



## Disallowance under Section 40(a)(ia) of the Income-tax Act can be made even for the amount paid during the year – Supreme Court

### Background

Recently, the Supreme Court of India (Supreme Court) in the case of Palam Gas Service<sup>1</sup> (the taxpayer) held that when the entire scheme of obligation to deduct the tax at source and paying it over to the government is read holistically, it cannot be held that the word 'payable' occurring in Section 40(a)(ia) of the Income-tax Act, 1961 (the Act) refers to only those cases where the amount is yet to be paid and does not cover the cases where the amount is actually paid. Accordingly, Section 40(a)(ia) of the Act covers not only those cases where the amount is 'payable' but also when it is 'paid' and tax has not been deducted on the same.

### Facts of the case

- The taxpayer is engaged in the business of purchase and sale of LPG cylinders under the name and style of Palam Gas Service. The main contract of the taxpayer for carriage of LPG was with the Indian Oil Corporation. Subsequently, the taxpayer had sub-contracted the same to three persons. The taxpayer had, in turn, got the transportation of LPG done through three persons to whom the taxpayer made the freight payment without deducting tax at source.
- The Assessing Officer (AO) observed that the taxpayer is liable to deduct tax at source from the payment made to sub-contractors within the meaning of Section 194C

of the Act. On account of his failure to do so, the said freight expenditure was liable to be disallowed under the provisions of Section 40(a)(ia) of the Act.

- The Commissioner of Income-tax (Appeals) [CIT(A)] upheld the order of the AO. Subsequently, the Income-tax Appellate Tribunal and the High Court upheld the order of the CIT(A).

### Supreme Court's decision

#### ***Provisions of Section 194C, 200 of the Act and Rule 30 of the Rules***

- As per Section 194C of the Act, it is the statutory obligation of a person, who is making payment to the sub-contractor to deduct tax at source at the rates specified therein. Plain language of the Section suggests that such a tax at source is to be deducted at the time of credit of such sum to the account of the contract or at the time of payment thereof, whichever is earlier. Thus, tax has to be deducted in both the contingencies, namely, when the amount is credited to the account of the contractor or when the payment is actually made.
- Section 200 of the Act imposes further obligation on the person deducting tax at source, to deposit the same with the central government or as the Central Board of Direct Taxes (CBDT) directs, within the prescribed time.

<sup>1</sup> Palam Gas Service v. CIT (Civil Appeal No. 5512 of 2017C) – Taxsutra.com

- A conjoint reading of these two Sections would suggest that not only a person, who is paying to the contractor, is supposed to deduct tax at source on the said payment whether credited in the account or actual payment made, but also deposit that amount to the credit of the central government within the stipulated time. The time within which the payment is to be deposited with the central government is mentioned in Rule 30(2) of the Income-tax Rules, 1962 (the Rules).
- The Punjab & Haryana High Court in the case of P.M.S. Diesels & Ors. has held that the liability to deduct tax at source under the provisions of Chapter XVII is mandatory in nature. While holding the aforesaid view, the Punjab & Haryana High Court has discussed the decisions of the Calcutta<sup>2</sup> and Madras<sup>3</sup> High Courts, which had taken a similar view, and concurred with the same.
- The aforesaid interpretation of Sections 194C of the Act conjointly with Section 200 of the Act and Rule 30(2) of the Rules is clear and without any doubt. Thus, imprimatur view to be taken in the present case. The Allahabad High Court<sup>4</sup>, while interpreting Section 40(a)(ia) of the Act, did not deal with this aspect at all, even when it has a clear bearing while considering the amplitude of the said provision.

### ***The concept of 'paid' and 'payable'***

- Grammatically, it may be accepted that the two words, i.e. 'payable' and 'paid', denote different meanings. The Punjab & Haryana High Court, in P.M.S. Diesels & Ors. rightly remarked that the word 'payable' is, in fact, an antonym of the word 'paid'. At the same time, it took the view that it was not significant to the interpretation of Section 40(a)(ia) of the Act.
- Discussing this aspect further, the Punjab & Haryana High Court first dealt with the contention of the taxpayer that Section 40(a)(ia) relates only to those taxpayers who follow the mercantile system and does not cover the cases where the taxpayers who follows the cash system. The said contentions were rejected by the High Court observing that the purpose of the section is to ensure the recovery of tax. The section does not indicate that this object was confined to the recovery of tax from a particular type of taxpayer or taxpayers following a particular accounting practice. As far as this provision is concerned,

no difference to the government as to the accounting system followed by the taxpayers. The government is interested in the recovery of taxes. If for some reason, the government was interested in ensuring the recovery of taxes only from taxpayers following the mercantile system, we would have expected the provision to so stipulate clearly, if not expressly.

- In view of the decision of Punjab & Haryana High Court in the case of P.M.S. Diesels & Ors. it has been observed that Section 40(a)(ia) of the Act covers not only those cases where the amount is payable but also when it is paid. One has to keep in mind the purpose for which Section 40 of the Act was enacted. We have also to keep in mind the provisions of Sections 194C and 200 of the Act. Once it is found that the aforesaid Sections mandate a person to deduct tax at source not only on the amounts payable but also when the sums are actually paid to the contractor, any person who does not adhere to this statutory obligation has to suffer the consequences which are stipulated in the Act itself.
- Certain consequences of failure to deduct tax at source from the payments made, where tax was to be deducted at source or failure to pay the same to the credit of the central government, are stipulated in Section 201 of the Act. This Section provides that such person would be deemed to be an 'assessee in default' in respect of such tax. While stipulating this consequence, Section 201 of the Act categorically states that the aforesaid Sections would be without prejudice to any other consequences which that defaulter may incur. Other consequences are provided under Section 40(a)(ia) of the Act, namely, payments made by such a person to a contractor shall not be treated as deductible expenditure. When read in this context, it is clear that Section 40(a)(ia) deals with the nature of default and the consequences thereof.
- When the entire scheme of obligation to deduct the tax at source and paying it over to the central government is read holistically, it cannot be held that the word 'payable' occurring in Section 40(a)(ia) refers to only those cases where the amount is yet to be paid and does not cover the cases where the amount is actually paid.

<sup>2</sup> CIT v. Crescent Export Syndicate [2013] 216 Taxman 258 (Cal)

<sup>3</sup> Tube Investments of India Ltd. v. ACIT(TDS) [2010] 325 ITR 610 (Mad)

<sup>4</sup> CIT v. Vector Shipping Services (P) Ltd. [2013] 357 ITR 642 (All)

- If the provision is interpreted in the manner suggested by the taxpayer therein, then, even when it is found that a person, like the taxpayer, has violated the provisions of Chapter XVIIIB (or specifically Sections 194C and 200 in the instant case), he would still go scot free, without suffering the consequences of such monetary default in spite of specific provisions laying down these consequences.
- The Punjab & Haryana High Court has exhaustively interpreted Section 40(a)(ia) of the Act keeping in mind different aspects.

### **Observation on the decision of Vector shipping**

- On reference to the Allahabad High Court's decision in the case of Vector Shipping, it would indicate that the High Court, after noticing the fact that since the amounts had already been paid, it straightaway concluded, without any discussion, that Section 40(a)(ia) of the Act would apply only when the amount is 'payable' and dismissed the appeal of the tax department stating that the question of law framed did not arise for consideration.
- Even though the Special Leave Petition against the said decision was dismissed by the Supreme Court in limine, it would not amount to confirming the view of the Allahabad High Court<sup>5</sup>.
- Accordingly, it has been held that the view taken by High Courts<sup>6</sup> is the correct view and the decision of the Allahabad High Court in the case of Vector Shipping Services (P) Ltd. did not decide the question of law correctly. Thus, the decision of the Allahabad High Court has been overruled.

### **Our analysis**

The issue with respect to disallowance of expenditure under Section 40(a)(ia) of the Act when amount is not 'payable' at the end of the year but 'paid' during the year has been a subject matter of debate before the courts. The Supreme Court has dealt with this issue and held that when the entire scheme of obligation to deduct the tax at source and paying it over to the government is read holistically, it cannot be held that the word 'payable' occurring in Section 40(a)(ia) of the Act refers to only those cases where the amount is yet to be paid and does not cover the cases where the amount is actually paid. Accordingly, Section 40(a)(ia) of the Act covers not only those cases where the amount is 'payable' but also when it is 'paid' and tax has not been deducted on the same.

<sup>5</sup> V.M. Salgaocar & Bros. (P) Ltd. v. CIT [2000] 243 ITR 383 (SC), Employees Welfare Association v. Union of India, (1989) 4 SCC 187

<sup>6</sup> Punjab & Haryana, Madras and Calcutta High Court

### **Intention behind introduction of Section 40(a)(ia)**

The Finance Act, 2004 extended the application of Section 40(a) to cover the payments made to resident without deduction of tax at source. The Memorandum to the Finance Bill, 2004 states that with a view to augment compliance of TDS provisions, it is proposed to extend the provisions of Section 40(a) to certain payments made to resident taxpayers. Since the intention of the legislature is to ensure that taxpayers will adhere to the compliance of TDS provisions, any sort of non-deduction of tax may attract disallowance under Section 40(a) of the Act.

The above intention has also been discussed by the Calcutta High Court in the case of Crescent Export. The Calcutta High Court observed that the language used by the legislature in Section 40(a)(ia) is clear and unambiguous. The law was deliberately made harsh to secure compliance of the provisions requiring deductions of tax at source. This provision nowhere requires that the amount which is payable must remain so payable throughout during the year. Any such interpretation would require reading words which the legislature has not used. No such interpretation would even otherwise be justified because, the legislature could not have intended to bring about any such distinction neither the language used in the section brings about any such meaning<sup>7</sup>. The provision has certain strict and stringent requirements before the unpleasant consequences envisaged therein can be applied. Such requirements, however, cannot be enlarged by any addition or subtraction of words not used by the legislature.

### **Mandatory nature of TDS provisions**

All TDS provisions under Chapter XVII-B require a person to deduct tax at source at the specified rates. The requirement in each section is preceded by the word 'shall'. The provisions are, therefore, mandatory. There is nothing in any of the sections that would warrant reading the word 'shall' as 'may'. The point of time at which the deduction is to be made establishes that the provisions are mandatory. This view is also supported by the decision of the Calcutta<sup>8</sup> and Madras High Courts<sup>9</sup>.

<sup>7</sup> CIT v. Sikandarkhan N Tunvar [2013] 33 taxmann.com 133 (Guj)

<sup>8</sup> CIT v. Crescent Export Syndicate [2013] 216 Taxman 258 (Cal)

<sup>9</sup> Tube Investments of India Ltd. v. ACIT(TDS) [2010] 325 ITR 610 (Mad)

### **Section 40(a)(ia) is applicable irrespective of method of accounting followed**

The purpose of Section 40(a)(ia) is to ensure the recovery of tax. There is no indication in said Section that this objective was confined to the recovery of tax from a particular type of taxpayers following a particular accounting practice. If the government intended to ensure the recovery of taxes only from taxpayers following the mercantile system, Section 40(a)(ia) would have provided so. Further Section 40(a)(ia) does not provide that taxpayers following the cash system are not liable to deduct tax at source<sup>10</sup>. Therefore, the intention is to ensure the collection of tax irrespective of the method of accounting followed by the taxpayer.

### **Discrimination**

If the interpretation as advanced by the taxpayer is accepted, it would lead to a situation where a taxpayer who though was required to deduct the tax at source but no such deduction was made, or deduction though made is not paid to the government, would escape the consequence only because the amount was already paid over before the end of the year, in contrast to another taxpayer who would otherwise be in similar situation but in whose case the amount remained payable till the end of the year. It leads to a discrimination between taxpayers who would be subjected to disallowance for payments not made during the year and taxpayers who can escape disallowance by paying off the amount during the year. Any such differentiation may result in inappropriate and seemingly contradictory consequences not intended by the legislature.

### **Per incuriam**

The Supreme Court in the case of Paras Laminates (P) Ltd<sup>11</sup>, held that the decision is given *per incuriam* when the court has acted in ignorance of a previous decision of its own or of a court of co-ordinate jurisdiction which covered the case before it.

The Allahabad High Court in the case of Vector Shipping Services (P) Ltd<sup>12</sup> without dealing with the decision of Calcutta and Gujarat High Court on the same issue have held that for disallowance of expenditure on which tax has not been deducted, the amount should be payable and not which has already been paid by the end of the year. Therefore, the decision in the case of Vector shipping Services (P) Ltd seems to be *per incuriam*.

<sup>10</sup> P.M.S Diesels v. CIT [2015] 374 ITR 562 (P&H)

<sup>11</sup> Paras Laminates (P) Ltd [1990] 186 ITR 722 (SC)

<sup>12</sup> CIT v. Vector Shipping Services (P) Ltd (ITA No.122 of 2013)

The Mumbai Tribunal in the case of Rishti Stock and Shares Pvt Ltd<sup>13</sup> dealt with this issue and held that the Allahabad High Court had given passing remarks, which are only *obiter dicta*. However, the Calcutta High Court and the Gujarat High Court had specifically disapproved it which is a *ratio decidendi* of these cases. It is the *ratio decidendi* of a decision which prevails upon the contrary *obiter dicta* of another decision.

The Supreme Court in the instant case observed that the view taken by the Allahabad High Court in the case of Vector Shipping Services (P) Ltd is not a correct view.

### **CBDT circular**

CBDT issued a circular<sup>14</sup> clarifying that disallowance under Section 40(a)(ia) would also cover amounts payable at any time during the year. It was clarified that the term 'payable' to include 'amounts which are paid during the previous year'. Though, CBDT Circular is binding on the tax authorities and not on taxpayers, it certainly provides CBDT/tax department's view on this issue.

### **Summing up**

The Supreme Court has put at rest the controversy with respect to applicability of Section 40(i)(a) of the Act vis-a-vis amounts paid or payable at the end of year. The Supreme Court has referred to all the relevant High Court decisions on this matter and has also looked into the intention behind introduction of Section 40(a)(ia) of the Act. Accordingly, it has been held that the provisions of Section 40(a)(ia) of the Act are applicable even if the amounts are paid during the year on which tax has not been deducted.

<sup>13</sup> ACIT v. Rishti Stock and Shares Pvt. Ltd (ITA No.112/Mum/2012)

<sup>14</sup> CBDT Circular No. 10/DV/2013, 16 December 2013

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