

K. J. Francis

Vs

Commissioner of Income Tax

Civil Appeal No. 1777 of 1979

(S. P. Bharucha, B. N. Kirpal JJ)

06.02.1996

ORDER

1. This is an appeal by certificate granted by the High Court of Kerala which answered the question referred to it in favour of the Revenue.

2. The appellant is an individual. He was carrying on business as its sole proprietor. The accounting year of the appellant was the financial year. On 14-10-1970, the books of account of the appellant were closed and the sole proprietary concern was taken over by a partnership with effect from 15-10-1970, the appellant being one of the partners. During Accounting Year 1969-70, relevant to Assessment Year 1970-71, an Ordinance had been issued, known as "the Kerala Industrial Employees' (Payment of Gratuity) Ordinance", which made it obligatory for employers to set aside particular amounts for payment as gratuity to their employees. It is not in dispute that the liability in respect of Accounting Year 1969-70, and for the earlier years, did arise in that accounting year, but the appellant chose not to make any entry in his books of account towards the discharge of that liability. In the following accounting period, i.e., 1-4-1970 to 14-10-1970, when his proprietorship came to an end, the assessee debited the amount in his books of account and claimed a deduction of the gratuity which was payable to his employees.

3. The Income Tax Officer rejected the claim of the appellant on the ground that the amount included liabilities of earlier accounting years. According to him, the liability for that year alone, i.e., Assessment Year 1971-72, could be allowed. The appellant filed an appeal before the Appellate Assistant Commissioner who held that a provision in respect of the liability should have been made when the Ordinance was promulgated on 9-12-1969 and the statutory liability should have been claimed as a deduction by the appellant in the first year in which it arose because he followed the mercantile system of accounting. The claim of the appellant was, accordingly, rejected.

4. The appellant filed a further appeal to the Tribunal. The Tribunal agreed with the Appellate Assistant Commissioner that the liability arose for the first time in the accounting year relevant to Assessment Year 1970-71 and that the appellant should have claimed the deduction in that year as he followed the mercantile system of accounting. The Tribunal, however, came to the conclusion that this amount should be treated as expenditure of the year 1971-72 because in computing the income for the period ending 14-10-1970, provision for gratuity had already been debited to the profit and loss account. The Tribunal held that the firm had taken over the entire business as a running concern and, if the appellant had not debited his business with this amount, then the credit he would have got in the books of the firm would have increased by the said amount, i.e., his capital account would have gone up to that extent. The firm had not given him this credit and, therefore, according to the Tribunal, the entries made in the books of the appellant towards the gratuity had

been taken over by the firm as its liability and, as far as the appellant was concerned, the amount had been paid off by him.

5. On an application under Section 256(1) of the Income Tax Act, 1961, the Tribunal referred the following question to the High Court :

"Whether on the facts and in the circumstances of the case, the Income Tax Appellate Tribunal is right in law in holding that for Assessment Year 1971-72 the assessee is entitled under Section 37 of the Income Tax Act, 1961 to a deduction of Rs 56,485 as gratuity to his employees under the Kerala Industrial Employees' Payment of Gratuity Act, 1970, when the assets and liabilities of the assessee's proprietary business including the employees and the liability to pay gratuity to them were taken over as a running concern on 15-10-1970 by a firm consisting of himself and another as partners ?"

The High Court answered the question in favour of the Revenue, holding that it was unable to sustain the contention of the appellant that so far as he was concerned, there was a discharge of the liability as evidenced by the entries in the profit and loss account. It held that the liability had arisen and it could have been claimed as a deduction only in Assessment Year 1970-71.

6. It has been contended by learned counsel for the appellant that the decision of the Tribunal in allowing the deduction was correct for the reason that as far as the appellant was concerned, he had discharged his liability when he debited his profit and loss account with Rs 56,485 towards payment of gratuity to his employees.

7. It is clear that the liability to pay this amount arose by reason of the promulgation of the Ordinance on 9-12-1969. The liability towards payment of gratuity was not only with respect to that accounting year but also in respect of the earlier years in which the employees of the appellant had served; the liability had to be computed by the amount of 15 days' wages for every year. Both the Appellate Assistant Commissioner as well as the Tribunal came to the conclusion that the liability had accrued in Accounting Year 1969-70 and not in the following accounting year with which we are here concerned. The High Court was right in holding that no claim for a deduction could have been allowed for Assessment Year 1971-72 merely because the appellant chose to debit his profit and loss account with the aforesaid amount of Rs 56,485 during its course. In fact, no payment was made by the appellant to any of the employees; this was merely an accounting entry. This entry could not and did not represent any disbursement of money by the appellant and, therefore, neither on the principles of the mercantile system of accounting nor on the basis of the cash system of accounting could the appellant validly claim this amount as a deduction.

8. The High Court rightly answered the question of law referred to it in favour of the Revenue. This appeal is accordingly dismissed. There shall be no order as to costs.