For Bad Debts, Full Debt Need Not Be Taxable

If brokerage offered to tax, the principal debt qualifies as a "bad debt" u/s 36(1)(vii) r.w.s. 36(2)

DCIT vs. Shreyas S. Morakhia (ITAT Mumbai Special Bench)

If brokerage offered to tax, the principal debt qualifies as a "bad debt" u/s 36(1)(vii) r.w.s. 36(2)

The assessee, a broker, claimed deduction for bad debts in respect of shares purchased by him for his clients. The AO rejected the claim though the CIT (A) upheld it. On appeal by the Revenue, the matter was referred to the Special Bench. Before the Special Bench, the department argued that u/s 36(2), no deduction on account of bad debt can be allowed unless "such debt or part thereof has been taken into account in computing the income of the assessee". It was argued that as the assessee had offered only the brokerage income to tax but not the value of shares purchased on behalf of clients, the latter could not be allowed as a bad debt u/s 36(1)(vii). HELD rejecting the claim of the department:

(i) In **Veerabhadra Rao** 155 ITR 152 the Supreme Court held in the context of a loan that if the interest is offered to tax, the loan has been "taken into account in computing the income of the assessee" and qualifies for deduction u/s 36(1)(vii). **The effect of the judgement is that in order to satisfy the condition stipulated in s. 36(2)(i), it is not necessary that the entire amount of debt has to be taken into account in computing the income of the assessee and it will be sufficient even if part of such debt is taken into account in computing the income of the assessee. This principle applies to a share broker**. The amount receivable on account of brokerage is a part of debt receivable by the share broker from his client against purchase of shares and once such brokerage is credited to the P&L account and taken into account in computing his income, the condition stipulated in s. 36(2)(i) gets satisfied. Whether the gross amount is reflected in the credit side of the P&L A/c or only the net amount is finally reflected as profit after deducting the corresponding expenses or only the net amount of brokerage received by the share broker is reflected in the credit side of the P&L account makes no difference because the ultimate effect is the same;

(ii) The argument that the loss was suffered owing to breach of SEBI Guidelines framed to safeguard the interest of brokers in respect of amount receivable from the clients against purchase of shares is irrelevant. If the broker chooses not to follow the guidelines, **it is a decision taken by him as a businessman having regard to his business relations with the client**. The loss **cannot be equated to expenditure incurred by the assessee for any purpose which is an offence or which is prohibited by law**. (**CIT vs. Pranlal Kesurdas** 49 ITR 931 (Bom) followed where bad debts on account of forbidden vayada transactions were held allowable);

(iii) The contention of the Revenue that the sale value of the shares remaining with the assessee should be adjusted against the amount receivable from the client so as to arrive at the actual amount of bad debt should be raised, if permissible, before the Division Bench.

IN THE INCOME TAX APPELLATE TRIBUNAL
MUMBAI BENCHES "C" (SPECIAL BENCH)
BEFORE SHRI R.V. EASWAR, PRESIDENT, SHRI D.K. AGARWAL, J.M. & SHRI P.M. JAGTAP, A.M.
ITA No. 3374/Mum/2004
Assessment Year 1998-99

Appellant		**Respondent**
The Dy. C.I.T., Range 7(2), Mumbai.	Vs.	Shri Shreyas S. Morakhia,3-A, Khatau A.D. Modi Street, Building, Fort, Mumbai 400023 .PAN AACPM 9655 F
Appellant by		Shri Ajit Kumar Sinha
Respondent by		Shri Hiro Rai

ORDER

PER P.M. JAGTAP, AM.

This Special Bench has been constituted u/s 255(3) of the Income Tax Act, 1961 to decide the following question which is arising out of the present appeal:-

"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 client apart from the commission earned by him."

2. The relevant facts of the case giving rise to the question which has been referred to the Special Bench are that the assessee is a share broker. The return of income for the year under consideration was filed by him on 2.11.1998 declaring total income of Rs. 67,797/- . In the said return, deduction of Rs. 28,24,296/- was claimed by the assessee on account of business loss. According to the assessee, the said amount represented the amount due to him by his clients on account of transactions of shares effected by him on their behalf. It was stated that the said amount has become irrecoverable and the same is claimed as deduction after having written it off as irrecoverable from the books of account. The copies of ledger accounts of the concerned parties were filed by the assessee before the A.O. in support. According to the A.O., there was no other evidence filed by the assessee except the said copies of the ledger accounts to show that any action was taken against the concerned parties to recover the amounts due from them. He also noted that the Bombay Stock Exchange Card held by the assessee was already sold by him and the business in respect of which the debts in question had arisen was ceased to exist in the year under consideration. He, therefore, disallowed the deduction claimed by the assessee

on account of bad debts and made the addition of Rs. 28,34,096/- to the total income of the assessee.

3. The matter was carried before the ld. CIT(A) who found that even though the BSE Membership Card was already sold by the assessee, he continued to carry on the business as a sub-broker. He held that there being hardly any distinction between the business of share broker and sub-broker, the business of the assessee had not ceased to exist on transfer of BSE Membership Card but the same was continued during the year under consideration. He also held that the failure on the part of the assessee to initiate recovery proceedings against the concerned agents could not be a ground for denying the assessee's claim for bad debt u/s 36(1)(vii). Accordingly, the claim of the assessee for deduction on account of bad debt was allowed by the ld. CIT(A).

4. Aggrieved by the order of the ld. CIT(A), the Revenue filed an appeal before the Tribunal and during the course of hearing of the said appeal before the Division Bench, it was sought to be contended on behalf of the Revenue that the assessee having credited only the brokerage amount to the P&L Account, the amount of bad debts claimed was not taken into account in computing the total income of the relevant previous year or even of any earlier previous year. It was contended that the condition stipulated in section 36(2) thus was not satisfied and the assessee was not entitled to claim deduction in respect of the said bad debts u/s 36(1)(vii). It was noted by the Division Bench that this stand of the Revenue was accepted by the co-ordinate Bench of the Tribunal in the case of India Infoline Securities Pvt. Ltd. Vs. A.C.I.T. 25 SOT 123 (Mum) and in the case of ACIT vs. B.N. Khandelwal 101 TTJ 717. It was also noted by the Division Bench that there was however a contrary view taken by the co-ordinate Bench in the cases of ACIT vs. Olympia Securities Ltd. (ITA No. 4053/Mum/02 dtd. 21.12.2006), ACIT vs. PRS Shares and Finance Ltd. (ITA 4280/Mum/07 dtd. 20.5.2008) and Shri Somen P. Sangani vs. ITO (ITA No. 3410/Mum/05 dtd. 5.6.08). It was held by the co-ordinate Benches in the said cases that the condition u/s 36(2) stands satisfied where the assessee has taken into consideration the brokerage income connected with the transaction effected by it on behalf of his clients. It was held that the claim of the assessee in respect of deduction on account of bad debts u/s 36(1)(vii) therefore cannot be denied on the ground that the amount of bad debts has not been taken into consideration for the purpose of computing his income of the relevant previous year or any earlier year. Keeping in view these contrary views expressed by the co-ordinate Benches on the issue, the question as indicated above was sought to be referred by the Division Bench to the Special Bench and accordingly this Special Bench has been constituted by Hon'ble President to decide the said question.

5. The ld. D.R., at the outset referred to the provisions of section 36(1)(vii) as amended by Finance Act 1987 w.e.f. 1.4.89 to point out that the deduction provided in section 36(1)(vii) on account of bad debts is subject to the fulfillment of condition as laid down in section 36(2). He contended that as per the provisions of section 36(2), no deduction on account of bad debt shall be allowed unless such debt or part thereof has been taken into account in computing the income of the assessee of the relevant previous year or of any earlier previous year. He submitted that the meaning of words "taking into account in

computing the income of the assessee" has to be understood in the right perspective. He contended that even though these words do not mean that the whole amount of bad debts claimed u/s 36(1)(vii) should have taxed as income, such amount atleast should have been reflected on the credit side of the P&L account so that the net amount after deducting the corresponding expenses is included in the total income of the assessee chargeable to tax. He contended that in the case of a share broker what is credited in the P&L account is only brokerage amount and not the value of shares purchased on behalf of the clients. He contended that the amount of such shares which has been claimed to be deductible as bad debts, therefore, cannot be considered to have been taken into account in computation of income of the assessee. According to him, the transactions of sale/purchase of shares actually do not belong to the share brokers but the same belong entirely to the clients and it is also not necessary that brokerage is always relatable to the value of share transaction. He submitted that it may in some cases be even the fixed periodical amount subject to SEBI and Stock Exchange guidelines. He contended that brokerage income therefore cannot be equated with the price of securities transacted and hence such price of securities cannot be said to have been taken into account in computation of income by virtue of brokerage being credited in the P&L account in the case of share broker.

6. The ld. D.R. also contended that in the case of the broker, the 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. He submitted that the income on account of brokerage accrues to the broker the moment he conducts the transaction on behalf of his client, but the client does not become a debtor of the broker at this point of time. He submitted that it is only on the settlement day which is later in point of time that the client becomes debtor of the broker in case the former fails to pay the amount against purchase of shares and the broker has to make the said payment on behalf of the client.

He contended that in such a situation also the broker has underlined security in the form of shares purchased against the amount receivable from client and there is hardly any possibility of the said debts becoming bad if the broker has ensured receipt of prescribed 20% margin money from the client. He contended that it cannot therefore be said that by virtue of brokerage being taken into account in computation of income that the value of purchase of shares on behalf of client has also been taken into account in the computation of income of the assessee who is broker. He contended that the debt representing the amount receivable by the broker against purchase of shares on behalf of clients is not taken to the credit of the P&L account of the broker as income and the condition stipulated in section 36(2) thus cannot be said to be satisfied.

7. The ld. D.R. once again referred to the provisions of section 36(2) and pointed out that there is only one specific exception provided from satisfying the condition stipulated therein and that is in respect of money lending/banking business. He submitted that as provided specifically in this context, the claim of the assessee engaged in money lending/banking business for bad debts is allowable in respect of amount which represents money lent in the ordinary course of business despite the fact that the said amount has not been taken into account for computing the income of the assessee

engaged in money lending business of the relevant previous year or any earlier previous year. He contended that this exception, however, is provided only in respect of money lending/banking business and not in respect of any other business including the business of share broking. He contended that the legislature thus has restricted itself to provide only one exception and the same cannot be extended to share brokers. He contended that the debts representing value of purchase of shares made by the assessee as a broker on behalf of clients thus cannot be said to have been taken into account in computing the income of the assessee and there being no satisfaction of condition stipulated in section 36(2), no deduction on account of the said debts can be allowed u/s 36(1)(vii) even though the same have been written off as irrecoverable by the assessee from his books of account.

8. The learned D.R. also submitted that the modus operandi followed in the transactions of purchase and sale of shares and securities is qualitatively different than the one followed in trading of other commodities. He contended that the shares are dealt with by the “share traders” and not by “share brokers”. He submitted that the role of the broker is limited in relation to such transactions and the actual traders of shares are his clients and not the share broker himself. He submitted that the transactions of trading in shares are governed by rules and regulations of stock exchange and the broker has a limited specified role in such transactions as prescribed by SEBI. He invited our attention to the relevant circular issued by SEBI in this context and took us through the various guidelines laid down therein to show the restrictions imposed on brokers and safeguards provided to protect the interest of the broker. He submitted that if the said guidelines are strictly followed, a broker would never put him in a situation where he has an irrecoverable debts from his clients and there will be no occasion for him to claim deduction on account of bad debts. He contended that only when the said guidelines are violated by a broker that he may have the risk of suffering loss as a result of bad debts and such loss would rise only when there is infraction of law laid down by SEBI under SEBI Act. He contended that this aspect therefore needs to be taken into consideration while examining the claim of the share broker for deduction on account of bad debts.

9. The ld. D.R. then took us through the various decisions of the Tribunal wherein a similar issue has been decided in favour of the Revenue. For instance, he pointed out that in the case of India Infoline Securities (P) Ltd. (supra), it is held by the Tribunal after analyzing the nature of share transactions and relationship between the share broker and his clients that the value of shares purchased by the brokers on behalf of the clients could not be said to have been taken into account in computing the income of the assessee and the deduction on account of bad debts representing the said value could not be allowed u/s 36(1)(vii) because the condition prescribed u/s 36(2)(i) was not fulfilled. He also invited our attention to the decision of the Tribunal in the case of B.S. Vasa vs. ITO 26 SOT 462 wherein a similar view as taken in the case of India Infoline Securities Pvt. Ltd. is expressed by the Tribunal.He contended that even in the case of Mahesh J. Patel vs. ACIT 109 ITD 35 (TM) the Tribunal has taken a similar view and the said decision being that of a Third Member has a force of a Special Bench.

10. As regards the decisions of the Tribunal wherein a view in favour of the assessee has been taken on the issue, the ld. D.R. contended that neither the peculiar nature of share transactions nor the relevant guidelines laid down by the SEBI have been taken into account by the Tribunal. He contended that similarly in the cases of D.B. (India) Securities Ltd. 318 ITR 26 and Bonanza Portfolio Ltd. 320 ITR 178, these relevant aspects were not brought to the notice of the Hon'ble Delhi High Court and Their Lordships thus had no occasion to consider the same while deciding the issue relating to satisfaction of condition prescribed u/s 36(2). He contended that the said decisions rendered by the Hon'ble Delhi High Court, in any case, are not the decisions of the Jurisdictional High Court and this Special Bench is not bound to follow the same as held by the Ahmedabad Bench of ITAT in the case of Kanel Oil & Export Industries Ltd. in ITA No. 2667/Ahd/02 dated 18.08.2009 especially because two vital aspects have not been taken into consideration. He contended that in several other decisions, a similar claim of the assessee being a share broker on account of bad debts representing amounts receivable from clients against purchase of shares has been allowed by the Tribunal as a business loss u/s 28 which by implication indicates that the same is held to be not allowable u/s 36(1)(vii). He relied on the decision of Hon'ble Supreme Court in the case of A.V. Thomas & Co. Ltd. Vs. CIT 48 ITR 67 (SC) wherein it was held in a similar context that a debt means something which is related to the business or results from it and it is an outstanding which if recovered would have swelled the profits. He contended that if this concept of debt explained by the Hon'ble Apex Court is taken into consideration, the amount receivable by the assessee as share broker from his clients against purchase of shares cannot be described as a debt and deduction u/s 36(1)(vii) cannot be allowed on account of bad debts.

11. In reply, the learned counsel for the assessee submitted that the fundamental issue involved for the consideration of the Special Bench relates to the satisfaction of condition prescribed in section 36(2) in the case of a broker where only the brokerage income is credited to the P&L account and not the value of purchase of shares made on behalf of the clients. Referring to the provisions of section 36(2), he submitted that the expression used therein is "taken into account in computing the income of the assessee". He contended that in the case of CIT vs. T. Veerabhadra Rao K. Koteshwar Rao & Co. 155 ITR 152 (SC), Hon'ble Supreme Court has explained the meaning of this expression by holding that when the interest income accrued on a debt was taxed in the hands of the assessee in the earlier year, the said debt was to be considered as taken into account in computing the income of the assessee. It was also held that interest was taxed as income because it represented an accretion accruing during the earlier year on money owed to the assessee by the debtor and the item constituted income because it represented interest on loan. It was held that the nature of the income indicated the transaction from which it is emerged and the said transaction constituting debt was taken into account in computing the income of the assessee of relevant previous year. The ld. Counsel for the assessee contended that the ratio laid down by the Hon'ble Apex Court in the case of T. Veerabhadra Rao K. Koteshwar Rao & Co. is squarely applicable to the issue under consideration.

12. As regards the arguments of the ld. D.R. that only one exception is specifically provided from the satisfaction of condition u/s 36(2) in respect of money lending business, the ld. Counsel for the assessee contended that there is always a possibility in the case of money lending business that interest is not taken into account in computing the income of the assessee but still the amount of corresponding loan is claimed as bad debts. He contended that keeping in view such a possibility, exception has been provided in respect of money lending business and the same cannot be used to draw any adverse inference in relation to the claim of the assessee for deduction on account of bad debts in respect of any other business. He submitted that even in case of trading or manufacturing business, corresponding purchases and other expenses are claimed and after deducting the same from sales, what is effectively taken into account in computing the income of the assessee is only the net profit. He contended that if the department's stand is to be accepted, assessee will not be entitled to deduction on account of bad debts even in respect of trading or manufacturing business.

13. The ld. Counsel for the assessee strongly relied on the decision of Hon'ble Delhi High Court in the case of CIT vs. DB (India) Securities Ltd.(supra) and submitted that as held therein, the amount receivable by the assessee as a broker from his clients against purchase of shares made on their behalf represent his debts and the brokerage which was received in the said transactions having been shown as income by the assessee in the previous year and it was taxed as such by the assessing authority, he was entitled to deduction u/s 36(1)(vii) for the said debts after having written off the same as bad or irrecoverable. He also relied on the decision of Hon'ble Delhi High Court in another case CIT vs. Bonanza Portfolio Ltd. (supra) wherein it was held while dealing with a similar issue that the money receivable by the share broker from his clients against purchase of shares had 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. It was also held that since the brokerage payable by the client was a part of the debt and that debt had been taken into account in the computation of income of the assessee, the conditions stipulated in section 36 (1)(vii) and 36(2) stood satisfied.

14. The ld. Counsel for the assessee submitted that the issue involved for consideration of the Special Bench thus stands squarely covered in favour of the assessee by the aforesaid two decisions of Hon'ble Delhi High Court in the case of CIT vs. DB (India) Securities Ltd.(supra) and CIT vs. Bonanza Portfolio Ltd. (supra). He contended that the benefit of these decisions rendered subsequently by the Hon'ble Delhi High Court was not available to the Tribunal while deciding a similar issue in some of the cases against the assessee which have been relied upon by the ld. D.R. He also contended that even the decision of Hon'ble Supreme Court in the case of T. Veerabhadra Rao K. Koteshwar Rao & Co (supra), the ratio of which is squarely applicable to the issue under consideration, has not been taken into consideration by the Tribunal in the said cases while deciding the similar issue against the assessee. He also relied on the decision of Hon'ble Supreme Court in the case of A.V. Thomas & Co. Ltd. Vs. CIT 48 ITR 67 and that of Hon'ble Bombay High Court in the case of CIT Vs. Pranlal Kesurdas 49 ITR 931 and submitted that the said decisions of Hon'ble Apex Court and Hon'ble jurisdictional High Court also support the case of the assessee on the issue under consideration. He contended that the decisions

rendered by the Hon'ble Delhi High Court in the case of CIT vs. DB (India) Securities Ltd.(supra) and CIT vs. Bonanza Portfolio Ltd. (supra) are directly applicable to the issue under consideration and there being no decision of Hon'ble jurisdictional High Court or any other High Courts cited by the ld. D.R. taking a contrary view in favour of the Revenue, the same are required to be followed by this Special Bench.
15. As regards the SEBI guidelines strongly relied upon by the ld. D.R., the learned counsel for the assessee submitted that the same are hardly relevant in deciding the issue under consideration. He submitted that the issue before this Special Bench is that when the assessee as a share broker suffers a loss as a result of amount receivable from his clients against purchase of shares becoming irrecoverable, whether he is entitled for deduction u/s 36(1)(vii) r.w.s. 36(2) or not. He submitted that whether such loss is suffered by the assessee as a result of not following the SEBI guidelines or even after following the said guidelines is not relevant in this context and what is relevant is whether he has actually suffered such loss or not. He has contended that this is not the case even of the A.O. that there was no loss actually suffered by the assessee on account of non-recovery of debt representing amount receivable by the assessee from his clients against purchase of shares.

16. As regards the submission of the ld. D.R. that it is not very clear either from the order of the A.O. or that of the ld. CIT(A) that the amount in question claimed as bad debts was written off by the assessee as irrecoverable from its books of account, the ld. Counsel for the assessee filed a copy of ledger account of one of the clients of the assessee to show that the amount receivable from the said party was written off from the books of account of the assessee as irrecoverable. He submitted that such copies of ledger account of all the concerned parties were filed by the assessee before the A.O. during the course of assessment proceedings to show that the amounts receivable from them were duly written off as irrecoverable.

17. As regards the other objection raised by the ld. D.R. as to whether the brokerage income in respect of transactions in question claimed as bad debts were actually offered by the assessee as its income in the year under consideration or any earlier years, the ld. Counsel for the assessee submitted that even the A.O. has not disputed this position in the assessment order. He submitted that if at all this matter is required to be verified, the assessee has no objection if it is got verified from the A.O.

18. We have considered the rival submissions and also perused the relevant material on record. We have also carefully gone through the various judicial pronouncements cited by the learned representatives of both the sides. The assessee in the present case is a share broker and during the year under consideration, he suffered a loss as a result of the amount receivable from his clients against purchase of shares made on their behalf becoming irrecoverable. The said amount is claimed to have been written off by the assessee as irrecoverable from its books of account and it is being claimed as deduction being bad debts written off u/s 36(1)(vii). In order to claim deduction u/s 36(1)(vii), one of the conditions that is required to be satisfied as laid down u/s 36(2)(i) is that the debt claimed to be deductible as bad or part thereof has been taken into account in computing the income of the assessee of the relevant previous year or of any earlier previous year.

The fundamental question that arises in this context which has been referred to this Special Bench is whether the said condition is satisfied in case of share broker where only the brokerage income is credited to the P&L account and not the value of purchase of shares made on behalf of the clients. The condition stipulated in the first limb of clause (i) of sub-section (2) of section 36 is that no deduction on account of bad debt or part thereof 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. As per the second limb of clause (i) of sub-section (2) of section 36, the said condition is not applicable where such debt represents money lent in the ordinary business of banking or money lending which is carried on by the assessee. In the present case, the debt in question undisputedly does not represent money lent in the ordinary course of banking or money lending business carried on by the assessee and therefore the second limb of clause (i) of sub-section (2) of section 36 is not relevant in the present case atleast at this stage. We may, however, have to consider the same at appropriate stage while dealing with the arguments raised by the ld. D.R. referring to the said limb. What we are concerned at this stage is whether the condition stipulated in the first limb of section 36(2)(i) is satisfied in the case of the assessee in as much as whether the debt representing amount receivable by the assessee as share broker from his clients against purchase of shares on their behalf or part thereof can be said to have been taken into account in computing the income of the assessee. The stand of the assessee in this regard is that the brokerage receivable by the assessee on the transactions of purchase of shares made on behalf of the clients is part of the debt receivable from the clients on account of the said transaction and the amount of brokerage having been taken into account in computing the income of the assessee, the condition stipulated in the first limb of section 36(2)(i) stands satisfied. In support of this contention, reliance has been placed on behalf of the assessee, inter alia, on the decision of Hon'ble Supreme Court in the case of T. Veerabhadra Rao K. Koteshwar Rao & Co (supra).

19. In the case of T. Veerabhadra Rao K. Koteshwar Rao & Co (supra), the assessee was a partnership firm which took over the business of earlier firm. All the liabilities of the predecessor firm passed to the assessee firm including a debt of Rs. 23,577/- due from Lakshmi Trading Co. to the predecessor firm. The total amount due in the account relating to Lakshmi Trading Co. was Rs. 40,549/- comprising outstanding amount of Rs. 29,200/-and interest thereon amounting to Rs. 11,349/-. The amount of interest was taxed in the hands of the assessee for A.Y. 1963-64. On 31st March 1965, the parties effected a settlement under which a sum of Rs. 25,500/- was accepted by the assessee in full settlement of the said debt. The balance of Rs. 15,100/- was written off as irrecoverable and claimed as deduction for A.Y. 1965-66 as bad debt. While disallowing the claim of the assessee for the said deduction, one of the grounds taken by the Revenue was that the requirement of clause (i) of sub-section (2) of section 36 was not satisfied and when the matter reached to the Hon'ble Supreme Court, it was held by the Hon'ble Apex Court in this context that the debt was taken into account in computing the income of the assessee for A.Y. 1963-64 when the interest income accruing thereon was taxed in the hands of the assessee. It was held that the interest was taxed as income because it represented accretion accrued during the earlier year on money owed to the assessee by the debtor

and the item was considered as income because it represented interest on loan. It was held that the nature of the income indicated the transaction from which it emerged and the said transaction representing debt thus was taken into account in computing the income of the assessee of the relevant previous year. It was held that the condition stipulated in clause (i) of sub-section (2) of section 36 thus was duly satisfied. Hon'ble Supreme Court thus has clearly laid down that in order to satisfy the condition stipulated in section 36(2)(i), it is not necessary that the entire amount of debt has to be taken into account in computing the income of the assessee and it will be sufficient even if part of such debt is taken into account in computing the income of the assessee. At the time of hearing before us, even the ld. D.R. has not disputed this proposition clearly propounded by the Hon'ble Supreme Court in the case of T. Veerabhadra Rao K. Koteshwar Rao & Co (supra).

20. The ld. D.R. has contended that the ratio laid down in the case of T. Veerabhadra Rao K. Koteshwar Rao & Co (supra), however, is not applicable in the case of assessee who is a share broker. According to him, even though section 36(2)(i) does not require that the whole amount of bad debt claimed u/s 36(1)(vii) should have been taxed as income, such amount atleast should have been reflected on the credit side of the P&L account so that the net amount after deducting the corresponding expenses is included in the total income of the assessee chargeable to tax. He has contended that in the case of a share broker, only the brokerage amount is credited to the P&L account and not the value of shares purchased on behalf of the clients. He has also contended that the transaction of sale/purchase of shares actually belong to the clients of the share broker and it is not necessary that brokerage is always relatable to the value of share transactions. He has contended that even the accrual of brokerage income and accrual of debt against clients in respect of share purchases are two different events that happen at two different times. He has contended that the brokerage income thus cannot be treated as part of the debts receivable by the share broker from clients in respect of share purchases and it cannot be said that the assessee having assessed in respect of share brokerage income, the said debt or part thereof has been taken into account in computing his income.

21. We are unable to agree with the contentions raised by the learned D.R. while disputing the applicability of the ratio laid down by the Hon'ble Supreme Court in the case of T. Veerabhadra Rao K. Koteshwar Rao & Co (supra) to the case of the assessee who is a share broker. It is worthwhile to note here that whether the gross amount is reflected in the credit side of the P&L account and only the net amount is finally reflected as profit after deducting the corresponding expenses or only the net amount say of brokerage received by the share broker is reflected in the credit side of the P&L account, the ultimate effect is one and the same and it is that the net amount gets included in the total income of the assessee chargeable to tax. It is just a different way of recording the relevant transactions in the books of account and their reflection finally in the P&L account. But in so far as the ultimate effect on the total income of the assessee is concerned, the same remains one and the same. It, therefore, cannot be said that such different treatment given in the books of account and reflection thereof in the P&L account is a material aspect having any bearing on the issue under consideration. Even in the case of loan transaction, what is reflected on the credit side of the P&L account of the

assessee carrying on money lending or banking business is only the interest and not the loan amount as such. Even as regards the contention of the ld. D.R. that the 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, we find that similar is the situation in case of loan transactions effected by the assessee carrying on the business of money lending or banking wherein the client becomes debtor when the amount of loan is disbursed in his favour whereas income on account of interest accrues to the lender only after a specified period of interval as agreed between the parties. As held by the Hon'ble Supreme Court in the case of T. Veerabhadra Rao K. Koteshwar Rao & Co (supra), interest is taxed as income because it represents an accretion accruing during the relevant year on money owed to the assessee by the debtor and the nature of such income indicates the transaction from which it emerges. It therefore follows that 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

22. The learned D.R. has laid great emphasis on the guidelines issued by SEBI to safeguard the interest of brokers in respect of amount receivable from the clients against purchase of shares. According to him, if the said guidelines are strictly followed, there will be hardly any occasion for the broker to suffer loss on account of the amount receivable from clients becoming irrecoverable. However, the issue under consideration presupposes a fact situation which as exists in the present case is that the assessee who is a share broker has actually suffered such a loss. In such a situation, whether such loss is suffered by the assessee as a result of not following the guidelines or even after following such guidelines is not going to change the fact that the assessee has suffered such loss. If the assessee broker has not followed such guidelines in a particular case, it is a decision taken by him as a businessman taking into consideration all the relevant facts and circumstances including his business relations with the concerned clients. This aspect, however, will not change the fact situation that the assessee has suffered a loss as a result of non-recovery of amounts receivable from clients against purchase of shares during the course of his business and the admissibility or otherwise of the said loss, in our opinion, is required to be considered in accordance with the relevant provisions of law governing the claim of bad debts. This aspect of the matter therefore cannot change the factum of loss suffered by the assessee although it may have some bearing on the quantum of such loss which is required to be arrived at after taking into consideration the corresponding shares which the assessee is entitled to sale and adjust the sale proceeds thereof against the amount receivable from clients against purchase of the said shares. The department, therefore, is at liberty to raise this issue before the Division Bench at the time of hearing of the appeal of the assessee if it is permissible to do so.

23. As regards the rules and regulations of stock exchange and guidelines issued by SEBI from time to time, we find that the same certainly govern the relationship between the broker and its clients. They also impose certain restrictions on brokers. However, as already observed by us, where the assessee broker has actually suffered a loss as a result of non-recovery of the amount receivable from his clients against purchase of shares on their behalf, the allowability thereof is required to be considered in accordance with the relevant provisions of the Income Tax Act and it is irrelevant whether such loss has been suffered by the assessee as a result of not following the said rules and regulations and guidelines or even after following the same. Moreover, even if it is assumed that such loss has been incurred by the assessee as a result of not following the rules and regulations and guidelines issued by the SEBI, the same cannot be equated to expenditure incurred by the assessee for any purpose which is an offence or which is prohibited by law. The reliance of the ld. D.R. on the said rules and regulations of stock exchange and guidelines issued by SEBI thus is clearly misplaced and the arguments raised by him relying thereon cannot be accepted being devoid of merits. In the case of CIT vs. Pranlal Kesurdas 49 ITR 931, the claim of the assessee for bad debts was disallowed by the A.O. on the ground that the said debt was arising out of forbidden wayada transactions and was unenforceable. However, the Hon'ble Bombay High Court held that if the profits of a trade even though it may be illegal are to be taxed, the computation of the profits will have to be done in accordance with the mode prescribed by the statute. It was held that profits chargeable to tax have to be arrived in a commercial manner by deducting such expenses as in a commercial sense can be regarded as expenses of the business. It was held that computation of such profits permits the deduction of dues or debts due to the assessee in the course of the business, which have become bad or irrecoverable.

24. Relying on the second limb of clause (i) of sub-section (2) of section 36, the ld. D.R. has contended that as provided therein, the claim bad debts of the assessee who is engaged in money lending/banking business is allowable in respect of debts which represent money lent in the ordinary course of business despite the fact that the said amount has not been taken into account in computing the income of the assessee engaged in money lending business. According to him, this exception, however, is provided specifically by the legislature in respect of money lending/banking business and the same cannot be extended to any other business including the business of share broking. In our opinion, the reason for providing such exception in section 36(2)(i) in respect of debt representing money lent in the ordinary course of business of banking or money lending is entirely different than what has been sought to be assigned by the ld. D.R.. As held by the Hon'ble Supreme Court in the case of Madan Gopal Bagla vs. CIT 30 ITR 174, a debt in order to fall within the provisions of section 36(1)(vii) must be one which can properly be called a trading debt i.e. a debt of a trade, the profits of which are being computed. Generally, in case of debt arising from the business of supply of goods or services, the criteria which can be applied to ascertain whether the said debt is a trading debt or not is to see whether the said debt or part thereof has been taken into account in computing the total income of the assessee. If the said condition gets satisfied and the debt or part thereof has already been taken into account while computing the income of the assessee, the debt can be regarded as a trading debt. In the case of money lending or banking

business, the situation, however, is altogether different because the money itself constitutes stock in trade of the said business and any debt representing money lent in the ordinary course of banking or money lending business clearly constitutes the trading debt of that business. It is therefore not necessary to apply the test laid down in first limb of section 36(2)(i) to ascertain whether the debt representing money lent in the ordinary course of banking or money lending business is trading debt or not since the said debt going by the very nature of banking/money lending business itself is a trading debt. In our opinion, this is the rationale behind the exception provided in the second limb of section 36(2)(i) in respect of banking/money lending business and therefore no adverse inference on the basis of the said exception can be drawn against the assessee carrying on the business of share broking as sought by the ld. D.R.

25. At the time of hearing before us, the ld. D.R. has relied, inter alia, on the decisions of the tribunal in the case of India Infoline Securities (P) Ltd. Vs. ACIT (supra), Addl. CIT vs. B.N. Khandelwal (supra) and Mahesh J. Patel vs. ACIT 109 ITD 35 (TM) in support of the Revenue's case on the issue under consideration. A perusal of the said decisions shows that the issue was decided against the assessee and in favour of the Revenue by the Tribunal holding that the debt representing unpaid purchase price of shares did not fulfill the requirement of section 36(2)(i) because what the assessee offered to tax was only the brokerage income and the assessee was also not engaged in purchase and sale of shares. However, the decision of Hon'ble Supreme Court in the case of CIT vs. T. Veerabhadra Rao K. Koteshwar Rao & Co (supra), the ratio of which is squarely applicable in this context, was not brought to the notice of the Tribunal and the Tribunal thus had no occasion to consider the same. Even the benefit of the decisions subsequently rendered by the Hon'ble Delhi High Court in the case of in the case of CIT vs. DB (India) Securities Ltd.(supra) and CIT vs. Bonanza Portfolio Ltd. (supra) was not available to the Tribunal. As regards the Third Member decision of the Tribunal in the case of Mahesh J. Patel (supra), it is observed that this issue raised in ground no. 1 of the appeal was decided by Division Bench and there being no disagreement between the two Members of the Division Bench thereon, the same was not referred to Third Member at all. The decision on this issue thus was rendered in the case of Mahesh J. Patel by the Division Bench and not by the Third Member and the same therefore cannot be said to have a force of Special Bench decision as sought to be contended by the ld. D.R.

26. The ld. D.R. has also relied on the decision of Hon'ble Supreme Court in the case of A.V. Thomas & Co. Ltd. Vs. CIT (supra) in support of the Revenue's case. It is, however, observed that this decision actually supports the case of the assessee in so far as it explains the term 'debt' used in the context of deduction on account of bad or doubtful debt so as to mean something which is related to business or results from it. It was held by the Hon'ble Supreme Court in this context that the debt to be a debt proper had to be one which if good would have swelled the taxable profits. As already discussed, these conditions get satisfied in the case of a share broker because the amount receivable by him from the clients against purchase of shares on their behalf is certainly related to its business of share broking and it results from such business. Moreover, the said debt if good would have swelled a taxable profit of the assessee broker in the form of brokerage income.

27. Here, we may also refer to the case of CIT vs. City Motor Service Ltd. 61 ITR 418 wherein Hon'ble Madras High court was concerned with section 10(2)(xi) of the 1922 Act. This section is the forerunner of section 36(2)(i) of the 1961 Act, but there was no condition that the debt should have been taken into account in computing the income of the assessee for the relevant assessment year or any earlier year. Despite this, Hon'ble Madras High Court held that such a condition must be read into the section. The relevant portion of the judgment in this context is extracted below from page 421 of the report:-

> "…….the question is whether it is necessary for the assessee to show, in order that it may be eligible for the deduction under the first part of the clause, that the bad debt, if realized, would have gone to swell its profits. There is no express indication in the language of the first part of this clause that it should be such a debt. But it is obvious to us that, in the context of the section, the debt, in order to be deductible must be one which, when realized, would have gone to swell the profits……. It is no doubt true that the amount lent as principal will not by itself swell the profits and what is meant is that it is taken into account in the context of computation of income……."

28. Hon'ble Madras High Court thus read into section 10(2)(xi) of the 1922 Act, the condition that the debt should have been "taken into account" in computing the income of the assessee and after having done so, proceeded further to observe at page 425 as under:-

> "Learned counsel appearing for the revenue contends that the requisite that the debt if realized should have gone to swell the profits of the business is not satisfied. We are unable to accept this contention. The fact that in the previous assessment years the revenue brought to charge the interest due from advances made by the assessee to Sungo Limited demonstrates that the debt did go to swell the business profits of the assessee. As we mentioned earlier, the interest so due to the assessee was treated by the revenue itself throughout as business income. It cannot, therefore, be pretended that the debt was not one which if realized would not have gone to swell the business profits of the assessee."

It would be clear from the above observations of Hon'ble Madras High Court that the condition that the debt should have been "taken into account" in computing the assessee's income stands satisfied since the interest in respect of the debt is assessed in the assessee's hands as business income. This is the meaning which has been attributed to the condition which has been read into the provisions of section 10(2)(xi) of the 1922 Act even though the express language of the provision did not prescribe such a condition. 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.

29. At the time of hearing before us, the ld. Counsel for the assessee has strongly relied on the decisions of Hon'ble Delhi High Court in the case of CIT vs. DB (India) Securities Ltd.(supra) and in the case of CIT vs. Bonanza Portfolio Ltd. (supra) stating that the same are directly on the point in issue and there being no contrary decision of the Hon'ble jurisdictional High Court or any other High Courts, this Special Bench has to follow the same. We have carefully perused the said decisions of the Hon'ble Delhi High Court. In the case of DB (India) Securities Ltd.(supra), the assessee was a member of Delhi Stock Exchange and was carrying on the business of shares and stock broking. The assessee had purchased shares on behalf of his client for the total value of Rs. 1.06 crores at an average price of Rs. 55 per share. The said client made a payment to the extent of Rs. 65 lacs only to the assessee and the remaining amount of Rs. 41 lacs had remained unpaid. The brokerage income earned by the assessee in respect of the said transaction of purchase of shares was duly declared in its return of income and was assessed as well in the earlier year. The balance amount of Rs. 41 lacs remained unpaid even in the next year also apparently because of the reason that the price of shares fell from Rs. 55 to Rs. 5 per share. In the return of income filed for the said year, the assesse claimed deduction of Rs. 41 lacs as bad debts u/s 36(1)(vii). The A.O. disallowed the claim of the assessee for the said deduction which was confirmed by the ld. CIT(A). On further appeal by the assessee, the Tribunal, however, allowed the said deduction and when the matter reached to the Hon'ble Delhi High Court, it was sought to be canvassed on behalf of the Revenue that the amount receivable by the assessee from its client against purchase of shares could not be treated as "debt" under the provisions of section 36(2) and therefore, the question of allowing any deduction for the said amount treating the same as bad debt would not arise. Hon'ble Delhi High Court did not find merit in this contention raised on behalf of the Revenue holding that there was a valid transaction between the assessee and his client and since the assessee had to make payment on behalf of his client which he could not recover to the extent of Rs. 41 lacs, the said sum has to be treated as his "debt". It was also held that the brokerage which was received for the said transaction was shown as income by the assessee in the earlier years and the same was taxed as such by the assessing authority. It was held that the assessee therefore was entitled for deduction on account of bad debt u/s 36(1)(vii) r.w.s. 36(2). A similar issue again came up for consideration before the Hon'ble Delhi High Court in the case of CIT vs. Bonanza Portfolio Ltd. (supra) wherein the question of law which arose for consideration was whether in view of the provisions of section 36(1)(vii), the total debit balance including the consideration collectible by the assessee company for the sale/purchase of shares could be claimed by the assessee as bad debts when it had only credited brokerage in the P&L account and it was held by the Hon'ble Delhi High Court following, inter alia, the decision in the case of CIT vs. DB (India) Securities Ltd. that the money receivable by the assessee as share broker from his clients against purchase of shares made on their behalf has to be treated as "debt" and since the brokerage payable by the client was a part of that debt and that part had been taken into account in computation of his income, the conditions stipulated in section 36(1)(vii) and 36(2) stood satisfied and the assessee was entitled for deduction in respect of the said amount since it had become bad. In our

opinion, the ratio of these decisions of the Hon'ble Delhi High Court in the case of CIT vs. DB (India) Securities Ltd.(supra) and in the case of CIT vs. Bonanza Portfolio Ltd. (supra) is squarely applicable to the issue which is under consideration in the present case before this Special Bench.

30. The learned D.R. has contended before us that the rules and regulations of stock exchange governing relations between broker and his clients as well as the guidelines issued by the SEBI from time to time protecting the interest of share broker were not brought to the notice of the Hon'ble Delhi High Court in the cases of CIT vs. DB (India) Securities Ltd.(supra) and CIT vs. Bonanza Portfolio Ltd. (supra) and Their Lordships thus had no occasion to consider the issue in the light of the same. However, as already held by us, the said rules and regulations as well as guidelines are not relevant in the context of issue referred to this special bench which raises a specific question of law. We have already noted that the fact which is not in dispute is that the assessee has actually suffered the loss as a result of the amount in question representing debt becoming irrecoverable. It is therefore not relevant whether such loss has been incurred by the assessee as a result of not following the relevant rules and regulations and guidelines or even after following the same. As observed by us, this aspect may be relevant in the context of quantification of such loss. As a matter of fact, one of the arguments raised on behalf of the Revenue in the case of DB (India) Securities Ltd. (supra) was that the assessee having not sold the shares to anybody else in the market, the assessee could not claim the amount in question as bad debt and while dealing with the same, it was held by the Hon'ble Delhi High Court that the sale consideration which such shares could fetch in the market needs to be adjusted against the amount of bad debt claimed by the assessee for arriving at the actual figure of "bad debts".

31. The contention raised on behalf of the Revenue based on the sale value of shares which are bound to remain with the assessee and which the assessee is entitled to sale and adjust the sale consideration thereof against the amount receivable from the client so as to arrive at the actual amount of bad debt thus is relevant for quantifying the actual amount of bad debt and it is at liberty to raise the same, if permissible, before the Division Bench during the course of hearing of the appeal. The ld. D.R. has also raised certain other doubts or disputes in the written submissions filed before this Special Bench relating to certain factual aspects of the case. Although, no such doubts or disputes appear to have been raised even by the A.O. in the assessment order, the ld. Counsel for the assessee has fairly agreed that if it is so felt by the Division Bench after considering the arguments of both the sides while hearing the appeal of the assessee that these aspects need verification, the assessee will have no objection for getting such verification done from the A.O.

32. Keeping in view all the facts of the case and the legal position emanating from the various judicial pronouncements as discussed above, we are of the view that the amount receivable by the assessee, who is a share broker, from his clients against the transactions of purchase of shares on their behalf constitutes debt which is a trading debt. The brokerage/commission income arising from such transactions very much forms part of the said debt and when the amount of such brokerage/commission has been taken into

account in computation of income of the assessee of the relevant previous year or any earlier year, it satisfies the condition stipulated in section 36(2)(i) and the assessee is entitled to deduction u/s 36(1)(vii) by way of bad debts after having written of the said debts from his books of account as irrecoverable. We, therefore, answer the question referred to this Special Bench in the affirmative that is in favour of the assessee.

33. The matter will now go before the regular Bench for disposing of the appeal keeping in view our decision rendered hereinabove.

34. Before parting, we may recapitulate that there are certain arguments which have been raised by the ld. D.R. for the first time before this Special Bench relating to quantification of the amount of bad debts and verification of some factual aspects. As already observed by us in this context, the Department is at liberty to raise these arguments, if it is permissible to do so, at the time of hearing of the regular appeal before the Division Bench, which shall consider the same in accordance with law.

Order pronounced on 16th July, 2010.

Sd/-	**sd/-**	**sd/-**
(R.V. EASWAR)	**(D.K. AGARWAL)**	**(P.M. JAGTAP)**
PRESIDENT	**JUDICIAL MEMBER**	**ACCOUNTANT MEMBER**

Mumbai, dated 16th July , 2010.