

## TAX FLASH NEWS

### Mere passing of the book entries, which are subsequently reversed, would not give rise to an obligation to deduct tax at source under the Income-tax Act

#### Background

Recently, the Delhi High Court<sup>1</sup> held that mere passing of book entries, which are subsequently reversed, would not give rise to an obligation to deduct tax at source since there is no debt acknowledged by the payer. No income had accrued or arisen or deemed to have accrued or arisen, which is chargeable to tax in the hands of a payee. Imposition of an obligation to deduct tax at source in these circumstances would amount to enforcing payments from one person towards a tax liability of another, even where the person does not acknowledge that any sum is payable. This is contrary to the scheme of provisions relating to a collection of tax deducted at source under the Income-tax Act, 1961 (the Act). Therefore, the taxpayer was not obliged to deduct tax at source.

#### Facts of the case

- The taxpayer, an Indian company, is engaged in the business of installation and commissioning of telecom projects and information technology systems relating thereto. The taxpayer is a wholly owned subsidiary of a company incorporated in Sweden.
- The taxpayer entered into a Corporate Visual Identity Agreement with the holding company for the use of the trademark. In terms of the agreement, the taxpayer was obliged to pay royalty at 1 per cent of the total sales to holding company, for the use of the trademark.
- In order to account for the royalty payable under the aforesaid agreement, the taxpayer passed an entry in the books of accounts debiting 'royalty account'

and crediting 'accrued expenses account'.

Subsequently, the taxpayer passed another entry in its books transferring the credit balance standing in the 'accrued expenses account' to the account of the holding company, thereby crediting the holding company's account in the ledger maintained by the taxpayer. The taxpayer neither deducted nor paid any tax at source in respect of the amount credited to the account of the holding company maintained by the taxpayer in its books.

- Subsequently, the taxpayer reversed the entries passed in its books of accounts by debiting the account of the holding company and crediting royalty account. Thus, the entries passed earlier were nullified.
- The Assessing Officer (AO) held that the taxpayer was liable to deduct tax at source under Section 195 of the Act. However, having defaulted in deducting tax at source on the amount of royalty credited by the taxpayer to the account of holding company, the AO passed an order under Section 201(1) of the Act.
- The Commissioner of Income-tax (Appeals) [CIT(A)] upheld the order of the AO. However, the Income-tax Appellate Tribunal (the Tribunal) held that there was no accrual of income on account of royalty in the hands of the holding company, which resulted in an obligation on the part of the taxpayer to deduct any tax at source.

#### High Court's ruling

- On a perusal of Section 195(1) of the Act, it indicates that the obligation of a payer to deduct tax at source arises when the amounts payable are credited into the accounts of the payee, even if the same is credited prior to making the payment thereto. However, this obligation is contingent on the amount credited being chargeable to tax under the provisions of the Act.

<sup>1</sup> Taxsutra.com

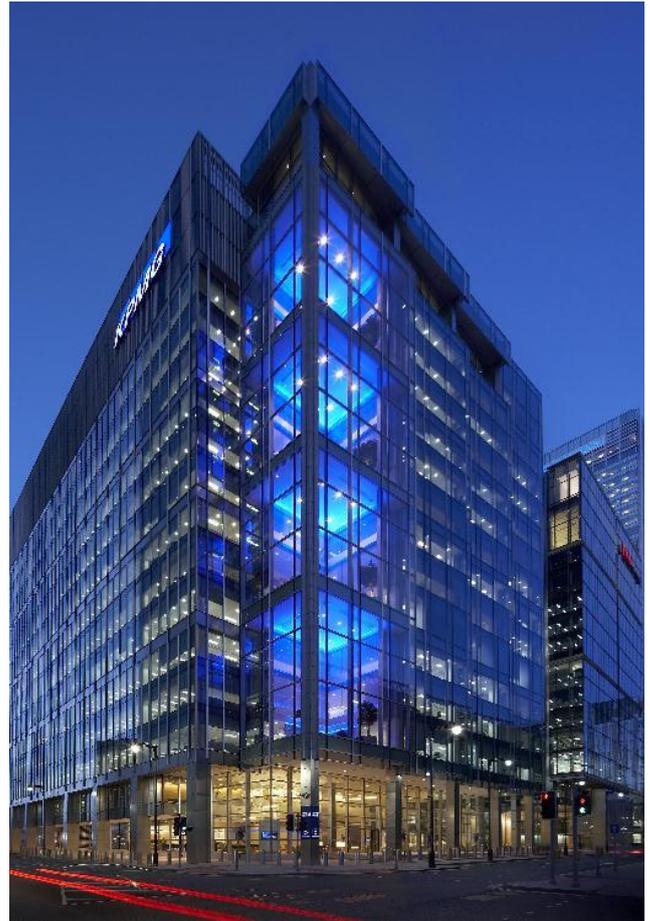
- Thus, all sums credited/paid are not to be subjected to withholding tax and the provisions of Section 195(1) of the Act are only applicable where the sums in question either credited to the account of the intended recipient or actually paid are chargeable to tax under the Act.
- In the present case, the taxpayer firmly contended that no income chargeable to tax arose or accrued in relation to or as a result of the entries in question, passed by the taxpayer in its books of accounts. It is necessary to bear in mind that the provisions of Section 195 of the Act fall in Chapter XVII of the Act, which relates to collection and recovery of tax. The machinery Sections of collection and recovery of tax cannot be read in isolation of the charging provisions.
- Section 195 of the Act which is a part of the machinery provisions for collection of tax would be applicable only in respect of a total income of a non-resident or a foreign company which falls within the scope of Section 5(2) of the Act.
- Reading the language of Section 195(1) of the Act, it is clear that credit of any amount to the account of a non-resident or foreign company, maintained in the books of the payer, would be subject to withholding tax only if credit of such amount reflects accrued income in the hands of the payee, which is chargeable to tax under the Act.
- It is also necessary to understand that once tax has been deducted by any person, he has an obligation to deposit the same with the income tax authorities. Such amount is treated by the authorities as the tax paid to the credit of the person whose account is credited. The payer ceases to have any control over the said amount deducted and deposited with the income tax authorities and cannot seek a refund of such tax. It is only the payee who can interact with the income tax authorities in respect of such amount deposited in its favour.
- The rationale for imposing an obligation to deduct tax at source on a credit entry being passed by a payer in favour of payee is that such entry represents an acknowledgement of debt by a payer in favour of a payee. The debt acknowledged is in respect of an income that has accrued in favour of the payee and such income is exigible to tax under the Act.
- Once a payer has unequivocally acknowledged the debt payable by crediting the account of payee in its books or has actually paid the same (whichever is earlier), the provisions of Chapter XVII of the Act relating to deducting tax at source and depositing with the income tax authorities are triggered and not otherwise.
- It is also necessary that the question whether a transaction results in an obligation to deduct tax at source, be viewed from the standpoint of the payer and not from the standpoint of a person claiming any amount from the payee. Thus, if a debt owed by a person is not acknowledged as payable, there would be no obligation to withhold or deposit any tax.
- The obligation imposed on a person to deduct tax at source and deposit the same with the tax authorities is an obligation similar in nature to the directions in garnishee proceedings where the person obliged to deduct tax at source stands as a garnishee and tax authorities stand as a garnisher. There cannot be an obligation to pay, where the debt allegedly payable is disputed by a garnishee.
- The obligation of a person to deduct tax at source under Section 195(1) of the Act would arise only if it satisfies the specified conditions. In the present case, the entries passed by the taxpayer in its books of accounts were indisputably reversed and consequently its effect was nullified. The taxpayer had also not charged the amount of royalty for the relevant period as expenditure in its books. There was no allegation that this position asserted by the taxpayer was not *bona fide*. It was not the case of the tax department that nullifying the entries passed by the taxpayer was a subterfuge to avoid any obligation.
- The taxpayer had provided an explanation for the reversal of entries relating to royalty in its books by referring to the industrial policy issued by the Government of India. The taxpayer had accepted that no royalty was to be payable by the taxpayer to the holding company at the relevant time. The taxpayer had also not charged the same as expenditure in its books.
- In such circumstances, it was difficult to accept that there was any income chargeable to tax which had accrued in favour of the holding company. The taxpayer cannot be held to have acknowledged the same by crediting the account of the holding company, as admittedly, that entry had been reversed.
- Mere passing of the book entries, which were reversed, would not give rise to an obligation to deduct tax at source by the taxpayer, as clearly, there was no debt that can be said to be acknowledged by the taxpayer. Imposition of an obligation to deduct tax at source in these circumstances would amount to enforcing payments from one person towards a tax liability of another, even where the person does not acknowledge that any sum is payable. This is contrary to the scheme of provisions relating to the collection of tax deducted at source under the Act.

- Accordingly, no income had accrued or arisen or deemed to have accrued or arisen, which is chargeable to tax in the hands of holding company.
- In the absence of any income chargeable to tax arising on account of royalty in the hands of holding company, the question of withholding of tax would not arise. The decision of the Supreme Court in the case of Transmission Corporation of AP Ltd.<sup>2</sup> is distinguishable on the facts of the case. Accordingly, the taxpayer was not obliged to deduct tax at source.

## Our comments

Whether merely passing a book entry can raise an obligation to deduct tax at source, this has been a matter of debate before the Courts/Tribunal.

In the instant case, the Delhi High Court has held that mere passing of the book entries, which have subsequently been reversed, would not give rise to an obligation to deduct tax at source since there is no debt acknowledged by the taxpayer. No income had accrued or arisen or deemed to have accrued or arisen, which is chargeable to tax in the hands of a payee. Imposition of an obligation to deduct tax at source in these circumstances would amount to enforcing payments from one person towards a tax liability of another, even where the person does not acknowledge that any sum is payable. This is contrary to the scheme of provisions relating to the collection of tax deducted at source under the Act.



<sup>2</sup> Transmission Corporation of AP Ltd. v. CIT [1999] 239 ITR 587(SC)

[www.kpmg.com/in](http://www.kpmg.com/in)

**Ahmedabad**

Commerce House V, 9th Floor,  
902 & 903, Near Vodafone House,  
Corporate Road,  
Prahlad Nagar,  
Ahmedabad – 380 051  
Tel: +91 79 4040 2200  
Fax: +91 79 4040 2244

**Bengaluru**

Maruthi Info-Tech Centre  
11-12/1, Inner Ring Road  
Koramangala, Bangalore 560 071  
Tel: +91 80 3980 6000  
Fax: +91 80 3980 6999

**Chandigarh**

SCO 22-23 (1st Floor)  
Sector 8C, Madhya Marg  
Chandigarh 160 009  
Tel: +91 172 393 5777/781  
Fax: +91 172 393 5780

**Chennai**

No.10, Mahatma Gandhi Road  
Nungambakkam  
Chennai 600 034  
Tel: +91 44 3914 5000  
Fax: +91 44 3914 5999

**Delhi**

Building No.10, 8th Floor  
DLF Cyber City, Phase II  
Gurgaon, Haryana 122 002  
Tel: +91 124 307 4000  
Fax: +91 124 254 9101

**Hyderabad**

8-2-618/2  
Reliance Humsafar, 4th Floor  
Road No.11, Banjara Hills  
Hyderabad 500 034  
Tel: +91 40 3046 5000  
Fax: +91 40 3046 5299

**Kochi**

Syama Business Center  
3rd Floor, NH By Pass Road,  
Vytilla, Kochi – 682019  
Tel: +91 484 302 7000  
Fax: +91 484 302 7001

**Kolkata**

Unit No. 603 – 604,  
6th Floor, Tower – 1,  
Godrej Waterside,  
Sector – V, Salt Lake,  
Kolkata 700 091  
Tel: +91 33 44034000  
Fax: +91 33 44034199

**Mumbai**

Lodha Excelus, Apollo Mills  
N. M. Joshi Marg  
Mahalaxmi, Mumbai 400 011  
Tel: +91 22 3989 6000  
Fax: +91 22 3983 6000

**Noida**

6th Floor, Tower A  
Advant Navis Business Park  
Plot No. 07, Sector 142  
Noida Express Way  
Noida 201 305  
Tel: +91 0120 386 8000  
Fax: +91 0120 386 8999

**Pune**

703, Godrej Castlemaine  
Bund Garden  
Pune 411 001  
Tel: +91 20 3050 4000  
Fax: +91 20 3050 4010

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

© 2015 KPMG, an Indian Registered Partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name, logo and "cutting through complexity" are registered trademarks or trademarks of KPMG International Cooperative ("KPMG International").

This document is meant for e-communications only.

© 2015 KPMG, an Indian Registered Partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.