



REJECTION OF BOOKS OF ACCOUNT BY AO – A STUDY

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Books of account of an assessee are a must for assessment proceedings. The Income Tax Act, 1961, The Income Tax Rules, 1962 contain elaborate provisions with respect to maintenance of books of account and number of Income computation and disclosure Standards. The assessee as well as the Assessing Officer are bound to keep them in mind while completing their respective statutory duties in order to minimize rejection of books accounts and its consequences.

Introduction

1. Section 145 of the Income Tax Act 1961, provides that income chargeable under the head "Profit & Gains of Business or Profession or Income from other sources", subject to accounting standards as notified by the central government (i.e., Income Computation and Disclosure Standards or in short "ICDS") shall be computed in accordance with either cash or mercantile system of accounting.

Prior to 1st April 1997: The said Section allowed an assessee to follow either the cash or mercantile or the hybrid system which has elements of both aforesaid methods.

After 1st April 1997: Since the hybrid system does not reflect the correct income, the said section has been amended vide Finance Act 1995 w.e.f 01.04.1997. According to amendment income chargeable under the head "Profit & Gains of Business or Profession or Income from other sources" shall be computed only in accordance with either cash system or mercantile or accrual system of accounting. Accordingly, the amendment will be applicable from the assessment year 1997-98 onwards.

What are Books of Account?

2. According to P. Ramanatha Aiyar's Concise Law Dictionary, unbound sheets of paper in whatever quantity, though filled up with one continuous account are not books of account. The books of account signify a collection of sheets of paper bound together with the intention that such binding shall be permanent and the papers used shall be collectively in one volume.

According to Section 2(12A) of the Income Tax Act, 1961, books or books of account, include ledgers, day-books, cash books, account-books and other books, whether kept in the written form or as print-outs of data.

The Hon'ble Income Tax Appellate Tribunal, Delhi Bench, in Brij Lal Goyal v. Asstt. CIT [2004] 88 ITD 413 held that the Books of Account mean those books of account whose main object is to provide credible data and information to file the tax returns.

Interestingly, Section 145 does not specify any set of accounts to be maintained by an assessee. Also, Rule 6F of Income Tax Rules, 1962 prescribes certain set of books only for professionals and not for other assessees or businesses or traders.

What is Acceptance of Books of Account?

3. In business or profession and in respect of income from other sources, the assessee is required to maintain certain accounts showing day-to-day transactions either in cash or in mercantile system of accounting. The system of accounting adopted by the assessee for his dealing with outside world, say for public information would be adopted for the purpose of computing the profit or loss for tax purposes also. Section 145(1)

Further, accounts are required to be audited with unqualified reports and must be consistent with the chosen method.

In *Md. Umer v. CIT* [1975] 101 ITR 525 (Pat.) it was held that where none of the three situations as provided in Sub-Section 3 of Section 145 (discussed in subsequent paragraphs) exists, a method of accounting regularly followed by the assessee must be accepted.

The Hon'ble Supreme Court in *Indore Malwa United Mills Ltd. v. State of Madhya Pradesh* [1966] 60 ITR 41 held that when an assessee produces before the Assessing Officers all relevant registers, it is not open to the revenue to pick and choose some of the registers which are in its favour.

Whether there can be different methods of accounting for different sources?

3.1 The answer is in the affirmative. The Hon'ble Allahabad High Court in *JK Bankers v. CIT* [1974] 94 ITR 107 held that there can be different methods of accounting for a different source of income.

What is Rejection of Books of Account?

4. Under Income Tax provisions, the Assessing officer has a discretionary power to reject books of account as assessed by an assessee and complete his assessment by "Best Judgment Assessment." It is Assessing Officer's duty to determine the method of accounting regularly employed by an assessee and assess the income, profit and loss in accordance with such method of accounting.

Sub-section (3) of Section 143 empowers the Assessing Officer to make Best Judgment Assessment as provided under Section 144. There are three circumstances, which are –

- (i) *If not satisfied with the correctness or completeness of accounts; or*
- (ii) *If either cash or mercantile system has not been followed consistently; or*
- (iii) *If notified accounting standards have not been followed consistently.*

"Followed consistently" - In *CIT v. Woodward Governor* [2009] 312 ITR 254/179 *Taxman* 326 the Hon'ble Supreme Court held that the accounting method followed by an assessee continuously for a given period of time has to be presumed to be correct till the Assessing Officer comes to know the

reasons to be given that system does not reflect correct picture and true profits.

Methods of Accounting Recognized

5. As said above, up to 31st March 1997, the Central Government has allowed to follow either the cash or mercantile or the hybrid systems. Consequent to amendment brought vide Finance Act, 1995 w.e.f 1st April 1997, Section 145 recognizes only two methods of accounting to compute income chargeable under the head "Profit & Gains of Business or Profession or Income from other sources."

The Hon'ble Supreme Court in *Morvi Industries Ltd. v. CIT* [1971] 82 ITR 835 held that under the cash system, it is only actual cash receipts and actual cash payments that are recorded.

The mercantile or double entry or accrual system is different from cash system where credit entries are made. The Hon'ble Supreme Court *Morvi Industries Ltd.* (supra) held that when credit entries are made under mercantile system, they become legally due and before they are actually received. Similarly, the expenditure incurred is immediately debited even before the amounts in question are actually settled.

Cash or Mercantile System - It is a matter of choice..!!

6. Even though there is aforesaid amendment, yet the choice of selecting suitable method of accounting still remains with the assessee. The revenue cannot compel an assessee to adopt mercantile system of accounting. If the assessee chooses to adopt cash system under Section 56 of the Act, he cannot be assessed on the accrual basis. *J.K Bankers case (supra)*

Apex Court's Observation on recognized methods

7. The Hon'ble Supreme Court in *CIT v. A Krishna Swamy Mudaliar* [1964] 53 ITR 122 observed that in some cases recognized systems, say cash as well as mercantile system may not give a clear picture of the true profits earned and certainly not of taxable profits.

Income Computation and Disclosure Standards - In Brief

8. For the mercantile system of accounting, the Central Government may prescribe certain standards for computation of income and its

disclosure with respect to a class of income or assessees.

Accordingly, the Central Government, vide Notification No. S.O. 3078 (E), dated 29.09.2016 notified "Income Computation and Disclosure Standards" which apply to all kinds of assessees

except Individuals and HUFs who are not required to get their accounts audited under the provisions of Section 44AD of the Act.

The said Notification will be applicable from the assessment year 2017-18 and subsequent assessment years.

9. Prescribed Income Computation and Disclosure Standards

Sl.No	ICDS	Relating to
1.	ICDS – I	Accounting Policies
2.	ICDS – II	Valuation of Inventories
3.	ICDS – III	Construction Contracts
4.	ICDS – IV	Revenue Recognition
5.	ICDS – V	Tangible Fixed Assets
6.	ICDS – VI	Effects of changes in Foreign Exchange Rates
7.	ICDS – VII	Government Grants
8.	ICDS – VIII	Securities
9.	ICDS – IX	Borrowing Costs
10.	ICDS – X	Provisions, Contingent Liabilities & Contingent Assets

Constitutional Validity of ICDS - Recent Pronouncement

10. The Hon'ble Delhi High Court in "Chamber of Tax Consultants v. Union of India [2017] 87 taxmann.com 92, held that in order to preserve its constitutionality, Section 145(2) of the Income Tax Act, 1961 has to be read down to restrict power of the Central Government to notify ICDS that does not seek to override binding judicial precedents or provisions of the Act. The power to enact a validation law is an essential legislative power that can be exercised, in the context of the Act, only by the Parliament and not by the executive. If Section 145 (2) of the Act as amended is not so read down it would be ultra vires, the Act and Article 141, read with Articles 144 and 265 of the Constitution.

The ICDS is not meant to overrule the provisions of the Act, the Rules thereunder and the judicial precedents applicable thereto as they stand.

The Hon'ble Delhi High Court, to certain extent has been struck, namely, ICDS - I, II, III, IV, VI, VII, VIII by stating that ultra vires to the Income Tax Act, 1961.

The moot point here is Whether the latest verdict is binding outside the Delhi jurisdiction?

10.1 It is appropriate to mention that the Hon'ble Bombay High Court *Ballarpur Industries Ltd. v. Union of India* [1987] 30 ELT 267 held that a verdict

by any High Court must be binding unless there is a different decision by a High Court or the Apex Court.

Rejection of Books of Account - Whether Justified?

10.2 As said above, the Assessing Officer has a discretionary power to reject books of account. The accounting method may be rejected by virtue of sub-Section (1) of Section 145. Further, books of account itself by virtue of said sub-section, read with Section 144 or under sub-section (3) of Section 143.

10.3 Instances of rejection of books of account –

- ◆ Where entries in respect of certain transactions are altogether omitted or incorrect, etc.
- ◆ Where the accounts show an abnormally low rate of profit
- ◆ Where there is an inherent lacuna in the system of accounting

The assessment completed after the rejection of books of account under Section 145 is not an assessment under Section 144 but is only an assessment under Section 143(3) which is to be made in the manner provided in Section 144.

Burden of Proof

10.4 It is for revenue to consider whether there are sufficient grounds for rejecting a method of

accounting regularly employed by an assessee? In *Veeraiah Reddier v. CIT* 385 ITR 152 (sic.) and *Punjab Trading Co. Ltd. v. CIT* [1964] 53 ITR 335 (Punj. & Har.), it was held that it is not for the assessee to prove that the method of accounting followed ought not to be rejected.

10.5 Whether rejection is justified?

Yes. Justified..!! But not in all instances..!!

Before rejection of books of account, the Assessing Officer must record a clear finding that system of accounting followed by an assessee cannot deduce correct profit or income. Where the accounts are consistently maintained on a basis that has been accepted in the past and there is no material to indicate how it was defective the Assessing Officer cannot reject the books of account merely because in his view, a different method of accounting would be better suited. *CIT v. Margadarshi Chit Funds (P.) Ltd.* [1985] 155 ITR 442/[1984] 19 Taxman 73 (AP).

11. Relevant case laws

11.1 In Favour of Revenue

11.1.1 The Hon'ble Supreme Court in *Kachwala Gems v. Jt. CIT* [2007] 288 ITR 10/158 Taxman 71 held that rejection of books of account under section 145 justified and best judgment assessment under section 144 of the Act needed.

Brief facts: The assessee was dealing in precious stones. The Assessing Officer noticed certain defects in his books of account. The Assessing Officer did not find any evidence or records to verify the closing stock. Hence, the Assessing Officer resorted to best judgment assessment.

11.1.2 The Hon'ble Bombay High Court in *Bastiram Narayandas v. CIT* [1994] 210 ITR 438/74 Taxman 454 held that rejection of books of account justified under section 145 and best judgment assessment under section 144' needed.

Brief facts: The assessee, a Bidi manufacturer, has failed to produce relevant records of its day-to-day manufacture of Bidis.

11.1.3 The Hon'ble Madras High Court in *Abdul Khadar (P.) v. CIT* 36 ITR 341 (sic.) held that presence of unexplained cash credits may justify rejection of books of account.

11.1.4 The Hon'ble Jharkhand High Court in *Amitabh Construction (P.) Ltd. v. CIT (Addl.)* [2011] 335 ITR 523/[2012] 20 taxmann.om 385 held that where purchases are found not to be genuine, the books of account have been rejected rightly.

11.1.5 The Hon'ble Income Tax Appellate Tribunal, "A" Bench, Jaipur, in *Champa Lal Choudary v. Dy. CIT* [2012] 54 SOT 398/24 taxmann.com 308 confirmed the rejection of books of account.

Brief facts: The assessee was a stone dealer and his books of account did not meet the test of deduction of the true and correct picture of profits due to improper stock records.

11. 2 In Favour of Assesseees

11.2.1 The Hon'ble Supreme Court in *CIT v. Padamchand Ramgopal* [1970] 76 ITR 719 held that insignificant mistakes noticed in the books of account of one year, like one item of interest not brought into account or one item of receipt having been incorrectly recorded, cannot form the basis for rejection of books of account.

Brief facts: The assessee, a HUF was in various businesses including money lending, had produced his books of account books. The Income-tax Officer rejected them by stating they were unreliable and completed his assessment by best judgment assessment. The Assessing Officer in his order did not give any reason for not relying on the accounts submitted.

On appeal, the Assistant Commissioner of Income Tax (Appeals), found that in Assessing Officer's order one of the items of interest received by the assessee during the accounting year had not been brought to account and another entry relating to the receipt of income during that year was not correct.

11.2.2 The Hon'ble Karnataka High Court, recently, in *CIT v. Anil Kumar & Co.* [2016] 386 ITR 702/67 taxmann.com 278 held that jurisdiction to estimate assessee's income is not available when books of account have not been rejected.

11.2.3 The Allahabad High Court, recently, in *CIT v. Pashupati Nath Agro Food Products (P.) Ltd* dated 4th May 2017 held that the Assessing Officer did not reject the books of account; it shows that the assessee has maintained the books of account as prescribed under Section 145 of the Act. If so, the

Assessing Officer is not entitled to make any addition on account of sale of goods out of books or for investment in stock out of undisclosed sources.

Appellate Authority - Powers of

12. Even though Section 145 empowers an Assessing Officer to reject the books of account under such circumstances, it is well-settled position that the Commissioner of Income Tax (Appeals) during appellate proceedings has all the powers entrusted on Assessing Officer for the first time in appeal. *CIT v. McMillan & Co.* [1958] 33 ITR 182 (SC)

Reference To Court

13. The question related to the Method of accounting, *Method adopted regularly or not, Profits and gains deduced properly, Change in method of valuation of stock*, is mixed of question of fact and law. In number of cases, it was held that there was no substantial question of law in the context of Section 145 and sub-section (2) of Section 145. To name a few:

- ◆ *CIT v. Bhawan & Path Nirman Bohra* [2002] 258 ITR 676/[2003] 127 Taxman 467 (Raj.)
- ◆ *CIT v. Fazilka Co- Op Sugar Mills Ltd.* [2002] 255 ITR 411/125 Taxman 375 (Raj. & Har.)
- ◆ *CIT v. Ghodawat Pan Masala Products* [2001] 250 ITR 570/119 Taxman 206 (Bom.)
- ◆ *CIT v. Bansal Rice & General Mills* [2001] 250 ITR 588/119 Taxman 212 (Raj. & Har.)
- ◆ *Saddruddin Hussain v. CIT* [2002] 120 Taxman 798 (Raj.)

Interestingly, in many cases it was also held that Section 145 involves only findings of facts or question of facts. To name a few:

- ◆ *Relaxo Footwear v. CIT* [2003] 259 ITR 744/[2002] 123 Taxman 322 (Raj.)
- ◆ *Action Electricals v. Dy. CIT* [2002] 258 ITR 188/[2003] 132 Taxman 640 (Delhi)
- ◆ *Chetan Das Lachhman Dass v. CIT* [2002] 255 ITR 197/122 Taxman 351 (Delhi)

Rejection of Books of Account - Impact of

14. The rejection of the books helps in computing correct income, profit and gains and, accordingly, tax liability.

Impact of rejection of books of account may be summarized as follows:

Addition of lump sum

14.1. When the books are rejected, a lump sum addition is made to the original return of income. Such addition may be based on estimate of turnover and profit rate or disallowance of claims, expenditure, etc. *CIT v. Pilliah & Sons* [1967] 63 ITR 411(SC)

Addition of Specific items

14.2. The Assessing Officer may consider to add certain omissions, defects, etc. Addition to an estimate of the gross receipts or only one of the additions depends on each case. *Akhtari Begum & Sons v. CIT* [1984] 145 ITR 295/[1983] 12 Taxman 79 (MP).

Conclusion

15. The Assessing Officer before resorting to reject books of account, is obliged to use his powers judicially without compromising on the principles of natural justice and also bring on record of material on which basis he concludes his assessment.

Reference

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3. Taxmann's Direct Taxes Manual Vol. 3 47th Edition
4. Sampath Iyengar's Law of Income Tax 12th Edition
5. A N Aiyar's Indian Tax Laws 2017 54th Edition