

## BAD DEBTS UNDER THE HEAD "CAPITAL GAINS"

Adv. Bharat Agarwal

CA Sneha Sarbhusan

For Acelegal

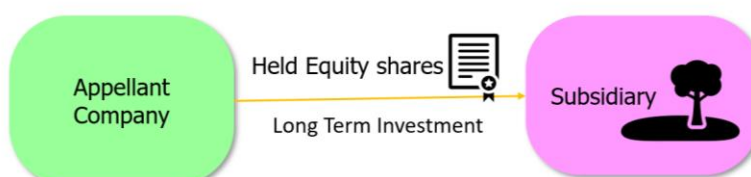
**Publisher link :** <https://taxguru.in/income-tax/bad-debts-head-capital-gains.html>

Recently, an interesting question arose before the Delhi ITAT in the case of *M/s. Anant Raj Limited v. DCIT*<sup>1</sup>. Where the assessee has offered an income under the head capital gain in past years, can he change the head of income in subsequent years for the related transaction?

The ITAT has held in affirmative stating that an assessee can correct the head of income in the subsequent years for such related transaction. The ITAT has reiterated that there cannot be an estoppel against law. A mistake cannot perpetrate merely because it was accepted in earlier years. The Tribunal has further reminded that the income tax assessments are not adversarial proceedings. Both parties have to come together to assess correct income. The department should not take advantage of error committed by an assessee. We analyse the said case:

### FACTS OF THE CASE :

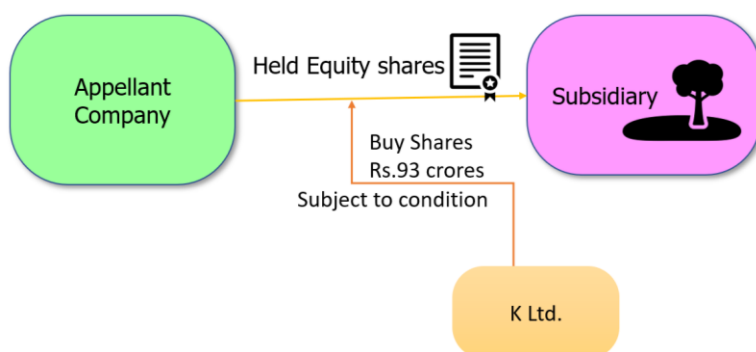
The Appellant company is engaged in real estate business. It acquired land through various subsidiaries. The Subsidiaries would hand over the acquired land for development to the Appellant company. The Appellant had to apply for any change in land use, obtain other permission from the Government. The Appellant classified the shares in subsidiaries as 'Long-Term Investments' under disclosure norms of the Companies Act.



The Appellant made investment in one of its subsidiary company Silver Town Inn and Resorts Pvt. Ltd. ("**Subsidiary**"). This subsidiary owned agricultural/plot of land. The Appellant Company wished to dispose of the land in subsidiary. It agreed to transfer the shares in the Subsidiary to K Ltd. for a total consideration of Rs.93 crores. The value of shares of Subsidiary were determined on the basis of value of land held by Subsidiary. The Appellant Company received advance of Rs.15 crores. The balance receivable Rs.78

<sup>1</sup> ITAT no. 5167 and 5699/ Del/2017, order dated 11/05/2020

crores was conditional upon the Appellant getting CLU and other clearances by the Government.



The agreement for transfer of shares was entered in the AY 2010-11. Appellant offered the entire consideration of Rs.93 crores on accrual basis under the head "Long Term Capital Gain" and calculated and paid the long term capital gain tax on the sale of such shares.

In unfortunate turn of events the adjacent land and the part of the said land was acquired by the Government for widening of the national highways. Certain areas were declared as green belt. The entire project failed and CLU and other legal permission could not be obtained. In FY 2012-13, it became clear that the buyer K Ltd. will not pay the balance amount of Rs.78 crores since the land value had collapsed. The Appellant wrote off the said receivable and claimed it as bad debt under the head "Profits and gains from business or profession".

The AO disallowed the bad debt claim on the ground that :

- (i) The bad debt is write off of receivables of sale of shares. Hence it is capital in nature. The shares sold were held as investment and not as stock-in-trade. Therefore, it cannot be allowed under the head "profit and gains from business or profession".
- (ii) The assessee cannot write off as revenue amount in profit and loss account, the capital gain of Rs.71.84 crores offered in earlier year.

CIT(A) confirmed the addition made by the AO on the ground that the said bad debt is not out of any transaction on account of business or venture.

#### **QUESTION BEFORE ITAT :**

Whether the said claim of loss should be allowed as 'business loss' or 'long term capital loss' ?

#### **APPELLANT'S SUBMISSION :**

- (i) One must examine the substance of transaction. Consideration for sale of shares and income for service rendered in connection with the CLU and other clearance is a business activity of the Appellant.
- (ii) Assessee can claim loss under correct head of income even if declared wrongly in earlier years. Here, it is business income / business loss. The AO is duty bound to assess correct income as per provisions of law. Reliance was placed on the decision of *Calcutta Discount Co. Ltd. v. ITO*<sup>2</sup>.
- (iii) Income accrue when right to receive has arisen. Right to receive accrue only upon receipt of CLU which didn't arise since CLU was cancelled. Therefore, the tax was paid earlier on an income which was never earned.

#### **AO'S CONTENTION :**

- (i) Appellant himself has offered income from sale of shares under the head "capital gains" in AY 2010-11. Once the character of income is in nature of capital, then same cannot be changed.
- (ii) Appellant has not revised the computation of income for the AY2010-11. Therefore, now the assessee is estopped from changing the stand and claim the loss as bad debt under the head "profits and gains from business or profession".

#### **ITAT VERDICT :**

The ITAT allowed the claim of the assessee. While doing so that ITAT held that the claim regarding the allowability of the bad debts or business loss has to be determined by the AO in the year in which the loss is claimed in P&L account. Each assessment year is different. Therefore, the assessment of the corresponding income as capital gain in an earlier year will not bind the assessee. It is always open for the assessee to point out that it is to be assessed under the correct head, that is business income.

The ITAT further relied upon the *CBDT Circular no. 14(XL-35) of 1955 dated 11/04/1955* to hold that it's the duty of the AO to assess the income correctly. The AO should advise the assessee to correctly offer the income. The AO should not take advantage of the assessee's ignorance.

The ITAT placed heavy reliance upon the two decisions of the apex court besides others:

- a) *CIT v. Manmohan Das*<sup>3</sup> and;
- b) *CIT v. Western India Oil Distributing Co. Ltd.*<sup>4</sup> :

---

<sup>2</sup> (1961) 41 ITR 191 (SC)

<sup>3</sup> (1966) 59 ITR 699 (SC)

<sup>4</sup> (2001) 249 ITR 517 (SC)

The ITAT culled out the following principles from the discussion of the above two decisions:

- (i) Call as to whether a particular business loss incurred in earlier year is to be set off in a subsequent year is to be taken in the course of proceedings for AY in which set off is claimed;
- (ii) When an assessee incur a loss in business in a year, such loss has to be subject to fulfilment of other preconditions is to be set off against profit of the same business in subsequent year ;
- (iii) In the course of proceedings for AY in which set off is claimed, it is open to even decide the true nature and character of loss incurred in earlier relevant assessment year.

Finally, the ITAT held that:

- (i) Any deduction has to be examined afresh in the year in which it is claimed
- (ii) Bad debt or loss which is claimed in this year has to be determined in this year only without distributing the earlier assessment which has attained finality.

The ITAT also observed that a justice oriented approach is warranted. The assessee has paid tax on hypothetical income in earlier years which it never received. It cannot be precluded from setting off loss under other head merely on technicality.

## **ACELEGAL ANALYSIS :**

### **ACCRUAL OF INCOME:**

Under the Income Tax Act, 1961, the scope of total income is defined in section 5. As per the said section, the total income of a person includes all income from whatever source derived which "accrues" or "arises" or is deemed to "accrue" or "arise". The Apex Court has described the words, "accrues", "arise" and "received" in the case of *E.D. Sassoon & Company Ltd. v. CIT*<sup>5</sup>. Apex Court has held that income would accrue or arise only if the assessee acquired right to receive income. Income may accrue to an assessee without the actual receipt of the same. If the assessee acquires a right to receive the income, the income can be said to have accrued to him though it may be received later on its being ascertained. The basic concept is that he must have acquired a right to receive the income. There must be a debt owed to him by somebody.

---

<sup>5</sup> (1954) 26 ITR 27 (SC)

Applying the said rule of the Apex Court in the present case, the Appellant Company has offered income on sale of shares to tax under the head "Capital Gains" in the year in which the transaction of sale took place i.e. AY 2010-11 even though the entire amount of sale consideration was not received. The balance consideration was held back because the assessee had to fulfil certain conditions.

#### **BAD DEBT OF CAPITAL RECEIPT :**

The income offered under the head "profits and gains from business or profession" u/s. 28 of the Income Tax Act, 1961 in earlier year is allowed as bad debt from business income in subsequent year in which the amount becomes irrecoverable. Thus, there is no problem as far as income under the head "profits and gains from business or profession" is concerned.

However if income is offered under "Capital Gains" on accrual basis, there is no such provision which allows claim of bad debts. This leads to unjust enrichment of revenue and it violates Article 265 of Constitution .

In the present case, the assessee offered to tax income on sale of shares under the head "Capital Gains" and paid tax @ 20% on amount of Rs.78 crores on accrual basis. The assessee realised that there was no practically possible way under the Income Tax Act, 1961 to claim back refund on income of capital nature wrongly offered to tax.

The assessee realised that commercially it was a "land" deal through the transfer of shares of subsidiary. Accordingly, the assessee claimed the loss under the head "profits and gains from business or profession" as it resulted from business activity. Before the ITAT, the assessee took the plea that the sale of shares is a business income since the underlying transaction was sale of land.

On these facts, the ITAT observed that the substance of the transaction was the sale of agricultural land and more importantly, the services of CLU which has made the asset more valuable. Thus, the taxing authorities cannot ignore the legal character of the transaction and tax it on the basis of what may be called 'substance of the matter'. One must find the true nature of the transaction as held by the hon'ble Supreme Court in the case of *UOI v. Play World Electronics Pvt. Ltd.*<sup>6</sup>. Accordingly, the ITAT allowed the bad debts to be claimed as deduction from business income.

#### **Taxing Real Income**

The Income Tax Act was enacted to provide for levy and collection of tax on income earned by a person. The Apex Court in the case of *H. M. Kashiparekh & Co. Ltd. v. CIT*<sup>7</sup> has observed that one of the rule in income tax is that income to be taxed is the real

---

<sup>6</sup> (1989) 3 SCC 181

<sup>7</sup> [1960] 39 ITR 706 (SC)

income of the assessee. The court further observed that in examining any transaction and situation, the court would have more regard to the reality and speciality of the situation rather than the purely theoretical or doctrinaire aspect of it. It will lay greater emphasis on the business aspect of the matter viewed as a whole when that can be done without disregarding statutory language. Thus, while taxing any income, the reality ought to be checked.

### **Nature of Assessment proceedings:**

Section 143(3) mandates the AO to pass an order in writing assessing total income or loss of the assessee. The said order has to be passed by the AO only after considering the evidence as may be produced by the assessee and such other evidence as may be required by the AO on specified points and after taking into account all relevant material, which the AO has gathered.

The purpose of assessment proceeding is to correctly assess the income of the assessee as per law after considering all the evidences produced by assessee and gathered by the AO.

A reading of *Circular no. 14(XL-35) of 1955 dated 11/04/1955* issued by CBDT shows that a duty is cast upon the AO to assist and aid the assessee in the matter of taxation. They are obliged to advise the assessee and guide them and not to take advantage of any error or mistake committed by the assessee or of their ignorance. The function of the Assessing Officer is to administer the statute with solicitude for public exchequer with an inbuilt idea of fairness to taxpayers.

### **Fresh claim in assessment proceedings or before appellate authority :**

From the above circular, it is clear that the purpose of assessment proceedings is to correctly compute the taxable income of the assessee regardless of the position of the assessee. Thus, even if an assessee wrongly does not claim an expense which he is otherwise entitled to then the AO is duty bound to grant the said claim suo moto.

Recently, in the case of *Sesa Goa Limited v. JCIT*<sup>8</sup>, the assessee claim deduction on account of "cess" through a letter before the AO during the course of assessment proceedings. The said claim was made through letter since the assessee failed to claim the deduction in original return of income and due date for revised return has expired. The High Court relied upon the decision of Bombay High Court in the case of *Ahmedabad Electricity Co. Ltd. v. CIT*<sup>9</sup> to lay down the proposition that the appellate authorities have

---

<sup>8</sup> Tax appeal nos. 17 and 18/ 2013 (Bombay High Court at Goa), order dated 28/02/2020

<sup>9</sup> (1993) 199 ITR 351 (Bom.)

very wide powers while considering an appeal as it may confirm, reduce, enhance or annul the assessment of remade the case to the assessee. Hence, if such claim is not allowed by the AO, then the appellate authorities are enabled to allow such claims.

**Now, wrong claim in one AY, can be corrected in another AY :**

In the present case, the Delhi ITAT has held that an income which is wrongly offered to tax in an earlier year is eligible for set off in a subsequent year. Thus, supporting the Article 265 of the Constitution that the tax has to be collect on right income.

Thus repeatedly the courts and tribunals have held that if the assessee has by mistake or inadvertence or on account of ignorance, included in his income any amount which is exempted from payment of income-tax, then the assessee may bring the same to the notice of the assessing officer who after satisfaction must grant the assessee necessary relief and refund the tax paid in excess, if any.

There is no dispute on the law reiterated by the ITAT as above. However, on the issue whether the sale of share is capital gain or business income, the decision is incomplete. The ITAT has not considered the decision of Karnataka High Court in the case of *Bhoruka Engineering Inds Ltd. v. DCIT*<sup>10</sup>. In this case, the assessee held 98.73% shares in BFSL which held land. The assessee sold its shares in BFSL to DLF. The question before the High Court was whether the transfer of shares by assessee would amount to sale of immovable property? The High Court held that what is transferred is the shares and not immovable property. The Court further held that the effect of transaction is that DLF became entitled to enjoy the asset held by BFSL. Hence, the form took precedence over the substance for income tax purposes.

Similarly, in the case of *Adar Poonawalla v. ACIT*<sup>11</sup> the Pune ITAT held that the sale of shares in such situation is capital gain. The Question before the Pune ITAT was whether the CIT (A) was justified in holding that the capital gain on account of sale of shares of M/s. C Ltd. is Long Term Capital Gain when the underlying asset which got transferred due to sale of shares was 'land'? The Department contention was that the real intent behind sale of unlisted equity shares of M/s. C Ltd. was to transfer the land and such an activity has to be reckoned as an adventure in nature of trade in the hands of the assessee shareholder.

Pune ITAT held that the plea of the Revenue cannot be accepted because the business and assets of a corporate entity are not business and assets of its shareholders. The ITAT relied upon the decision of hon'ble Supreme Court in the case of *Mrs. Bacha F. Guzdar v.*

---

<sup>10</sup> ITA no. 120/2011 dated 09/04/2013

<sup>11</sup> ITA No.764/PN/2012, order dated 30-01-2015

*CIT*<sup>12</sup> wherein the Court held that a shareholder acquires a right to participate in the profits of the company may be readily conceded but it is not possible to accept the contention that the shareholder acquires any interest in the assets of the company. A shareholder has got no interest in the property of the company though he has undoubtedly a right to participate in the profits if and when the company decides to divide them.

### **Conclusion :**

After considering all the above mentioned factors, it can be stated the Courts have time and again gravitated towards the taxing of real income. It is a trite law that the state cannot claim unjust enrichment on technical grounds. Thus, the AO / Appellate authorities are duty bound to assess correct income and collect right taxes after considering all the evidence. To perform the duty, the AO / appellate authorities have been given powers to allow the assessee to correct an error in the return of income for one year by making a fresh claim in the same year during the assessment proceedings. Now, due to this decision, the AO may be compelled to correct a mistake in earlier year.

Secondly, the legislature has to come up with a provision which allows bad debts of capital nature to be claimed as deduction under the head "capital gains". In absence of said provision, there will be collection of tax on amount which is not income at all and the assessee would have to travel to the Court for claiming relief.

---

<sup>12</sup> (1955) 27 ITR 01 (SC)