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IN THE HIGH COURT OF JUDICATURE AT BOMBAY
ORDINARY ORIGINAL CIVIL JURISDICTION
INCOME TAX APPEAL NO.89 OF 2011

The Commissioner of Income Tax,
Central-II, Mumbai Appellant

Versus

Shri Shreyas S. Morakhia Respondent

Mr.Vimal Gupta with Ms.Padma Divakar for appellant.

Mr.Hiro Rai with Mr.Subhash S. Shetty for respondent.

CORAM: DR.D.Y. CHANDRACHUD &
M.S.SANKLECHA, JJ.

February 28, 2012.

ORAL JUDGMENT (PER DR.D.Y.CHANDRACHUD,J.)

1. This appeal by the Revenue arises from a decision of a Special Bench of the Income Tax Appellate Tribunal dated 16 July 2010. The Special Bench of the Tribunal was constituted to decide the following question of law

> Whether on the facts and circumstances of the case and in law, the assessee, who is a share broker, is entitled to deduction by way of bad debts under Section 36(1)(vii) read with Section 36(2) of the Income Tax Act, 1961 in respect of the amount which could not be recovered from its clients in respect of transactions effected by him on behalf of his clients apart from the commission earned by him.

The Special Bench answered the question referred in the affirmative and in favour of the assessee.

2. In the batch of appeals, a common question of law arises. We proceed to dispose of the appeal arising out of the decision of the Special Bench. The Court has, however, in the interest of fairness heard the counsel in the batch of appeals on the questions of law raised. The appeal by the Revenue raises the same question of law as was referred to the Tribunal as noted above. The appeal is admitted on the question formulated and taken up for hearing and final disposal with the consent of the counsel for the Revenue and the counsel for the assessee.

3. The Assessment Year to which the appeal pertains is

1998-99. The assessee is a share broker. A return of income was filed on 2 November 1998 declaring a total income of Rs.67,797/-. The assessee claimed a deduction of Rs.28.24 lacs representing an amount due to him by his clients on account of transactions of shares effected by the assessee on their behalf. The assessee claimed that the amount had become irrecoverable. The amount was claimed as a deduction after having been written off as irrecoverable from the books of account. The Assessing Officer disallowed the deduction holding that the business in respect of which the debts had arisen had ceased to exist in the year under consideration and also on the ground that no action was taken against the clients to recover the amounts due from them. In appeal, the Commissioner (Appeals) held that though the assessee had sold the membership card of the Mumbai Stock Exchange, he continued to carry on broking business as a sub broker and hence the business of the assessee had not ceased to exist but continued during the year under consideration. The Commissioner held that the failure of the assessee to initiate recovery proceedings could not be a ground for denying a claim for bad debts under Section 36(1)(vii). The claim of the assessee was accordingly allowed. An appeal was filed by the Revenue before the Income Tax Appellate Tribunal; the contention of the Revenue being that

since the assessee had credited only the amount of the brokerage to the profit and loss account, the amount of bad debts claimed was not taken into account in computing the total income of the relevant previous year or of any earlier previous year. Hence according to the Revenue the condition stipulated in Section 36(2) was not satisfied and the assessee was not entitled to claim a deduction in respect of the bad debts under Section 36(1)(vii). Since there was a conflict of opinion among coordinate Benches of the Tribunal, a Special Bench was constituted which has rendered its decision on the question of law referred.

4. Counsel appearing on behalf of the Revenue submits that admittedly in the present case it is only the brokerage charged to the client of the assessee which was reflected on the credit side of the profit and loss account. The debt which was due and owing to the assessee from its clients on account of the non payment of the purchase price of the shares transacted did not form part of the profit and loss account and was, therefore, according to the Revenue not taken into account in computing the income of the assessee for the previous year. Consequently it was urged that the assessee would not be entitled to claim a deduction on account of bad debts for want of compliance with the

provisions of Section 36(2)(i). Another limb of the submission is that, whereas brokerage is charged to the client when the order is executed, the stock broker, on the settlement day has to make good the payment for the purchase price of the shares transacted to the stock exchange irrespective of whether the payment is received from the client. Hence it has been submitted that brokerage and the debt towards the purchase price of shares arise at different points in time. Consequently, where the assessee credits only the brokerage to the profit and loss account, as in the present case, it cannot be postulated that the debt or any part thereof has been taken into account in computing the income of the assessee. In other words, the submission is that the debt due by the client to the stock broker on account of the value of the shares purchased is distinct from the debt due on account of the brokerage payable on the transaction in shares.

5. On the other hand, it has been urged on behalf of the assessee by Counsel that there is a fundamental fallacy in the contention of the Revenue that the conditions of Section 36(2)(i) are not satisfied only on the ground that only brokerage is shown as a credit in the profit and loss account. The words used in Section 36(2)(i) are “no such deduction shall be allowed unless such debt or part thereof has been taken into account in

computing the income of the assessee of the previous year". The assessee as a stock broker raises a bill reflecting (i) The rate, quantity and total value of the shares transacted; (ii) Security Transaction Tax; and (iii) Brokerage together with service tax. The value of the shares transacted on behalf of the client and the brokerage form part of one composite transaction. The amount of brokerage is credited, in the profit and loss account. The true test is whether the debt or any part thereof has been taken into account in computing the income of the assessee. The brokerage is taxed as income because it is a charge for the service rendered by the broker to its client. Both the value of the shares and brokerage form part of one transaction. If the client of the stock broker fails to pay the amount due on account of the shares transacted, the stock broker is obliged to make good the purchase price to the Stock Exchange. The shares which would be delivered to the assessee by the Stock Exchange are liable to be accounted for to the client of the assessee, as and by way of mitigation, which is a separate and distinct issue. In substance, the submission which has been urged on behalf of the assessee is that the expression "taken into account" in Section 36(2)(i) is not the same as "included in the total income".

6. Section 36(1) provides that the deductions enunciated in the succeeding clauses of the provision shall be allowed in respect of the matters dealt with therein, in computing the income referred to in Section 28. Clause (vii) is to the following effect:

> (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 (viia) 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;
>
> Explanation: 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.

Clause (i) of sub-section (2) of Section 36 is to the following effect:

> (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 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 is written off 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;

7. Now, under Section 36(1)(vii), the amount of any bad debt or any part thereof which is written off as irrecoverable in the accounts of the assessee for the previous year is to be allowed as a deduction in computing income under Section 28. This is subject to the provisions of sub-section (2). In view of the judgment of the Supreme Court in **TRF Ltd. Vs. CIT**[1]**,** it is now a settled position in law that after 1 April 1989 it is not necessary for the assessee to establish that the debt has in fact

1. 323 ITR 397

become irrecoverable and it would be sufficient if the bad debt is written off as irrecoverable in the accounts of the assessee. The essence of the controversy in the present appeal is whether the requirements of Section 36(2)(i) have been fulfilled. What clause (i) of sub-section (2) of Section 36 stipulates is that a deduction for a bad debt or part thereof shall not be allowed unless (a) the debt 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 is written off or of an earlier previous year; or (b) the debt represents money lent in the ordinary course of business of banking or money-lending which is carried on by the assessee. In the present appeal the issue is as to whether requirements of (a) above are fulfilled.

8. The Tribunal in the present case has held as follows:

> "21. ... even if accrual of brokerage income and accrual of debt against client in respect of share purchase are two different events which happen at two different times, brokerage income accrues to the share broker as a result of transaction of purchase of shares on behalf of the clients and this nature of brokerage income indicates

that it emerges from the transaction of purchase of shares by the assessee on behalf of his clients in the capacity of share broker. The amount receivable by the assessee on account of brokerage thus is a part of debt receivable by the share broker from his clients against purchase of shares and once such brokerage is credited to the P & L account of the broker and the same is taken into account in computing his income, the condition stipulated in section 36(2)(i) gets satisfied."

"28. ... *A fortiori*, where section 36(2)(i) specifically prescribes such a condition, then it should be deemed to have been satisfied if the brokerage income from the transactions of purchase of shares by the assessee as a broker on behalf of his clients has been taxed in his hands as business income. In the present case, such brokerage has already been taxed in the hands of the assessee under the head business income and this being so, we are of the view that the condition prescribed in section 36(2)(i) has been satisfied and the write off of

> the debt representing amount receivable by the assessee from his clients against purchase of shares on their behalf must be held allowable as a bad debt."

9. One of the contentions which was urged on behalf of the Revenue was based on the value of the shares which are bound to remain with the assessee and which the assessee is entitled to sell and to adjust the sale consideration against the amount receivable from the client. That would have to be taken into account so as to arrive at the actual amount of the bad debt. The Tribunal has clarified that this issue would be considered when the appeal itself is taken up by the regular Bench in the light of the decision of the Special Bench.

10. The requirement which has been imposed by Parliament in Section 36(2)(i) is that a deduction on account of a bad debt can be allowed only where 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 the debt is written off. The assessee is a stock broker who engages in transactions of sale and purchase of shares for his clients. The bill raised on the client reflects the rate, quantity and total value of the

shares transacted as well as the brokerage, apart from the Security Transaction Tax and the service tax. The brokerage from the transaction of the purchase of shares has been taxed in the hands of the assessee as its business income. Once that is so, it is evident that within the meaning of Section 36(2)(i) the debt or part thereof has been taken into account in computing the income of the assessee. The debt comprises, inter alia, of the value of the shares transacted and the brokerage payable by the client on whose behalf the transaction takes place. The brokerage as well as the value of the shares constitute a part of the debt due to the assessee since both arise out of the same transaction. The test is whether the debt or part thereof has been taken into account in computing the income of the assessee. The answer to that test has to be in the affirmative. That being the position, the requirements of Section 36(2)(i) are duly fulfilled.

11. The view which we are inclined to take finds support from a decision of the Supreme Court in **Commissioner of Income Tax Vs. T. Veerabhadra Rao.**[2] In that case the assessee succeeded to the business of a firm and took over all its assets and liabilities including a debt due from a third party. The assessee carried on the business of the firm and

2. 155 ITR 152

for Assessment Year 1963-64. Income tax was paid on the interest accrued on the debt due from the debtor. On 31 March 1965 a settlement was effected under which the assessee accepted a part of the amount due while the balance was written off as irrecoverable. The issue was whether the assessee could for Assessment Year 1965-66 claim the amount written off as a bad debt under Section 36(1)(vii). The Revenue contended that the requirements of clause (i) of sub-section (2) of Section 36 were not fulfilled. The Supreme Court held that the recovery of the debt was allowed to be transferred from the transferor to the transferree and if the law permits the transferor to treat the debt as irrecoverable and to claim a deduction on that account, the same right would be recognized as inhering in the transferee. For the purpose of present appeal, the judgment of the Supreme Court is of significance since it decides the issue as to whether the requirements of clause (i) of sub-section (2) of Section 36 would be fulfilled. The Supreme Court held as follows:

> "... It is true that Clause (i) of Sub-Section (2) of Section 36 declares that a deduction can be allowed only 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 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 represented 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 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 satisfaction 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 Clause (i) of Sub-section (2) of Section 36 are satisfied in the present case, and the High Court as well as the Appellate Tribunal and the AAC are right in the view which they took."

12. The point to be emphasized from the above extract from the decision is that according to the Supreme Court, the debt was taken into account in the income of the assessee for Assessment Year 1963-64 when

the interest income accruing thereon was taxed in the hands of the assessee. The Supreme Court noted that the transaction was a debt and that debt was taken into account in computing the income of the assessee of the relevant previous year.

13. A similar issue arose before the Delhi High Court in **Commissioner of Income Tax Vs. Bonanza Portfolio Ltd.**[3] The assessee who was in the business of share broking had purchased shares on behalf of a client and had paid money for the purchase. The brokerage received was credited in the books of account of the assessee for the previous year but the balance could not be received from the client on whose behalf the shares were purchased and was written off as a bad debt. Both the Assessing Officer and the Commissioner (Appeals) disallowed the claim of a bad debt on the ground that the requirements of Section 36(1)(vii) and 36(2) were not fulfilled. The Tribunal in appeal allowed the claim. The Tribunal had noted the question as to whether a payment made by the assessee on behalf of its client as broker for the purchase or sale of shares could be considered to have been taken into account in computing the income of the earlier years since the brokerage payable

3. [2010] 320 ITR 178

was a part of the debt. Since part of the debt had been taken into account in computation of the income, the entire debt including the purchase / sale price paid by the assessee has to be taken as considered in computation of income and the conditions prescribed by Section 36(2)(i) were held to be fulfilled. In appeal, the Division Bench of the Delhi High Court held that merely because the assessee had made payment against those shares would not make it an investment by the assessee on his own behalf. As a matter of fact since the assessee had shown income in the books of account as income from brokerage, that showed that the transaction was entered into by the assessee on behalf of its clients and not on its own behalf. The Delhi High Court held as follows:

> "... the money receivable from the client has to be treated as "debt" and since it became bad, it was rightly considered as "bad debt" and claimed as such by the assessee in the books of account. Since this bad debt occurred in the year in question, it was shown by the assessee in that manner. Since the brokerage payable by the client is a part of the debt and that debt had been taken into account in the computation of the income, the conditions stipulated in sub-section (2) of section 36 read with section 36(1)(vii) stand satisfied in this case.

> Hence, the question of law stands decided against the Revenue and in favour of the assessee."

We are in respectful agreement with the view taken by the Delhi High Court. A Special Leave Petition[4] against the judgment of the Delhi High Court was dismissed by the Supreme Court on 30 July 2010.

14. The value of the shares transacted by the assessee as a stock broker on behalf of its client is as much a part of the debt as is the brokerage which is charged by the assessee on the transaction. The brokerage having been credited to the profit and loss account of the assessee, it is evident that a part of the debt is taken into account in computing the income of the assessee. The fact that the liability to pay the brokerage may arise, as contended by the Revenue, at a point in time anterior to the liability to pay the value of the shares transacted would not make any material difference to the position. Both constitute a part of the debt which arises from the very same transaction involving the sale or as the case may be purchase of shares. Since both form a component part of the debt, the requirements of Section 36(2)(i) are fulfilled where a part thereof is taken into account in computing the income of the assessee.

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Before concluding, we again take note of the fact that in paragraph 31 of its impugned decision the Tribunal has left the issue as regards the value of the shares which remain in the hands of the assessee which has to be adjusted against the amount receivable from the client to be determined before the regular Bench of the Tribunal following the view of the Special Bench. The view which has been taken by the Special Bench is, with respect, in accordance with law. We accordingly dispose of the appeal by answering the question of law as formulated in the affirmative and in favour of the assessee. There shall be no order as to costs.

(DR.D.Y. CHANDRACHUD,J.)

(M.S.SANKLECHA, J.)