EDUCTION OF INCOME TAX AT SOURCE UNDER SECTION 194 C OF INCOME TAX ACT 1961, FROM YEAR END PROVISIONS MADE IN THE ACCOUNTS

CMA Niranjan Swain
Advocate, Odisha High Court

1. BACKGROUND

Maintenance of Books of Accounts is one of the mandatory compliances that every business assesseee including company needs to follow.

1.1 Section 128 of the Companies Act 2013 provides that books of account are required to be kept on an accrual basis and based on the double entry system of accounting to represent a true and fair view of the company's state of the affairs or its branches. As per Section 145 of the Income Tax Act, any assessee having taxable income under the heads **"Profits and gains from business or profession"** or **"Income from Other Sources"** has to compute their taxable income in accordance with cash or mercantile system of accounting. Furthermore, the section states that the Central Government may notify from time to time if it is to be followed by any class of taxpayer or in any class of income. Accordingly the assessee who are computing their taxable income on accrual basis is required to maintain the books of account under accrual system. Ind. AS - 37 / AS -29 provides for to recognise a provision for expenses when an entity has a present obligation (legal and constructive) arising out of a past event and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation. So from above brief provisions narrated, it is concluded that the assessee who is maintaining the books of accounts under accrual system is required to make provisions for expenses at the year end to close books of accounts and preparation of financial statement.

1.2. Section 190 of Chapter XVII of Income Tax Act, 1961 provides for deduction / collection of tax at source while making certain payments to the payee. While making provisions for expenses many of the expenses are accounted on reliable estimate basis as well as many cases the expenses is accrued but payable at a later date but at the time of accrual and making provisions in the books of accounts the payee is not ascertainable / details as required under income tax is not available.

i) The present article discuss, whether the payer is liable to deduct income tax at source from the year end provision of expenses when the details of payee as required is not available / not ascertainable. To have a focused discussion, a case study has been produced below which will be taken for analysis

2. CASE STUDY:

XYZ Ltd is a company (here in after a Company) incorporated under the Company Act, 2013. The Company is inter alia engaged in manufacture of industrial products & have its manufacturing units at Bhubaneswar. During course of business, it engages man power supply contractor with a rate per day mutually agreed. The cost of contract for labour includes basic wages, holiday wages, over time wages, establishment expenses, PF, ESI, bonus & gratuity etc. While all the elements are claimed by the contractor being paid in a regular interval, only bonus is claimed on yearly basis. However, gratuity being a payment only at the time of retirement of contract labour, the same is only to be claimed very occasionally and only to be claimed by the contractor during whose period the contract employee retires.

The Company is making provision for gratuity as per actuarial valuation for the contract labouers engaged by contractors. Since gratuity is a future liability, the actuarial valuation is done considering certain assumptions like future hike in wages, retirement age, mortality rate, discount rate etc. & the assessed value is basically the present value of future obligation. The gratuity liability is credited to a separate A/c head "provision for gratuity – contractual employees".

As per the payment terms of contract, the gratuity amount will be reimbursed to contractor only when it is paid to the contract labour. Thus, the income will accrue in the hands of the contractor at the time of raising bill for gratuity after payment to the contract labour. Moreover since there may be changes in Contractor but the contract labour shall continue and such payment will be made by the contractor who continue during the retirement of contract labour.

On the above facts, it is my view that the present contract on which gratuity liability accounted as "provision for

gratuity – contractual employees" is a purely labour contract covered under section 194C of income tax act. Before concluding the deduction of tax at source u/s 194C, let us examine applicability of income tax deduction at source on the gratuity liability of contract labours which is credited to a separate A/c head "provision for gratuity – contractual employees" in compliance to provisions of income tax act and rule there under.

3. LEGISLATIVE FRAMEWORK, JUDICIAL PRONOUNCEMENTS

3.1. Chapter II of the Income Tax Act, 1961 contains the provisions with respect to the basis of charge of income tax. Section 4 of the Act is the charging Section and reads as under:-

3.1.1. Section 4 of Income TAX Act, 1961 - Charge of income-tax.

(1) Where any Central Act enacts that income-tax shall be charged for any assessment year at any rate or rates, income-tax at that rate or those rates shall be charged for that year in accordance with, and subject to the provisions (including provisions for the levy of additional income-tax) of, this Act in respect of the total income of the previous year of every person:

Provided that where by virtue of any provision of this Act income-tax is to be charged in respect of the income of a period other than the previous year, income-tax shall be charged accordingly.

(2) In respect of income chargeable under sub-section (1), income-tax shall be deducted at the source or paid in advance, where it is so deductible or payable under any provision of this Act."

It is apparent from the plain language of Section 4(1) that income tax is charged in respect of the total income of the previous year of every person. Whilst total income is the basis of the charge of income tax and also the basis of the impose, the liability imposed is on the person whose total income is subjected to tax. Thus, the levy may be in respect of total income of a person but the tax is levied on the person so earning the income.

It may be concluded that, for any charge to be sustained under the Act, it is essential that

(a) there is an assessee whose income would form the basis of the charge; and

(b) there is income which is subject to tax under the provisions of the Act.

3.2. Since we assumed the expenses provisioned at the yearend on which tax at source to be deducted under section 194C, of Income Tax Act, 1961, the relevant Provision is produced below for further analysis.

3.2.1. Section 194 C- Payments to contractors.

(1) Any person responsible for paying any sum to any resident (hereafter in this section referred to as the contractor) for carrying out any work (including supply of labour for carrying out any work) in pursuance of a contract between the contractor and a specified person shall, at the time of credit of such sum to the account of the contractor or at the time of payment thereof in cash or by issue of a cheque or draft or by any other mode, whichever is earlier, deduct an amount equal to—

(i) one per cent where the payment is being made or credit is being given to an individual or a Hindu undivided family;

(ii) two per cent where the payment is being made or credit is being given to a person other than an individual or a Hindu undivided family,

of such sum as income-tax on income comprised therein.

*(2) **Where any sum referred to in sub-section (1) is credited to any account, whether called "Suspense account" or by any other name, in the books of account of the person liable to pay such income, such crediting shall be deemed to be credit of such income to the account of the payee and the provisions of this section shall apply accordingly.***

3.3. Further Section 190 of the Act provides for deduction of tax at source in accordance with the provisions of Chapter XVII. Sub-section 2 of Section 190 makes it clear that the provisions of Sub-section 1 of Section 190 would not prejudice the charge of tax under the provisions of Section 4(1) of the Act.

In case of ***UCO Bank* v. *Union of India*** **[2014] 369 ITR 335/51 taxmann.com 253/[2015] 228 Taxman 141, Hon'ble Delhi High Court** clearly held as follows:

"Therefore, when a general provision is made without crediting the interest to the accounts of identifiable payees, the credit of interest to such account is not a credit to an account of a person who is liable to be assessed to tax. In this view, the petitioner would have no obligation to deduct tax, because at the time of credit there is no person assessable in respect of that income which may be represented by the interest accrued/paid in respect of the deposits. The words "credit of such income to the account of the payee" occurring in Section 194A of the Act have to be ascribed a meaning in conformity with the scheme of the Act and that would necessarily imply that deduction of tax bears nexus with the income of an assessee".

In absence of an assessee, the machinery provisions for deduction of tax to his credit are ineffective. The expression "payee" under Section 194A would mean the recipient of the income whose account is maintained by the person paying interest.

It is apparent that in absence of an ascertainable assessee, the machinery of recovering tax by deduction of tax at source breaks down because it does not aid the charge of tax under Section 4 but takes a form of a separate levy, independent of other provisions of the Act. This is, clearly, impermissible

The above principles and decision also equally applicable to tax deduction at source under section 194C.

3.4. In case of *Dishnet Wireless Ltd.* v. *Dy. CIT*[2015] 60 taxmann.com 329/154 ITD 827 (Chennai - Trib.), it was held that

"Section 194C of the Income-tax Act, 1961 - payments to Contractors/sub-contractors, (Telecommunication services) - Where assessee-telecom operator made provision for dismantling towers and restoration of site to its original position after termination of lease period and the ultimate payees could not be identified on the last day of the financial year, it was not required to deduct tax at source while making said provision. However, where assessee made 'year-end provisions' in respect of various services like address verification, credit certification, content development, etc. on estimate basis, wherever particulars and details of payees were available and amount payable could be quantified, assessee had to necessarily deduct tax at source"

3.5. In case of *Apollo Tyres Ltd.* v. *Dy. CIT* [2017] 78 taxmann.com 195/163 ITD 177 (Delhi - Trib.)it was held as

"Section 199 of the Income-tax Act, 1961 - Deduction of tax at source - Credit for tax deducted (General) - Identification of person from whose account income-tax is deducted at source is a pre-requisite condition so as to make provision of Chapter XVII-B workable. When tax deductor cannot ascertain payee who is beneficiary of a credit of tax deduction at source, mechanism of Chapter XVII-B cannot be put into service. Where assessee could not have ascertained identity of payees when provision of expenditure under several heads of income at year end was made, assessee was not required to deduct tax at source in respect of such provision".

3.6. *Industrial Development Bank of India* v. *ITO* [2007] 107 ITD 45 (Mum.)

"Under the Act, tax is on the income and it is in the hands of the person who receives such income……A plain reading of section 190 and section 191, which are first two sections under the Chapter XVII, and of sections 199, 202 and 203(1), would show this underlying feature of the tax deduction at source mechanism.
The whole scheme of tax deduction at source proceeds on the assumption that the person whose liability is to pay an income knows the identity of the beneficiary or the recipient of the income. It is a sine qua non for a vicarious tax deduction liability that there has to be a principal tax liability in respect of the relevant income first, and a principal tax liability can come into existence when it can be ascertained as to who will receive or earn that income, because the tax is on the income and in the hands of the person who earns that income. ***Therefore, tax deduction at source mechanism cannot be put into practice until identity of the person in whose hands it is includible as income can be ascertained.***

…..Accordingly, no tax was required to be deducted at source in respect of the provision for interest payable made by assessee which reflected provision for interest accrued but not due" in a situation where the ultimate recipient of such 'interest accrued but not due' could not have been ascertained at the point of time when the provision was made"

***3.7. Alliance Media & Entertainment Ltd.* v. *ITO (TDS)*[2017] 79 taxmann.com 114 (Mum. - Trib.)it was held that**

The payees in the present case were not identifiable. Therefore, in the absence of the details of the beneficiaries of the credit, as well as the respective amounts of credits remaining unascertainable. The tax deduction mechanism could not have been pressed into service because the liability of tax deduction at source is in the nature of a vicarious or substitutionary liability which presupposes existence of a principal or primary liability.

Thus, in the backdrop of the aforesaid settled position of law, when in the case of the present assessee the amounts to be paid to the artists had not been ascertained and was a subject matter of negotiations and under consideration, it could safely be concluded that neither the artists, i.e., payees qua the amounts to be paid were identifiable, nor the amounts to be paid stood crystallized. ***Therefore, in the absence of any identifiable payee or the quantification of the duly ascertained amount of the liability, the provisions of TDS could not have been made applicable. Thus, to be brief and explicit, if no income is attributable to the payee, there is no liability to deduct tax at source in the hands of the tax deductor.***

3.8. Pfizer Ltd. v. *ITO (TDS)*[2012] 28 taxmann.com 17/[2013] 55 SOT 277 (Mum.) it was held that

*"**As the provision was made without making specific entries into the accounts of the parties and the payee was not identifiable, the TDS provisions are not applicable**. The whole scheme of TDS proceeds on the assumption that the person whose liability is to pay an income knows the identity of the beneficiary or the recipient of the income. The TDS mechanism cannot be put into practice until identity of the person in whose hands it is includible as income can be ascertained (Industrial Development Bank of India v. ITO[2007] 107 ITD 45 (Mum) - followed)"*

3.9. Besides above it further examined that, the identity of the ultimate beneficiary (payee) and the precise amount payable to the payee are the prerequisites to press the TDS provisions into service. In other words, if no income is attributable to the identifiable payee, there is no liability to deduct tax at source in the hands of the tax deductor. ***In compliance part practice also, the deductor has to issue Form 16A prescribed under Rule 31(1)(b) of the Income-tax Rules, 1962 for the tax deducted at source after filing required returns under TDS. The assessee has to necessarily give the details of name and address of deductee, the PAN of deductee and amount paid or credited.***

In case, the deductor could not identify the name, address, PAN of deductee and not in a position to quantify the amount payable, the provision which requires deduction of tax at source fails. Hence, the assessee cannot be faulted for non-deduction of tax at source while making such general provisions. However the Assessee while computing income from business or profession shall require to ensure compliance of section 40(a)(i)(ia). Once the assessee makes voluntary disallowance u/s.40(a)(i)/(ia) for non-deduction of tax at source, he cannot be subject to TDS provisions again so as to make the assessee liable to pay the tax u/s. 201 and interest u/s. 201(1A).

4. CONCLUSION:

Having analysed and dwelt upon the relevant legislative provisions and judicial pronouncements, the conclusions are as follows.

In the absence of any identifiable payee or the quantification of the duly ascertained amount of the liability, the provisions of TDS could not be made applicable. Thus, to be brief and explicit, if no income is attributable to the payee (i.e. the Contractor), there is no liability on the part of the Company to deduct tax at source on such provisions of gratuity of contract labour accounted under - A/c head "provision for gratuity – contractual employees" in the books of accounts of XYZ Ltd . However while computing income from business or professions of XYZ Ltd, the amount of expenses provisioned at the yearend on which tax has not been deducted at source to be taken as disallowance in compliance to section 40(i)(ia) of Income Tax Act, 1961.