Disallowance under Section 40(a)(ia) of the Income-tax Act, 1961 – Law is evolving

Background

Recently, the High Court of Punjab and Haryana (High Court) in the case of P.M.S Diesels\(^1\) (the taxpayer) held that consequences under Section 40(a)(ia) of the Income-tax Act, 1961 (the Act) would operate on account of failure to deduct tax where the tax is liable to be deducted at source under Chapter XVII-B of the Act, and the term ‘payable’ has been used in that sense. The High Court in the present case, did not agree with the decision of the Allahabad High Court in the case of Vector Shipping Services (P) Ltd.\(^2\) wherein the Allahabad High Court had held that when expenditures incurred by the taxpayer were totally paid and did not remain payable at the end of the relevant accounting period, the provisions of Section 40(a)(ia) of the Act are not applicable.

Facts of the case

- The taxpayer has been following the mercantile system of accounting. During the scrutiny assessment, the taxpayer admitted that the tax has not been deducted at source in respect of the payments made/deemed to have been made by the taxpayer.
- In view of Section 40(a)(ia) of the Act, the Assessing Officer (AO) disallowed the expenditure relating to the amounts in respect of which tax was liable to be deducted at source and liable to be deposited to the credit of the Central Government, but was not deducted and/or deposited.

High Court’s ruling

- The Tribunal rightly held that if a taxpayer is liable to deduct tax at source under Section 194C of the Act and the taxpayer fails to do so, the payments are to be disallowed in view of Section 40(a)(ia) of the Act.
- All the Sections in Chapter XVII-B require a person to deduct tax at source at the rates specified therein. The requirement in each of the sections 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. For instance, under Section 194C of the Act, a person responsible for paying the sum is required to deduct tax at the time of credit of such source under various provisions of Chapter XVII-B. This view is supported by the judgments of the Calcutta\(^3\) and Madras High Courts\(^4\).
- The words ‘payable’ and ‘paid’ have different connotations. The word ‘paid’ is an antonym of the word ‘payable’. This however, is not significant to the interpretation of Section 40(a)(ia) of the Act.
- The purpose of Section 40(a)(ia) is to ensure the recovery of tax. There is no indication in the said Section that this object was confined to the recovery of tax from a particular type of taxpayer following a certain accounting practice.

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\(^1\) P.M.S Diesels v. CIT [ITA No.716 of 2009 (O&M), dated 29 April 2015] (P&H) – Taxsutra.com
\(^2\) CIT v. Vector Shipping Services (P) Ltd. [2013] 262 CTR 545 (All)
\(^3\) CIT v. Crescent Export Syndicate [2013] 216 Taxman 258 (Cal)
\(^4\) Tube Investments of India Ltd. and another v. ACIT (TDS) and others [2010] 325 ITR 610 (Mad)
• If for some reason, the government was interested in ensuring the recovery of taxes only from taxpayers following the mercantile system, it would be expected that the provision stipulate clearly so, if not expressly. It is not suggested that taxpayers following the cash system are not liable to deduct tax at source.

• Adherence to the provisions ensures not only the collection of tax but also enables the authorities to bring within their fold all such persons who are liable to come within the network of taxpayers. The intention was to ensure the collection of tax irrespective of the accounting system followed by the taxpayers.

• Accordingly, Section 40(a)(ia) applies not only to taxpayers following the mercantile system but also to taxpayers following the cash system.

• The term ‘payable’ only indicates the type or nature of payments by the taxpayers to the persons/payees referred to in Section 40(a)(ia), such as contractors.

• The consequences under Section 40(a)(ia) would operate on account of failure to deduct tax where the tax is liable to be deducted under the provisions of the Act and in particular Chapter XVII-B thereof, and the term ‘payable’ has been used in that sense.

• The term ‘payable’ is descriptive of the payments which attract the liability to deduct tax at source. It does not categorise defaults on the basis of when the payments are made to the payees of such amounts, which attract the liability to deduct tax at source.

• If a taxpayer recovers the amount from the payee subsequently, it would still constitute a deduction from the amount payable to the payee. It would only constitute a subsequent deduction.

• The High Court in the present case, did not agree with the decision of the Allahabad High Court in the case of Vector Shipping Services (P) Ltd. wherein the Allahabad High Court had held that when the expenditure incurred by the taxpayer were totally paid and did not remain payable at the end of the relevant accounting period, the provisions of Section 40(a)(ia) are not applicable.

• Subsequently, the Supreme Court dismissed the department’s petition for a special leave to appeal. However, the special leave petition was dismissed in limine, without giving any reason, and therefore, the dismissal did not confirm the view of the Allahabad High Court, as held by the Supreme Court in various case laws.

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**Our comments**

The issue of disallowance of expenditure under Section 40(a)(ia) of the Act has been a matter of debate before the courts. The question is whether the disallowance under Section 40(a)(ia) could be made only in respect of such amounts which are payable as on 31 March of the year under consideration or not.

The Special Bench of the Visakhapatnam Tribunal in the case of Merilyn Shipping & Transports held that the provisions of Section 40(a)(ia) of the Act are applicable only to the amounts of expenditure remaining unpaid as on 31 March every year and that the said provision would not be attracted in case the amounts have already been paid without deducting tax.

Subsequently, the Calcutta High Court in the case of Crescent Export Syndicates and the Gujarat High Court in the case of Sikandarkhan N Tunvar, have overruled the ratio laid down by the Special Bench Tribunal in the case of Merilyn Shipping. On the other hand, the Allahabad High Court in the case of Vector Shipping Services (P) Ltd, without referring to the decision of the Calcutta High Court and the Gujarat High Court, has 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.

In the present case, the High Court has held that the consequences under Section 40(a)(ia) of the Act would operate on account of failure to deduct tax where the tax is liable to be deducted at source under Chapter XVII-B of the Act and the term ‘payable’ has been used in that sense. The High Court in the present case, did not agree with the decision of the Allahabad High Court in the case of Vector Shipping Services (P) Ltd. wherein the Allahabad High Court had held that when the expenditure incurred by the taxpayer were totally paid and did not remain payable at the end of the relevant accounting period, the provisions of Section 40(a)(ia) are not applicable.

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5 Merilyn Shipping & Transports v. ACIT [2012] 20 taxmann.com 244 (Vis)
6 CIT v. Sikandarkhan N Tunvar [2013] 33 taxmann.com 133 (Guj)

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