

Loss on embezzlement of funds is an allowable deduction in the year of “discovery” not in the year of “detection”

September 7, 2017

In brief

In a recent decision¹ of the Jammu and Kashmir High Court (HC), it was held that the loss on embezzlement of funds was incidental to the taxpayer’s banking business and the same should be allowed as a deduction in the year of “discovery” and not in the year of “detection”. The expression “discovery” has to be interpreted to mean that loss must be deemed to have arisen when the employer comes to know about it and realises that the loss cannot be recovered, not merely from the date of acquiring the knowledge on which embezzlement took place.

In detail

Facts

- The taxpayer, an Indian bank, claimed embezzlement loss in the return of income filed for the assessment year (AY) 1997-98.
- The taxpayer emphasised that although the embezzlement came to its knowledge in a particular year but the exact amount may be ascertained (i.e. date of discovery) after investigation in subsequent year
- The Tax Officer (TO) disallowed the claim of the taxpayer on the ground that the embezzlement came to the notice in earlier years and the taxpayer had detected the loss in

previous year. Therefore, the claim of the taxpayer was disallowed by the TO in the current AY.

- The taxpayer approached the HC against the order of the Income-Tax Appellate Tribunal (Tribunal) which had held that the loss should have been claimed in the year as soon as the same is was detected notwithstanding whether the same has had been crystallised

Issues before the High Court

- Whether the loss on account of embezzlement could be claimed when the information of embezzlement was acquired, or when the embezzlement was discovered? Whether the

terms “detection” and “discovery” had the same connotations?

- Whether the loss on embezzlement being incidental to the banking business should have been allowed as a deduction in the year of detection or the year in which it was discovered?

High Court’s judgment

- Loss of embezzlement by employees should have been treated as incidental to the business and should have been allowed as deduction in the year in which it was discovered.
- There is a difference between the expression “detection” and “discovery”. The former means that when embezzlement .

¹ ITA No. 17/2007

comes to the notice of an employer, such embezzlement is “detected” by the employer. The latter indicates detection as the result of uncovering, revealing or laying open to view what was hidden, concealed or unknown.

- That the loss must be deemed to have arisen only when the employer came to know about

it and realised that the amount embezzled could not be recovered and not merely the date of acquiring knowledge on which the embezzlement had taken place.

The takeaways

- The loss on account of embezzlement shall be taxable in the year in which the actual

amount is quantified after investigation and there is a reasonable certainty that the same cannot be recovered and not in the year in which it came to knowledge.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor

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