SUPREME COURT OF INDIA

Mercantile Bank Limited, Bombay

Vs

Commissioner of Income Tax Bombay City-III

Appeal (Civil) 310 of 2001; C.A. No.311 of 2001

((Mrs.) Ruma Pal and Dalveer Bhandari, JJ)

01.05.2006

JUDGMENT

MRS. RUMA PAL, J.

The assessment year in question is 1978-79. The two questions which are to be answered in this appeal are:

i) Whether the appellant is liable to be taxed under the Income Tax Act, 1961 (referred to hereinafter as the "Act") in respect of the interest on doubtful advances credited to the interest suspense account?

ii) Whether two separate limits apply for the purposes of computing disallowance under Section 40A (5) of the Act where an employee retires and ceases to be in employment during the previous year, so that one limit will apply in respect of the amounts and benefits received by him as an employee and another for the amounts and benefits received by him as a former employee.

The High Court answered both the questions in favour of the Revenue and against the Assessee. Being aggrieved the appellant has approached this Court. As far as the first question is concerned, the High Court answered it in the affirmative relying on the decision of this Court in State Bank of Travancore vs. Commissioner of Income Tax . In the decision of State Bank of Travancore Vs.

Commissioner of Income Tax the minority opinion expressed by Tulzapurkar, J, was that the stickiness of advances or loans objectively established to the satisfaction of the Taxing Authorities by furnishing a proper material, is sufficient to prevent the accrual of interest thereon as real income and would have the affect of rendering such income hypothetical. Therefore the interest cannot be brought to tax irrespective of the method of accounting followed, provided the assessee was able to establish to the satisfaction of the Taxing Authority that the loans had in fact becomes sticky during the concerned year or years by producing proper material and that the assessee had invariably followed the practice of carrying the interest of such loans to interest suspense account instead of crediting the same to interest account or profit and loss account with the additional safeguard of offering the same for taxation if and when it was subsequently realized. The majority view, however was that carrying certain amounts which had accrued as interest without treating it as a bad debt or irrecoverable interest but keeping it in suspense account would be repugnant to Section 36(1)(vii) read with Section 36 (2) of the Act. Where the mercantile system of accounting was followed and loans had not been written off the amounts accrued on the loans were income assessable to tax.

The question again arose for consideration before a bench of three Judges in the case of UCO Bank Vs. Commissioner of Income Tax , where the Court affirmed the minority view of Tulzapurkar J, in State Bank of Travancore's case. The assessment year in question in that case was 1981-82. The interest on loans the recovery of which was doubtful had not in fact been recovered by the assessee bank for the last three years and had been kept in a suspense account and had not been brought to the profit and loss account of the assessee because the amounts were not likely to be realized. The Court found that this method of accounting was in accordance with established accounting practice. Additionally it was held that the Central Board of Direct Taxes had issued a circular on 6th October 1952 stating that the interest on sticky loans which were entered in the suspense account need not be included in the assessee's assessable income provided the Income Tax Officer was satisfied that there was no real probability of the loans being repaid.

Although the 1952 circular was withdrawn in June 1978 in view of the decision of the Kerala High Court to the contrary in State Bank of Travancore vs. Commissioner of Income Tax 1975 Indlaw KER 45, the principle was reintroduced by the Central Board of Direct Taxes by another Circular dated 9th October, 1984. The 1984 Circular clarified that up to the Assessment years 1978-79 the taxability of interest on doubtful debts credited to suspense account would be decided in the light of the Board's earlier Circular dated 6th October, 1952 as the said Circular was withdrawn only in June, 1978. With effect from 1979-80 the new procedure prescribed under the 1984 circular would apply. The procedure prescribed is not relevant for our purposes. But it is clear that the circular issued in 1978 was effectively set aside and rendered ineffective.

The Court in UCO Bank's case (supra) was of the view that these Circulars dated 6th October, 1952 and 9th October, 1984 were binding on the authorities under Section 119(1) of the Act. The Court was also of the view that the judges in State Bank of Travancore (supra) did not have the occasion to consider the 1984 circular and proceeded on the assumption that the 1978 circular was in force. The Court did not agree with the conclusion expressed by the majority in State Bank of Travancore and said:-

"The relevant circulars of CBDT cannot be ignored. The question is not whether a circular can

override or detract from the provisions of the Act: the question is whether the circular seeks to mitigate the rigour of a particular section for the benefit of the assessee in certain specified circumstances. So long as such a circular is in force it would be binding on the departmental authorities in view of the provisions of Section 119 to ensure a uniform and proper administration and application of the Income Tax Act". (para 18, pg.610)

Therefore the assessment year in question in this appeal should have been dealt with by the Department in accordance with the 1952 Circular under which the interest on doubtful loans could not be brought to tax. The decision of the High Court on the first question, having been based on the decision in State Bank of Travancore must be held to be incorrect in view of the subsequent judgment of this Court in the case of UCO Bank Vs. Commissioner of Income Tax. As far as the second question is concerned, Section 40A (5) in so far as it is relevant provided:-

"40A. Expenses or payments not deductible in certain circumstances.

(1) The provisions of this section shall have effect notwithstanding anything to the contrary contained in any other provision of this Act relating to the computation of income under the head "Profits and gains of business or profession".

(2) xxx xxx xxx xxx xxx

(a) xxx xxx xxx xxx xxx

(b) xxx xxx xxx xxx xxx

(3) xxx xxx xxx xxx xxx

(4) xxx xxx xxx xxx xxx

(5) (a) Where the assessee

(i) Incurs any expenditure which results directly or indirectly in the payment of any salary to an employee or a former employee, or

(ii) Then, subject to the provision of Clause (b), so much of such expenditure or allowance as is in excess of the limit specified in respect thereof in Clause (c) shall not be allowed as a deduction;

(c) The limits referred to in clause

(a) Are the following, namely:-

(i) in respect of the expenditure referred to in sub-clause (i) of Clause (a), in the case of an employee, an amount calculated at the rate of five thousand rupees for each month or part thereof comprised in the period of his employment in India during the previous year, and in the case of a former employee, being an individual who ceases or ceased to be the employee of the assessee during the previous year or any earlier previous year, sixty thousand rupees:

The issue is - when an employee ceases to be in employment during the previous year, is the employer entitled to deduction at the rate of Rs. 5, 000/- p.m. as long as the employee was in employment and again up to the limit of Rs. 60, 000/- when the employee retires?

The Calcutta High Court in the case of Hindustan Motors Limited Vs. Commissioner of Income Tax 1985 Indlaw CAL 57 construed the provisions of Section 40A (5) (c) came to the conclusion that for the period that an employee remains in service he is to be treated as an employee and all payments made to him as an employee would be allowed as a deduction within the permissible monthly limit. After that period, when such an employee retires, he is to be treated as a former employee and payments made to him as former employee again ought to be deductible within the permissible limit. The Court was of the view that any other construction of such section under which such an employee is treated only as "an employee" or as a "former employee" in the year in question would render one part or the other of the section nugatory. The Court rejected the submission on behalf of the Revenue that the status of the employee as on the last date of the previous year should be taken into consideration for the purpose of fixing the limit of deductions. The Court said if this contention was to be accepted then the salary paid to the employee while he was in employment cannot be taken into account in determining the ceiling of allowable deduction under Section 40A (5). The Court referred to Section 40A (5)(a) and noted that the first proviso thereunder provided a ceiling of Rs. 72, 000/- on the permissible deduction or of expenditure or allowances consisting of the aggregate of four different types of expenses and allowances mentioned thereunder. Similarly, under Section 40A (6) where any expenditure was incurred by an assessee on payment of fees as well as on payment of salary to that employee, the deduction in respect of such expenditure was limited to Rs. 60, 000/- in the aggregate. The Court noted that wherever the legislature had intended to limit the expenditure taking the different contingencies into account it has made the appropriate provision by prescribing an aggregate ceiling. Section 40A (5) (a), (i) read with Section 40A(5) (c) (i) of the Act did not refer to any aggregate amount of deduction although two different contingencies were provided therein. The Court was also of the view that if the contrary interpretation were accepted, the employer would defer the payment of the gratuity or any other sum payable to an employee on his employment to the subsequent accounting year to get out of the mischief of the ceiling prescribed under Section 40A (5) (c) (i) of the Act. This could not have been the intention of the legislature. Finally, it was held that if a provision of a taxing statute was reasonably capable of more than one interpretation, that interpretation which was favourable and beneficial to the assessee must be accepted, even if it results in his obtaining a double advantage.

The Bombay High Court disagreed with the reasoning. It relied on the definition of "salary" in Section 17 which included pension, gratuity and other retiral benefits. It has also noted that under Section 45A (c) (i) the expression "employee" comes within the definition of expression "former employee". It held that the status of an "employee" on the last date of the relevant previous year would have to be seen for fixing the limit of deduction. It held that there were no separate limits prescribed by Section 40A (5). There was only one limit in respect of the "salary" and, therefore, the object was to limit the deduction of expenditure on account of "salary" and that limit was the single one of Rs. 60, 000/- Learned counsel appearing on behalf of the appellant has urged that the view expressed by the Calcutta High Court in Hindustan Motors Vs. Commissioner of Income Tax should be accepted. As far as the respondents are concerned, they have reiterated the reasoning of the Bombay High Court and have submitted in addition that the word "and" in Section 40 A(5) (c) (i) should be read disjunctively as "or". Several decisions have been cited in support of this principle of interpretation.

We are of the opinion that the opinion expressed by the Bombay High Court is correct. The intention of the Legislature was to fix limits of deduction under the various clauses of sub section (5) of Section 40A. If the view accepted by the Calcutta High Court were to be accepted the fixation would be meaningless as the limits would vary depending on the date on which an employee may retire. According to the Calcutta High Court's view if an employee serves for 12 months, and retires on the last day of the previous year, the employer would be entitled to claim a deduction of Rs.60, 000/- on account of salary paid to an employee while in service and another limit of Rs.60, 000/- on account of 'salary' paid to the employee on retirement. In other words, the employer would be entitled to a deduction of two different amounts.

Yet Clause (c) (ii) of sub section (5) of Section 40A speaks of "an amount". This would indicate that the employer is only entitled to deduction of one amount. Clause (c)(i) also speaks of an employee as being not only one who has ceased to be in employment, but one who ceases to be in employment. In respect of the latter it is assumed that the employee served for a period but ceases to be so employed during the previous year in question. In such a case, the section expressly provides for a limit on the deduction of Rs.60, 000/- Explanation (2)(a) in sub section (5) of Section 40 A provides:

"Explanation 2. In this sub- section, -

(a) "Salary" has the meaning assigned to it in clause (1) read with clause (3) of section 17 subject to the following modifications, namely:-

(1) in the said clause (1), the word "perquisites" occurring in sub-clause (iv) and the whole of sub-clause (vii) shall be omitted;

(2) in the said clause (3), the references to "assessee" shall be construed as references to "employee or former employee" and the references to "his employer or former employer" and "an employer or a former employer" shall be construed as references to the assessee". Section 17 as it then stood defined 'salary' as:

(i) Wages;

(ii) Any annuity or pension;

(iii) Any gratuity;

(iv) Any fees, commission, perquisites or profits in lieu of or in addition to any salary or wages;

(v) Any advance of salary;

(vi) the annual accretion to the balance at the credit of an employee participating in a recognized provident fund, to the extent to which it is chargeable to tax under rule 6 of Part A of the Fourth Schedule of an employee participating in a recognized provident fund, to the extent to which it is chargeable to tax under sub-rule (4) thereof".

In terms of this there is only one limit for all salary whatever it may be comprised of whether wages or terminal benefits.

Reliance on the use of the word "aggregate" in the first provisos to Section 40A(5)(a) and in Section 40A(6) was inapt. Both the proviso and sub section (6) deal with different kinds of payment or expenditure which therefore necessitated the use of the word "aggregate". Thus the first proviso refers to:

"(a) The expenditure and allowance referred to in sub- clauses (i) and (ii) of this clause; and

(b) The expenditure and allowance referred to in sub- clauses (i) and (ii) of clause (c) of section 40".

Similarly sub section (6) refers to "(a) such expenditure by way of fees, or

(b) where the assessee has also incurred in relation to such person any expenditure by way of salary referred to in sub-clause (i) of clause (a) of sub-section (5), the aggregate of such expenditure by way of fees and by way of salary".

Sub section (5)(c) on the other hand as we have seen speaks of an "amount" and "salary" indicating a single deduction where the use of the word "aggregate" was uncalled for.

We would therefore affirm the answer given in the impugned judgment to the second question in favour of the revenue and hold that only one limit is prescribed for deduction on account of salary whether paid to an employee in service or a retired employee in any one previous year.

The appeal is accordingly partially allowed. No order as to costs.

Civil Appeal No. 311 of 2001

This appeal is partially allowed without any order as to costs in view of our judgment in Civil Appeal No.310 of 2001.