

Section 40(a)(ia) is constitutionally valid and there is no arbitrariness, unreasonableness or discrimination in said provision: Madras HC

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What are the consequences of not deducting the TDS or after deducting not paying the deducted tax to the Government?

As per section 201 of Income Tax Act 1961,

- Without prejudice to any other consequences, the defaulter will be deemed to be an assessee in default.
- He is liable to pay an interest at 12% P.A. from the date on which the tax was deductible till the date of actual payment.
- The TDS along with the interest will be a charge on all the assets of the defaulter.
- He is liable to rigorous imprisonment for a term which shall not be less than 3 months, but which can extend up to 7 years and fine.
- He is liable to a penalty equal to the tax not deducted.

Knowing the above liabilities, no sane person would invite the wrath of the department by not deducting TDS or after deducting not paying to the government. But there is more! A new sub clause (1 a) of Sec 40 (a) has been inserted into the Income Tax Act by Finance Act (No. 2) of 2004. Under this clause if on any interest, commission or brokerage, rent, royalty, fees for professionals etc., TDS is deductible and if not so deducted or after deduction not paid, the entire expenditure will not be deducted while computing the income chargeable under Profits and gains of business or profession. Putting in English, this can be explained by the following example:-

Supposing you have paid Rs. 1.00 Crore in the previous year as Interest fee etc, and you have either not deducted tax or after deducting not paid it to the Government, apart from the five consequences mentioned above, this one Crore will not be permitted as an expenditure in your profits and gains computation. With the result you may have to pay a higher rate of income tax on the entire amount of Rs. 1.00 Crores in the year of default.

Supposing your income was Rs. 2.00 Crores and your expenditure (including the fee of Rs. 1.00 Crore) was Rs. 1.80 Crores, you get a profit of Rs. 20 lakhs on which you may have to pay an income tax of Rs. 6.00 lakhs. But if this Rs. 1.00 Crore is not allowed to be deducted your income is Rs. 2.00 Crores and expenditure is Rs 0.80 Crores leaving a profit of Rs. 1.20 Crores, on which you will have to pay a tax of about Rs. 36.00 Lakhs.

This seems to be a too heavy a blow that an assessee has approached the Madras High Court challenging the constitutional validity of this new clause (1a) of Sec 40 (a) of Income Tax Act 1961.

The High Court directed that:

- The assessee will file self assessment return by including the amount for which the tax is deducted at source.
- The petitioner will pay tax on self assessment income.
- The Dept will accept the return and is restrained from taking penal action as of now.
- The filing of the return and payment of tax shall be purely provisional.
- The petitioner will be liable to file modified returns and pay the due tax in the event the petitioner fails to get a final order in its favour from the High Court.

This and several other similar writs are now decided by the madras High Court.

In all these writ petitions, the common challenge is to Section 40 (a)(ia) of the Income Tax Act to declare it as ultra vires of the Constitution.

The contentions are three fold.

1. that the implication of Section 40(a)(ia) is arbitrary, unreasonable and in violation of Article 14 of the Constitution;
2. it imposes unreasonable restrictions in violation of Article 19(1)(g) of the Constitution and
3. it lacks legislative competence and is in violation of Articles 265 and 300A of the Constitution.

The High Court observed on several grounds raised by the petitioners,

Draconian?:

It cannot be said that the objective sought to be achieved viz., augmentation of TDS

provisions by bringing out a stringent provision in the form of Section 40(a)(i) or 40(a)(ia) can be said to be draconic or highly excessive in its approach. Therefore, the submission made does not inspire to hold that the provision should be held to be unreasonable or arbitrary and in violation of Article 14 of the Constitution. For the same reason, the contention that it is in violation of Article 265 of the Constitution is also liable to be rejected.

Within Legislative Competence?:

When there is a provision inbuilt in the impugned Section itself providing for rectification of any default and thereby restore the financial implications suffered, it will have to be held that by virtue of such a procedural safeguard provided in the provision, it would be well within the Legislative competence of the Parliament in having set out a provision as contained in Section 40(a)(ia) of the Act. The proviso provides a remedial measure and thereby enable the assessee to claim for deduction either in the immediate subsequent year or in any other subsequent year to the relevant year in which the default came to be committed.

Harsh?:

when Section 40(a)(ia) is read along with its proviso, there is no scope to hold that the said provision is so very harsh or creates any insurmountable situation for the assessee to claim the deduction of expenditure actually made. It is held that Section 40(a)(ia) cannot be read in isolation but must be read along with its proviso and when it is read in that manner, there would be no scope to hold that there will be any harsh treatment meted out to any assessee in the matter of disallowance of any expenditure validly made by them.

Hostile scheme of taxation, in which on the ground of default of tax recovery from a contractor's income, the whole of the contractor's income is taxed at the hands of the petitioners while such tax on the said sum is paid by the contractor himself in his returns even in the absence of the TDS effected by the petitioners?. It can be noticed that the disallowance provided under Section 40(a)(ia) is for the failure of the petitioners in making the TDS as provided under Chapter XVII-B of the Act, which varies from 2% to 10%. If the TDS has been effected, such deduction would be credited to the tax liability of the contractor when his liability is assessed. Only in the event of non-deduction or non-payment of the deducted amount, there would be scope for the contractor being mulcted with the entire liability inclusive of TDS which could have been otherwise made under Chapter XVII-B. Therefore, the argument of the petitioners which proceeds on the basis of double taxation is palpably erroneous. Since the submission has been made by an erroneous reading of the relevant provision, the said submission is liable to be rejected at the very outset. Certainly on this ground, it cannot be held that there was any hostile treatment meted out to the petitioners as that would amount to any arbitrariness or unreasonableness violative of Article 14 of the Constitution.

The relief through the mechanism of the proviso is onerous and near impossible since Section 40(a)(ia) shifts the business expenditure of the previous year, to the subsequent year which when computed along with regular expenditure of the subsequent year, exaggerates the expenditure to yield huge loss neutralizing the profit with mere carry forward facility under Section 72 and thereby the tax referred in the year of assessment can hardly be secured back unless business is carried on with profit to absorb the loss of the subsequent year. The said argument is to be stated only to be rejected. Such a submission made on hypothetical basis cannot invalidate the provision. After all the proviso has been inserted in order to ensure that even a defaulter is not put to serious prejudice, in as much as, by operation of the substantive provision, the expenditure which is otherwise allowable as a deduction is denied on the ground that the obligation of TDS provisions are violated. The law makers while imposing such a stringent restriction wanted to simultaneously provide scope for the defaulter to gain the deduction by complying with the TDS provision at a later point of time. Therefore such a remedial measure provided in the form of a proviso cannot be tested in the anvil of the grievance which is sought to be demonstrated by stating that in order to get the adjustments one has to survive in the business and that in the course of such survival, he should also make a profit. On the basis of such extreme imaginary consideration, which are farfetched, the vires of a provision cannot be tested.

Section 2(24) having defined the term 'income' have included only profits or gains of business or profession and the disallowance provided under Section 40(a)(ia) is indisputably an expenditure in the hands of the assessee and in the absence of deeming such expenditure as income of the assessee falling under Section 2(24) of the Act, no tax liability can be imposed on the assessee. The said submission failed to take note of one important factor viz., the proviso which would enable the assessee to claim the deduction as and when in any subsequent year compliance of the TDS provisions are duly made. It can also be stated that the disallowance committed under Section 40(a)(ia) is not a disallowance in toto but a temporary phenomenon, the ratification of which is in the hands of the assessee themselves. Therefore, it is a misnomer to call it an income while as a matter of fact it is an expenditure not properly claimed.

Section 40(a)(ia) does not serve any socio-economic cause. Even assuming to be true, it cannot be a ground for striking down the said provision. It is besides the fact that after the introduction of Section 40(a)(ia), the object with which the provision came to be introduced was nearly achieved, in as much as, the statistical data of collection and refund for the financial year 2008-09 upto 01.08.2009, discloses that at least 50% of such collection was by way of TDS.

Section 40(a)(ia) fails to cover all assessee in all situation and thereby it is highly inequitable and unreasonable: Section 40(a)(ia) will apply wherever Chapter XVII-B gets attracted. Therefore, in respect of all those assessee who are governed by Chapter XVII-B would be equally governed by Section 40(a)(ia). We are unable to understand as to how there could be any inequality or unreasonableness in such a situation. On the other hand, in respect of assesseees who are governed by Chapter XVII-B of the Act, Section 40(a)(ia) does not make any discrimination and consequently the said contention has no legs to stand.

Section 40(a)(ia) is the only provision where it provides for Double Taxation. It is a misnomer to call the process created under Section 40(a)(ia) as one resulting in Double Taxation. We are not therefore impressed with such a contention of the petitioners.

The High Court concluded:

(a) That so far as it is reasonably possible to read down a provision in order to construe the legislation as being within its power.

(b) By applying the doctrine of Reading Down, no additional words into a statutory order which would transgress the limits of such order or the scheme. It can only be resorted to give the statute a reasonable meaning in order to make it constitutionally valid.

(c) Under the guise of Reading Down a provision nothing can be supplemented. Where a literal interpretation leads to an absurd or intended result, the language of the statute can be modified to accord with the intention of Parliament and to avoid absurdity.

(d) The Doctrine of Reading Down a statutory provision is to make it a valid provision and prevents its nullification as unconstitutional.

Keeping the above principles in mind, it will have to be stated that having considered the various submissions on the grounds of arbitrariness, unreasonableness as well as discrimination, the High Court found that such grounds are not available for the petitioners when challenging the impugned Section 40(a)(ia).

Therefore when there is no ambiguity to be cleared, the question of applying the doctrine of Reading Down to Section 40(a)(ia) does not arise. Equally, there is no doubt that the provision is constitutionally valid, having regard to the various inbuilt safeguards in the substantive Section read along with its proviso. In such circumstances, the very question of applying the doctrine of Reading Down does not arise.

In as much as we have reached a conclusion that the object sought to be achieved while enacting Section 40(a)(ia) was for augmenting the provision of TDS, with which object we do not find any impermissibility or lack of constitutionality and hence there is no scope for applying the doctrine of Reading Down to the said provision.

The High Court finally held:

In all these writ petitions, wherever the petitioners seek to challenge the action of the respondents on merits, such questions will have to be agitated by the said petitioners before the appropriate Appellate Forum.

Where the challenge is to the vires of Section 40(a)(ia), in as much as those writ petitions where the challenge is made to the vires of the substantive provision, in all fairness those parties should be permitted to work out their appellate remedies within a reasonable time.

It is held that Section 40(a)(ia) is constitutionally valid and there is no arbitrariness, unreasonableness or discrimination in the said provision.