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Introduction

1. The expenditures which pertain to the earlier previous years are generally called prior period expenses. The mercantile system of accounting requires that expenditure should be claimed in the year to which they pertain to. For the purposes of assessment of income such prior period items assume importance as assessee would prefer to claim the prior period expenses in the current year and may ignore the income of such earlier years not offered to tax in those years. On the other hand, the Department takes a stand that expenses pertaining to prior years cannot be claimed against the income of the current year but would prefer to tax income of the earlier years if offered for tax by the assessee. This diametrically opposite view leads to litigation, even though the principle is well-settled that "an assessee cannot claim to deduct an item of liability which is not accepted by him, but which, on the contrary, is disputed by him. It is also equally well-settled that liability is deductible only when it crystallizes into an ascertained liability."In this article the principles governing the claim and allowability of prior period expenses under IT Act are summarily described below.

Substantiation of the claim is necessary

2. Where an assessee claims prior period expenditure in the current year onus is on him to substantiate the claim. Where assessee brings nothing on record to substantiate its claim neither before the lower authorities nor before Tribunal then the claim cannot be allowed. It is because the settled principle is that the deductions can be permitted in respect of only those expenses which are incurred in the relevant accounting year for the purpose of computing yearly profits and gains [refer- *Tipco Industries Ltd.* v. *ACIT* [IT Appeal No. 5708 (Mum.) of 2009, dated 3-8-2012] Where assessee is not able to prove that prior period expenses have been crystallized during relevant year, same could not be allowed as deduction. [refer- *JCL Electromet (P.) Ltd.* v. *Addl. CIT* [2017] 83 taxmann.com 250 (JP - Trib.); *Dy. CIT* v. *Cosmo Films Ltd.* [2012] 24 taxmann.com 189/139 ITD 628 (Delhi); *Lupin Ltd.* v. *Asstt. CIT* [2016] 70 taxmann.com 8/159 ITD 10 (Mum. - Trib.)]. On the other hand, where bills or claims were made during relevant year, it could be said that liability became known for first time when such claims were made and same were allowable in that year as liability got crystallized. [refer- *SRF Ltd.* v. *Dy. CIT* [2009] 34 SOT 1 (Delhi)].

Prior period expenses in percentage completion method

3. Where the Assessing Officer computes income of an assessee for the project as a whole, including that part also which relates to the period anterior to the setting-up of the project office in India, then such expenditure is allowable, so long as the expenditure is identifiable with the project. If the receipts from the project as a whole are considered, then expenditure on the project as a whole has to be deducted in accordance with matching concept which requires that the revenue has to be matched with the costs. [refer- *Dy. DIT (International Taxation)* v. *Stork Engineers & Contractors B.V.* [2010] 3 taxmann.com 22/127 ITD 211 (Mum.)].

Year when expenses crystallize

4. For deciding as to whether prior period expenditure claimed in the profit and loss account is allowable in the year in which it is debited in the profit and loss account, it is to be determined as to when the expenses actually crystallized. A liability accrues only when it is ascertained and quantified. Merely because the expenses related to the prior period and accounts are made on mercantile accounting basis, that by itself cannot be a basis to hold that the prior period expenses debited in the profit and loss account are *prima facie* not allowable. The onus is on the AO to carry out inquiries to determine as to when expenses claimed in the profit and loss account crystallized. [refer- *Asstt. CIT* v. *Indian Farmer Fertilizer Co-operative Ltd.* [2012] 21 taxmann.com 179/51 SOT 112 (Delhi) (URO)]. Some of the criteria for crystallization of liability upon the assessee are (*i*) when the claim of liability was made upon the assessee, (*ii*) when the assessee had accepted the liability to make the payment, (*iii*) whether there was any statutory order enforcing liability on the assessee, (*iv*) when the payment in respect of the liability was made, (*v*) when the fraud was detected in case of liability arising from fraud committed by employees. The Hon'ble Gujarat High Court in *Saurashtra Cement & Chemical Industries Ltd.* v. *CIT* [1995] 80 Taxman 61/213 ITR 523, held that:

"Merely because an expense relates to a transaction of an earlier year it does not become a liability payable in the earlier year, unless it can be said that the liability was determined and crystallized in the year in question on the basis of maintaining accounts on the mercantile basis. In each case where the accounts are maintained on the mercantile basis it has to be found in respect of any claim, whether such liability was crystallized and quantified during the previous year so as to be required to be adjusted in the books of account of that previous year. If any liability, though relating to the earlier year, depends upon making a demand and its acceptance by the assessee and such liability has been actually claimed and paid in the later previous years it cannot be disallowed as deduction merely on the basis the accounts are maintained on the mercantile basis and that it related to a transaction of the previous year."

4.1 ***Some examples of liability relating to prior period but crystallizing in the subsequent year:***

4.1-1 *Financial irregularities and fraud* - Where the assessee-company debited a sum to its account on account of financial irregularities committed by the erstwhile chief finance officer and an employee from the accounts department, it was held that since fraud and financial irregularities were detected during the year under consideration, the claim of such financial irregularities had to be allowed during the year under consideration. [refer- *Asstt. CIT* v. *Boots Piramal Health Care Ltd.* [2017] 81 taxmann.com 434 (Mum. - Trib.)]. The Hon'ble Supreme Court in the case of *Associated Banking Corpn. of India*

Ltd. v *CIT* [1965] 56 ITR 1 has held that "the loss by embezzlement must be deemed to have occurred when the assessee came to know about the embezzlement and realized that the amount embezzled could not be recovered".

4.1-2 Where the other party to the joint venture agreement refused to reimburse the sale promotion expenditure incurred by the assessee within the terms of the agreement, it was held that claim for expenditure had crystallized in the year when the other party refused to reimburse. The fact that expenditure was incurred and it was incurred for business purposes was not disputed. Merely because expenditure related to prior period could not be a reason to disallow the same. [refer- *Citadel Fine Pharmaceuticals (P.) Ltd.* v. *Asstt. CIT* [2018] 92 taxmann.com 79 (Chennai - Trib.)]

4.1-3 Where Custodial Fees paid to Central Depository Services India Ltd. for F.Y. 2008-09 was raised during A.Y. 2010-11, it was held that liability to payment crystallized during the A.Y. 2010-11 and, therefore, it was allowable in that year, even though it pertained to A.Y. 2009-10. [refer- *Dy. CIT* v. *Zydus Wellness Ltd.* [2016] 76 taxmann.com 328/[2017] 162 ITD 604 (Ahd. - Trib.)].

4.1-4 *Liability is crystallized on consolidation of accounts* - The assessee-bank had number of branches all over the India and certain expenses of previous year were claimed after the closing of books of account, which had been clarified by the auditor in audit report. The genuineness of the expenses had not been doubted by the lower authorities. Therefore, the prior period expenses claimed by the assessee had crystallized during the year under consideration. [refer- *State Bank of Bikaner & Jaipur* v. *Asstt. CIT* [2016] 69 taxmann.com 365 (JP - Trib.)].

4.1-5 *Liability is crystallized on discovery of errors and omissions* - Where prior period expenditure arises as a result of error or omission in preparation of the financial statement of earlier years as explained in Accounting Standard-5 issued by ICAI, the claim has to be allowed. [refer- *State Bank of Bikaner & Jaipur's* case (*supra*)].

4.1-6 *Liability crystallizes on receipt of bills* - Liability for claim would arise in the case of assessee company when bill relating to expenses are submitted to it. For example, the bills relating to travel for purposes of business of the assessee are submitted to the assessee in the current year then they have to be reimbursed. When the assessee has received the bills the liability for payment arises and further, when reimbursements are made in the current year then assessee can claim such expenses against the business income of the current year. They would be allowable. [refer- *Kellogg India (P.) Ltd.* v. *Asstt. CIT* [2013] 33 taxmann.com 397 (Mum. - Trib.); *CIT* v. *Jagatjit Industries Ltd.* [2010] 7 taxmann.com 21/194 Taxman 158 (Delhi)].

Assessee claimed deduction in respect of provision of optical fibre cable (OFC) charges on account of payment to department of telecom (DOT). AO held that such provision pertained to prior period expenses and, therefore, same could not be allowed. It was held that where bill of DOT was received during current financial year which meant that expenditure crystallized during year under consideration, the claim of deduction of provision of OFC charges was allowable. [refer- *TATA Communications Ltd.* v. *Jt. CIT* [2013] 32 taxmann.com 197/57 SOT 1 (Mum. - Trib.); *Sutna Stone & Lime Co.*

Ltd. v. *CIT* [1991] 192 ITR 478/54 Taxman 121 (Cal.); *Jagdish Prasad Gupta* v. *CIT* [2017] 85 taxmann.com 105/250 Taxman 308/397 ITR 578 (Delhi)].

4.1-7 *Liability crystallizes on revision of prices* - Where prices were revised by the supplier and as a result the assessee had to pay an amount larger than what was taken into consideration in the earlier year and it was booked as prior period expenses in the year when prices were revised, it was held that claim would be allowable in the year to which to pertained these and not in the year when it was revised. [refer- *Sony India (P.) Ltd.* v. *Dy. CIT* 2009 taxmann.com 1012 (Delhi - Trib.)]. It appears that the judgment is not free from doubt because assessee could not have anticipated in earlier year that prices were being revised in subsequent years. There could not have been any clairvoyance. In another case, it was held that liability for additional incentive would crystallize for the assessee only when assessee was informed of actual sales made by dealers and, therefore, it was entitled to deduct liability in relevant assessment year. [refer- *CIT* v. *Shri Ram Pistons & Rings Ltd.* [2008] 174 Taxman 147 (Delhi)].

4.1-8 *Liability crystallizes on execution of agreement* - Where assessee incurred expenditure between January to March 2002 but agreement was executed in August 2002 then the assessee's liability for expenditure under the agreement would arise and accrue in August, 2002, when the agreement was executed and, therefore, its liability to pay for period January, 2002 to March, 2002 arose and crystallized in August, 2002. [refer- *CIT* v. *Exxon Mobil Lubricants (P.) Ltd.* [2010] 8 taxmann.com 249/328 ITR 17 (Delhi)].

4.1-9 *Liability crystallizes when the decree is passed by High Court* - Where the assessee disputed its liability, including liability to pay interest after the date of the award of the appellate authority there was no legal liability on the part of the assessee to pay interest. It could not be said that there was any liability *in praesenti* on the part of the assessee till the time the High Court passed a decree on 28-1-2000 after the end of the accounting year. The liability to pay interest crystallized only on the High Court's passing a decree and awarding interest.[refer- *National Agrl. Co-operative Federation of India Ltd.* v. *Jt. CIT* [2010] 122 ITD 24 (Delhi)].

Expenditure covered u/s 40(a)(i)

5. Section 40(*a*)(*i*) provides that certain expenses in the nature of interest, royalty, fee for technical services will be allowed as expenditures in the year when tax deducted on their payment has been paid before due date of filing of return. Therefore, such expenses cannot be disallowed on the ground that they are prior period expenses. They will be allowed in the year when tax deducted thereon is paid before filing the return for that year. [refer- *CIT* v. *SMCC Construction India Formerly Mitsui Kensetsu India Ltd.* [2011] 198 Taxman 181/[2010] 320 ITR 534 (Delhi)]

When claim is made on the basis of stand of the Department

6. Where Department had been taking stand in the case of an assessee in an earlier year that interest paid on borrowed capital had be included in the cost of the land and later on, when the transaction did not mature and borrowed capital had to refunded to the bank with interest then the claim for interest was allowable in the year when transaction did not mature. [refer- *CIT* v. *Nav Sansar Agro Products* [2017] 88 taxmann.com 480/392 ITR 399 (Delhi)]

If income is taxed, expenditure relating thereto has to be allowed

7. Where AO made addition in respect of income earned in the earlier years on account of they having accrued in current year, it was held that expenditure relating to earning of such income had to be allowed as deduction and could not be disallowed on the ground that they were prior period expenses. Income and expenditure are correlated. If income is to be considered, then automatically expenditure in relation to such income needs to be taken care of. [refer- *Hindustan Gum & Chemicals Ltd.* v. *ITO* [2008] 23 SOT 143 (Kol.)] Thus, the tax authorities are not justified in disallowing entire amount of the prior period expenses, while assessing the entire amount of the prior period income. [refer- *Mazagaon Dock Ltd.* v. *ITO* [2017] 85 taxmann.com 213 (Mum. - Trib.)].

Conclusion

8. Even though on matching principle and under mercantile system of accounting, income and expenditure pertaining to a year should be accounted for in that year, but where the Department taxes income of prior period, it has to allow expenditure relating to such income. Expenditure is a liability. It can be allowed as deduction also in the year in which it is ascertained and quantified, or say, when it is crystallized. A liability for expenses is crystallized when either Court of law decides and/or assessee accepts or pays. It can also be claimed in a subsequent year if statute so directs.