

EY Tax Alert

Supreme Court disallows bad debt deduction on advance given by real estate developer and financier to purchase commercial property

Executive summary

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This Alert summarizes a recent decision¹ of three-judge bench of Supreme Court (SC) in the case of PCIT v. Khyati Realtors Pvt. Ltd² (Taxpayer) on bad debt deduction for advance given by a real estate developer and financier to purchase commercial property.

The Taxpayer claimed write off of advance as bad debt deduction under section (s.) 36(1)(vii) of the Income tax Act, 1961 (ITA) and alternatively, as revenue business expenditure or trading loss under s. 37(1). The tax authority and the first appellate authority (FAA) denied deduction under both provisions on the grounds that (a) the conditions for claiming bad debt deduction were not fulfilled and (b) since the claim fell under bad debt deduction provision but could not be allowed due to non-fulfilment of conditions thereof, it cannot be allowed under s.37(1) as well.

On further appeal by the Taxpayer, the Mumbai Tribunal confirmed non-admissibility of claim as bad debt deduction due to non-fulfillment of conditions thereof but allowed the deduction under s.37(1) on the ground that the advance was given in the ordinary course of real estate development business. The Tribunal also noted that the Taxpayer had offered subsequent recovery of part of advance in subsequent tax year as business income. On further appeal by the tax authority, the Bombay High Court (HC) upheld the Tribunal ruling on allowance of deduction under s.37(1). The tax authority appealed further to the SC.

¹ Dated 25 August 2022

² TS-671-SC-2022

Reversing the decisions of the Tribunal and the HC, the SC ruled in favor of the Tax Authority and held that the deduction was not allowable for the following reasons:

- (a) The Taxpayer could neither establish from its accounts that the advance was given in the ordinary course of Taxpayer's business nor could it establish that the amount was given as loan in the ordinary course of moneylending business.
- (b) Furthermore, the Taxpayer could not establish from its record that the bad debt was written off as irrecoverable in the books of account.
- (c) Also, since the advance was given to acquire immovable property, it was in the nature of capital expenditure and, hence, not allowable as revenue business expenditure.
- (d) It is true that a revenue expenditure incurred wholly and exclusively for business purposes, if not allowable under any of the specific provisions, is allowable as deduction under residual provision of s.37(1). However, in the present case, as held by the SC in an earlier ruling³, provision for doubtful debt not allowable under s.36(1)(vii) is also not allowable under s.37(1), since s.37(1) applies only to items which do not fall under earlier provisions.

Background

- ▶ The provisions of the ITA dealing with business income computation include a specific provision for allowing bad debt deduction by way of s.36(1)(vii) for which relevant conditions are as follows:
 - ▶ The debt should either (a) have been taken into account in computing the taxpayer's income of the tax year in which it is written off or in an earlier tax year ("trading debt") or (b) represent moneys lent in the ordinary course of business of banking or moneylending carried by the taxpayer.
 - ▶ The bad debt should be "written off" as irrecoverable in the accounts of the taxpayer for the relevant tax year.
 - ▶ Post amendment made by Finance Act 2001 with retrospective effect from tax year 1988-89, the "write off" does not include provision for bad and doubtful debts made in the

accounts of the taxpayer. In this regard, the SC in an earlier ruling in the case of Southern Technologies Ltd v. JCIT⁴ (Southern Technologies ruling) has explained the distinction between "write off" and "provision".

- ▶ There is also a residual or general provision by way of s.37(1) which allows deduction for expenditure (not being capital expenditure or personal expenditure) incurred wholly and exclusively for business purposes. But the condition for allowance of deduction under this provision is that such expenditure should not be of the nature described in earlier provisions (including bad debt deduction under s.36(1)(vii))
- ▶ Another well-settled principle of relevance is that incidental trading losses incurred in the ordinary course of business can be claimed as deduction u/s. 28/29.

Facts of the case

- ▶ The Taxpayer is engaged in real estate development business, trading in transferable development rights and financing activity.
- ▶ In tax year 2006-07, the Taxpayer gave an amount of INR 100m to another real estate developer by way of advance against booking to purchase commercial premises in an upcoming project being developed by such developer. No interest was charged on such advance since it was towards reserving booking for purchase of commercial property.
- ▶ But the project did not take off and Taxpayer started efforts to recover the advance back from the said developer. Since, the Taxpayer could not recover the advance, its Board of Directors passed a resolution on 28 March 2009 to write off the advance in its accounts as bad debt. Subsequently, in tax year 2011-12, the Taxpayer could recover a part of such debt written off in tax year 2008-09, which it offered to tax as business income.
- ▶ The Taxpayer claimed deduction of write off of bad debt of INR 100m in its income tax assessment for tax year 2008-09 primarily under s.36(1)(vii) and alternatively under s.28/37(1). However, the tax authority and the FAA denied deduction under both provisions on the grounds that (a) the conditions for claiming bad debt deduction were not fulfilled and (b) since the claim fell under bad debt deduction provision but could not be allowed due to non-fulfilment of conditions thereof, it cannot be allowed under s.37(1) as well.

³ Southern Technologies Ltd v. JCIT (2010)(320 ITR 577)(SC)

⁴ (2010)(320 ITR 577)(SC)

- ▶ On further appeal by the Taxpayer, the Mumbai Tribunal⁵ confirmed non-admissibility of claim as bad debt deduction due to non-fulfilment of conditions thereof. More particularly, it held that the advance given did neither represent a trading debt offered as income in the past nor represented monies lent in the ordinary course of moneylending since no interest was charged thereon. However, the Tribunal allowed the deduction under s.28/37(1) on the ground that the advance was given in the ordinary course of real estate development business. It did not represent capital expenditure since the commercial premises was stock in trade for taxpayer engaged in real estate business. The Tribunal also noted that the Taxpayer had offered recovery of part of advance in subsequent tax year as business income.

- ▶ As it appears, the Taxpayer did not file any appeal against the Tribunal ruling denying bad debt deduction under s.36(1)(vii) - most probably, since the overall decision was in Taxpayer's favor whereby Tribunal allowed deduction as incidental trading loss under s.28/37(1). The tax authority filed further appeal before the Bombay HC. The question of law considered by the Bombay HC on tax authority's appeal was limited to correctness of Tribunal ruling in allowing alternate claim of deduction under s.37(1).

- ▶ The Bombay HC⁶ upheld the Tribunal ruling on allowance of deduction under s.37(1). The Bombay HC specifically noted that the Memorandum of Association (MOA) of the Taxpayer permitted to engage in wide range of activities in real estate. Hence, the loss of advance given for purchase of commercial property as a commercial venture was clearly a business loss.

- ▶ The tax authority appealed further to the SC against the Bombay HC ruling.

Taxpayer's contentions before SC:

- ▶ The undisputed facts of the case are that the Taxpayer is engaged in the business of real estate and financing; the Taxpayer's MOA permitted wide range of real estate activities as also lending of money; the Taxpayer paid advance of INR 100M as advance to purchase commercial property; the advance was given in ordinary course of business and it was written off in tax year 2008-09.

- ▶ The Taxpayer is not required to establish that the debt written off became irrecoverable. Reliance was placed on earlier SC ruling in the case of *T.R.F. Limited v. CIT*⁷ (TRF ruling).

- ▶ Even if the write off is not allowable as bad debt deduction under s.36(1)(vii), it is still allowable as deduction under s.37(1). Reliance, amongst others, was placed on SC ruling in the case of *CIT v. Mysore Sugar Co. Ltd*⁸ (Mysore Sugar ruling) where the SC allowed deduction of write of advances given by sugar manufacturer to sugarcane suppliers towards purchase of sugarcane which, due to drought conditions, the suppliers could neither supply sugarcane nor refund the advance.

Tax authority's contentions before SC:

- ▶ It is obligatory upon the Taxpayer to prove that conditions germane to bad debt deduction under s.36(1)(vii) are fulfilled. Reliance was placed on earlier SC ruling in the case of *Catholic Syrian Bank v. CIT*⁹ (Catholic Syrian ruling) for this proposition. The Tribunal and HC were in error since the Taxpayer's claim was not supported by any material or document.

- ▶ There was no material to support either that the amount was given as advance to purchase commercial property or that it was given as loan. The claim of loan was not supported by any material indicating terms of loan or conditions of repayment including interest.

- ▶ The Taxpayer's alternative claim under s.37(1) was an after-thought raised for the first time after the first appellate authority's order.

SC ruling:

Reversing the decisions of the Tribunal and the HC, the SC ruled in favor of the Tax Authority and held that the deduction was not allowable under both s.36(1)(vii) and s.37(1) for following brief reasons:

Non-admissibility as bad debt deduction under s.36(1)(vii)

- ▶ It is true that if taxpayer carries on business, it is entitled to bad debt deduction under s.36(1)(vii) but it is subject to fulfilment of conditions specified therein.

- ▶ The Southern Technologies ruling confirms the distinction between "write off" of bad debt and making "provision" in respect of bad or doubtful debt. S.36(1)(vii) allows deduction for "write off" but not for "provision". Furthermore, Catholic Syrian ruling confirms that it is obligatory upon the taxpayer to prove to the tax authority that it satisfies the conditions germane to bad debt deduction

⁵ ITA No. 129/Mum/2014 dated 4 March 2016

⁶ [2019] 108 taxmann.com 449 (Bom)

⁷ [2010] 323 ITR 397 (SC)

⁸ [1962] 46 ITR 649 (SC)

⁹ [2012] 343 ITR 270 (SC)

including the condition of "write off" in accounts.

- ▶ It is true that TRF ruling upheld that it is not necessary for the taxpayer to establish that the debt, in fact, has become irrecoverable and it is sufficient to show that the debt is written off in the accounts. But in this ruling, the SC did not examine other conditions for claiming bad debt deduction as in case of Southern Technologies and Catholic Syrian rulings - although one of the judges¹⁰ was common to all three rulings. Catholic Syrian ruling was a three-judge bench ruling as compared to other two rulings which were of two-judge benches. In the circumstances of the present case, the SC felt it appropriate to accord primacy to Southern Technologies ruling.
- ▶ The SC summarized the principles emerging from the above referred three SC rulings as follows:
 - ▶ The amount of any bad debt or part thereof has to be written-off as irrecoverable in the accounts of the Taxpayer for the relevant tax year.
 - ▶ Such bad debt or part of it written-off as irrecoverable in the Taxpayer's accounts cannot include any provision for bad and doubtful debts.
 - ▶ No deduction is allowable unless the debt or part of it has been offered to tax in current or earlier tax years, or represents money lent in the ordinary course of the business of banking or moneylending carried on by the Taxpayer.
 - ▶ The Taxpayer is obliged to prove to the tax authority that the case satisfies the ingredients of claiming bad deduction in terms of above referred conditions.
- ▶ In the facts of the present case, the Taxpayer could neither establish from its accounts that the advance was given in the ordinary course of Taxpayer's business nor could it establish that the amount was given as loan in the ordinary course of moneylending business. As noted by the FAA, there was no material in support of claim of advance for purchase of commercial property like time by which constructed unit was to be handed over, area agreed to be purchased etc. Similarly, there was no material in support of claim of loan like duration of loan, terms and conditions applicable to it, interest payable, etc.

- ▶ Furthermore, the Taxpayer could not establish from its record that the bad debt was written off as irrecoverable in the books of account.

- ▶ Also, since the advance was given to acquire immovable property, it was in the nature of capital expenditure and, hence, not allowable as revenue business expenditure.

Non-admissibility under s.37(1)

- ▶ S.37(1) allows deduction for expenditure which is not covered by earlier provisions; which is not capital expenditure or personal expenditure and is incurred wholly and exclusively for business purposes. Mysore Sugar ruling confirms that even if a claim for deduction is not allowed under s.36(1)(vii), the possibility of deduction under s.37(1) cannot be ruled out. This proposition is unexceptionable.

- ▶ However, in the facts of the case, the Southern Technologies ruling is appropriate and applicable. In that case, the SC denied alternative deduction for provision for doubtful debts under s.37(1). In that case, the SC held that a "provision" for doubtful debt which is outside the scope of s.36(1)(vii) cannot be alternatively allowed under s.37(1) since s.37(1) applies only to items not covered by earlier provisions. It further held that if a provision for doubtful debt is expressly excluded from s.36(1)(vii) then such provision cannot be claimed as deduction under s.37(1) even on the basis of "real income" theory.

¹⁰ Late Chief Justice S. H. Kapadia

Comments

The present three-judge SC ruling raises several interesting issues in view of its peculiarity and the manner in which each appellate authority looked at the facts of the case and applied the law.

On factual aspect, it seems the FAA held that there was no material to support the Taxpayer's claim of amount being advance to buy commercial property in the ordinary course of business or as loan. However, the Tribunal (which is the final factfinding authority) had accepted that the amount was paid as advance to buy commercial property in the ordinary course of real estate business (i.e., advance towards stock-in-trade). The Tribunal did reject the claim of bad debt deduction as the condition of the write off being in respect of amount which was considered as income in the past was not fulfilled. Since on an overall basis, the ruling was in favor of the Taxpayer, it seems the Taxpayer did not file further appeal before High Court. The High Court upheld the Tribunal order.

Before the SC, the tax authority disputed factual understanding which seems to have influenced the SC ruling. Particularly, the arguments raised before the SC were that there was no material to support, either that the amount was given as advance to purchase commercial property or that it was given as loan. There was no material to support the specific terms and conditions of either advance for purchase or loan. The SC went by FAA's findings and held that the record shows the Taxpayer's accounts nowhere showed that the advance was made in the ordinary course of the Taxpayer's business. This is interesting considering that the question of law posed by the tax authority before the HC did not appear to challenge the Tribunal's findings. It is well settled that the Tribunal is the final factfinding authority and unless the Tribunal's findings are challenged as perverse or not borne from record, the HC and SC generally give primacy to Tribunal's findings¹¹.

From the legal aspect, the bad debt claim was decided against the Taxpayer by the Tribunal. It seems the Taxpayer did not file further appeal before the HC on this aspect. The question of law considered by the HC was also limited to allowance of alternative claim under s.37(1) being deduction in respect of non-recoverable

¹¹ Refer, illustratively, Patnaik & Co Ltd v CIT [1986] 161 ITR 365 (SC) and K. Ravindranathan Nair v CIT [2001] 247 ITR 178 (SC)

advance admitted by Tribunal to be an advance towards stock-in-trade. Hence, it appears incongruous that the issue of bad debt deduction was re-agitated before the SC as also the fact that SC held that the Taxpayer's claim for bad debt deduction could not have been allowed by the Tribunal and HC.

While SC acknowledged that alternative claim of deduction under s.37(1) is not ruled out, however, it applied Southern Technologies ruling to deny the alternative claim in the present facts. It may be noted that in Southern Technologies ruling, the SC was concerned with deductibility of provision for bad and doubtful debts made by non-banking financial institutions in respect of monies lent in the ordinary course of money lending. While the SC, in that case, denied the deduction on the basis that s.36(1)(vii) permits deduction of "write off" and not mere "provision", it also denied an alternative claim of deduction under s.37(1) on the ground that s.37(1) does not apply to items covered by earlier provisions. In other words, the subject matter of deduction (i.e., bad debts) was covered by s.36(1)(vii), which the taxpayer engaged in moneylending business could claim by "writing off" the debts in its accounts and an alternative claim that mere provision qualified for deductions. s.37(1) was rejected as non-tenable. In the facts of the case, the Tribunal's finding was that the amount was written off in the books. Incidentally, the fact of write off (as distinguished from "provision") does not appear to have been disputed nor raised as an objection by the Tax Authority before the SC.

In the present case, the SC did not accept the Taxpayer's claim that the advance was given in the ordinary course of moneylending business. Hence, the application of Southern Technologies ruling raises interesting issue. Furthermore, the SC held that the money paid for acquisition of immovable property was capital expenditure (as against Tribunal's finding that the acquisition of commercial property was stock in trade for the Taxpayer dealing in real estate). This shows the divergence of consideration of facts as compared to those considered by the Tribunal.

The ruling highlights the significance of the Taxpayer establishing the facts of the case with proper documentation and fulfillment of conditions germane to deduction under any provision.

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