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STATE BANK OF TRAVANCORE

v.

COMMISSIONER OF INCOME TAX, KERALA

JANUARY 8, 1986

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[V.D. TULZAPURKAR, SABYASACHI MUKHARJI AND RANGANATH MISRA, JJ.]

Income Tax Act, 1961:

Sections 28, 29 & 145 - Banking Company - Advances considered doubtful of recovery-interest on such 'sticky' advances not carried in 'Profit and Loss Account' - Credited to separate account - 'Interest suspense account' - Accrual of income - Whether arises - Interest amount - Whether exemption from tax - Concept and notion of real income - Explained. C

Method of accounting - How far relevant for computation of income, profits and gains - Mercantile and cash systems of accounting - Difference between. D

Devaluation of Indian Rupee - Exchange difference arising therefrom - Whether income assessable to tax.

The assessee, a subsidiary bank of the State Bank of India, used to maintain in the accounting years 1964, 1965 and 1966, its accounts in mercantile system making entries and calculating income and loss on accrual basis and adopted the calendar year as its previous year. The assessee, in the course of its banking business, used to charge interest on advances considered doubtful of recovery termed as 'sticky advances' by debiting the concerned parties but instead of carrying the same to its 'Profit & Loss Account', credited the same to a separate account called 'Interest Suspense Account' as the principal amounts of these 'sticky advances' themselves had become not bad or irrecoverable, but extremely doubtful of recovery. In its returns the assessee disclosed such interests separately and claimed that the same were not taxable in its hands as income for the concerned years. E F G

The business of the assessee bank also included buying and selling of foreign exchange and before devaluation of the Indian Rupee on August 6, 1966, the assessee bank held foreign

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A exchange by way of cash balances available with their foreign correspondents, forward contracts, items in transits, etc. in U.S. Dollars and in Sterling, which on devaluation of the Indian Rupee when converted back to rupees at the post devaluation rates gave rise to a profit of 57.5% in the transaction; the assessee bank-credited this surplus to an account designated "Provision for Contingencies". In the Assessment B Year 1967-68 the assessee bank claimed that profit by way of exchange difference on devaluation should not be taxed as it was of a casual and non-recurring nature.

The claim of the assessee bank on both these aspects was rejected by the Income-tax Authorities, Income-tax Appellate C Tribunal and the High Court. The High Court held: (a) the assessee was following the mercantile system of accounting; such interest, therefore, had accrued to the assessee at the end of the accounting year; and (b) the assessee itself had treated such income as accrual of interest by charging the same to the parties concerned by making debit entries in their D respective accounts. However, if any part of these debits had later on become irrecoverable in any year, the assessee could have, in that year, treated the same as such and claimed deduction under section 36(1)(vii) of the Income Tax Act, 1961.

E In the appeals to this Court on behalf of the assessee-bank it was contended: (1) that the three sums representing interest on 'sticky' advances, i.e. advances in respect whereof there was high improbability of recovery of even the principal amounts, ought not to have been subjected to tax as income under the Act; that what are chargeable to income-tax F in respect of a business are profits and gains actually resulting from the transaction of the previous year, that is to say, the real profits and gains and not hypothetical profits or gains on a doctrinaire theory of accrual; that even under the mercantile system of accounting regularly adopted by an assessee it is only the acrual of "real income" in the G commercial sense which is chargeable to tax, that accrual is a matter of substance to be decided on commercial principles having regard to business character of the transaction and the realities of the situation and cannot be determined on any abstract theory of accrual or by adopting a legalistic approach and that if regard is had to the commercial princi- H ples and realities of the situation it will be clear that in

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the case of banks, financial institutions and money-lenders, whose bulk profits mainly consist of interest earned by them, there is no accrual of real income so far as interest on sticky advances and the debit entries made in respect of such interest in the respective accounts of the concerned debtors following the mercantile system of accounting merely reflected hypothetical income that does not materialise in the concerned accounting year or years during which the advances remain sticky and hence it is but proper to carry such interest to "Interest Suspense Account' as carrying the same to 'Profit and Loss Account' would result in showing inflated profits and might even lead to improper and illegal distribution or remittance thereof; (2) that there is a clear distinction between an irrevocable loan and a sticky loan; the former is a bad debt in respect whereof the chance of recovery is nil and as such can outright form the subject matter of deduction under section 36(i)(vii) of the Act while the latter is a loan to which a high degree of improbability of recovery attaches in a particular year or years depending upon the financial position of the concerned debtor due to which interest thereon becomes hypothetical income during such year or years and, as such, the same, not being real income, cannot be brought to tax; (3) that right from August 1924 onwards till the decision of the High Courts distinction between an irrecoverable loan and a sticky loan was recognised by the Central Board of Revenue as also by the Reserve Bank of India in their diverse Circulars in the case of banks, financial institutions and money-lenders regularly following the mercantile system of accounting and that Instructions had been issued not to treat the unrealised interest on sticky loans as income by carrying it to 'Profit and Loss Account' so that the figure of distributable profits should not get inflated and preferably to credit the same to a special account 'Interest Suspense Account' and that if the banks, financial institutions and money-lenders, who kept their accounts on mercantile system, maintained a suspense account in which the unrealised interest was entered, the same should not be included in the assessee's taxable income, if the Income Tax Officer was satisfied that there was really probability of the loans being repaid; (4) that the Instructions contained in various Circulars were in consonance with the accepted principle that what was chargeable under the Income Tax Act was the real income of an assessee but these instructions which held field for over 53 years were changed, though wrongly, under fresh circulars issued by the Central

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Board of Direct Taxes whereunder interest on doubtful or sticky loans became includible in the assessable income of the assessee with effect from the assessment year 1979-80, and (5) that in the case of banks and financial institutions who regularly adopted mercantile system of accounting the practice of carrying interest on such sticky loans to 'Interest Suspense Account' or 'Reserve for Doubtful Interest Account' in stead of crediting the same to 'Interest Account' or 'Profit and Loss Account' is a universally recognised practice invariably adopted by them and being wholly consistent with the mercantile system of accounting the Income Tax Officer was bound to give effect to it under section 145 of the Act and, therefore, the treatment of the three sums representing interest on sticky loans as the assessee's income for the concerned years would be unsustainable in law.

On behalf of the Revenue it was contended: (1) that though it is the real income that is chargeable to tax under the Act and not any hypothetical income of an assessee and that under section 28 in respect of a business the chargeability must attach to real profits and gains arising from the transactions of the previous year, but under section 5 read with section 28 of the Act the liability attaches to profits which have been either received by the assessee or which have accrued to him during the year of account and that income accrues when it "falls due", i.e. becomes legally recoverable irrespective of whether actually received or not and "accrued income" is that income which "the assessee has a legal right to receive" and since the assessee has been maintaining its accounts on mercantile basis the three sums being interest on loans, whether doubtful or sticky, fell due and became payable to the assessee at the end of each of the three accounting years and constituted its accrued income and, therefore, justifiably brought to tax in the concerned assessment years; (2) that though, while imposing the tax liability under the Act, the Courts have recognised the theory of real income by having regard to the business character of the transactions and realities of the situation but these aspects have been taken into account for the purpose of determining whether the income could be said to have legally accrued or not and once it is found to have legally accrued it is brought to tax and that the theory of real income has been invoked and confined only to two types of cases (a) where there has been a surrender of income which may in theory have accrued, and (b) where there has been diversion of income at source either

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under a statute or by over riding title but in none of the cases has the aspect of high improbability of recovery been regarded as sufficient to prevent accrual; therefore the theory of real income should not be extended so as to exclude from chargeability such income which has accrued but merely suffers from high improbability of recovery, because such B extention would be neither permissible nor advisable - not permissible because it goes against the very concept of accrued income and not advisable because if done it will apply to all cases and not merely to cases of interest accruing to banks and financial institutions. Such extension will moreover entrench upon section 36(1) (vii) which provides for deductions of a debt or part thereof on its becoming bad on fulfil- C ment of certain conditions specified in sub-section (2) thereof; for these reasons the extension of the theory of real income so as to take within its ambit the consideration of high improbability of recovery is not warranted. As regards the Circulars of C.B.R. and R.B.I., it was submitted that these merely granted a concession to and conferred no right in D favour of the assessee which could be and has been withdrawn later by issuing fresh Circulars but since the benefit or the concession in favour of the assessee could not be withdrawn retrospectively, the withdrawal of concession has been effected prospectively from the assessment year 1979-80.

Dismissing the appeals, E

HELD: Per Tulzapurkar, Mukharji and Ranganath Misra, JJ. (concurring).

The principle that if the stock-in-trade remains unused or unsold the mere book appreciation in the value thereof cannot be brought to tax is well accepted. However, in the instant case, the assessee bank by carrying the surplus F resulting from the devaluation of the Indian rupee to an account designated 'Provision for Contingencies' could be said to have clearly treated such surplus as its business income. Further, the Appellate Assistant Commissioner in his appellate order recorded a categorical finding that the stock in trade in terms of foreign currency was sold and used by the assessee G in its normal business. Having regard to this factual position the exchange difference arising out of devaluation of the Indian rupee was rightly treated as income of the assessee in the assessment year 1967-68. [65 C; 66 G-H; 67 A & D]

C.I.T. v. Mughal Line Ltd., 46 I.T.R. 590 referred to. H

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Per Mukharji, J. (1) It is the income which has really accrued or arisen to the assessee that is taxable. Under Income-tax law, receipt of income, either actual or deemed, is not a condition precedent to the taxability. These were assessable if these had arisen or accrued or deemed to have accrued or arisen under the Act. This principle would be B attracted even in cases where an assessee followed the mercantile system of accounting. However, in examining any transaction or situation, the court would have more regard to the reality of the situation rather than purely theoretical or doctrinaire aspect. [92 A; 86 F-G]

2. The profits and gains chargeable to tax under the Act C are those which have been either received by the assessee or have accrued to the assessee during the period between the first and the last day of the year of account and are receivable. Income received or income accrued are both chargeable to tax under section 28 of the Act. [74 C]

3. By and large, two systems of account keeping are D followed one is the cash and the other, mercantile. The cash system postulate actual receipt of money; and for exigibility of income tax, such receipt from business, profession or vocation or from other sources has to be actual in the relevant year of account. The mercantile system is one where accounts are maintained on the basis of entitlement to credit E and/or debit. A sum of money, as soon as it becomes payable, is taken into account without reference to actual receipt and a debit becomes admissible when liability to pay is created even though the sum of money is yet to be paid. [72 B-C]

Dhakeshwar Prasad Narain Singh v. Commissioner of Income F **Tax, Bihar & Orissa,** 4 I.T.R. 71 at 74, **Commissioner of Income Tax, Bombay v. Sarangpur Cotton Manufacturing Co. Ltd.,** 6 I.T.R. 36, **Commissioner of Income-tax v. Shrimati Singari Bai,** 13 I.T.R. 224 and **Commissioner of Income-tax, Madras v. A. Krishnaswami Mudaliar and Ors.,** 53 I.T.R. 122 referred to.

G 4. The income of the assessee will have to be determined according to the provisions of the Act in consonance with the method of accountancy regularly employed by the assessee. The method of accounting regularly employed by the assessee helps computation of income, profits and gains under section 28 of the Act and the taxability of that income under the Act, will H then have to be determined. The circulars being executive in

character cannot alter the provisions of the Act and being in the nature of concessions could always be prospectively withdrawn. [75 A-B]

Commissioner of Income-tax, Madras v. K.R.M.T.T. Thiagaraja Chetty & Co., 24 I.T.R. 525, **Dhakeshwar Prasad Narain Singh v. Commissioner of Income Tax, Bihar & Orissa**, 4 I.T.R. 71 at 74, **Commissioner of Income-tax v. Shrimati Singari Bai**, 13 I.T.R. 224 & **Commissioner of Income-tax, Madras v. A. Krishnaswami Mudaliar and Ors.**, 53 I.T.R. 122 referred to.

5. Mere improbability of recovery, where the conduct of the assessee is unequivocal cannot be treated as evidence of the fact that income has not resulted or accrued to the assessee. After debiting the debtor's account and not reversing that entry - but taking the interest merely in suspense account cannot be such evidence to show that no real income has accrued to the assessee or treated as such by the assessee. If the actuality of a situation or the reality of a particular situation makes an income not to accrue, then very different considerations would apply. But where interest has accrued and the assessee has debited the account of the debtor, the difficulty of the recovery would not make the accrual non-accural of interest. [92 C-D; 89 B-C]

Catholic Bank of India (In liquidation) v. Commissioner of Income-tax, Kerala, Ernakulam, 1964 K.L.T. 653 = 1965 (1) I.T. Journal 355, **Commissioner of Income-tax, Bombay I v. Confinance Ltd.**, 89 I.T.R. 292 and **James Finlay & Co. v. Commissioner of Income Tax**, 137 I.T.R. 698 approved.

6. An acceptable formula of co-relating the notion of real income in conjunction with the method of accounting for the purpose of computation of income for the purpose of taxation is difficult to evolve. Besides, any straight-jacket formual is bound to create problems in its application to every situation. It must depend upon the facts and circumstances of each case. It would be difficult and improper to extent the concept of real income to all cases depending upon the ipse dixit of the assessee which would then become a value judgment only. What has really accrued to the assessee has to be found out and what has accrued must be considered from the point of view of real income taking the probability or improbability of realisation in a realistic manner and dovetailing

of these factors together, but once the accrual takes place on the conduct of the parties subsequent to the year of closing, an income which has accrued cannot be made "no income". The conduct of the parties in treating the income in a particular manner is material evidence of the fact whether income has accrued or not. [91 B-C; E-F; 92 C]

7. The concept of real income is a well accepted one and must be applied in appropriate cases but with circumspection and must not be called in aid to defeat the fundamental principles of income-tax as developed. [92 F]

8. The concept of real income would apply where there has been a surrender of the income which in theory may have accrued but in the reality of the situation no income has resulted because the income did not really accrue. Where a debt has become bad and deduction in compliance with the provisions of the Act should be claimed and allowed. If there is any diversion of income at source under any statute or by overriding title then there is no income to the assessee. [92 A-C]

9. Once the accrual takes place and income accrues, the same cannot be defeated by any theory of real income. In some limited fields where something which is the reality of the situation prevents the accrual of the income, then the notion of the real income i.e. making the income accrue in the real sense of the term can be brought into play, but the notion of real income cannot be brought into play where income has accrued according to the accounts of assessee and there is no indication by the assessee to treat the amount as not having accrued. Suspended animation following inclusion of the amount in suspense account does not negate accrual and after the event of accrual, corroborated by appropriate entry in the books of account on the mere ipse dixit of the assessee, no reversal of the situation can be brought about. [88 D; 81 B-D]

Morvi Industries Ltd. v. Commissioner of Income-Tax (Central), Calcutta, 82 I.T.R. 835 and **Calcutta Co. Ltd. v. Commissioner of Income-Tax, West Bengal**, 37 I.T.R. 1 relied upon.

Commissioner of Income-Tax, Bombay City, I v. Messrs. Shoorji Vallabhdas and Co., 46 I.T.R. 144, **Commissioner of Income-tax, Bombay North Kutch and Saurashtra, Ahmedabad v. Chamanlal Mangaldas & Co.**, 29 I.T.R. 987, **Morvi Industries**

Ltd. v. Commissioner of Income-Tax (Central) Calcutta, 82 I.T.R. 835, **H.M. Kashiparekh & Co. Ltd.'s case**, 39 I.T.R. 706, **Commissioner of Income-Tax, West Bengal, II v. Birla Gwalior (P) Ltd.**, 89 I.T.R. 266, **Commissioner of Income-tax, Tamil Nadu-V v. Motor Credit Co. (P) Ltd.**, 127 I.T.R. 572, **Commissioner of Income-Tax, Madras Central v. Devi Films (P) Ltd.**, 143 I.T.R. 386 and **Commissioner of Income-Tax, Amritsar-II v. Ferozepur Finance (P) Ltd.**, 124 I.T.R. 619 distinguished.

10. The concept of real income cannot be so used as to making accrued income, non-income simply because after the event of accrual, the assessee neither decides to treat it as bad debt nor claims deduction under section 36(2) of the Act, but still enters the same with a diminished hope of recovery in the suspense account. Extension of the concept of real income to this field to negate after the amount had become payable is contrary to the postulates of the Act. [82 B-C]

Per Ranganath Misra, J. (concurring)

Section 36(2) of the Act covers the entire field regarding deduction for bad debt. Though the concept of 'real income' is well recognised one, it cannot be introduced as an outlet of income from taxman's net for assessment on the plea that though shown in the account book as having accrued, the same became a bad debt and was not earned at all. The citizen is entitled to the benefit of every ambiguity in a taxing statute but where the law is clear considerations of hardship, injustice or anomaly do not afford justification for extempting income from taxation. [93 C-D]

Mapp v. Oram, 1969 (Vol.III) All E.R. 219 (H.L.) referred to.

Per Tulzapurkar, J. - (dissenting)

1. Under the Income Tax Act in order that income should accrue it should not merely fall due or become legally recoverable but should also be factually and practically realisable during the accounting year or years. In other words mere non-receipt of income, when it is reasonably realisable, will not affect accrual but factual or practical unrealisability thereof may prevent its accrual depending upon the facts and circumstances attending upon the transaction. [59 F-G]

2. This theory of real income could be and should be extended to interest on sticky loans and that on principle such interest being hypothetical cannot be brought to tax. [64 G-H]

3. That the stickiness of advances or loans objectively established to the satisfaction of the taxing authorities by producing proper material, is sufficient to prevent the accrual of interest thereon as real income and would have the effect of rendering such income hypothetical and the same cannot be brought to tax. [59 E-F]

4. Under section 145 the assessee's regular method of accounting determines the mode of computing the taxable income but it does not determine or even affect the range of taxable income or the ambit of taxation. In other words, any hypothetical income which may have theoretically accrued but has not truly resulted or materialised in the concerned accounting year cannot be brought to charge simply because the assessee has been regularly employing the mercantile system of accounting and makes entries in his books in regard to such hypothetical income. [47 F-G]

5. The method of accounting regularly employed by an assessee is relevant only for the purpose of computation of income, profits and gains under s. 28 of the Act and that it cannot enlarge or restrict the content of the taxable income under the Act and that under s. 145 the assessee's regular method of accounting determines the mode of computing taxable income but it does not determine or even effect the range of taxable income or ambit of taxation. [49 C-D]

6. In the case of interest on sticky loans the practice of debiting the accounts of the concerned debtors with such interest and carrying the same to 'Interest Suspense Account' instead of to "Interest Account' or 'Profit and Loss Account' is a well recognised and accepted practice of commercial accountancy, that it is wholly consistent with mercantile method of accounting and that it prevents the wrong crediting and improper and illegal distribution or remittance of inflated and unreal profits. [52 D-E]

7. Under s. 5 taxability is attracted not merely when income is acutally received but also when it has 'accrued' and income accrues when it 'falls due', that is to say when it becomes legally recoverable irrespective of whether it is actually received or not and 'accrued income' is that income which 'the assessee has a legal right to receive.' [52 F-G]

8. Where income or part thereof has theoretically accrued but has been, either unilaterally or as a result of bilateral arrangement, voluntary relinquished or surrendered by the assessee before its accrual the same cannot be regarded as real income of the assessee and cannot be brought to tax. Such conclusion is reached having regard to the business character of the transactions and the realities of the situation notwithstanding that some entries have been made in the assessee's books maintained in the mercantile system. [55 C-D]

9. Even under the mercantile system of accounting whenever adopted it is only the accrual of real income which is chargeable to tax, that accrual is a matter of substance and that is to be decided on commercial principles having regard to the business character of the transactions and the realities and specialities of the situation and cannot be determined by adopting purely theoretical or doctrinaire or legalistic approach. [58 H; 59 A]

Catholic Bank of India (In Liquidation) v. Commissioner of Income-tax, Kerala, 1964 K.L.T. 653 = 1965 (1) Income-tax Journal 355, **C.I.T. v. Confinance Ltd.**, 89 I.T.R. 292 & **James Finlay & Co. v. C.I.T.**, 137 I.T.R. 698 overruled.

C.I.T. v. Motor Credit Co. (P) Ltd., 127 I.T.R. 572, **C.I.T. v. Devi Films (P) Ltd.**, 143 I.T.R. 386, **C.I.T. v. Ferozepur Finance (P) Ltd.**, 124 I.T.R. 619, **Dhakeswar Prasad Narain singh v. Commissioner of Income Tax**, 4 I.T.R. 71 at 74 & **H.M. Kashiparekh Co.'s case**, 39 I.T.R. 706 approved.

C.I.T. v. Sarangpur Cotton Mfg. Co., 6 I.T.R. 36 at 40, **C.I.T. v. Singari Bai**, 13 I.T.R. 224 at 227, **C.I.T. Madras v. A. Krishnaswami Mudaliar & Ors.**, 53 I.T.R. 122, **C.I.T. v. Shoorji Vallabhdas & Co.** 46 I.T.R. 144, **C.I.T. v. Birla Gwalior (P) Ltd.**, 89 I.T.R. 266 and Kohler's Dictionary for Accountants 3rd Edn. relied on.

C.I.T. v. Thiagaraja Chetty, 24 I.T.R. 525 at 531, **Morvi Industries Ltd. v. C.I.T. Calcutta**, 82 I.T.R. 835 at 840, **C.I.T. v. Harivallabhadas Kalidas & Co.**, 39 I.T.R. 1, **C.I.T. Madhya Pradesh v. Kalooram Govindram**, 57 I.T.R. 630, **Poona Electric Supply Co. Ltd. v. C.I.T. Bombay**, 57 I.T.R. 521, **C.I.T. v. Sir S.M. Chitnavis**, 6 I.T. Cases 453 Shukla and Grewal referred to.

A CIVIL APPELLATE JURISDICTION : Civil Appeal Nos. 1860-62 (NT) of 1973.

From the Judgment and Order dated 22.3.1973 of the Kerala High Court in I.T.R. Nos. 27 to 29 of 1971.

N.A. Palkhiwala, S.E. Dastur, M/s. J.B.Dadachandji, Ravinder Narain, Mrs. A.K. Verma and Jeol Peres for the Appellant.

B V.S. Desai, B.B. Ahuja and Miss A. Subhashini for the Respondent.

N.A. Palkhiwala, S.E. Dastur, M/s. J.B. Dadachanji, Mrs. A.K. Verma and D.N. Mishra, for the Intervenors (M/s. Grindlays Bank, Calcutta and State Bank of Travancore).

C Dr. P. Pal and D.N. Gupta for the Intervenor (Chartered Bank).

F.N. Kaka, Mr. S.E. Dastur, C.S. Shroff, S.S. Shroff and S.A. Shroff for the Intervenor (Industiral Credit & Investment Corpn., & American Express International Bank and City D Bank Banking Corpn.)

S.E. Dastur, S.N. Talwar and H.S. Parihar for the Intervenor (Mercantile Bank Ltd.).

E K. Ram Kumar, K. Ram Mohan and Mrs. J. Ramachandran for the Intervenor (Indian Overseas Bank, Madras).

The following Judgments were delivered

F TULZAPURKAR, J. These appeals by certificate from the High Court raise the following two interesting questions of law for our determination:

> (1) Whether on the facts and in the circumstances of the case the addition of the sum of Rs. 67,170, Rs. 47,777 and Rs. 57,889, representing interest on 'sticky' advances, as income for the assessment G years 1965-66, 1966-67 and 1967-68 respectively was justified in law?
>
> (2) Whether on the facts and in the circumstances of the case the exchange difference of Rs. 1,66,128

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arising on devaluation of the Indian rupee on 6.6.1966 was rightly treated as income for the assessment year 1967-68?

The facts giving rise to the first question lie in a narrow compass and are these. The assessee is a subsidiary of the State Bank of India; it maintains accounts on mercantile system making entries on accrual basis; it adopts the calendar year as its previous year and the calendar years 1964, 1965 and 1966 are respectively the relevant previous years for the assessment years 1965-66, 1966-67 and 1967-68 to which the question relates. In the course of its banking business the assessee charged interest on advance considered doubtful of recovery otherwise called sticky advances by debiting the concened parties but instead of carrying it to its 'Profit and Loss Account' credited the same to a separate account styled 'Interest Suspense Account' as the principal amounts of these stickly advances themselves had become, not bad or irrevocerable but extremely doubtful of recovery. However, in its returns the assessee disclosed such interest separately and claimed that the same was not taxable in its hands as income for the concerned years. The amounts so charged to the concerned parties but credited to the 'Interest Suspense Account' were Rs. 67,170 Rs. 47,777 and Rs. 57,889 for the assessment years 1965-66, 1966-67 and 1967-68 respectively.

Before the taxing authorities as also before the Tribunal and the High Court the assessee raised the contention that having regard to the deteriorating financial position of the concerned parties and history of their accounts, the recovery of even the principal amounts had become highly improbable and extremely doubtful rendering the advances 'sticky' and as such the interest thereon, though debited to them, was, following a well recognised principle of commercial accountancy, taken to 'Interest Suspense Account' so as to avoid showing inflated profits by including hypothetical income and since such interest was not its real income, the same was not taxable in its hands. The contention was rejected at all the levels principally on two grounds - (a) since admittedly the assessee was following the mercantile system of accounting such interest had accrued to it at the end of each accounting year and (b) the assessee had itself shown the accrual of such interest by charging the same to the concerned parties by making debit entries in their accounts. It was observed that if any part of the debts later became irrecoverable in any

A year the assessee could in that year treat it as such and claim deduction under s. 36 (1) (vii) of the Income Tax Act 1961. In holding that these three sums were taxable as income in the hands of the assessee for the concerned years the High Court followed its earlier decision in the case of **Catholic Bank of India (In Liquidation) v. Commissioner of Income-tax, Kerala,** [1964] K.L.T. 653 = [1965] 1 Income-tax Journal 355 B where despite the directive issued by the Reserve Bank of India to the assessee-bank not to carry interest on such sticky advances to 'Profit and Loss Account' and despite the fact that the assessee-bank had in pursuance thereof ommitted such interest from its 'Profit and Loss Account' the Court had taken the view that such interest was taxable as income in the C hands of the assessee-bank because of the mercantile system of accounting that had been regularly employed by it, which had not been changed even after receiving the directive from the Reserve Bank. The High Court was of the view that the facts of the instant case were indistinguishable from those obtaining in the **Catholic Bank's** case except that there was a directive D from the Reserve Bank of India to the Catholic Bank which was absent in the case before it but in its opinion the presence or absence of such directive from the Reserve Bank could not determine the question whehter there was accrual of income or not and that in the case before it also there was accrual of income to the assessee considering the mercantile method of E accounting that had been regularly adopted by it. In this view of the matter the High Court answered the question against the assessee and in facour of the revenue. Incidentally it may be stated in the case of this very assessee the High Court, following the decision herein, took a similar view and answered a similar question against the assessee for the F subsequent year 1968-69 which decision rendered in 1975 is reported in 110 ITR 336. The assessee has challenged this view before us in these appeals.

Mr. Palkhivala the learned counsel for the assessee raised a two-fold contention in support of his plea that the three sums representing interest on 'sticky' advances, i.e. G advances in respect whereof there was high improbability of recovery of even the principal amounts ought not to have been subjected to tax as income under the Act. In the first place he contended that what are chargeable to income tax in respect of a business are profits and gains actually resulting from the transactions of the previous year, that is to say, the H real profits and gains and not hypothetical profits or gains

on a doctrinaire theory of accrual, that even under the mercantile system of accounting regularly adopted by an assessee it is only the accrual of real income in the commercial sense which is chargeable to tax, that accrual is a matter of substance to be decided on commercial principles having regard to business character of the transactions and the realities of the situation and cannot be determined on any abstract theory of accrual or by adopting a legalistic approach and that if regard is had to commercial principles and realities of the situation it will be clear that in the case of banks, financial institutions and money lenders, whose bulk profits mainly consist of interest earned by them, there is no accrual of real income so far as interest on sticky advances is concerned, and the debit entries made in respect of such interest in the respective accounts of the concerned debtors following the mercantile system of accounting merely reflect hypothetical income that does not materialise in the concerned accounting year or years during which the advances remain sticky and hence it is but proper to carry such interest to 'Interest' Suspense Account' as carrying the same to 'Profit and Loss Account' would result in showing inflated profits and might even lead to improper and illegal distribution or remittance thereof. In this behalf counsel cited several decisions of this Court as also of the High Courts where the principle of real income has been recognised and invoked while considering the tax liability under the Act and in particular strong reliance was placed on two decisions of the Madras High Court in **C.I.T. v. Motor Credit Co.(P) Ltd.**, 127 I.T.R. 572 and **C.I.T. v. Devi Films (P) Ltd.** 143 I.T.R. 386 and one decision of the Punjab and Haryana High Court in **C.I.T. v. Ferozepur Finance (P) Ltd.** 124 I.T.R. 619 where a view has been taken that it will be totally unrealistic to treat interest on sticky loans as income and the same was excluded from computation of the assessee's income. According to Counsel there is a clear distinction between an irrecoverable loan and a sticky loan; the former is a bad debt in respect whereof the chance of recovery is nil and as such can out right form the subject matter of deduction under s. 36 (1) (vii) of the Act while the latter is a loan to which a high degree of improbability of recovery attaches in a particular year or years depending upon the financial position of the concerned debtor due to which interest thereon becomes hypothetical income duringsuch year or years and, as such, the same, not being real income, cannot be brought to tax. Counsel pointed out that right from August 1924 onwards till the

impugned decision herein as also the further decision in 110 ITR 336 were rendered by the Kerala High Court in 1973 and 1975 respectively the aforesaid distinction between an irrecoverable loan and a stickly loan was recognised by the Central Board of Revenue as also by the Reserve Bank of India in their diverse Circulars in the case of banks, financial institutions and money lenders regularly following the mercantile system of accounting and he further pointed out that Instructions had been issued not to treat the unrealised interest on such sticky loan as income by carrying it to 'Profit and Loss Account' so that the figure of distributable profits should not get inflated and preferably to credit the same to a special account such as 'Interest Suspense Account' and that if the banks, financial institutions and money lenders, who kept their accounts on mercantile system, maintained such a suspense account in which the unrealised interest was entered, the same should not be included in the assessee's taxable income, if the Income Tax Officer was satisfied that there was really little probability of the loans being repaid. (Vide C.B.R. Circular No. 37/54 dated 25.8.1924, No. 41(V-6) D of 1952 dated 6.10.1952, CBDT's Letter F.No. 207/10/73 ITA II dated 16.4.1973 and RBI Circular IFD No. O.P.R. 1076/1(5) to SFCs dated 21.11.1973, copies whereof were furnished to the Court). Counsel urged that such Instructions contained in these Circulars were in consonance with the accepted principle that what was chargeable under the Income Tax Act was the real income of an assessee but according to him these Instructions which held field for over 53 years were changed, though wrongly, under fresh Circulars dated June 20, 1978 and October 9, 1984 issued by the Central Board of Direct Taxes whereunder such interest on doubtful or sticky loans became includible in the assessable income of the assessee (subject to some relief specified therein) with effect from the assessment year 1979-80. Secondly, counsel contended that in any view of the matter in the case of banks and financial institutions who regularly adopt mercantile system of accounting the practice of carrying interest on such sticky loans to 'Interest Suspense Account' or 'Reserve for Doubtful Interest Account' instead of crediting the same to 'Interest Account' or 'Profit and Loss Account', is a universally recoginsed practice invariably adopted by them and being wholly consistent with the mercantile system of accounting the Income Tax Officer was bound to give effect to it under s. 145 of the Act, and, therefore, the treatment of the three sums representing interest on sticky loans as the

assessee's income for the concerned assessment years would be unsustainable in law; and in this behalf counsel placed reliance on the standard text books of accountancy of authors like Spicer and Pegler, Shikla and Grewal and the Approved Text of International Accounting Standard 18.

Since the issues raised before us have a vital bearing upon the tax liability and business interests and policies of serveral financial institutions including foreign banks, six interverners, namely, American Express International Banking Corpn., Mercantile Bank Limited through its successors Hongkong & Shenghai Banking Corporation, Citi Bank N.A., Chartered Bank, Grindlays Bank and Industrial Credit & Investment Corpn. of India sought our permission to intervene in these appeals and we granted the requisite permission in view of the importance of the issues involved and it may be stated that Counsel appearing for the interveners have adopted the arguments of Mr. Palkhiwala and generally supported the submissions made by him on behalf of the assessee in these appeals; but special mention may be made of the fact that in the written submissions filed on their behalf it has been categorically asserted that while maintaining their accounts regularly on mercantile system each one of these institutions in the matter of interest on doubtful or sticky loans invariably follow the practice of debiting such interest to the account of concerned borrower but instead of crediting it to 'Interest Account' or 'Profit and Loss Account' the same is carried to a special account styled 'Interest Suspense Account' or 'Reserve for Doubtful Interest Account' and only upon realisation the same is credited to Interest Account and Profit and loss Account in the year of realisation and is offered for taxation. It is also claimed by some of the Interveners that they have an elaborate and well controlled system of evaluation for the purposes of assessing the recoverability and position of various accounts of their borrowers and the financial condition of each borrower is periodically reviewed by Senior Management Personnel on the basis of detailed reports and data collected in regard to each before treating the laons as sticky. Counsel reiterated on behalf of the Interveners that the benefit under the earlier Circulars of C.B.R. and R.B.I. did not depend upon the ipse dixit of the assessee but was available only if the safeguards specified therein were observed and the taxing authority was satisfied on objective materials that the loan had become sticky and there was really little probability of the same being repaid.

A On the other hand, counsel for the Revenue pressed for our acceptance the view taken by the High Court. He fairly conceded that it is the real income that is chargeable to tax under the Act and not any hypothetical income of an assessee and that under section 28 in respect of a business the charge-
B ability must attach to real profits and gains arising from the transactions of the previous year but he contended that under section 5 read with section 28 of the Act the liability attaches to profits which have been either received by the assessee or which have accured to him during the year of account and it is well settled that inncome accrues when it "falls due", i.e., becomes legally recoverable irrespective of
C whether actually received or not and "accrued income" is that income which "the assessee has a legal right to receive": vide **C.I.T. v. Thiagaraja Chetty**, 24 I.T.R. 525 at 531 and **Morvi Industries Ltd. v. C.I.T. Calcutta**, 82 I.T.R. 835 at 840 and since admittedly the assessee has been maintaining its accounts on mercantile basis the three sums being interest on
D loans, whether doubtful or sticky, fell due and became payable to the assessee at the end of each of the three accounting years and constituted its accrued income and were, therefore, justifiably brought to tax in the concerned assessment years. Counsel for the revenue fairly conceded that Courts have, while imposing the tax liability under the Act, recognised the
E theory of real income by having regard to the business character of the transactions and realities of the situation but these aspects have been taken into account for the purpose of determining whether the income could be said to have legally accrued or not and once it is found to have legally accrued it is brought to tax. He pointed out that all the
F decisions of this Court show that this theory has been invoked and confined only to two types of cases (a) where there has been a surrender of income which may in theory have accrued, and (b) where there has been diversion of income at source either under a statute or by over-riding title but in none of these cases has the aspect of high improbability of recovery
G been regarded as sufficient to prevent accrual; counsel therefore urged that this theory of real income should not be extended so as to exclude from chargeability such income which has accrued but merely suffers form high improbability of recovery. Counsel submitted such extension would be neither permissible nor advisable - not permissible because it goes
H against the very concept of accrued income and not advisable because if done it will apply to all cases and not merely to cases of interest accruing to banks and financial

institutions. Moreover, such extension will entrench upon section 36 (1) (vii) which provides for deduction of a debt or part thereof on its becoming bad on fulfilment of certain conditions specified in sub-section (2) thereof. For these reasons counsel submitted that the extension of the theory of real income so as to take within its ambit the consideration of high improbability of recovery is not warranted. As regards the earlier Circulars of C.B.R. and R.B.I. on which reliance was placed by the assessee, counsel for the revenue submitted that these merely granted a concesssion to and conferred no right in favour of the assessee which could be and has been withdrawn later by issuing fresh Circulars but since the benefit or the concession in favour of the assessee could not be withdrawn retrospectively, the withdrawal of concession has been effected prospectively from the assessment year, 1979-80.

Having regard to the rival contentions urged before us by counsel on either side it is clear that the following questions do arise for our serious consideration on the first issue raised for determination in these appeals. Did the three sums representing interest on sticky loans constitute real income of the assessee for the concerned assessment years? Had such income really accrued to the assessee for those years? Does real accrual of income depend on its falling due by mere lapse of requisite contractual period at the end of which it becomes legally payable or upon the business character of the transaction and the realities of the situation? How far is the method of accounting regularly adopted by the assessee (here mercantile) relevant for deciding the question of real accrual? What is the effect of making debit entries in respect of such interest in the respective accounts of the concerned debtors under the mercantile system of accounting? And lastly, can and should the theory of real income be extended so as to exclude a particular income from chargeability under the Act because of high improbability of recovery attaching to it in the concerned accounting year or years? We would like to deal with these questions in the light of decided cases.

The material provisions in regard to the computation of income of an assessee under the head 'Profits and Gains of Business' are to be found in sections 28 (i) 29 and 145 (1) but these have to be read subject to sec. 5 of the Act. Section 28 (i) taxes the profits and gains of any business carried on by the assessee at any time during the previous year and such profits and gains are, under sec. 29 to be

computed in accordance with the provisions contained in ss. 30 to 43A, that is to say after making allowances and deductions mentioned in those sections. Section 145 (1) provides that income chargeable under the head 'Profits and Gains of Business' shall be computed in accordance with the method of accounting regularly employed by the assessee, provided that, in any case where the accounts are correct and completed to the satisfaction of the Income-Tax Officer but the method is such that, in his opinion, the income cannot be properly deduced therefrom then the computation shall be made upon such basis and in such manner as the Income-Tax Officer may determine; but where he is not satisfied about the correctness or completeness of the accounts of the assessee, or where no method of accounting has been regularly employed by the assessee, he can proceed to make the assessment to the best of his judgment. It is well-settled, as a result of the Privy-Council decision in **C.I.T. v. Sarangpur Cotton Mfg. Co.**, 6 I.T.R. 36 at 40 that the section clearly makes such regularly employed method of the opinion of the Income tax Officer, the income, profits and gains cannot properly be deduced therefrom.

Though these provisions provide for charging the income by way of profits and gains of business and prescribe the manner of computation the question as to at what point of time its chargibility arises is answered by s. 5 of the Act which states that the total income of a resident assessee from whatever source derived becomes chargeable either **when it is received** by him or **when it accrues or arises** to him during the previous year. In other words taxability is attracted even when income has accrued and it is clear that the receipt of income is not the sole test of taxability under the Act; but whether on receipt basis or accrual basis it is the real income and not any hypothetical income which may have theoretically accrued that is subjected to tax under the Act and this latter aspect arising under our Act is well settled by decisions of this Court and the High Court to which I will presently refer.

However, before referring to the decisions which deal with the doctrine of real income it will be desirable to indicate the main difference between the two methods of accounting that are usually employed by business men as also to deal with the aspect as to how far and to what extent a method of accounting - particularly the mercantile method - has a bearing on the question of real accrual of income. In **Dhakeswar**

Prasad Narain Singh v. Commissioner of Income Tax, 4 I.T.R. 71 at 74 Sir Courtney Terrell, C.J. described the 'cash system' in these words:

> "According to the system a record is kept of actual receipts and actual payments, entries being made only when money is actually collected or disbursed and if the profits of the business are accounted in this way the tax is payable on the difference between the receipts and the disbursements for the period in question."

On the other hand the 'mercantile accountancy system, otherwise known as the 'book profits system of accountancy' or the 'complete double entry book-keeping' has been described by Sir Iqbal Ahmed, C.J. in **C.I.T. v. Singari Bai,** 13 I.T.R. 224 at 227, as follows:

> "Under this system the net profit of loss is calculated after taking into account all the income and all the expenditure relating to the period, whether such income has been actually received or not and whether such expenditure has been actually paid or not. That is to say, the profit computed under this system is the profit actually earned, though not necessarily realized in case, or the loss computed under the system is loss actually sustained, though not necessarily paid in cash. The distinguishing feature of this method of accountancy is that it brings into credit what is due immediately it becomes legally due and before it is actually received; and it brings into debit expenditure the amount for which a legal liability has been incurred before it is actually disbursed."

The distinction between these two accounting systems has been adverted to by this Court in several of its decisions but I need refer only to one decision in **C.I.T. Madras v. A. Krishnaswami Mudaliar & Others,** 53 I.T.R. 122 where the distinction has been elaborately brought out by Shah J (as he then was) in the following passage occurring at pages 129-130 of the Report;

> "Among Indian businessmen, as elsewhere, there are current two principal systems of book keeping. There is, firstly, the cash system in which a

record is maintained of actual receipt and actual disbursements, entries being posted when money or money's worth is actually received, collected or disbursed. There is, secondly, the mercantile system, in which entries are posted in the books of account on the date of the transaction, i.e., on the date on which rights accrue or liabilities are incurred, irrespective of the date of payments. For example, when goods are sold on credit, a receipt entry is posted as of the date of sale, although no cash is received immediately in payment of such goods; and a debit entry is similarly posted when liability is incurred although payment on account of such liability is not made at the time. There may have to be appropriate variations when this system is adopted by an assessee who carries on a profession. Whereas under the cash system no account of what are called the outstandings of the business either at the commencement or at the close of the year is taken, according to the mercantile method actual cash receipts during the year and the actual cash outlays during the year are treated in the same way as under the cash system, but to the balance thus arising, there is added the amount of the outstandings not collected at the end of the year and from this is deducted the liabilities incurred or accrued but not discharged at the end of the year. Both the methods are somewhat rough. In some cases these methods may not give a clear picture of the true profits earned and certainly not of taxable profits. The quantum or allowances permitted to be deducted under diverse heads under section 10 (2) from the income, profits and gains of a business would differ according to the system adopted. This is made clear by defining in sub-section (5) the word 'paid' which is used in several clauses of sub-section (2) as meaning actually paid or incurred according to the method of accounting upon the basis of which the profits or gains are computed under section 10. Again where the cash system is adopted, there is no question of bad debts or outstandings at all, in the case of mercantile system against the book profit some of the bad debts may have to be set off when they are found to be irrecoverable. Besides the cash system

> and the mercantile system, there are innumerable other systems of accounting which may be called hybrid or heterogeneous - in which certain elements and incidents of the cash and mercantile systems are combined."

On the aspect as to how far and to what extent a method of accounting has a bearing on the question of real accrual of income the Court has made the following significant observation at page 128 of the Report:

> "But the section (section 13 of the 1922 Act equivalent to section 145 of the 1961 Act) only deals with a computation of income, profits and gains for the purposes of sections 10 and 12 (sections 28 and 56 of the 1961 Act) and **does not purport to enlarge or restrict the content of taxable income, profits and gains under the Act.**"

Obviously for the content of taxable income one must have regard to the substantive charging provisions of the Act. This decision, in my view, has emphasised two important aspects in regard to the two methods of accounting usually employed by business men. In the first place the Court has pointed out that both the methods are somewhat rough and in some cases these methods may not give clear picture of the true profits earned and certainly not of taxable profits; and secondly, whatever be the method regularly employed by an assessee the same has to be adopted as the basis and is relevant only for the purpose of the computation of income, profits and gains under sections 28 and 56 of the Act but it cannot enlarge or restrict the content of the taxable income, profits and gains under the Act. It is thus clear that, under section 145, the assessee's regular method of accounting determines the mode of computing the taxable income but it does not determine or even affect the range of taxable income or the ambit of taxation. In other words, any hypothetical income which may have the oretically accrued but has not truly resulted or materialised in the concerned accounting year cannot be brought to charge simply because the assessee has been regularly employing the mercantile system of accounting and makes entries in his books in regard to such hypothetical income.

In the light of above I would recapitulate the admitted facts and the manner in which the assessee treated or dealt with the three sums representing interest on sticky loans in

its books pursuant to the mercantile system of accounting regularly adopted by it. Indisputably, the three sums in question represented the assessee's income by way of interest on advances made by it to some of its customers but having regard to the deteriorating financial position of the concerned parties and the history of their accounts the assessee felt that the advances had become sticky during the concerned accounting years inasmuch as even the recovery of the principal amounts had become highly improbable and extremely doubtful in those years; therefore, though it charged such interest by debiting the concerned parties it did not carry it to its profit and loss account but credited the same to a separate account styled 'Interest Suspense Account' so as to avoid showing unreal or inflated profits and claimed that it was not taxable in its hands as real income had not accrued to it. The facts that the advances or loans had, during the concerned accounting years, become sticky and that such interest had not materialised or resulted to the assessee in those years were not disputed but as stated earlier the claim was negatived by the taxing authorities and the Tribunal on the ground that the advances or loans had not been treated as irrecoverable or bad debts under s. 36 (1) (vii), that the aspect that the advances or loans had become sticky was irrelevant, that since the assessee was following the mercantile system of accounting such interest has accrued to it at the end of each accounting year and that the assessee had itself shown the accrual of interest by changing the same to the concerned parties by making debit entries in their accounts. The High Court also affirmed the view that there had been accrual of the income at the end of each accounting year and in that behalf laid emphasis on the fact that the assessee had been regularly adopting the mercantile system of accounting and observed that the assessee's income will have to be determined in accordance with that method. In other words it is clear that in coming to the conclusion that the three sums in question were liable to be brought to tax the taxing authorities, the Tribunal and the High Court, relying on the mercantile system employed by the assessee, adopted a legalistic approach and took the view that because such interest had fallen due and become legally recoverable by the assessee at the end of each of the accounting years it had accrued to it, though by reason of the stickiness of the advances or loans such interest had in fact not resulted or materialised but remained its hypothetical income. Two questions arise: Should such legalistice approach prevail over

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the doctrine of real income that has been recognised and invoked by Courts while imposing tax liability under the Act? Secondly, can the mercantile system of accounting, though regularly employed, 'determine' accrual of real income?

Since the answer to the second question has been already indicated in the earlier part of our judgment we shall dispose B of second question first. As regards the mercantile system of accounting regularly employed by the assessee there are two aspects which we like to stress. First, the High Court, in my view, was in error in observing that the assessee's income "will have to be **determined** pursuant, to the provisions contained in the Income Tax Act 1961, in accordance with the accounts regularly maintained by it." I have already indicated C above that the method of accounting regularly employed by an assessee is relevant only for the purpose of computation of income, profits and gains under s. 28 of the Act and that it cannot enlarge or restrict the content of the taxable income under the Act and that under s. 145 the assessee's regular method of accounting determines the mode of computing taxable D income but it does not determine or even effect the range of taxable income or ambit of taxation. In other words simply because the assessee has been regularly employing the mercantile system of accounting it would not mean that any hypothetical income which may have theoretically accrued but has not truly resulted to him in the concerned accounting year can be E brought to charge and, therefore, the question whether the three sums representing interest on sticky loans had really accrued to the assessee or not would be a matter of substance and cannot be determined by merely having regard to the method of accounting (here mercantile system) adopted by the assessee. Secondly it will have to be borne in mind that this F is not a case where the assessee had ignored or failed to make any entries at all in regard to such interest on advances or loans which had become sticky in its books maintained on mercantile system but it had charged such interest by debiting the accounts of concerned debtors and had designedly credited it to 'Interest Suspense Account' instead of carrying it to G 'Profit and Loss Account' with a view to avoid showing unreal or inflated profits. A 'suspense account' in book-keeping means "an account in which items are temporarily carried pending their final disposition; it does not appear in financial statements" (vide Kohler's Dictionary for Accountants, Third Edition). Since the final disposition of the sums in question H was uncertain and hung in balance these items were properly

carried to 'Interest Suspense Account' and could not and did not find a place in the financial statement like the Profit and Loss Account. From the mere fact that such interest was charged to the concerned debtors by making debit entries in their respective accounts no inference could be drawn that the assessee had regarded it as accrued income because simultaneously such interest was credited to Interest Suspense Account and not to Profit and Loss Account. The taxing authorities, the Tribunal and the High Court clearly erred in drawing such inference against the assessee. In fact by making the aforesaid entries and treating the three sums in the manner done the assessee must be regarded as having demonstrably shown an intention to treat such interest as its hypothetical and not real income.

Counsel for the assessee pointed out that after all the primary purpose of book-keeping, whatever be the method of accounting, was to make a systematic record of business transactions in a manner which must show the correct financial position of a business house at a given point of time and reflect the real and true profits of the business done by it during the year of account and contended that in treating the three sums in question in the manner done the assessee had merely followed a universally recognised practice invariably adopted by banks and financial institutions who maintain their accounts on mercantile system and what was more this practice accorded with the principle that no item should be treated as income unless it has been actually received or has accrued in the sense that there is reasonable certainty that it will be realised. I find considerable force in this contention of counsel for the assessee. That the practice of carrying interest on such sticky loans to 'Interest Suspense Account' instead of crediting the same to 'Interest Account' or to 'Profit and Loss Account' is a universally recognised practice and is wholly consistent with the mercantile system of accounting will be clear from the standard text books on accountancy. For instance, in the treatise 'Advanced Accounts' by Shukla and Grewal (Ninth Revised and Enlarged Edition 1981) a clear reference to such practice finds a place in the following paragraph occurring at page 1089 under the heading 'Interest on doubtful debts':

> "Interest on doubtful debts should be debited to the loan account concerned but should not be credited to Interest Account. Instead it should be

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> credited to Interest Suspense Account. To the extent the interest is received in cash, the Interest Suspense Accounts should be transferred to Interest Account; the remaining amount should be closed by transfer to the Loan Account. This treatment accords with the principle that no item should be treated as income unless it has been received or there is a reasonable certainty that it will be realised."

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Similarly in Spicer and Pegler's 'Practical Auditing' by W.W. Bigg (Fourth Indian Edition by S.V. Ghatalia) the learned author has suggested that instead of leaving irrecoverable interest on doubtful loans out of account altogether the practice of charging such interest to the parties concerned but crediting it to the Interest Suspense Account is more appropriate for reflecting the correct state of affairs and the true profits. The relevant passage occurring at pages 186-187 runs thus:

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> "Where interest has not been paid, it is sometimes left out of account altogether. This prevents the possibility of irrecoverable interest being credited to revenue, and distributed as profit. On the other hand, this treatment does not record the actual state of the loan account, and in the case of banks and other concerns whose business it is to advance money, it is usual to find that interest is regularly charged up, but when its recovery is doubtful, the amount thereof is either fully provided against or taken to the credit of an Interest Suspense Account and carried forward, and not treated as profit until actually received."

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Reference may also be made to the Approved Text of the 'International Accounting Standard 18' (Supplement to 'The Management Accountant', December 1982) a publication of the International Accounting Standards Committee. The concept of revenue recognition is explained thus in para 5:"

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> "Revenue recognition is mainly concerned with when revenue is recognised in the income statement of an enterprise. The amount of revenue arising on a transaction is usually determined by agreement between the parties involved in the transaction.

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> When uncertainties exist regarding the determination of the amount, or its associated costs these uncertainties may influence the timing of revenue recognition."

The effect of uncertainties on revenue recognition has been B set out in paragraphs 16 to 27 and para 25 is material which runs thus:

> "Revenues arising from the use by others of enterprise resources yielding interest, royalties and dividends **should only be recognised when no significant uncertainty as to** measurability or C **collectability exists."**

In other words according to International Accounting Standard 18 if significant uncertainty as to collectability of interest exists such revenue should not be recognised. In view of what has been stated in the standard books on accountancy as also in the International Accounting Standard 18 I am clearly of D the view that in the case of interest on sticky loans the practice of debiting the accounts of the concerned debtors with such interest and carrying the same to 'Interest Suspense Account' instead of to 'Interest Account' or 'Profit and Loss Account' is a well recognised and accepted practice of commercial accountancy, that it is wholly consistent with mercantile E method of accounting and that it prevents the wrong crediting and improper and illegal distribution or remittance of inflated and unreal profits and by making the appropriate entries following such practice the assessee had clearly indicated that the three sums in question being interest on sticky loans constituted its hypothetical income and not real income.

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Turning to the first question it is true that under s. 5 taxability is attracted not merely when income is actually received but also when it has 'accrued' and it is also true, as has been explained by this Court in **Thiagaraja Chetty's** case (supra) and **Morvi Industries'** case (supra) that income G accrues when it 'falls due', that is to say when it becomes legally recoverable irrespective of whether it is actually received or not and 'accrued income' is that income which 'the assessee has a legal right to receive'. Incidentally it may be stated that in both of these cases, where the legal aspect of accrual has been explained, no question of applying the H doctrine of real income could arise; for, in the former case

after the commission payable to the managing agents had accrued at the end of the accounting year the managed company had, instead of paying it, kept it in a suspense account pending settlement of a dispute in regard to another debt owed to it by the managing agents (which proposed settlement was ultimately rejected) and the Court held that such keeping it in the suspense account pending settlement of another indebtedness would not prevent its accrual to the managing agents, while in the other case a unilateral relinquishment of the commission by the managing agents was after its accrual and hence the Court ruled that it could not escape liability to tax. While the legal aspect of accrual thus holds good this Court in **C.I.T. v. Shoorji Vallabhdas & Co.** 46 I.T.R. 144 has enuciated the doctrine of real income in these terms:

> "Income-tax is a levy on income. No doubt, the Income-tax Act takes into account two points of time at which the liability to tax is attracted, via., the accrual of the income or its receipt; but the substance of the matter is the income. **If income does not result at all, there cannot be a tax, even though in book-keeping, an entry is made about a hypothetical income, which does not materialise.** Where income has, in fact, been received and is subsequently given up in such circumstances that it remains the income of the recipient, even though given up, the tax may be payable. **Where, however, the income can be said not to have resulted at all, there is obviously neither accrual nor receipt of income, even though an entry to that effect might, in certain circumstances, have been made in the books of account."**
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> (Emphasis supplied)

The above observations were made in the context of these facts. The assessee-firm was the managing agent of two shipping companies; between April 1, 1947 and December 31, 1947 an amount of Rs. 1,71,885 from one company and Rs. 2,56,815 from the other company became due to the assessee as commission @ 10 per cent under the managing agency agreement and in its books the assessee had credited these amounts to itself and debited them to the managed companies. In November, 1947 the assessee desired to have the managing agency transfered to two private limited companies and in this connection agreed in

December 1948 to accept 2-1/2 per cent as commission and gave up 75 per cent of its earnings. The department sought to assess the amounts of Rs. 1,36,903 and Rs. 2,00,625 being the 75 per cent which the assessee have given up, on the ground that commission at 10 per cent had already accrued to the assessee in the year of account which ended on March 31, 1948 and the agreement in December 1948, after the close of the previous year, to give up a portion of income could not save that portion from liability to income-tax. Negativing the contention this Court, in agreement with the High Court's view, held that the subsequent agreement has altered the rate of commission in such a way as to make the income which really accrued to the assessee different from what had been entered in the books of account and that this was not a case of a gift by the assessee to the managed companies of a portion of income which had already accrued, but an agreement to receive a lesser remuneration than what had been agreed upon. The Court relied upon the fact that the assessee had in fact received only the lesser amount in spite of the entries in the accounts books and held that such lesser amount alone was taxable.

A large number of decisions rendered by this Court as well as by the High Courts were cited at the bar by Counsel on the either side in which this aforesaid theory of real income has been invoked and applied and in some of them emphasis has been laid on the aspect that accrual is the matter of substance to be decided on commercial principles having regard to the business character of the transactions and the realities of the situation. After having gone through these decisions I am in agreement with the submission of the learned counsel for the revenue that these decisions involving the application of the concept fall into two groups: (a) cases where there has been a surrender or relinquishment of income that may have theoretically accrued and (b) cases where these has been diversion of income at source either under a statute or by over riding title; but in both types of cases the Court's endeavour was to determine whether there was accrual of real income having regard to the realities or specialities of the situation. It is not necessary to deal with each and every decision falling under either one or the other group but confining attention to the decision of this Court it will suffice to indicate that in the former group fall the following decisions, namely **C.I.T. v. Hari Vallabhadas Kalidas & Co.**, 39 I.T.R. 1, **C.I.T. v. Chamanlal Mangaldas & Co.** and

C.I.T. v. Mangaldas Girdhardas Parekh Ltd., 39 I.T.R. 8, **C.I.T. v. Messrs Shoorji Vallabhadas and Co.** (supra), **C.I.T. Madhya Pradesh v. Kalooram Govindram**, 57 I.T.R. 630 and **C.I.T. v. Birla Gwalior (P) Ltd.**, 89 I.T.R. 266, while the decision in **Poona Electric Supply Co. Ltd. v. C.I.T. Bombay**, 57 I.T.R. 521, falls in the latter group. Since the instant case is not one of diversion of income at source either under a statute or by over-riding title I need dilate only on the decisions in the former group.

As regards the decisions falling in group (a) I would like to point out that the ratio of all these decisions clearly is that where income or part thereof has theoretically accrued but has been, either unilaterally or as a result of bilateral arrangement, voluntary relinquished or surrendered by the assessee before its accrual the same cannot be regarded as real income of the assessee and cannot be brought to tax, and such conclusion has been reached having regard to the business character of the transactions and the realities of the situation notwithstanding that some entries have been made in the assessee's books maintained in the mercantile system. The decision of the Bombay High Court in **H.M. Kashiparekh Co.'s** case 39 I.T.R. 706 is a typical instance in point. The assessee, which maintained its accounts in the mercantile system, was the managing agent of a paper mill company; under the managing agency agreement it was under a duty to forego up to one-third of its commission where the profits of the managed company were not sufficient to pay a divident of 6 per cent; for the accounting year ending March 31, 1950 the assessee earned a commission of Rs. 1,17,644 but as a result of resolutions passed by the managed company and the assessee company the assessee gave up a sum of Rs. 97,000 (Rs.57785 over and above Rs. 39215 which it was bound to forego) in December 1950. Though the Appellate Tribunal found that the excess amount of Rs. 57785 had also been given up for reasons of commercial expediency it held that the maximum amount which could be foregone by the assessee was only Rs. 39215 and therefore included the excess amount of Rs. 57785 in the taxable income. On a Reference, the High Court held that it was the real income of the assessee company for the accounting year that was liable to tax, that the real income could not be arrived at without taking into account the amount foregone by the assessee and that in ascertaining the real income of the fact that the assessee followed mercantile system of account did not have any bearing. The Court further held that the

accrual of commission, the making of the accounts, the legal obligation to give up part of the commission and the foregoing of the commission at that time of the making of the accounts were not disjointed facts; there was a dovetailing about them which could not be ignored and therefore the real income of the assessee was Rs.27644 and the amount of Rs.97000 foregone by the assessee could not be included in the real income of the assessee for the accounting year.

It will be significant to mention that during the hearing of the Reference counsel for the revenue raised a contention that even if the amount of Rs. 57785 had been foregone by the assessee company on grounds of commercial expediency that was not done in the accounting year which ended on March 31, 1950 but it was done in December 1950 as a result of two resolutions, one passed by the managed company and the other passed by the assessee company and that since admittedly the assessee was following the mercantile system of accounting it could not avail of the benefit of the doctrine of real income where the income by way of the managing agency commission had been credited in the books in the year of account and had been surrendered by it in the next year; in other words it was specifically urged that if the surrender was not made and entered in the books in the same year no question of real income could arise and in this behalf counsel relied upon the well-settled rule that for purposes of income-tax each year was required to be regarded as a distinct and self-contained unit. Apropos this contention the Court observed thus:

> "The two rules that income-tax is annual in its structure meaning thereby that for computation each year is a distinct self-contained unit and the other that the income to be taxed is the real income of the assessee do not seem to us to be incompatible or irreconcilable. Mr. Joshi (counsel for the revenue) also is not prepared to go so far as that and has fairly stated that there is no antithesis between the two rules. The facts of a case may present some difficulty in applying the rules by the conflict would, in our opinion, be rather apparent than real. The facts of a given case may create the impression of a discrepant situation but the apparent discrepancy can be solved in a manner not inconsistent with the basic concepts underlying the two rules. In our judgment,

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they permit of harmonious application, though the application is to a degree must depend on the circumstances of each case. Some propositions could be formulated but whether a general formula applicable to all circumstances could be hit on we rather doubt.

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Though it may not be possible to prescribe a general formula which successfully compose every conflicting situation, the position in law seems clear to us that in applying the two rules to particular transactions regard must be had to the true legal rights and the true situation. A fair interpretation of the transaction and the situation would lead to a preferable and, if we may say so, a correct solution than sheer adherence to one rule and discounting of the other."

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At page 720 of the Report the Court went on to observe thus:

"In the course of his argument, learned counsel for the Revenue stated that there must have been entries in the books of the managed company and the managing company in consonance with clause 5 of the managing agency agreement..... we shall proceed on the footing that, the assessee company having followed the mercantile system of account, there must have been entries made in its books in the accounting year in respect of the amount of the commission. In our judgment, we would not be justified in attaching any particular importance in this case to the fact that the company followed the mercantile system of account. That would not have any particular bearing in applying the principle of real income to the facts of this case. Incidentally, we may observe that we ourselves pointed out in the case of **Commissioner of Income-tax v. Shoorji Vallabhadas & Co.** that the question whether the income accrued or not is not a mere matter of cogency of the entries made in the account books of the assessee but is essentially one of substance and of the real nature of what happened; a mere book entry is not conclusive of the question whether the assessee had become entitled to the

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sums or not. It may also be mentioned that in that case we were dealing with an assessee who followed the mercantile system of account. The crucial question before us, therefore, is whether the two facts, one the amount of Rs. 1,17,644.4 annas which would have become payable to the managing company but for the surrender and the factus of surrender, are to be isolated or treated as of cogency in determining the actual accrual of income, by which we mean the real income of the assessee company. If the fact of foregoing or surrendering the amount of Rs. 57,000 odd is to be regarded as of cogency in the context of the present point of real income and if it be remembered that the surrender was made at the time of ascertaining the quantum of the commission payable to the assessee company and further if it be remembered, as now found by the Tribunal, that the surrender was made bona fide and on grounds solely of commercial expediency, it seems very difficult to us to see how the Revenue is justified in contending that the real income of the assessee was something different than the amount of Rs. 20,000. (Sic R.27644) which was shown by it at the time of assessment as its income from managing agency commission."

The Court further expressed the view that the principle of real income was not to be so subordinated as to amount virtually to a negation of it when a surrender or concession or rebate in respect of managing agency commission is made, agreed to or given up on grounds of commercial expediency, simply because it takes place some time after the close of the accounting year and that in examining any transaction and situation of this nature the Court would have more regard to the reality and speciality of the situation rather than the purely theoretical or doctrinaire aspect of it and it will lay greater emphasis on the business aspect of the matter viewed as a whole when that can be done without disregarding the decision of the Bombay High Court has been fully approved by this Court in **Birla Gwalior (P) Ltd.'s** case (supra).

It will thus be clear that even under the mercantile system of accounting whenever adopted it is only the accrual of real income which is chargeable to tax, that accrual is a matter of substance and that it is to be decided on commercial

principles having regard to the business character of the transactions and the realities and specialities of the situation and cannot be determined by adopting purely theoretical or doctrinaire or legalistic approach. If, therefore, for the purpose of determining whether there has been accrual of real income or not regard is to be had to the business character of the transactions and the realities and specialities of the situation in preference to theoretical, doctrinaire or legalistic approach I fail to appreciate why interest on sticky loans, which has theoretically accrued but has not factually resulted or materialised at all to an assessee hypothetical income and not real income? There is no reason why the factum of stickiness of loans operating throughout the accounting period or periods, not on the basis of mere **ipse dixit** of the assessee but on being objectively established to the satisfaction of the taxing authorities by reference to the facts showing the deteriorating financial position of the concerned debtors and the history of their accounts should not have the effect of preventing the accrual of interest thereon as real income to the assessee? If voluntary relinquishment or surrender of income done unilaterally or as a result of bilateral arrangement can prevent its real accrual there is no reason why the factum of stickiness of loans objectively established should not prevent accrual of interest thereon as real income. In fact in the former case considerations of commercial expediency could be a motivating force behind such voluntary relinquishment or surrender of the income resulting in its non-accrual but in the latter case the non-accrual would be due to circumstances beyond the assessee's control. I am, therefore, clearly of the view that the stickiness of advances or loans objectively established to the satisfaction of the taxing authorities by producing proper material, is sufficient to prevent the accrual of interest thereon as real income and would have the effect of rendering such income hypothetical and the same cannot be brought to tax. In my view under the Income Tax Act in order that income should accrue it should not merely fall due or become legally recoverable but should also be factually and practically realisable during the accounting year or years. In other words mere non-receipt of income, when it is reasonably realisable, will not affect accrual but factual or practical unrealisability thereof may prevent its accrual depending upon the facts and circumstances attending upon the transaction.

Counsel for the revenue raised two objections to extend the theory of real income so as to exclude from chargeability the interest on sticky loans merely because it suffers from high improbability of recovery. In the first place he urged that the Act contains no provision excluding or deducting such interest from computation of income and the only provision for deduction of debts is to be found in s. 36 (1) (vii) whereunder debts which are established to have become irrecoverable and bad in the previous year are permitted to be deducted on fulfilment of certain conditions specified in sub-section (2) and as such the extension of the theory of real income as sought would entrench upon s. 36 (1) (vi). Secondly, it was urged that such extension will be ill-advised inasmuch as, if done, it will apply to cases of interest accruing to all money-lenders and not merely to cases of interest accruing to banks and financial institutions. As regards the first objection the argument amounts to saying that the exclusion or deduction in respect of irrecoverable and bad debts under s. 36 (1) (vii) read with the conditions mentioned in sub-sec. (2) proceeds on the basis that in substance such debts do not constitute real income of the assessee and therefore exclusion of interest on sticky loans from computation of income for which there is no provision in the Act and that too without any conditions would impinge upon the specific provision contained in s. 36 (1) (vii) read with sub-section (2). The answer to this objection is that it is not as if that in the absence of some specific provision exclusion of hypothetical income cannot be done; in fact such exclusion rests not upon any slippery or slushy ground but upon the principle that under the Act chargeability is attracted only to real income and in this behalf it will be pertinent to mention that the provision for exclusion or deduction of bad debts was introduced in the income tax law (the 1922 Act) for the first time in 1939 but even prior to the insertion of such provision in the 1922 Act the Privy Council in **C.I.T. v. Sir S.M. Chitnavis**, 6 I.T. Cases 453 had, on the basis of ss. 10 and 13 of the 1922 Act, ruled that such bad debts were necessarily allowable as deduction on grounds of first principles of accountancy. At page 457 of the Report the Privy Council have observed: "Although the Act nowhere in terms authorises the deduction of bad debts of a business, such a deduction is necessarily allowable. What are chargeable to income-tax in respect of a business are the profits and gains of a year; and in assessing the amount of the profits and gains of a year

account must necessarily be taken of all losses incurred, otherwise you would not arrive at the true porfits and gains." Moreover, there is a clear distinction between an irrecoverable loan and a sticky loan; the former would be a bad debt in respect whereof the chances of recovery are almost nil having been written off the same can form the subject matter of a deduction under s. 36 (1) (vii) while the latter is a loan to which a high degree of improbability of recovery attaches in a particular year or years due to which interest thereon becomes hypothetical income and not real income during the said year or years and therefore, it cannot be brought to tax, though if realised subsequently the same could be and ought to be brought to tax, if this distinction is borne in mind no question of impinging upon the provision contained in s. 36 (1) (vii) read with sub-section (2) can arise by extending the theory of real income to the interest on sticky loans.

As regards the second objection, if on principle interest on sticky loans is merely hypothetical income and is not real income and is on that account to be excluded from computation of income we fail to see why the benefit of this principle under the theory of real income should not be available to private money-lenders. The theory of real income must apply to all cases irrespective of who the assessee is. All that is required to be ensured is that like the banks and financial institutions the money-lenders must also establish to the satisfaction of the taxing authority that the loans in question had in fact become sticky during the concerned year or years by producing proper material and that they have invariably followed the practice of carrying the interest of such loans to Interest Suspense Account in stead of crediting the same to Interest Account or Profit & Loss Account with the additional safeguard of offering the same for taxation if and when it is subsequently realised. It will be pertinent to mention in this connection that the earlier Circulars issued by the Central Board of Revenue and Reserve Bank of India (vide C.B.R. Circular No. 37/54 dated 25.8.1924, No. 41 (V-6) D of 1952 dated 6.10.1952, CBDT's Letter F.No. 207/10/73 ITA II dated 16.4.1973 and RBI Circular IFD No. O.P.R. 1076/1 (5) to SFCs dated 21.11.1973) which conferred the benefit of excluding such interest on sticky loans albeit by way of concession were applicable to private money lenders also. In the circumstances both the objections are liable to be rejected.

I may now deal with the decisions of the High Courts. Directly on the point at issue there are five decisions which

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we need consider. Out of these counsel for the assessee relied upon three decisions, two of the Madras High Court in **Motor Credit Co.** case, and **Devi Films** case and one of the Punjab & Haryana High Court in **Ferozepur Finance** case (supra) where a view has been taken that interest on sticky loans being hypothetical and not real income should be excluded from the computation of the assessee's income while counsel for the revenue relied upon two decisions one of the Bombay High Court in **C.I.T. v. Confinance Ltd.** 89 I.T.R. 292 and the other of the Calcutta High Court in **James Finlay & Co. v. C.I.T.** 137 I.T.R. 698 as both these apparently seem to take a contrary view.

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I shall first deal with two decisions on which counsel for the revenue placed reliance. In **C.I.T. v. Confinance Ltd.** the assessee was carrying on money lending business and banking business and followed mercantile system of accounting. For the accounting year ending March 31, 1959 the assessee stated that no credit was taken in its balance-sheet in respect of interest on several loans advanced by it as interest had remained unpaid from March 31, 1956. For the assessment years 1959-60 and 1960-61 interest in respect of amounts due by debtors amounting to Rs. 9,275 and Rs. 13,033 respectively was brought to tax by the I.T.O. and A.A.C. The Tribunal reversed the orders on the ground that the records showed that there had hardly been any receipts of interest for a number of years past. On a reference, the High Court reversed the Tribunal's view and held that the facts that there were hardly any receipts in respect of items of interest or that the bona fides of the assessee in not charging interest was not disputed were circumstances which by themselves were in sufficient to support the conclusion that there was no real income in respect of items of interest inasmuch as none of the debts due by the several debtors was written off by the assessee and no evidence was produced to show that interest in respect of the debts was given up and therefore the two sums were properly includible in the total income of the assessee for the two assessment years respectively. From the judgment we find that counsel for the assessee sought to apply the doctrine of real income as expounded in **Kashiparekh's** case to the facts of the case but the High Court declined to do so by adopting a legalistic approach that the assessee had been following mercantile system of accounting that the interest had accrued and further laid considerable emphasis on two aspects, namely, that none of the debts due by the several debtors was written off by the

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assessee and no evidence was produced to show that interest in respect of the debts was given up. In my view the High Court failed to appreciate that the method of accounting employed by an assessee merely determined the mode of computing the income and not the range of taxable income and further failed to notice that there could be and was a clear distinction between an irrecoverable or a bad debt on the one hand the sticky loan on the other to which we have adverted earlier.

In **James Finlay's** case decided by the Calcutta High Court the items of interest receivable from two parties on advances made to them were sought to be excluded from computation of income of the assessee for 1970-71 on the ground that since 1.1.1968 the assessee had decided to change its method of accounting in respect of interest, which was doubtful of recovery, by crediting the same to the Suspense Account and also on the ground that before the closing of the books of account of the relevant accounting year the assessee had adbandoned its claim for such interest. The High Court held that there was no change in the mercantile system of accounting that had all along been empolyed by the assessee, that the transfer of items of interest to Suspense Account could not be termed as a change in the method of accounting and therefore the amounts were assessable on accrual basis; as regards the other ground the High Court held that though there was difficulty in realising the interest in the year of account there was no material to show that there was any agreement with the debtors to waive the interest or to keep it in the Suspense Account and hence the claim for interest had not been given up. In our view the decision mainly turned upon whether the assessee had changed its method of accounting or not and the finding was it has not and as far as the theory of real income is concerned the Court did not reject the same but on facts came to the conclusion that it was not applicable inasmuch as the claim for interest had not been relinquished or given up.

On the other hand in the three decisions on which counsel for the assessee relied two High Courts have invoked and applied the theory of real income to cases of interest on sticky loans and taken the view that such interest being hypothetical and not real is not includible in the assessable income of the assessee. Only one decision may be referred to in detail. In the **Motor Credit Co's** case the assessee in the course of its business as financiers for purchase of motor vehicles advanced, under a hire purchase agreement, moneys to two firms which were plying buses. The routes of these two

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firms having been taken over by the State Transport Corporation, the firms defaulted in making payments of hire purchase instalments, and consequently the buses were seized. As the assessee company was advised that there was no prospect of recovering even the principal amount it did not credit the B interest on the outstandings from the two firms even though it was adopting the mercantile system of accounting. The ITO, however, included a sum of Rs. 56,163 by way of accrued interest on the amounts outstanding from these two firms, The AAC deleted the addition. The Tribunal held that the assessee could not have expected to get any interest income on the C outstandings found due from two firms and it would be wholly unrealistic on the part of the assessee to take credit from the interest income and consequently confirmed the AAC's order. On a reference at the instance of the Commissioner the Madras High court held that the Tribunal was right in its conclusion that though the assessee had adopted the mercantile D system of accounting no interest income could be assessed in its hands on accrual basis and it would be very unrealistic on the part of the assessee to take credit for the highly illusory interest. Following the decision of this Court in **Shoorji Vallabhdas Co's** case and of the Bombay High Court in **Kashiparekh's** case the High Court took the view that the E regular mode of accounting merely determined the mode of computing the taxable income and the point of time at which the tax liability was attracted and it could not determine or affect the range of taxable income or the ambit of taxation. It further observed that it was not the hypothetical accrual of income based on the mercantile system of accounting follow- F ed by the assessee that had to be taken into account but what should be considered was whether the income had really materialised or resulted to the assessee and that question had to be considered with reference to commercial and business realities of the situation in which the assessee had been placed and not with reference to his system of accounting and G held that since there was not even the remotest possibility of any interest income materialising in favour of the assessee in respect of the outstandings for the accounting year relevant to the assessment year in question no liability to tax could be imposed on the assessee. To the same effect are the other two decisions in **Devi Films** case and **Ferozepur Finance** case. I H approve these three decisions.

In view of my conclusion that this theory of real income could be and should be extended to interest on sticky loans and

that on principle such interest being hypothetical cannot be brought to tax it is unnecessary to deal with the earlier Circulars of the Central Board of Revenue and the Reserve Bank of India all of which were in the nature of concession granted to an assessee according to counsel for the revenue.

Having regard to the above discussion it is clear that the three sums representing interest on sticky advances in the instant case being hypothetical and not real income of the assessee could not be brought to tax for the three concerned assessment years and we answer the first question in the negative in favour of the assessee and against the revenue. Of course it goest without saying that if and when these sums or any part thereof are realised subsequently the same could be brought to tax in the year of realisation.

The second question raised for our determination in these appeals relates to the taxability of Rs. 1,66,128 which represents the exchange difference arising on devaluation of the Indian Rupee on August 6, 1966 and the question relates to the assessement year 1967-68 only. The facts giving rise to the question are these. Admittedly the business of the assessee-bank included buying and selling of foreign exchange and therefore any foreign currency held by it would be its stock-in-trade and if foreign currencies bought at the pre-devaluation rate of exchange were sold at post devaluation rate of exchange resulting in a surplus the same would be its business receipt or revenue receipt and therefore liable to tax as part of business profits. Indisputably, just before the devaluation of the Indian Rupee on August 6, 1966 the assessee-bank held foreign exchange by way of cash balances available with their foreign correspondents, forward contracts, items in transit etc., amounting to L-33,780,76 in US Dollars and L-9552.0.2 in Sterling which when converted back to Rupees at the post devaluation rates gave rise to a profit of 57.5% or Rs. 1,66,128 in the transaction; the assessee-bank credited this surplus to an account designated "Provision for Contingencies". It was contended on behalf of the assessee before the lower taxing authorities that this profit should not be taxed as it was of a casual and non-recurring nature. The contention was negatived by the authorities on the ground that even assuming, without conceding, that it was a windfall and, therefore, of a casual nature the same had arisen from the business activities of the assessee-bank and, therefore, was not exempt but was liable to tax. Before the Appellate Tribunal an attempt was made by counsel for the assessee-bank to contend that the cash balance in terms of

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dollars and sterlings at the end of the accounting period, i.e., on December 31, 1966 was higher than that as existed on the crucial date, namely, August 6, 1966 and, therefore, this precluded any inference that the stock of dollars and sterlings that existed on the devaluation date had been converted B into Indian currency thus resulting in profits. The Tribunal rejected the contention as being without force inasmuch as the assessee-bank had revalued the cost of foreign exchange in terms of rupees as on the date of devaluation to bring it on par with the post-devaluation rate by giving a corresponding credit to the "Provision for Contingencies" thus treating the C surplus resulting from the fluctuation of exchange rate as its income and the mere fact that the same had been carried to the account style "Provision for Contingencies" did not alter the true character of the transaction. The High Court confirmed the ultimate conclusion of the Tribunal by answering the relevant question referred to it in favour of the Revenue.

D Counsel for the assessee fairly conceded two positions arising in the case. In the first place he conceded that foreign exchange was held by the assessee-bank as its stock-in-trade and he further conceded that any sale of such stock-in-trade must result in business income but he urged that if the stock-in-trade remains unused and unsold its notional E appreciation or book appreciation in value does not result in taxable profit (vide **C.I.T. v. Mughal Line Ltd.** 46 I.T.R. 590, and according to him this is what had happened in the instant case. According to counsel the fact that the stock-in-trade in terms of foreign currency that was held by the assessee just prior to the date of devaluation was shown not to have been F depleted between the date of devaluation and December 31, 1966 (the end of accounting period) clearly suggested that the stock-in-trade initially held had remained unused and unsold during this entire period, especially when the sotck-in-trade held on December 31, 1966 was shown to be higher than the one held just prior to the devaluation date; and therefore it was G a case of a mere nominal appreciation or book appreciation in the value of the stock and as such the same could not be brought to tax. There can be no dispute with regard to the principle that if the stock-in-trade remains unused or unsold the mere book appreciation in the value thereof cannot be brought to tax but on the facts requisite to sustain the pro- H position the assessee-bank does not seem to stand on any firm footing. In the first place by carrying the surplus resulting

from the devaluation of the Indian rupee to an account designated "Provision for Contingencies" the assessee bank itself could be said to have clearly treated such surplus as its business income. Secondly, the AAC in his appellate order has recorded a categorical finding that the stock in trade in terms of foreign currency was sold and used by the assessee in its normal banking business. This is what the AAC has observed:

> "What is important is that the profit on account of the difference in exchange rate should have arisen in the course of trading operations of the bank. There is no dobut that it did so arise in the instant case. The bank acquired and sold the foreign exchange assets in course of its normal banking business and therefore, the profit arising out of the fluctuation in exchange rates, however, large and however unexpected any particular fluctuation may be, arose in the course of and incidental to such business of the bank."

Having regard to the aforesaid factual position I confirm the High Court's view that the second question has to be answered in the affirmative in favour of the Revenue and against the assessee.

In the result I would allow the appeals in so far as the first question is concerned and dismiss the same as regards the second question. In the circumstances there will be no order as to costs.

SABYASACHI MUKHARJI,J. These appeals by certificate arise from the decision of the High Court of Kerala in respect of the assessment years 1965-66, 1966-67 and 1967-68 relating to the previous calendar year 1964, 1965 and 1966 respectively. The following two questions are involved in these appeals:

> (1) Whether, on the facts and in the circumstances of the case, the addition of the sums of Rs.67,170. Rs. 47,777. and Rs. 57,889 representing interest on 'sticky' advances as income for the assessment years 1965-66, 1966-67 and 1967-68 respectively was justified in law?
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> (2) Whether on the facts and in the circumstances of the case, the exchange difference of Rs.

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1,66,128 arising on revaluation of the Indian rupee on 6.6.1966 was rightly treated as income of the assessment year 1967-68?

In view of the categorical findings of fact recorded by the Tax authorities and the Tribunal and mentioned in the judgment of Tulzapurkar, J., I am in respectful agreement with the opinion of Tulzapurkar, J. that the High Court was right and the second question must be answered in the affirmative and in favour of the revenue, and the appeals on this aspect must be dismissed.

With regard to the first question, with respect, it is not possible to agree with the reasoning and the conclusions arrived at by Tulzapurkar, J., in the judgment. It is necesary for this reason to reiterate in brief the facts relating to the first question. The assessee is a subsidiary bank of the State Bank of India. It used to maintain in the relevant accounting years its accounts in mercantile system; therefore, entries were made and income and loss were calculated on accrual basis. The assessee in the course of its banking business used to charge interest on advances, including even those which it considered doubtful of recovery and which the assessee termed as 'sticky advances' by debiting the concerned parties but in stead of carrying the same to its 'Profit & Loss Account', credited the same to a separate acccount called 'Interest Suspense Account'. According to the assessee the principal amounts of these advances labelled as 'sticky advances' had become not bad or irrecoverable, but extremely doubtful of recovery. In its returns the assessee had disclosed such interests separately and claimed that the sums were not taxable as income of the concerned years. In view of the relevant years involved, the question must be considered in the light of the provisions of the Income Tax Act, 1961 (hereinafter called the 'Act').

Before the Taxing Officers, the Tribunal and the High Court, the assessee's contention was that having regard to bad and deteriorating financial conditions of the parties concerned as well as history of their accounts, the recovery of even the principal debts had become improbable and doubtful, thereby making these loans or advances as the assessee called 'sticky' and, as such interest on these though debited to the respective debtors was taken to 'Interest Suspense Account'. This, according to the assessee, became necessary

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to avoid showing inflated profits by including hypothetical and unreal income and, such income, according to the assessee, was not his real income. It was contended by the assessee that the said sums namely the interest on the so called 'sticky' loans was not taxable in its hands. This contention was, however, rejected by the Income-tax authorities as well as the High Court. B

The following were the grounds for such rejection:
(a) The assessee was following the mercantile system of accounting; such interest, therefore, had accrued to the assessee at the end of the accounting year.

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(b) The assessee itself had treated such income as accrual of interest by charging the same to the parties concerned by making debit entries in their respective accounts.

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It was pointed out that if any part of these debits had later on become irrecoverable in any year, the assessee could have, in that year, treated the same as such and claimed deduction under section 36(1)(vii) of the Act. Reliance was placed by the High Court on an earlier decision of the same High Court in the case of **Catholic Bank of India (In liquidation) vs. Commissioner of Income-Tax, Kerala, Ernakulam.**, [1964] K.L.T. 653 = [1965] 1 I.T. Journal 355. In that case in spite of the directions issued by the Reserve Bank of India to the assessee bank not to carry interest of such sticky advances to 'Profit and Loss Account' and also in spite of the fact, that the assessee bank in pursuance of these directions omitted their interest from its 'Profit and Loss Account', the court took the view that such interest was taxable as income in the hands of the assessee bank because the mercantile system of accounting had been regularly followed by the bank and that had not been changed even after receiving directions from the Reserve Bank of India. The Kerala High Court had relied upon certain observations in the commentary on the Income Tax Act, 1961, by Kanga, 5th Edn. Vol. I, page 665 wherein the learned author has stated:

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"The assessee cannot escape liability to tax by omitting to make an entry or making a wrong entry in the acccounts. The date of taxability of income

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> is the date when the appropriate entries are made or should be made in the accounts in accordance with the method of accounting regularly employed by the assessee. The substantive part of the section makes it clear that the income is to be computed' in according with the method of accounting regularly employed.' The Income-tax Officer may include in the computation of income an amount which does not figure in the accounts but the inclusion of which is required by the assessee's method of accounting; that is to say, the Income-tax officer may without deviating from the assessee's method, make such adjustments in the profit and loss account as are necessary for giving full and true effect to that method itself. Having adopted a regular method of accounting, the assessee cannot be allowed to change it or depart from it for a particular year or for part of the year or in respect of particular transactions."

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The High Court of Kerala was of the view that the facts of the instant case out of which these appeals arise being the same as those in **Catholic Bank's** case except that there was a direction from the Reserve Bank of India to Catholic Bank, which is absent in the instant case before us, the same conclusion must follow. In the opinion of the High Court, the presence or absence of such direction from the Reserve Bank was not determinative of the question. There was accrual of income to the assessee considering the fact that the assessee had been following the mercantile method of accounting which had been regularly adopted by the assessee and accepted by the taxing authorities. The High Court in that view of the matter answered the question in favour of the revenue. For subsequent years 1968-69 in respect of the same assessee, an identical view was reiterated by the said High Court in the assessment year 1968-69 as reported in 110 I.T.R. 336. The correctness of this view is under challenge in these appeals before us.

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The assessee indubitably maintained its accounts on mercantile basis and had regularly adopted it. The assessee claimed that the three sums represented interests on what it called 'sticky' loans in its books of account but having regard to the deteriorating financial position of the concerned debtors and the history of these accounts, the assessee was of the view that in the relevant years the advances had become

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so 'sticky' that even the recovery of the principal amounts had become highly improbable and extremely doubtful. Therefore, though the assessee **charged such interests by debiting the concerned parties** (emphasis supplied) yet it credited the said amounts to a separate account styled as 'Interest Suspense Account'. This the assessee claimed on the theory that it was to avoid showing unreal or inflated profits. The assessee claimed that it was not taxable as real income had not accrued to it. It was, however, disallowed on the ground that the advances had not been treated as irrecoverable or bad debts in terms of section 36(1)(vii) of the Act. In coming to the conclusion that these sums were taxable, the taxing authorities, the Tribunal and the High Court proceeded on well- settled principles pertaining to the mercantile system and took the view that such interest had fallen due and became legally recoverable in accordance with the system of accounting during each of the relevant accounting years.

In support of the assessee's contention learned counsel contended before us that what are chargeable to income-tax in respect of a business, are profits and gains of that business actually resulting from the transactions of the previous year. It was submitted that even under the mercantile system of accounting accrual or "real income" in the commercial sense only was chargeable to tax and this must accrue in substance according to the realities of the situation. It was submitted that if regard is had to realities of the situation as well as the actual commercial principles, it would be evident that in cases of banks, financial institutions and money-lenders bulk of the income is usually earned by way of interest and as such there cannot be any accrual of real income from interest on doubtful advances or sticky advances and, therefore, the entries made in respect of such accounts in case of all such traders following the mercantile system of accounting only reflected hypothetical income which does not materialise in income. It was submitted that, therefore, it was proper to carry such interest to 'Interest Suspense Account' as carrying the same to 'Profit and Loss Account' would amount to showing an unreal and inflated profit and thereby lead to improper and illegal distribution or remittances thereof.

Therefore, the question, is, whether on the theory of real income, interests which had accrued legally to an assessee - in this case banking institution following the mercantile system of accountancy can be kept out of the net of

taxation. How far does the concept of real income defeat accrual of income in any particular case according to the well-recognised theory of accounting principles which are accepted by the legal standards so far followed?

In this country, by and large, two systems of account keeping are followed - one is the cash and the other, mercantile. Plainly speaking, the cash system postulates actual receipt of money; and for exigibility of income tax, such receipt from business, profession or vocation or from other sources has to be actual in the relevant year of account. The mercantile system, on the other hand, is one where accounts are maintained on the basis of entitlement of credit and/or debit. A sum of money, as soon as it becomes payable, is taken into account without reference to actual recceipt and a debit becomes admissible when liability to pay is created even though the sum of money is yet to be paid.

Several circulars issued by the Central Board of Taxes were placed before us in course of the hearing. One such was C.B.R. Circular No. 37/54 dated 25th August, 1924. There the Central Board had said that it accepted the conclusion reached at the Conference of Income-tax Commissioners held in August, 1924 that if a money-lender who kept his accounts on the commercial system maintained a suspense account in which he entered loans which in his opinion were extremely unlikely to be recoverable though he did not yet wish actually to write them off, interest accruing on such loans need not be included in the assessee's taxable income, if the Income-tax officer was satisfied that there was little provability of recovery of the loan. This was obviously on the footing that the last ray of hope of recovery had not been extinguished and the stage for write off had not come. The second circular is one dated 6th October, 1952, which is Circular No. 41(V-6)D of 1952 dealing with the subject of bad and doubtful debts - irrecoverable loans or bank interest on such debts. It was indicated therein that when there was unlikelihood of loans being revcovered, interests from such loans need not be included in the taxable income if the Income-tax Officer was satisfied that there was really little possibility of the loans being repaid. But an account was to be maintained for future allowances for taxation of recoveries in subsequent assessment years. There is also a letter dated 16th April, 1973, from the Under Secretary, Central Board of Direct Taxes referring to D.O. letter dated 15th March, 1973 reiterating that the

amounts kept in suspense account under those circumstances would not be taxable. The assessee was, however, required to maintain a systematic method of accounting in respect of dobutful debts subject to checks and counter-checks. By the letter dated 21st November, 1973, the Reserve Bank of India wrote that there was no uniformity in the practice followed by State Financial Corporations on sticky loans wehre the same position was reiterated. A letter was written on 20th June, 1978, by the Central Board of Direct Taxes to the Commissioner of Income-tax soon after the decision rendered in the assessee's case in 110 I.T.R. 336 referred to hereinbefore. In that letter reference was made to the previous circulars and it was pointed out that the stand taken in these circulars was not acceptable to the Revenue Audit Department and it had objected to the exclusion of such amounts of interest from the total income. The Board advised that where accounts were kept on mercantile basis, interest was taxable irrespective of whether the same was credited to suspense account or to interest account. Reference was made to the decision of the Kerala High Court in 110 I.T.R. 336 which has been followed in the instant case. The Central Board, therefore, directed that such interests should be includible in the taxable income, and all pending cases should be disposed of keeping the present instructions in view. It was further directed that immediate review should be undertaken under section 147(b) or sectin 263 of the Act in respect of assessments which had been completed in accordance with the Board's earlier directions. In the last letter, the same position was reiterated but it was further clarified as to future course of action. In these appeals we are not concerned with the actual effect of these Circulars and these need not be set out and examined.

Several financial institutions sought to intervene as the question involved herein is of some importance to them. We have allowed them to make their submissions and taken them into consideration. It was urged that the instructions contained in these circulars noted before were in consonance with the accepted principles of accountancy and these instructions have held the field for over 53 years. It was also submitted that as such claims have been allowed to be exempted for more than half a century, and the practice had transformed itself into law, this position should not have been deviated from. This submission, of course, cannot be accepted. The question of how far the concept or real income enters into the question of taxability in the facts and circumstances of this

A case and how far and to what extent the concept of real income should inter-mingle with the accrual of income will have to be judged in the light of the provisions of the Act, the principles of accountancy recognised and followed and the feasibility. The earlier circulars being executive in character cannot alter the provisions of the Act. These were B in the nature of concessions and could always be prospectively withdrawn. However, on what lines the rights of the parties should be adjusted in consonance with justice inview of these circulars is not a subject matter to be adjudicated by us and as rightly contended by counsel for the revenue, the circulars cannot detract from the Act.

C The profits and gains chargeable to tax under the Act are those which have been either received by the assessee or have accrued to the assessee during the period between the first and the last day of the year of account and are receivable. Income received or income accrued are both chargeable to tax under section 28 of the Act. The computation of this income is D provided for in section 29 of the Act. While we are on the sections, it may be appropriate to refer to section 36 also. Section 36(a) provides for certain deductions from the computation of income and sub-section (vii) thereof deals with bad debts in these terms:

> E "(vii) subject to the provisions of sub-section (2), the amount of any debt, or part thereof, which is established to have become a bad debt in the previous year."

Section 36(2) prescribes the conditions to be satisfied for F earning deduction for a bad debt. There is no dispute in these appeals that such conditions are not satisfied.

Section 56 of the Act deals with income from other sources and section 57 deals with deductions in computation of income from other sources. Section 145 deals with the method of accounting. Sub-section (1) of the said section provides G that income chargeable under the head "Profits and gains of business or profession" or "Income from other sources" shall be computed in accordance with the method of accounting regularly employed by the assessee. The proviso in certain eventualities permits the Income-tax Officer to adopt the mode for computation of income. Similar too is the position of H sub-section (2).

It is settled that the income of the assessee will have to be determined according to the provisions of the Act in consonance with the method of accountancy regularly employed by the assessee. The method of accounting regularly employed by the assessee helps computation of income, profits and gains under section 28 of the Act and the taxability of that income under the Act will then have to be determined. The question, is, whether the income which has been computed according to the method of accounting followed regularly by an assessee can be diminuted or diminished by any notion of real income. This has to be judged in the light of the well-settled principles.

In **Commissioner of Income-tax, Madras, v. K.R.M.T.T. Thiagaraja Chetty & Company**, 24 I.T.R. 525, this Court as early as 1953 reiterated that once the sum of Rs. 2,26,850 in that case was arrived at as income that had accrued to the assessee, it did not cease to be the income by reason of the fact that it was carried to the suspense account by a resolution of the directors and that it was, therefore, assessable to tax. The assessee firm therein was a managing agent of a limited company. Under the managing agency agreement the assessee was entitlted to a certain monthly remuneration - a commission of ten per cent on the net profits of the company and a small percentage on sales and purchases. The agreement further provided that the assessee was at liberty to retain, reimburse and pay themselves out of the funds of the Company all moneys expended on its behalf and all sums due to them for commission or otherwise. During the year of account ending 31st March, 1942, the assessee had become entitled to a commission of Rs. 2,26,850. On 30th March, 1942, the assessee wrote to the company requesting that a certain debt, which the assessee owed to the company for along time past, should be written off. The directors by their resolution, passed on the same debt, refused to write off the amount without consulting the general body of shareholders and pending the settlement of the dispute resolved to keep the sum of Rs. 2,26,850 was debited as a revenue expenditure of the company and was allowed as deduction in computing the profits of the company for the purpose of income-tax. The question was whether in the assessment year 1942-43, the assessee was liable to pay tax on the sum of Rs. 2,26,850. The Tribunal held that the assessee was being assessed on cash basis in previous years, that the income had not accrued to the assessee and that the sum of Rs. 2,26,850 should be excluded from taxation as not having been received in the accounting year. The High Court came to

the conclusion that there was no material for the Tribunal's finding that the assessee was being assessed on cash basis in the previous years but held (Satyanarayana Rao, J., confirming the decision of the Appellate Tribunal; Viswanatha Sastri, J., contra) that the sum of Rs. 2,26,850 was not liable to tax, inasmuch as it was not income of the assessee which had accrued or arisen in the accounting year. This Court in appeal held that the High Court was right in its conclusion that there was no material for the Tribunal's finding that the assessee was being assessed on cash basis on the sums mentioned which had accrued to the assessee and it did not cease to be income. In this connection, this Court at page 531 of the Report referred to the observations of Viswanatha Sastri, J. wherein the learned judge had stated: "The sum had irrevocably entered the debit side of the company's account as a disbursement of managing agency commission to the firm and had been appropriated to the firm's dues and same could not again be entered in a suspence account at a later date. The sum, therefore, belonged to the firm and had to be included in the computation of the profits and gains that had accrued to it unless the firm had regularly kept its accounts on a cash basis, which is not the case here."

This problem may be better looked into if the question of difference between the mercantile system and cash system is examined in a little detail.

Sir Courtney Terrel, C.J. delivering the judgment of the Patna High Court in **Dhakeshwar Prasad Narain Singh v. Commissioner of Income Tax, Bihar & Orissa,** 4 I.T.R. 71 at 74., noted the difference between the two methods of accounting for income, profits and gains of business. The learned Chief Justice observed at page 74 of the report:

> "Now, there are two methods of accounting for the income, profits and gains of a business which are generally referred to as the cash basis and the mercantitle basis. According to the former a record is, as in this case, kept of actual receipts and actual payments, entries being made only when money is actually collected or disbursed and if the profits of the business are accounted for in this way the tax is payable on the difference between the receipts and the disbursements for the period in question. There is, secondly, the mercantile

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system under which a profit and loss account is maintained. At the end of the financial year the assets and liabilities are valued and entered in the account and the difference between the two is the profit upon which the tax is paid." B

The **Commissioner of Income Tax, Bombay v. Sarangpur Cotton Manufacturing Co. Ltd.,** 6 I.T.R. 36. Lord Thankerton, speaking for the Judicial Committee after referring to section 13 of 1922 Act which was more or less similar to section 145 of the present Act observed at page 40 as follows:

"Their Lordships are clearly of opinion that the section relates to a method of accounting regularly C employed by the assessee for his own purposes - in this case for the purposes of the Company's business - and does not relate to a method of making up the statutory return of assessment to income-tax. Secondly, the section clearly makes sucha method of accounting a compulsory basis of D computation unless in the opinion of the Income-tax Officer, the income, profits and gains cannot properly be deduced therefrom. It may well be that, though the profit brought out in the accounts is not the true figure for income-tax purposes the true figure can be accurately deduced therefrom. E The simplest case would be where it appears on the face of the accounts that a stated deduction has been made for the purpose of a reserve. But there may will be more complicated cases in which nevertheless, it is possible to deduce the true profits from the accounts, and the judgment of the Income- F tax Officer under the proviso must be properly exercised. It is misleading to describe the duty of the Income-tax Officer as a discretionary power."

Iqbal Ahmad, C.J. has aptly described in **Commissioner of Income Tax v. Shrimati Singari Bai,** 13 I.T.R. 224, the mercantile system of accountancy and has observed at page 227 of the G report as follows:

"The distinguishing feature of this method of accountancy is that it brings into credit what is due immediately it becomes legally due and before it is actually received; and it brings into debit H

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expenditure the amount for which a legal liability has been incurred before it is actually disbursed. The 'mercantile accountancy system' is the opposite of the 'cash system' of book-keeping' under which a recordis kept of actual cash receipts and actual cash payments, entries being made only when money
B is actually collected or disbursed."

In **Commissioner of Income-Tax, Madras v. A. Krishnaswami Mudaliar and Others**, 53 I.T.R. 122, this Court had to refer to the distinction between mercantile system and cash system. Referring, however, to the relevant section appropriate to section 145 of the present Act, this Court observed that the
C section did not compel the Income-tax Officer to accept a balance-sheet of cash receipts and outgoings prepared from the books of account: it was for him to compute the income in accordance with the method of accounting regularly employed by the assessee. Referring to the prevalent system of book-keeping in India, Shah, J. speaking for this Court observed at
D pages 129-130 of the report as follows:

"Among Indian businessmen, as elsewhere, there are current two principal systems of book-keeping. There is, firstly, the cash system in which a record is maintained of actual receipt and actual disbursements, entries being posted when money or
E money's worth is actually received, collected to disbursed. There is, secondly, the mercantile system, in which entries are posted in the books of account on the date of transaction, i.e., on the date on which rights accrue or liabilities are incurred, irrespective of the date of payment. For
F example, when goods are sold on credit, a receipt entry is posted as of the date of sale, although no cash is received immediately in payment of such goods; and a debit entry is similarly posted when a liability is incurred although payment on account of such liability is not made at the time. There
G may have to be appropriate variations when this system is adopted by an assessee who carries on a profession. Whereas under the cash system no account of what are called the outstandings of the business either at the commencement or at the close of the year is taken, according to the mercantile
H method actual cash receipts during the year and the

actual cash outlays during the year are treated in the same way as under the cash system, but to the balance thus arising, there is added the amount of outstandings not collected at the end of the year and from this is deducted the liabilities incurred or accrued but not discharged at the end of the year. Both the methods are somewhat rough. In some cases these methods may not give a clear picture of the true profits earned and certainly not of taxable profits. The quantum of allowances permitted to be deducted under diverse heads under section 10(2) from the income, profits and gains of a business would differ according to the system adopted. This is made clear by defining in sub-section (5) the word "paid" which is used in several clauses of sub-section (2) as meaning actually paid or incurred according to the method of accounting upon the basis of which the profits or gains are computed under section 10. Again where the cash system is adopted, there is no question of bad debts or outstanding at all, in the case of mercantile system against the book profits some of the bad debts may have to be set of when they are found to be irrecoverable. Besides the cash system and the mercantile system, there are innumerable other systems of accounting which may be called hybrid or heterogeneous - in which certain elements and incidents of the cash and mercantile systems are combined."

For the content of the taxable income, one has to refer to the substantive provisions of the Act, mainly section 5 of the Act read with other relevant sections.

In **Commissioner of Income-Tax, Bombay City I v. Messrs. Shoorji Vallabhdas and Co.**, 46 I.T.R. 144, this Court discussed the concept of real income. There the relevant fact was that before the close of the relevant accounting year which was from 1st April, 1947 to 31st December, 1947, in November, 1947 the assessee had desired to have the managing agency transferred to two private companies and this was transferred by a subsequent agreement after the close of the year. The assessee in that case in fact received only the lesser amount in spite of the entries in the account books, and it was held that this lesser amount alone was taxable. It

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was reiterated by Hidayatullah J. as the learned Chief Justice then was, that income-tax is a levy on income and the Income-tax Act took into account two points of time at which the liability to tax was attracted viz., the accrual of the income or its receipt; yet the substance of the matter was income. If income did not result at all, there could not be any tax, even
B though in book-keeping, an entry was made about a "hypothetical income" which did not materialise. Where income has, in fact, been received and is subsequently given up, in such circumstances that it remains the income of the recipient, even though given up, the tax might be payable. Where, however, the income can be said not to have resulted at all,
C there was obviously neither accural nor receipt of income, even though an entry to that effect might, in certain circumstances, have been made in the books of account. This decision and the use of the expression that entry of the 'hypothetical income' is often misunderstood in the sense that after the accrual if the income did not materialise then on the basis of
D the actuality or reality of the situation it should not be considered to be income at all. But the significant fact which is often lost sight of is that within the relevant accounting year viz. 1st April, 1947 and 31st December, 1947, in November, 1947 the assessee had desired to have the managing agency transferred to two private companies and the subsequent agree-
E ment in the following year viz. December, 1948 was merely fructification or carrying into effect of that desire and as a result of the same, the income did not accrue. That this was the basis for the ratio of the decision of this Court would be clear because this Court referred to and relied on the
F decision of the Bombay High Court in **Commissioner of Income-tax, Bombay North, Kutch and Saurashtra, Ahmedabad v. Chamanlal Mangaldas & Co.,** 29 I.T.R. 987 in this respect. That was also a case of managing agency company's entitlement to receive commission at a certain rate. By another agreement, in the case of commission earned by the managing agent for the
G calender year 1950 was reduced to Rs. 1 lakh. That agreement i.e. the subsequent agreement took place during the previous year, and the resolution of the board of the director of the managed company was also in the previous year but it was, however, made final on 8th April, 1951, at a meeting of the board of directors but at a time beyond the previous year. The
H High Court had taken the view that by reason of the resolution during the currency of the previous year, the right of the assessee to commission ceased to be under the original agreement and dependent upon and arose only after the decision of

the board of directors to reduce the commission. The assessee was, therefore, held not liable on the larger sum as it was only a hypothetical income which it might have earned if the old agreement had subsisted. This Court found that the facts of that case were almost identical with the facts in **Shoorji Vallabdas's** case. Therefore **Shoorji Vallabhdas's** case must be understood on the footing that because of the desire in November, 1947, the commission did not accrue at the end of the accounting year. In that sense there was no accrual of the income. It may be reiterated that in some limited fields where something which is the reality of the situation prevents the accrual of the income, then the notion of real income i.e. making the income accrue in the real sense of the term can be brought into play but the notion of real income as it shall presently be indicated cannot be brought into play, where income has accrued according to the accounts of the assessee and there is no indication by the assessee to treat the amount as not having accrued. Suspended animation following inclusion of the amount in the suspense account does not negate accrual and after the event of accrual, corroborated by appropriate entry in the books of account, on the mere ipse dixit of the assessee, no reversal of the situation can be brought about.

Morvi Industries Ltd. v. Commissioner of Income-Tax (Central), Calcutta, 82 I.T.R., 835., was also a case of giving up the commission which had accrued though in that case the payment had been deferred till after the accounts had been passed in the meetings of the managed company. This Court held that such a situation did not affect the accrual of the income. This Court found that the amounts of income for the relevant years were given up unilaterally by the assessee after these had accrued and it could not escape liability to tax on those amounts. This Court reiterated that income accrued when it became due. The postponement of the date of payment did not affect the accrual of income. The fact that the amount of the income was not subsequently received by the assessee would not also detract from or affect the accrual of the income although non-receipt may in appropriate cases be a valid ground for claiming deduction. This Court reiterated that the mercantile system of accounting differed substantially from the cash system of book-keeping. Under the cash system, it was only actual cash receipts and actual cash payments that were recorded as credits and debits; whereas, under the mercantile system, credit entries were made in respect of amounts due immediately they became legally payable

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and before they were actually received. Similarly, the expenditure items for which legal liability had been incurred were immediately debited even before the amounts in question were actually disbursed. This position was reiterated by this Court in 1971 after taking into consideration various decisions of this Court. In our view, therefore, the concept of real income cannot be so used as to make accrued income non-income simply because after the event of accrual, the assessee neither decides to treat it as bad debt nor claims deductions under section 36(2) of the Act, but still enters the same with a diminished hope of recovery in the suspense account. Extension of the concept of real income to this field to negate accrual after the amount had become payable is contrary to the postulates of the Act.

It may be mentioned that before the decision of the Bombay High Court in **H.M. Kashiparekh & Co. Ltd.'s** case, 39 I.T.R. 706., rendered on 1st and 2nd April, 1960, a decision having relevance on the concept of real income and about whose important facts we shall advert later, this Court in February, 1960 in **Commissioner of Income-Tax Bombay North v. Chamanlal Mangaldas & Co.** (supra) had to consider some of these aspects. In that case there was provision for reduction of commission where profits were insufficient in case of the managing agent. There was modification of the commission before the end of the year. The amount was given up by the managing agent. The question that arose was whether the income had accrued and what was the effect of the entries made in the books of account. It was held by this Court that the agreement was an integrated and indivisible one and the managing agent's commission was only determinable and accrued when the year was over. It was further held that the fact that the amounts of commission were credited in the books of the managed company every six months only meant that as an interim arrangement the accounts of all sales were made up at the end of six months also. But this did not affect the construction of the clause containing the terms for payment of commission nor the deduction made therein as a result of the modified arrangement. The amount which arose or accrued and which the managing agent had the right to receive was not affected by the manner in which the entry was made. The managing agent was entitled to receive as commission only a sum of Rs. 4,11,875 and that amount alone accrued to the managing agent. This Court reiterated the principle that the amount which would

arise or accrue to the managing agent and the managing agent would have a right to receive would not be affected by the manner in which entry was made. The existence of the right to receive i.e. accrual, is important and that is a matter of the reality of the situation keeping the terms and conditions and the conduct of the parties. In **Kashiparekh's** case (supra), the Division Bench of the Bombay High Court dealt with an assessee firm which had maintained its account in the mercantile system. The assessee was the managing agent of a paper mill company. Under the managing agency agreement, it was under a duty to forgo upto one-third of its commission when the profits of the managed company were not sufficient to pay the dividend of 6 per cent. For the accounting year ending on 31st December, 1950, the assessee had earned a commission of Rs. 1,17,644 but as a result of the resolutions passed by the managed company and the assessee company the assessee gave up a sum of Rs. 97,000 in December, 1950. The Appellate Tribunal held that the maximum amount the assessee was bound to forgo was only Rs. 39,215 and included the balance of amount forgone viz. Rs. 57,785 in the taxable income. The Tribunal, however, found that the sum of Rs.57,785 was also given up for reasons of commercial expediency. The Division Bench of the Bombay High Court held that it was the real income of the assessee company for the accounting year that was liable to tax and that the real income could not be arrived at without taxing into the account the amount forgone by the assessee. In ascertaining the real income the fact that the assessee followed the mercantile system of accounting did not have any bearing. **The accrual of the commission, the making of the accounts, the legal obligation to give up part of the commission and the forgoing of the commission at the time of the making of the accounts were not disjointed facts: there was a dovetailing about them which could not be ignored** (emphasis supplied). The real income of the assessee, it was further held, was Rs. 27,644 and the amount of Rs. 97,000 forgone by the assessee could not be included as the real income of the assessee for the accounting year. The two rules that income-tax is annual in its structure, and, therefore, the computation for each year is a distinct self-contained unit and the other that the income to be taxed is the real income of the assessee are not incompatible or irreconcilable; they admit of harmonious application. The principle of real income is not to be so subordinated to virtually amount to a negation of it when a surrender or concession or rebate in respect of managing agency commission is made, agreed to or given on grounds of

A commercial expediency, simply because it takes place some time after the close of an accounting year. In examining any transaction and situation of this nature, the court would have more regard to the reality and speciality of the situation rather than the purely theoretical and doctrinaire aspect of it. It laid great emphasis on the business aspect of the B matter viewed as a whole when that could be done without disregarding the language of the statute. It may be pointed out that the decision in **Kashiparekh's** case (supra) has received approval of this Court in **Commissioner of Income-Tax, West Bengal II v. Birla Gwalior (P) Ltd.**, 89 I.T.R. 266., but in our opinion it is necessary to reiterate the real facts and C the basic principles of **Kashiparekh's** case. It is true that the concept of real income will have its effect also in mercantile system of accounting. There the accounting year was ending 31st March, 1950. For the account year 31st March, 1950 the assessee had earned commission but as a result of resolutions passed, the assessee company gave up Rs. 97,000 in D December, 1950.

The question involved, was, whether the accrued interest in the accounting year could be given up subsequently or not. Now looked at from the proper perspective, the Court was of the view, as we read it, that the right to the commission arose under the managing agency agreement. Under the agreement E there was a duty to forgo upto one-third of the commission where profit of the managed company was not sufficient to pay a divident of 6 per cent. It is in the peculiar situation arising out of the managing agency agreement that subsequently a sum of Rs. 97,000 was given up in December, 1950. In this context the fact of surrender and the concept of real income F must be viewed. It was really to implement the obligation under the managing agency agreement that the giving up took place. Therefore, the accrual of commission, the making of the accounts, the legal obligation to give up part of the commission and the forgoing of the commission at the time of the making of the accounts were considered not to be disjoin- G ted facts. There was dovetailing about these which in reality of the situation could not be ignored. This is not a case where there being no previous obligation after interest having been earned in the sense of having accrued according to the mercantile system of accounting, the assessee after the close of the accounting year without giving up the interest which H the assessee could have as a bad debt, did not offer it for taxation but carried it to 'interest suspense account'.

Carrying certain amount which had accrued as interest without treating it as bad debt or irrecoverable interest but keeping in suspense account would be repugnant to section 36(1)(vii) read with section 36(2) of the Act. The concept of real income must not be so read as to defeat the object and the provision of the statutory enactment. In that view of the matter **Kashiparekh's** case would not be of any assistance to the assessee for the contentions it sought to urge before this Court in the instant case.

As mentioned hereinbefore this Court in **Birla Gwalior (P) Ltd.'s** case (supra) had dealt with **Kashiparekh's** case. That decision before the court was an appeal from the decision of the Calcutta High Court (78 I.T.R. 788) in which I delivered the judgment. It was felt by the High Court that reading the order of the Tribunal as a whole though various contentions were raised before the Tribunal, the Tribunal had mainly decided the question applying the theory of real income and held that these amounts did not form the real income of the assessee, inasmuch as, according to the Tribunal, the remunerations were forgone on grounds of commercial expediency. The High Court held that once it was decided that these amounts did not form part of the real income of the assessee which was liable to tax, the question of deduction under section 10(2)(xv) of the 1922 Act became irrelevant. There the question really was when did the income really accrue – whether at the end of the accounting year or upon the making up of the accounts, in case of the entitlement of commission of the assessee in the managing agency commission and office allowance. This Court (at page 270 of 89 I.T.R.) noted that the date for payment of the commission was stipulated in the managing agency agreement. The accounting year of the assessee as well as the managed companies was the financial year. The respondent gave up the managing agency commission from both the managed companies, for the assessment years 1954-55 to 1956-57, after the end of the relevant financial years but before the accounts were made up by the managed companies. This Court emphasised that as the managing agency commission receivable could have been ascertained only after the managed company had made up its accounts and the assessee had given up the commission even before the managed company made up its accounts, and no date had been fixed in the agreement for the payment of the commission, the mere fact that the respondent was maintaining its accounts on the mercantile system did not lead to the conclusion that the

commission had accrued to it by the end of the relevant accounting year. The commission given up by the respondent could not be considered to be its real income. It is clear that the fact of the case was that the managing agency commission receivable by the assessee could have been ascertained only after the managed company had made up its accounts and as it had not made up its accounts, the commission did not accrue to the assessee company and therefore the giving up which was for valid reasons was not given up after the accrual of income.

Dealing with **Kashiparekh's** case this Court observed that an argument was advanced before this Court that as the assessee was maintaining its accounts on mercantile basis, the commission had accrued. This contention did not find favour with this Court, because this Court noted that no due date was fixed for payment of the commission under the managing agency agreement. Therefore, whether in a particular case managing agency commission had accrued or not would depend upon various factors and there is a dovetailing of these factors. It is in this light that this Court understood **Kashiparekh's** case and approved that decision at page 270 of the report. In my opinion, this approval by this Court on this basis does not help the assessee in the present appeals before us. It has to be pointed out that the facts in **Kashiparekh's** case were peculiar and the court wanted to relieve the assessee from the undue hardship of tax liability. The ratio of a case with such special features may not be available for general application.

The Bombay High Court in **Commissioner of Income-tax, Bombay I v. Confinance Ltd.**, 89 I.T.R. 292, held that under the income-tax law receipt of income, either actual or deemed, is not a condition precedent to taxability. These were assessable if these had arisen or accrued or deemed to have accrued or arisen under the Act. This principle would be attracted even in cases where an assessee followed the mercantile system of accounting. However, in examining any transaction or situation, the Court would have more regard to the reality of the situation rather than purely theoretical or doctrinaire aspect. It was held in that case after discussing the facts that there were hardly any receipts in respect of items of interest or that the bona fides of the assessee in not charging interest were not disputed, were circumstances which were by themselves insufficient to support the conclusion that

there was no real income in respect of the items of interest as none of the debts due by the several debtors was written off by the assessee and no evidence was produced to show that interest in respect of the debts was given up. The High Court, therefore, held that there was no giving up and these incomes were assessable. I am in respectful agreement with the conclusion of the Bombay High Court. In the instant case before us the facts are still worse. The assessee has not only not written off, but it is still treating loans as alive by keeping them in suspense account. Kantawala, J., as the Chief Justice then was, followed the correct principle therein after considering **Kashiparekh's** case (supra). The principles enunciated therein are in consonance with the decision of the Calcutta High Court in **James Finlay & Co. v. Commissioner of Income Tax.**, 137 I.T.R. 698, where all these relevant authorities including **Kashiparekh's** case as well as **Birla Gwalior (P) Ltd.'s case** have been discussed and analysed. In that case the accounts of the assessee company for the year 1970-71 included an amount of 8,264 from B & G and Rs. 55,920 from S.P. Ltd. receivable as interest. The interest due from B & G were on advances made in 1966 and that from S.P. Ltd. were on advances made in 1965. The assessee was following the mercantile system of accounting and the Income-tax Officer treated both the items of interest as the assessee's income for 1970-71. The assessee used to credit the interest to its profit and loss account. It urged that it had decided to change w.e.f. 1st January, 1968, its method of accounting in respect of interest which was doubtful of recovery, and that such interest was thence forward credited to the suspense account. The Tribunal held that there was no change in the method of accounting and that before the closing of the books of account of the relevant accounting year, the assessee had not abandoned its claim of interest and as such the amounts were assessable on accrual basis. On a referene, the High Court held that the alteration of practice in book-keeping and transfer of amounts to the suspense account could not be termed as a change in the method of accounting. In the instant appeals before us, the position is still worse for the assessee. There is no claim that there was any change in the method of accounting. The High Court further held in **James Finlay's** case that though there was difficulty in realising the interests in the year of account, there was no material to show that there was any agreement with the debtors to waive the interest or to keep these in suspense account. Hence, the claim for interest had not been given up. The amounts accrued

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and continued to remain accrued and were therefore income assessable to tax.

Our attention was drawn to certain passages in some recognised text books on accountancy. Reference was made to "Advanced Accounts" by Shukla and Grewal (Ninth Revised and
B Enlarged Edition 1981) as well as to Spicer and Pegler's "Practical Auditing" by W.W. Bigg (Fourth Indian Edition by S.V. Ghatalia) where it has been suggested that doubtful debts might be carried to interest suspense account. Reference was also made to the Approved Text of the "International Accounting Standard 18". Relevant passages from these books have been
C set out in the judgment of our learned brother Tulzapurkar, J. No useful purpose will be served by repeating these. Even if in a given circumstance, the amounts may be treated as interest suspense account for accountancy purpose that would not affect the question of taxability as such. This must be determined by well-settled legal principles and principles of
D accountancy which have been referred to hereinbefore.

The concept of reality of the income and the actuality of the situation are relevant factors which go to the making up of the accrual of income but once accrual takes place and income accrues, the same cannot be defeated by any theory of real income. Reference may be made to **Calcutta Co. Ltd. v. Commissioner of Income-Tax, West Bengal**, 37 I.T.R. 1.
E

Three decisions, two of the Madras High Court and one of the Punjab and Haryana High Court, which shall presently be noticed, were pressed into service on behalf of the assessee to suggest that the concept of real income can be so applied
F as to make, where the chances of realisation of accrued income are less it non est.

In **Commissioner of Income-tax, Tamil Nadu-V v. Motor Credit Co. Pvt. Ltd.**, 127 I.T.R. 572, the assessee, a private company, was carrying on business as financier for purchase of
G motor vehicles on hire purchase. It advanced under hire purchase agreements monies to two firms which were plying buses. The routes of these two firms having been taken over by a State Transport Corporation following nationalisation, the firms defaulted in making payment of the hire purchase instalments, and consequently the buses were seized. As the
H assessee-company was advised that there was no prospect of recovering even the principal amount, the assessee-company did

not credit the interest on the outstandings from the two companies even though it was adopting the mercantile system of accounting. The Income-tax Officer, however, included a sum of Rs. 56,163 by way of accrued interest on the amounts outstanding against these two firms. There in fact no interest accrued in view of the facts because there was hire purchase and the State transport corporation had taken over the firms. Therefore, there was no question of paying any hiring charges or interest. In that view it was considered to be unrealistic that income accrued. If the actuality of situation or the reality of a particular situation makes an income not to accrue, then very different considerations would apply. But where interest has accrued and the assessee has debited the account of the debtor the difficulty of the recovery would not make the accrual non-accrual of interest.

In **Commissioner of Income-Tax, Madras Central v. Devi Films (P) Ltd.**, 143 I.T.R. 386, the Madras High Court held that the regular mode of accounting only determined the mode of computing the taxable income and the point of time at which the tax liability was attracted. It would not determine or affect the range of taxable income or the ambit of taxation. It was further held that where no income had resulted,, it could not be said that income had accrued merely on the ground that the assessee had been following the mercantile system of accounting. Even if the assessee made a credit entry to that effect still no income could be said to have accrued to the assessee according to the Madras High Court. If no income had materialised, it was pointed out, there could be no liability to tax on any hypothetical accrual of income based on the mercantile system of accounting followed by the asessee that had to be taken into account, but what should be considered was whether the income had really materialised or resulted to the assessee. The question whether real income had materialised to the assessee had to be considered with reference to commercial and business realities of the situation. In that case the assessee company had entered into an agreement with M who was producing a Kannada film. The film was in the process of production and the producer wanted finance to complete the picture and approached the assessee and offered the exclusive distribution rights of the picture in certain areas in Karnataka State. The assessee agreed to advance a sum of Rs. 2,80,000. Under the agreement the assessee as distributor could deduct the commission and appropriate the balance

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towards the discharge of the amount advanced to the producer and after the advance was completely adjusted, the distributor had to remit to the producer the realisactions after deducting the commission. The distribution commission was to be calculated at 35% of the net realisation on the picture. The producer
B undertook to complete and deliver the prints for the release of the picture failing which the producer under took to pay damages together with interest for the amount received at 12% per annum from the date of default to the date of delivery of the prints and also provided certain sum for certain contin-
C gency. It is not necessary to set out in detail the further facts. It was held that the assessee was in a position to realise only Rs. 3,47,000 approximately during the three years in question as against a total sum or Rs. 4,37,828 incurred as the cost of production. The Tribunal was justified in the High Court's view that having regard to the terms of the agreement entered into between the parties and in the light of the
D entries contained in the accounts, the commission could not be said to have accrued in favour of the assessee, as commission could be earnt only after the entire advance had been realised. The decision, as is apparent from its tenor rested upon the peculiar facts. As the advances could not be realised because of the contingencies that happened in that case, the
E commissions did not accrue or could not be said to have actually accrued. As mentioned before, the concept of real income may have to be given precedence in computation of income in a particular case but accrued income cannot be waived as not having accrued to the assessee. Sethuraman, J. who delivered the judgment of the bench noted the distinction
F between the **James Finlay's** case and the case before him in the Madras High Court. Dealing with the **Calcutta** case, Sethuraman, J. observed at page 395 that the waiver of interest would be inconsistant with the entries in the books, since the interest had been credited to the suspense account. As in the instant case before us in these appeals the learned judges of the
G Madras High Court also referred to **Morvi Industries Ltd.** (supra) where affirming the Calcutta High Court decision, it was found that the relinquishment by the assessee of its remuneration after it had become due was of no effect and that the amount was liable to be taxed. The Madras High Court felt that this Court had considered only in the light of the system of
H accounting followed by the assessee and further observed that this Court in the aforesaid decision had not been referred to the notion of real income. It is unfortunate that the High

Court chose to side-track a binding decision of this Court on a wholly untenable ground.

In **Commissioner of Income-Tax, Amritsar-II v. Ferozepur Finance (P) Ltd.** 124 I.T.R. 619., the facts were different and the Punjab and Haryana High Court hald that that even in the mercantile system of accountancy an assessee could forgo the whole or part of a debt, which was irrecoverable. There the court came to the conclusion that there was no income in view of the particular facts and circumstances of the case.

An acceptable formula of co-relating the notion of real income in conjunction with the method of accounting for the purpose of computation of income for the purpose of taxation is difficult to evolve. Besides any straight jacket formula is bound to create problems in its application to every situation. It must depend upon the facts and circumstances of each case. When and how does an income accrue and what are the consequences that follow from accrual of income are well-settled. The accrual must be real taking into account the actuality of the situtation. Whether an accrual has taken place or not must in appropriate cases be judged on the principles of real income theory. After accrual non-charging of tax on the same because of certain conduct based on the ipse dixit of a particular assessee cannot be accepted. In determining the question whether it is hypothetical income or whether real income has materialised or not, various factors will have to be taken into account. It would be difficult and improper to extend the concept of real income to all cases depending upon the ipse dixit of the assessee which would then become a value judgment only. What has really accrued to the assessee has to be found out and what has accrued must be considered from the point of view of real income taking the probability or improbability of realisation in a realistic manner and dovetailing of these factors together but once the accrual takes place, on the conduct of the parties subsequent to the year of closing an income which has accrued cannot be made "no income".

The extension of such a value judgment to such a field is a pregnant with the possibility of misuse and should be treated with caution; otherwise one would be on sticky grounds. One should proceed cautiously and not fall a prey to the shifting sands of time.

As a result of the aforesaid discussion, the following propositions emerge;

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(1) It is the income which has really accrued or arisen to the assessee that is taxable. Whether the income has really accrued or arisen to the assessee must be judged in the light of the reality of the situation. (2) The concept of real income would apply where there has been a surrender of income which in theory may have accrued but in the reality of the B situation no income had resulted because the income did not really accrue. (3) where a debt has become bad deduction in compliance with the provisions of the Act should be claimed and allowed. (4) Where the Act applies the concept of real income should not be so read as to defeat the provisions of the Act. (5) If there is any diversion of income at source C under any statute or by over-riding title then there is no income to the assessee. (6) The conduct of the parties in treating the income in a particular manner is material evidence of the fact whether income has accrued or not. (7) Mere improbability of recovery, where the conduct of the assessee is unequivocal, cannot be treated as eivdence of the D fact that income has not resulted or accrued to the assessee. After debiting the debtor's account and not reversing that entry - but taking the interest merely in suspense account cannot be such evidence to show that no real income has accrued to the assessee or treated as such by the assessee. (8) The concept of real income is certainly applicable in E judging whether there has been income or not but in every case it must be applied with care and within well-recognised limits.

We were invited to abandon legal fundamentalism. With a problem like the present one, it is better to adhere to the basic fundamentals of the law with clarity and consistency F than to be carried away by common cliches. The concept of real income certainly is a well-accepted one and must be applied in appropriate cases but with circumspection and must not be called in aid to defeat the fundamental principles of law of income-tax as developed.

For the reasons aforesaid, with respect, it is not G possible for me to agree with the answer proposed by my learned brother, Tulzapurkar, J. on the first question. In the premises question number (1) should be answered in the affirmative and in favour of the revenue and question number (2) must also, in respectful agreement with my learned brother, be answered in the affirmative and in favour of the revenue. The H appeals therefore must fail and are dismissed. But in view of

the facts and circumstances of these cases, parties will bear their own costs throughout. A

RANGANATH MISRA, J. I have had the advantage of reading the two separate judgments by my learned brothren Tulzapurkar and Mukharji, JJ.

I am in agreement with both of them that the second question had been correctly answered in favour of the Revenue by the High Court and the appeals are to be dismissed on affirmation of that conclusion so far as that aspect is concerned. B

In regard to the answer proposed for the first question, I have bestowed my careful consideration and I am in agreement with the reasonings and conclusions reached by my learned Brother Mukharji, J. I am of the view that section 36(2) of the Income Tax Act covers the entire field regarding deduction for bad debt. Though the concept of 'real income' is well recognised one, it cannot be introduced as an outlet of income from taxman's net for assessment on the plea that though shown in the account book as having accrued, the same became a bad debt and was not earned at all. It is well settled that the citizen is entitled to the benefit of every ambiguity in a taxing statute but where the law is clear considerations of hardship, injustice or anomaly do not afford justification for exempting income from taxation (see **Mapp v. Oram.**, [1969] (vol.III) All Eng. Reports 219 (H.L.) C D E

The appeals shall stand dismissed with the direction that the parties shall bear their own respective costs throughout.

O R D E R

In view of the majority judgments appeals are dismissed. F

A.P.J.