



No tax is to be deducted when interest has not been paid and the provision has been reversed in the books of accounts as no income is accrued to the payee

Background

Recently, the Karnataka High Court (High Court) in the case of Karnataka Power Transmission Corporation Limited¹ (the taxpayer) held that when interest has not been paid to the payee and the provision of the same has been reversed in the books of accounts, there would be no liability to deduct tax as no income has accrued in the hands of the payee. Since interest is not considered to be an income of the payee, Section 194A(1) of the Income-tax Act, 1961 (the Act) is not applicable.

Facts of the case

The taxpayer is an undertaking of the Government of Karnataka engaged in power transmission. The taxpayer purchases electricity from various parties by entering into power purchase agreements. For such purchases, when payment of purchase price is delayed, the agreements provide for the payment of interest to the suppliers of electricity by the taxpayer.

- However, in respect of financial year ending 31 March 2007, a similar provision towards contingent interest payable on belated payments was created but at the end of the year, the said amount though was treated as expenditure in the profit and loss account and was not excluded to arrive at the taxable income in the return of income filed for the AY 2007-08.
- During the AYs 2005-06, 2006-07 and 2007-08, the taxpayer had created provisions for contingent payment of interest on belated payments to its suppliers. For the first two years, the taxpayer in their profit and loss account treated the said amount of provision as expenditure to arrive at the profit. However, in the return of income filed for the AY 2005-06 and 2006-07, the taxpayer did not treat the said amount of provision towards contingent interest payable as expenditure.
- The taxpayer claimed that since these provisions are created by way of book entries towards contingent interest payable for AYs 2005-06 and 2006-07, corresponding reversal entries were made in the books of accounts during the financial year 2007-08, indicating that the said amounts of provision towards contingent interest would never be paid.

¹ Karnataka Power Transmission Corporation Limited v. DCIT (ITA Nos.750 and 758-759/2009) – Taxsutra.com

- The Assessing Officer (AO) applied the provisions of Section 194(A)(1)² of the Act and held that the taxpayer should have deducted tax at source on the amount of provision made towards interest payable in respect of related purchase payments. Since the taxpayer did not deduct tax at source, the taxpayer was treated as an 'assessee in default' under the provisions of Section 201(1) and held liable to pay interest under Section 201(1A) of the Act.
- The Commissioner of Income-tax (Appeals) [CIT(A)] and the Bangalore Bench of the Income Tax Appellate Tribunal (the Tribunal) upheld the order of the AO.

High Court's ruling

Applicability of Section 194A of the Act

- Section 194A of the Act mandates the tax deductor to deduct 'income tax' on 'any income by way of interest other than income by way of interest on securities'. The phrase 'any income' and 'income tax thereon' if read harmoniously, would indicate that the interest which finally partakes the character of income, alone is liable for deduction of income tax on that income by way of interest.
- If the said interest is not finally considered to be an income of the deductee, as per the reversal entries of the provision in the present case, Section 194A(1) of the Act would not be made applicable. In other words, if no income is attributable to the payee, there is no liability to deduct tax at source in the hands of the tax deductor.
- In view of the admitted fact that interest was having not been paid to the payees and reversed in the books of accounts, there would be no liability to deduct tax as no income accrued to the payees.

² Any person, not being an individual or a Hindu Undivided Family, who is responsible for paying to a resident any income by way of interest other than income (by way of interest on securities), shall, at the time of credit of such income to the account of the payee or at the time of payment thereof in cash or by issue of a cheque or by draft or by any other mode, whichever is earlier, deduct income-tax thereon at the rates in force.

- The Delhi High Court while dealing with the case³ of Section 195 of the Act observed that the obligation of a person to deduct tax at source would be applicable to 'income chargeable under the Act'. The absence of such words 'chargeable to tax' under the provisions of Section 194A of the Act would not empower the authorities to invoke the provisions of Sections 201 and 201(1A) of the Act ignoring the words 'any income by way of interest'.
- It is the case of the taxpayer that the provision which was contingent was at no time materialised as income to be liable for payment of income tax on the said provision of interest.
- On perusal of the decision of the Supreme Court in the case of Kedarnath Jute Mfg. Co. Ltd.⁴ it indicates that the existence or absence of entries in the books of accounts is not a decisive or conclusive factor in deciding the right of the taxpayer claiming the deduction. The said Judgement is squarely applicable to the facts of the present case.

Applicability of Section 201(1) of the Act

- Section 200(1) of the Act contemplates that 'any person deducting any sum in accordance with the provisions of Chapter-XVII, shall pay within the prescribed time, the sum so deducted to the credit of the central government or as the board directs.
- Section 200(2) of the Act contemplates that any person being an employer referred to in Section 192(1A) of the Act shall pay, within the prescribed time, the tax deducted to the credit of the central government or as the board directs.
- In view of the aforesaid provisions, prior to passing of the Finance Act, 2008, the provisions of Section 200 of the Act mandated that the amount of tax deducted should be paid to the credit of the central government. It does not refer the person who has not deducted tax at source.

³ 61 taxmann.com 117 (Del)

⁴ Kedarnath Jute Mfg Co. Ltd [1971] 82 ITR 0363 (SC)

- If the said Section 200 of the Act is applied to Section 201(1) of the Act, it is only the following three categories of persons who are liable for the consequence of failure to deduct tax at source (a) any person deducting any sum (b) employer, who provides perquisites and (c) company making payment of dividends.
- The provisions of Section 201(1) of the Act have been amended⁵ and the term 'any such person' is substituted with 'any person' including the principal officer of the company. A new clause 'who is required to deduct any sum in accordance with the provisions of the Act' is introduced. This amendment is given retrospective effect from 1 June 2002 and has received the assent of the President of India on 10 May 2008.
- On a perusal of the facts of the present case, it indicates that the AO has passed the order based on a non-existent law during the interregnum period between the periods of the Finance Bill becoming the Finance Act by the assent of the President.

On perusal of the CBDT Circular No.1/2009 dated 27 March 2009 relied on by the tax department, it indicates that it was the intention of the legislature to bring the person i.e. the Principal Officer of a company who is required to deduct any sum in accordance with the provisions of the Act under the umbrella of Section 201(1) of the Act. The same is clarified by the Finance Act, 2008 with retrospective effect from 1 June 2002.

- This amendment in the Act was not in force at the time of passing of the order by the AO. Accordingly, the order of the Tribunal upholding the views of the AO and the CIT(A) would go contrary to the provisions of Section 201(1) of the Act that existed during the relevant time.

Our comments

The Karnataka High Court in the instant case has held that no tax is to be deducted when interest has not been paid, and the provision has been reversed in the books of accounts as no income is accrued to the payee.

The Karnataka High Court referred to the Delhi High Court's decision where it was held that mere passing of 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, 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 such circumstances could amount to enforcing payments from one person towards the tax liability of another, even where the person does not acknowledge that any sum is payable.



⁵ By the Finance Act 2008, with effect from 1 June 2002

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