and gains of business or profession", shall be chargeable to income-tax. The profits and gains of a business are charged to income-tax. To compute the profits and gains so chargeable, s.36 provides for allowing a number of deductions. Each of the deductions must relate to the business. If the same assessee was carrying on a business and he wrote off a debt relating to the business as irrecoverable, he would without doubt be entitled to a corresponding deduction under cl.(vii) of sub-s.(1) of s.36 subject to the fulfilment of the conditions set forth in sub-s.(2) of s.36. If a business, along with its assets and liabilities, is transferred by one owner to another, we see no reason why a debt so transferred should not be entitled to the same treatment in the hands of the successor. The recovery of the debt is a right transferred along with the numerous other rights comprising the subject of the transfer. If the law permits the transferor to treat the whole or part of the debt as irrecoverable and to claim a deduction on that account, it seems difficult to accept that the same right should not be recognised in the transferee. It is merely an incident flowing from the transfer of the business, together with its assets and liabilities, from the previous owner to the transferee. It is a right which should, on a proper appreciation of all that is implied in the transfer of a business, be regarded as belonging to the new owner. Unless the language of the statute plainly and clearly compels a construction to the contrary, the normal rule of the law should be given its proper play. It is true that cl.(i) of sub-s.(2) of s.36 declares that a deduction can be allowed only

A if the debt, or part thereof, has been taken into account in
computing the income of the assessee of that previous year or an
earlier previous year and that it has also been written off as
irrecoverable in the accounts of the assessee for that previous
year. In the present case, the debt was taken into account in
B the income of the assessee for the assessment year 1963-64 when
the interest income accruing thereon was taxed in the hands of
the assessee. The interest was taxed as income because it repre-
sented an accretion accruing during the earlier year on money
owed to the assessee by the debtor. The item constituted income
because it represented interest on a loan. The nature of the
income indicated the transaction from which it emerged. The
C transaction was the debt, and that debt was taken into account in
computing the income of the assessee of the relevant previous
year. It is the same assessee who has subsequently, pursuant to
a settlement, accepted part payment of the debt in full satisfac-
tion and has written off the balance of the debt as irrecoverable
in his accounts. It appears therefore that the conditions in both
sub-clauses (a) and (b) of cl.(1) of sub-s.(2) of s.36 are satis-
fied in the present case, and the High Court as well as the
D Appellate Tribunal and the Appellate Assistant Commissioner are
right in the view which they took.

It seems to us that even if the debt had been taken into
account in computing the income of the predecessor firm only and
had subsequently been written off as irrecoverable in the
E accounts of the assessee, the assessee would still have been
entitled to a deduction of the amount written off as a bad debt.
It is not imperative that the assessee referred to in sub-cl.(a)
must necessarily mean the identical assessee referred to in
sub-cl (b). A successor to the pertinent interest of a previous
assessee would be covered within the terms of sub-cl.(b). The
F successor assessee, in effect, steps into the shoes of his
predecessor.

Accordingly, we hold that the assessee in the instant case
was entitled to the deduction as a bad debt of the sum of Rs.
15,100 written off by it in its accounts of the previous year as
G irrecoverable.

We may add that although a number of decisions of various
High Courts were cited before us on behalf of the assessee we
consider it unnecessary to refer to them.

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As regards the sum of Rs.6,880 claimed by the assessee as legal expenses in connection with an appeal filed in this Court to recover an amount due from the Central Government, it is apparent that the transaction related to the predecessor firm and the suit instituted by it was continued by the assessee on taking over the assets and liabilities of the predecessor firm. The Income Tax Officer, the Appellate Assistant Commissioner, the Appellate Tribunal and the High Court dealt with this claim on the same basis as the claim made in respect of the bad debt. We are satisfied that the view we are taking in respect of the sum of Rs. 15,100 claimed as a bad debt should also form the basis for acknowledging the claim to deduction of Rs.6,880.

In the result, the appeal is dismissed with costs.

M.L.A.

Appeal dismissed.