HIGH COURT OF JUDICATURE OF ALLAHABAD

Income Tax Reference No.74 of 1999

Commissioner of Income Tax, Meerut v.
M/s Willard India Limited, Sikandrabad

Date of Judgement: 22.5.2007

Hon'ble R.K.Agrawal, J.
Hon'ble Bharati Sapru, J.

(Delivered by R.K.Agrawal, J.)

The Income Tax Appellate Tribunal, New Delhi has referred the following questions of law under Section 256(1) of the Income Tax Act, 1961 (hereinafter referred to as "the Act") for opinion to this Court:-

"R.A.No.980/Del/96 (A.Y.1984-85)

1. Whether on the facts and in the circumstances of the case, ld. ITAT was legally correct in deleting the addition of Rs.2,99,287/- towards cessation of liability which is clearly chargeable to tax u/s 41(1) of I.T. Act.?

2. Whether on the facts and in the circumstances of the case, ld. ITAT was legally correct in deleting the addition of Rs.1,77,953/- made by the A.O. u/s 40A(5) of IT At and holding that disallowance should be worked out in view of Rule 3(c)(ii) of I.T.Rules, 1962?

R.A.No.982/Del/96 (A.Y.1986-87)

1. Whether on the facts and in the circumstances of the case, ld. ITAT was legally correct in deleting the addition of Rs.1,80,075/- made by the A.O. u/s 40A(5) of IT Act and holding that disallowance should be worked out in view of Rule 3(c)(ii) of IT Rules?

R.A.No.981/Del/96 (A.Y.1985-86)

1. Whether on the facts and in the circumstances of the case, ld. ITAT was legally correct in deleting the addition of Rs.1,39,658/- made by the A.O. u/s 40A(5) of IT Act and holding that disallowance should be worked out in view of Rule 3(c)(ii) of IT Rules?

2. Whether on the facts and in the circumstances of the case, ld. ITAT was legally correct in deleting the addition of Rs.3,67,872/- made by the A.O. towards claim of bonus pertaining to previous accounting year as a result of change in method of accounting year as a result of change in method of accounting in respect of bonus from cash system in A.Y. 84-85 to mercantile

system in A.Y.85-86 in view of the decision of Hon'ble SC in the case of CIT vs. M/s British Paints India Ltd., 188 ITR 44.

R.A.No.983/Del/96 (A.Y.1987-88)

1. Whether on the facts and in the circumstances of the case, ld. ITAT was legally correct in deleting the addition of Rs.1,24,574/- made by the A.O. u/s 40A(5) of IT Act and holding that disallowance should be worked out in view of Rule 3(c)(ii) of IT Rules?

The reference relates to the Assessment Years 1984-85 to 1987-88. The first question of R.A.No.980 relates to the assessment year 1984-85 whereas the second question of R.A.No.980 and the first question of R.A.No.981,982 and 983 relate to the assessment years 1984-85 to 1987-88 respectively. The second question in R.A.No.981 relates to the assessment year 1985-86.

Briefly stated, the facts giving rise to the present reference are as follow:- A sum of Rs.2,99,287/-was written back by the respondent assessee during the previous year relevant to the assessment year in question as the amount was lying since last three years being unclaimed. It related to unclaimed sundry creditors. The Assessing Officer had added the aforesaid amount by invoking the provisions of Section 41(1) of the Act by treating it to be a case of cessation of liability. The Commissioner of Income Tax (Appeals) had upheld the action. However, in further appeal, the Tribunal had held that the addition was not justified. The Tribunal has held as follows:-

"The liability of the assessee to pay those amounts to the creditors does not depend upon the admission of those amounts by the assessee. Therefore, writing back of those amounts need not have any effect on the question of liability. The liability on the part of the assessee would continue to be there so long as the limitation period is available to the creditors to recover those amounts. Therefore, in our opinion, disallowance of the amounts cannot have any legal consequence. It is not the case of the A.O. that the debts due to the creditors were not true or genuine since all along they have been claimed in the accounts and they have been allowed in earlier years. In the absence of any evidence that the debts were not genuine and the creditors were bogus, the amounts should not be disallowed but should always be allowed as deduction while arriving at the real profit derived by the assessee in his business."

In respect of working out the amount of addition under Section 40A(5) of the Act, the facts are that the Assessing Authority had made an addition of Rs.1,77,953/-, Rs.1,39,658/-, Rs.1,80,075/- and Rs.1,24,574/- in respect of the assessment years 1984-85, 1985-86, 1986-87 and 1987-88, respectively, under Section 40A(5) of the Act. In appeal, the Tribunal has directed the Assessing Officer to work out the disallowance in term of Rule 3(c)(ii) of the Income Tax Rules, 1962.

So far as the remaining question is concerned, the facts are that during the assessment year 1985-86, the respondent assessee who was following the cash system of accounting in respect of bonus payable to its employees, had changed

it to mercantile system of accounting. However, the assessee had claimed deduction of Rs.3,67,872/- which pertains to the previous accounting year on the ground that the same pertains to the liability of earlier years but was paid during the year in question. The expenditure was disallowed by the Assessing Officer. However, the Tribunal has allowed the same on the ground that the change in the method of accounting is bona fide and whenever a change takes place, some corrections are required to be made. There is no question of any double deductions and whatever liability of the previous year, which was being allowed on cash system and has been paid during the year in question, has to be allowed apart from the liability which has accrued during the year in question.

We have heard Sri R.K.Upadhaya, learned Standing Counsel for the Revenue, and Sri Yashwant Verma, learned counsel appearing for the respondent assessee.

The learned Standing Counsel submitted that as the respondent assessee had written back the amount of sundry creditors lying unclaimed since last three years, there would be cessation of liability and can be brought to tax under Section 41(1) of the Act. He has relied upon a Division Bench decision of the Calcutta High Court in the case of Commissioner of Income Tax v. General Industrial Society Ltd., (1994) 207 ITR 169.

He further submitted that the disallowance under Section 40A(5) of the Act has to be worked out in accordance with the provisions of the Act and recourse to Rule 3(c)(ii) is not permissible. He relied upon a decision of the Apex Court in the case of Commissioner of Income Tax v. British Bank of Middle East, (2001) 251 ITR 217.

In respect of the last question, he submitted that the respondent assessee could not be permitted to change the method of accounting adopted regarding payment of bonus from the cash to mercantile system and, even if the change is permitted, the amount of bonus payable for the earlier years could not have been allowed as deductions during the previous year relevant to the assessment year in question. He submitted that the Tribunal has committed an error in deleting the addition of Rs.3,67,872/- in this behalf.

Sri Yashwant Verma, learned counsel, on the other hand, submitted that even though the respondent assessee had written back the amount due to sundry creditors on the ground that it was lying unclaimed for the last three years, yet there is no cessation of liability. The provision of Section 41(1) of the Act is not attracted. In support of his aforesaid plea, he has relied upon the decision of this Court in the case of Bhagwat Prasad v. Commissioner of Income Tax, (1975) 99 ITR 111, and Commissioner of Income Tax v. Iswari Khetan Sugar Mills Ltd., (1988) 172 ITR 431 and of the Apex Court in the case of Commissioner of Income Tax, Calcutta v. Sugauli Sugar Works (P) Ltd., (1999) 2 SCC 355. He further submitted that the decision of the Calcutta High Court in the case of General Industrial Society Ltd. (supra) has been considered by the Apex Court in the case of Sugauli Sugar Works (P) Ltd. (supra) and has been distinguished.

In respect of disallowance worked out under Section 40A(5) of the Act, he did not advance any serious argument. However, on the question of change of method of accounting, he submitted that the Tribunal has held that the change from cash system to mercantile system of account in respect of payment of bonus to the employees, is bona fide. According to him, change in method of accounting is permissible provided the same is bona fide and is followed from year to year thereafter. Relying upon a Division Bench decision of the Calcutta High Court in the case of Commissioner of Income Tax v. Kesoram Industries and Cotton Mills Ltd., (1993) 204 ITR 154, he submitted that the Tribunal had rightly deleted the addition of Rs.3,67,872/- in this behalf.

We have given our anxious consideration to the various pleas raised by the learned counsel for the parties.

It is not in dispute that a sum of Rs.2,99,287/- written back by the respondent assessee related to sundry creditors and was lying unclaimed for the last three years. This Court in the case of Bhagwat Prasad (supra) has held as follows:-

"The revenue cannot take advantage of the fiction created by section 41 of the Act. the second condition for the applicability of section 41(1), viz,. that the assessee should in the assessment year in question receive some benefit by way of cessation of its trading liability, also is not made out. When a liability becomes barred by the law of limitation, there is neither remission nor cessation of liability; the liability is not extinguished, only the creditor's remedy becomes barred. Therefore, the amount could not be taxed under section 41(1) as income for the year in which the debt due to the creditor became time barred as there was neither remission nor cessation of its liability in that year."

In the case of Iswari Khetan Sugar Mills Ltd. (supra), another Division Bench of this Court has held that there cannot be cessation of any liability by an unilateral act.

In the case of Sugauli Sugar Works (P) Ltd. (supra) the Apex Court has held as follows:-

"Thus, the obtaining by the assessee of a benefit by virtue of remission or cessation is sine qua non for the application of this Section. The mere fact that the assessee has made an entry of transfer in his accounts unilaterally will not enable the Department to say that Section 41 would apply and the amount should be included in the total income of the assessee. The reasoning of the High Court is correct and we are in agreement with the same."

It had distinguished the decision of the Calcutta High Court in the case of General Industrial Society Ltd. (supra) on the ground that it turns on the peculiar facts of the case. The Apex Court, in paragraphs 5 and 6 of the report, has held as follows:-

"5. Learned counsel for the appellant draws our attention to the judgment of the Calcutta High Court in Commr. of Income Tax v. General Industrial Society

Ltd., (1994) 207 ITR 169. The Division Bench of the Calcutta High Court has taken care to set out the two important factors in that case which weighed with them to come to the particular conclusion. The Bench said :

"It appears from the assessment order that there is one peculiar aspect in the present case. It is the practice of the assessee to write back such unclaimed and unspent liabilities from year to year on grounds of bar limitation of the liability and to get away without paying tax on such amount written back to profit on the same plea. This has been happening since the assessment year 1977-78. This fact, to our mind, is very significant. One more notable feature is that the assessee never divulged to the Assessing Officer the details and particulars of the claims despite specific enquiry. These two factors combine to lend to the case a colour different from the case relied upon on behalf of the assessee."

6. The Bench distinguished the other decisions referred to before it by pointing out that the facts were entirely different in those cases. Hence, the ruling of the Calcutta High Court in the case cited will not help the appellant as it turned on the peculiar facts of the case as stated in the passage extracted."

It has further held, in paragraph 12 of the report, as follows:-

"12. The principle that expiry of period of limitation prescribed under the Limitation Act could not extinguish the debt but it would only prevent the creditor from enforcing the debt, has been well settled. It is enough to refer to the decision of this Court in Bombay Dyeing and Manufacturing Co. Ltd. v. State of Bombay, 1958 SCR 1122 : (AIR 1958 SC 328). If that principle is applied, it is clear that mere entry in the books of accounts of the debtor made unilaterally without any act on the part of the creditor will not enable the debtor to say that the liability has come to an end. Apart from that, that will not by itself confer any benefit on the debtor as contemplated by the Section."

(Underlined by us)

In view of the decision of the Apex Court, referred to above, there cannot be any doubt that an unilateral entry on the part of the debtor to write back the amount on the ground of limitation having expired, would not tantamount to cessation of liability and, therefore, the provisions of Section 41(1) of the Act would not be attracted. The first question is answered in the affirmative, i.e., in favour of the assessee and against the Revenue.

So far as the question relating to addition under Section 40A(5) which is common to all the assessment years, we find that in view of the decision of the Apex Court in the case of British Bank of Middle East (supra) wherein the Apex Court has held that Section 40A(5) and Rule 3 deal with different situation and different set of assessee - one dealing with the employer assessee and the other with the employee assessee - and, therefore, the provision of Section 40A(5) cannot be controlled by Rule 3, it is to be answered in the negative, i.e., in favour of the Revenue and against the assessee.

So far as the last question is concerned, we may mention here that the Tribunal has recorded a categorical finding that the change of method from cash to mercantile system in respect of payment of bonus to the employee was bona fide. The law permits an assessee to change the method of accounting. In cases where change of method of accounting is adopted, there may appear some anomalies in order to arrive at the true profit and loss for the relevant assessment years and some adjustments have to be made. In the present case, we find that as the assessee was following the cash system of accounting in respect of payment of bonus to the employees in respect of the amount which had accrued as a liability in the preceding assessment years, but could not have been allowed as it was following the cash system of accounting, was liable to be allowed during the previous years relevant to the assessment years in question on actual payment basis even where there is a change of account system from cash to mercantile system. In this view of the matter, we do not find any illegality in the order of the Tribunal. The Tribunal was fully justified in deleting Rs.3,67,872/- in this behalf.

In view of the foregoing discussions, we answer this question referred to us in the affirmative, i.e., in favour of the assessee and against the Revenue. In view of the divided success, the parties are left to bear their own costs.