

**SECTION 40(a) – AMOUNTS NOT DEDUCTIBLE FOR  
NON-COMPLIANCE OF TDS PROVISIONS  
UNDER THE I.T. ACT, 1961**

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## **1. INTRODUCTION**

It is a maxim, and like most maxims often forgotten, that taxes, like water have a tendency to find the lowest level. The ideology of direct taxation has changed with the times and it has now become a phenomenon of fashion of come and go. The ideology of taxation is broadly based on three basic considerations – to raise revenue, to bring about certain economic and social results and to discourage the consumption and use of articles, which the State regards as obnoxious. In the present article, an attempt has been made to analyze the provisions of Section 40(a) *vis-à-vis* liabilities regarding tax deduction at source (TDS) as per the provisions of the I.T. Act, 1961, and the implications thereof. The rationale behind it and the injuries, which may be inflicted on the tax jurisprudence and tax administration, has also been discussed.

Though the provisions of **Chapter IV – COMPUTATION OF TOTAL INCOME** with its sub-Chapter **D – Profits and gains of business or profession** and **Chapter XVII – COLLECTION AND RECOVERY OF TAX** with its *sub-Chapter B – Deduction at source* deals with two different areas under the scheme of taxation of income as contained in the I.T. Act, 1961 and seldom meet, due to legislative adventurism, both have been mixed up in such manner that one has easily trespassed into the Territory of other.

## **2. PROVISIONS OF SECTION 40(a)**

### **2.1 Text of the provisions of Section 40(a)**

Section 40, falling in Chapter IV-D regarding computation of income from profits and gains of business and profession, as contained in sections 28 to 44DA, deals with the “*Amounts not deductible*” while computing the income under this head. While Clauses (a), (b) and (ba) deal with different categories of amounts, which are not deductible while computing the income from profits and gains of business and profession, sub-Clauses (i), (ia), (iii) and (iv) of Clause (a) exclusively deals with the amounts not deductible while computing the income chargeable under the head “Profits & Gains of business or profession” on account of failure in deduction and payment of TDS under Chapter XVII-B. For the ready reference, the text of these provisions is reproduced as under: -

#### ***“Amounts not deductible***

**40.** *Notwithstanding anything to the contrary in sections 30 to 38, the following amounts shall not be deducted in computing the income chargeable under the head “Profits and gains of business or profession”, —*

(a) *in the case of any assessee—*

(i) *any interest (not being interest on a loan issued for public subscription before the 1<sup>st</sup> day of April, 1938), royalty, fees for technical services or other sum chargeable under this Act, which is payable,—*

(A) *outside India; or*

(B) *in India to a non-resident, not being a company or to a foreign company,*

*on which tax is deductible at source under Chapter XVII-B and such tax has not been deducted or, after deduction, has not been paid during the previous year, or in the*

subsequent year before the expiry of the time prescribed under sub-section (1) of section 200 :

**Provided** that where in respect of any such sum, tax has been deducted in any subsequent year or, has been deducted in the previous year but paid in any subsequent year after the expiry of the time prescribed under sub-section (1) of section 200, such sum shall be allowed as a deduction in computing the income of the previous year in which such tax has been paid.

*Explanation.—For the purposes of this sub-clause,—*

- (A) “royalty” shall have the same meaning as in Explanation 2 to clause (vi) of sub-section (1) of section 9;
- (B) “fees for technical services” shall have the same meaning as in Explanation 2 to clause (vii) of sub-section (1) of section 9;

- (ia) any interest, commission or brokerage, fees for professional services or fees for technical services payable to a resident, or amounts payable to a contractor or sub-contractor, being resident, for carrying out any work (including supply of labour for carrying out any work), on which tax is deductible at source under Chapter XVII-B and such tax has not been deducted or, after deduction, has not been paid during the previous year, or in the subsequent year before the expiry of the time prescribed under sub-section (1) of section 200 :

**Provided** that where in respect of any such sum, tax has been deducted in any subsequent year or, has been deducted in the previous year but paid in any subsequent year after the expiry of the time prescribed under sub-section (1) of section 200, such sum shall be allowed as a deduction in computing the income of the previous year in which such tax has been paid.

*Explanation.—For the purposes of this sub-clause,—*

- (i) “commission or brokerage” shall have the same meaning as in clause (i) of the Explanation to section 194H;
- (ii) “fees for technical services” shall have the same meaning as in Explanation 2 to clause (vii) of sub-section (1) of section 9;
- (iii) “professional services” shall have the same meaning as in clause (a) of the Explanation to section 194J;
- (iv) “work” shall have the same meaning as in Explanation III to section 194C;

(ib) .....

(ic) .....

(ii) .....

(iia) .....

(iii) any payment which is chargeable under the head “Salaries”, if it is payable—

(A) outside India; or

(B) to a non-resident,  
and if the tax has not been paid thereon nor deducted there from under Chapter XVII-B;]

- (iv) any payment to a provident or other fund established for the benefit of employees of the assessee, unless the assessee has made effective arrangements to secure that tax shall be deducted at source from any payments made from the fund which are chargeable to tax under the head “Salaries”;

(v) .....

(Full text is being enclosed as **Appendix – I**)

The provisions and the categories of payments enumerated therein can be summarized as under: -

Provisions	The categories of payments covered therein
Section 40(a)(i)	Any interest, royalty, fees for technical services or other sum chargeable under this Act, which is

	payable outside India or in India to a non-resident or a foreign company.
Section 40(a)(ia)	Any interest, commission or brokerage, fees for professional services or fees for technical services payable to a resident, or amount payable to contractor or Sub-contractor being a resident.
Section 40(a)(iii)	Any payment chargeable under the head "Salaries" payable outside India or to a non-resident.
Section 40(a)(iv)	Any payment to a provident or other fund established for benefit or employees of assessee unless effective arrangement to secure the deduction of tax at source from any payment from the fund chargeable under the head "Salaries" has been made.

## 2.2 Legislative history

Although the scope of these provisions have been substantially enlarged by the Finance (No. 2) Act, 2004 w.e.f. **01.04.2005**, it is very relevant to discuss the legislative history of these provisions and in brief the same is given as under: -

### (a) Provisions in 1922 Act

The provisions of original section 40(a)(i) correspond to a part of the *proviso* to Section 10(2)(iii) of the 1922 Act. These provisions were related to the disallowance of any interest chargeable under this Act, which is payable outside India on which tax has not been deducted at source and in respect of which there is no person in India who may be treated as Agent under section 163. The original provisions, read as under: -

*“(i) any interest chargeable under this Act which is payable outside India (not being interest on a loan issued for public subscription before the 1<sup>st</sup> day of April, 1938), on which tax has not been paid or deducted under Chapter XVII-B and in respect of which there is no person in India who may be treated as an agent under section 163”*

### (b) Substitution by Finance Act 1988

The Finance Act 1988 has substituted section 40(a)(i) w.e.f. **01.04.1989** so as to cover the payments in respect of “*royalty, fees for technical services or other sums chargeable under the Act*” and omit the condition relating to ‘an Agent in India.’ It has also inserted a **proviso** for allowing such deduction where the tax has been paid or deducted under in subsequent year while computing the income of previous year in which such tax has been paid or deducted. The substituted provision read as;

*“(i) any interest (not being interest on a loan issued for public subscription before the 1<sup>st</sup> day of April, 1938), royalty, fees for technical services or other sum chargeable under this Act, which is payable outside India, on which tax has not been paid or deducted under Chapter XVII-B*

**Provided** that where in respect of any such sum, tax has been paid or deducted under Chapter XVII-B in any subsequent year, such sum shall be allowed as a deduction in computing the income of the previous year in which such tax has been paid or deducted.

*Explanation* : For the purposes of this sub-clause

- (A) "royalty" shall have the same meaning as in Explanation 2 to clause (vi) of sub-section (1) of section 9;
- (B) "fees for technical service" shall have the same meaning as in Explanation 2 to clause (vii) of sub-section (1) of section 9;

The scope and effect of this substitution has been explained in **Circular No. 528, dated 16.12.1988**, which is enclosed herewith as **Appendix – II**.

**(c) Substitution by Finance Act, 2003**

The Finance Act, 2003 has substituted Sub-clause (i) of Clause (a) w.e.f. **01.04.2004**, so as to cover those payments also, which are made "*in India to a non-resident, not being a company or to a Foreign company*", apart from the payments made outside India apart from the other amendments which were made to dilute the impacts of the provisions.

**(d) Substitution by Finance (No. 2) Act, 2004**

The Finance (No. 2) Act, 2004 has substituted Sub-clause (i) of Clause (a) w.e.f. **01.04.2005** by Sub-clauses (i), (ia) and (ib) which is now prevailing for the time being. There was some confusion about the effective date of these amendments, but the Notes on Clauses [**268 ITR (st.) 121**] and Memorandum Explaining the Provisions in the Finance (No. 2) Bill, 2004 [**268 ITR (st.) 121**] makes it clear that the changes are effective from **1<sup>st</sup> April, 2005** and are applicable in relation to Assessment Year 2005-06 and onwards.

**2.3 Aims and objects of the provisions**

The provisions of this Clause as applicable upto the Assessment Year 2003-04 were related to certain kinds of payments chargeable under the Act, which are payable outside India. The aim and object was to ensure effective compliance of provisions of Section 195 and to charge tax on such payments being made outside India but are chargeable under the Act, through the person making these payments. The payee being outside India, the idea was to ensure collection of tax on income accruing to them in India. The provisions were amended from Assessment Year 2004-05 to also cover such payments chargeable under the Act, which are payable in India to a non-resident, not being a company or to a foreign company.

The aim and object of the amended provisions effective from Assessment Year 2005-06 are "*to augment compliance of the TDS provisions*" as can be seen from the Memorandum Explaining the Provisions in Finance (No. 2) Bill, 2004. The relevant extract thereof is enclosed herewith as **Appendix – III**.

### **3. PROVISIONS ANALYSED**

#### **3.1 Scope of provisions of Section 40(a)**

These provisions are part of the set of provisions as contained in 'CHAPTER IV – COMPUTATION OF TOTAL INCOME' and have been placed under 'Sub-chapter D – Profit & Gains of Business or Profession.' As is explicit from the heading of the section “**Amounts not deductible**”, the provisions deal with the expenses, which are not deductible while computing the income from profits and gains of business or profession under certain conditions. The provisions of Clause (a) of section 40 deals with such amounts not deductible with respect to failure in compliance with the provisions of TDS as well as bar deductions on account of payment of certain taxes enumerated therein.

#### **3.2 Effect of *non-obstante* Clause**

The provisions of section 40 start with the words “*Notwithstanding any thing to the contrary in sections 30 to 38*”, which make these provisions as *non-obstante* or overriding in effect. Thus, even if an expenditure or allowance comes within the ambit of provisions of section 30 to 38 as also the provisions of section 40, it is the provisions of section 40, which shall prevail and the relative provisions shall have no application – *CIT v. Indian Molasses Co. Pvt. Ltd. (1970)78 ITR 474, 481 (SC)*.

#### **3.3 Bar on certain deductions**

The provision creates a bar on deduction of certain expenses, which are enumerated in various Sub-clauses of Clause (a) of section 40 of the I. T. Act, 1961 under certain conditions. The scope of such bar is limited only to the payments or expenses enumerated therein only and it cannot go beyond these items.

#### **3.4 Whether “tax” deductible includes “surcharge”**

The term “tax” has been defined in Sub-section (43) of section 2 of the I. T. Act, 1961 and it means income-tax chargeable under the provisions of this Act. It does not include penalty or interest and it has to be read with the limited meaning assigned to it – *Harshad Shantilal Mehta v. Custodian (1998) 231 ITR 871 (SC)*.

The “charge of Income-tax” in respect of Total Income of the previous year of every person is created as per the provisions of Section 4 of the I. T. Act, 1961 and Sub-section (2) of Section 4 specifically provides for charge of Income tax deducted at source or paid in advance. The provisions of each Finance Act provide for the rate of income-tax as well as TDS an advance tax for the relevant years. For example, in Finance Act, 2005, CHAPTER II – RATES OF INCOME TAX

provides for various rates of income-tax for the relevant assessment year and rates of advance-tax and TDS for the relevant previous year. As per Sub-section (5) and (6) of Section 2 of Finance Act, 2005, the deduction of tax at source has to be made at the rates specified in **Part II of the First Schedule** and “shall be increased, by a surcharge for the purposes of union, calculated in each case, in the manner provided therein”. Similarly, Sub-sections (7) and (8) provides for the rates of tax to be collected at source and surcharge thereon with respect to provisions of Section 194B and Section 206C of the I. T. Act, 1961. Hon’ble Supreme Court has already decided this issue in **CIT v. K. Srinivasan (1972) 83 ITR 346 (SC)** with respect to Finance Act, 1963 and has held that the tax has to be charged as per the provisions of relevant Finance Act and if it includes surcharge, it will be charged over and above the rates of income-tax and super-tax as part of it.

However, under the scheme of TDS there are two set of provisions under Chapter XVII-B, regarding rate at which the tax has to be deducted, one at fix rates prescribed in the Section itself and, others providing to deduct income-tax “at the rates in force”. The provisions falling within these two categories can be summarized as under: -

Provisions where in rates have been fixed	Provisions where TDS is to be deducted “at the rates in force”
Sections 194C, 194E, 194EE, 194F, 194G, 194H, 194I, 194J, 194K, 194L, 194LA	Sections 192, 193, 194, 194A, 194B, 194D, 195

So far as Section 40(a) is concerned it refers to tax “deductible at source under Chapter XVII-B” and therefore, where the rates of tax are fixed in the provisions of this Chapter itself, the “surcharge” will not form of part of tax and any default in payment of surcharge with respect to these provisions will not attract the provisions Section 40(a). However, for rest of the provisions where the tax has to be deducted “at the rates in force” the surcharge will be part of tax to be deducted and any default in this respect may attract provisions of Section 40(a).

### 3.5 Whether “tax” deductible includes “education cess”

It is well settled that various terms like rates, *A fortiori*, tax, duty and cess are legal terms having distinct character and meanings. The term “cess”, according to **Webster’s New International Dictionary** means, “1. An assessment; tax; levy; specifically; (a) A rate or local tax..... (b) In Scotland, the land tax, (c) In India, a tax for a special object; as, a road cess”. Hon’ble Andhra Pradesh High Court has held in **Balaraju v. Hyderabad Municipality [AIR 1960 AP 234, 241]** as “a cess is a tax confined to a local area for a specific object or a particular purpose”. Similarly, “cess” was termed as “a tax levied for a specific purpose often with a prefix word defining the object” in **Gwalior Sugar Co. v. State of Madhya Bharat [AIR 1954 MB 196]**. In **Guruswami & Co. v. State of Mysore; Shinde Bros. v. Deputy Commissioner [AIR 1967 SC 1512, 1525]** Hon’ble Supreme Court has observed, in the words of his Lordship **Hidayatullah J.**, as under: -

*“The word ‘cess’ is used in Ireland and is still in use in India although the word ‘rate’ has replaced it in England. It means a tax and is generally used when the levy is for some special administrative expense, which the name (health cess, education cess, road cess etc.) indicates”*

In context Sub-clause (ii) of clause (a) of Section 40 relating to “any sum paid on account of any rate or tax levied”, it has been held that the term “cess” being specially excluded therein, it is allowable as deduction unlike rate or tax. In **Ugar Sugar Works Ltd. v. State of Karnataka [(1985) 155 ITR 39 (Karn)]**, the ‘cess’ paid on sugarcane used by the assessee has been held allowable deduction in the context of the Agricultural Income-tax Act.

The Hon’ble Central Board of Direct Taxes has also clarified this legal position in **Board’s F. No. 91 / 58 / 66 - ITJ (19), dated 18.05.1967** as under:

*“Interpretation of provision of section 40(a)(ii) of IT act, 1961 –Clarification regarding, --  
“Recently a case has come to the notice of the Board where the Income-tax Officer has disallowed the ‘cess’ paid by the assessee on the ground that there has been no material change in the provisions of section 10(4) of the Old Act and section 40(a)(ii) of the New Act.*

**2.** *The view of Income-tax Officer is not correct. Clause 40(a)(ii) of the Income-tax Bill, 1961, as introduced in Parliament stood as under: --*

*“(ii) any sum paid on account of any cess, rate or tax levied on the profits or gains of any business or profession or assessed at a proportion of, or otherwise on the basis of, any such profits or gains.”.*

*When the matter came up before the Select Committee, it was decided to omit the word ‘cess’ from the clause. The effect of the omission of the word ‘cess’ is that only taxes paid are to be disallowed in the assessment for the years 1962-63 and onwards.*

**3.** *The Board desires that the changed position may please be brought to the notice of all the Income-tax Officers so that further litigation on this account may be avoided.”*

The Central Government has levied ‘education cess’ by Finance (No. 2) Act, 2004 as per the provisions contained in sections 91 to 95 of Chapter VI thereof. But no change has been made in section 40(a) in this respect and neither it has been included in Sub-clause (ii) nor in Sub-clause (i) along with the rate of TDS. The provisions relating to ‘education cess’ are yet not part of the income tax Act, 1961. In view of the fact that the term ‘cess’ has not been included in these provisions either regarding disallowances or in the rates of TDS to be deducted, any default in payment of education cess will not attract the provisions of Section 40(a) of the I. T. Act, 1961.

### **3.6 Provisions not applicable to tax collectible at source.**

It is evident from the plain reading as well as overall scheme of these provisions that Section 40(a) are applicable only in cases of default in deduction and payment of tax deductible at source and not with respect to the default in respect of provisions relating to tax collectible at source as provided in Section 194B and 206C of the I. T. Act, 1961.

### **3.7 “Paid” includes voluntary as well as involuntary payments**

Hon’ble Rajasthan High Court has interpreted the scope of expression ‘paid’ used in section 40(a)(i) in **Addl. CIT v. Farasol Ltd. (1987) 163 ITR 364 (Raj)**. The court observed that

“paid” as used in sub-clause (i) of clause (a) of section 40 should not be construed to mean only voluntary payment and does include payment made by the assessee in recovery proceedings initiated against him. The word “paid” in sub-clause (i) of clause (a) of section 40 is wide enough to include a payment whether made voluntarily or during the course of proceedings for recovery initiated against the assessee. It is immaterial whether the Revenue has received payment of the tax due either by a voluntary act on the part of the assessee or by initiation of the recovery proceedings against the assessee. It may also be observed that under the Act an involuntary payment of tax, whether by way of deduction at source or by way of recovery under the provisions of the Act, is regarded as tax paid. In this connection, reference may be made to section 199 of the Act which provides that any deduction made in accordance with the provisions of sections 192 to 194, section 194A, section 194B, section 194BB, section 194C, section 194D and section 195 of the Act and paid to the Central Government should be treated as payment of tax on behalf of the person from whose income the deduction was made.

Hon’ble Court has also referred to Section 219 of the Act wherein it has been provided that any sum, other than a penalty or interest, paid by or recovered from any assessee, as advance tax in pursuance of Part C of Chapter XVII shall be treated as payment of tax. In this context, reference was also made to Section 237 of the Act and the Court finally observed that the word “paid” as used in sub-clause (i) of clause (a) of section 40 covers not only voluntary payments but also payments made otherwise, i.e., the amount recovered from the assessee under the provisions of the Act.

### 3.8 Sub-clause (i) of Clause (a)

The provisions of Sub-clause (i) of Clause (a) of Section 40 deal with any interest, royalty, fees for technical services or other sum chargeable under this Act, which is payable outside India or in India to non-resident or a foreign company on which tax is deductible at source under Chapter XVII-B. For the sake of understanding the scope and effect of these provisions, an analysis of the provisions as applicable before the Assessment Year 2005-06 and thereafter is given as under:

-

Provisions as applicable for Assessment Year 2004-05	Provisions as applicable for Assessment Year 2005-06 and onwards
Any –	Any –
– interest (not being interest on a loan issued for public subscription before the 1 <sup>st</sup> day of April, 1938),	– interest (not being interest on a loan issued for public subscription before the 1 <sup>st</sup> day of April, 1938),
– royalty,	– royalty,
– fees for technical services or	– fees for technical services or
– other sum	– other sum
chargeable under this Act, which is payable –  (A) outside India; or (B) in India to a non-resident, not being a	chargeable under this Act, which is payable –  (A) outside India; or (B) in India to a non-resident, not being a

company or to foreign company, on which tax –	company or to foreign company, on which tax – <b>is deductible at source under Chapter XVII-B</b> and such tax
– has not been deducted or, after deduction,	– has not been deducted or, after deduction,
– has not been paid before the expiry of time prescribed under Sub-section (i) of Section 200 and in accordance with other provisions of Chapter XVII-B:	– has not been paid – <b>– during the previous year, or</b> <b>– in the subsequent year before the expiry of time prescribed under Sub-section (i) of Section 200</b>
<b>Provided</b> that where in respect of any such sum, –	<b>Provided</b> that where in respect of any such sum, –
– tax has been deducted under Chapter XVII-B or paid in any subsequent year, such sum shall be allowed as a deduction,	– tax has been deducted <b>– in any subsequent year or,</b> <b>– has been deducted in previous year but paid in any subsequent year after the expiry of time prescribed under Sub-section (i) of Section 200.</b> such sum shall be allowed as a deduction,
– in computing the income of the previous year in which such tax has been paid.	– in computing the income of the previous year in which such tax has been paid.

(The bold in table denote the changes made)

In explanation to the provisions the terms “royalty” and “fee for technical services” have been defined.

It is obvious from the careful comparative reading of the provisions that following change have been effected which are of immense importance: -

- (a) The provisions are now attracted only when the tax is deductible under Chapter XVII-B,
- (b) “The insertion of the tax has not been paid in the previous year or, in the subsequent year before the expiry of time prescribed under Section 200(1)”, makes these payments allowable,
- (c) The deduction will be allowed even if;
  - (i) the tax has been deducted in any subsequent year or,
  - (ii) has been deducted in the previous year but paid in any subsequent year after the expiry of time prescribed under Section 200(1)

in computing the income of the previous year in which such tax has been paid.

The changes take care of anomalies which could have arose due to the delayed payments made during the previous year but not within the time prescribed in Section 200(1) read with Rule 30 I.T. Rules, 1962. For example the TDS on the interest paid during the previous year on any date, say 11<sup>th</sup> November 2004, has to be paid within seven days from the end of the month in which such payment has been made i.e. 7<sup>th</sup> December, 2004, and in case it is paid beyond that, it will be against the provisions of Section 200(1). But since the payment has been made during the previous year 2004-05, it will be allowed as deduction while computing the income of said previous year.

### 3.9 Sub-clause (ia) of Clause (a)

This is an together new provision, which deals with any interest, commission or brokerage, fee for profession services or fees for technical services payable to a resident or amount payable to contractor or sub-contractor, being resident for carrying out any work, including supply of labour, on which tax is deductible at source under Chapter XVII-B. The scope of this Sub-clause (ia) is limited to the following categories only: -

Categories mentioned in Sub-clause (ia)	Relevant provisions of TDS
(a) Any interest	Sections 193 and 194A
(b) "commission or brokerage" shall have the same meaning as in clause (i) of the Explanation to Section 194H	Section 194H
(c) "fees for technical services" shall have the same meaning as in Explanation 2 to clause (vii) of sub-section (1) of section	Section 194J
(d) "professional services" shall have the same meaning as in clause (a) of the Explanation to section 194J	Section 194J
(e) "work" shall have the meaning as in Explanation III to section.	Section 194C

The provisions of this Sub-clause, therefore, do not cover the following other categories of expenses and payments, which are allowable as expenditure and are liable for tax deduction at source under various provisions of the I. T. Act, 1961: -

Categories not mentioned in Sub-clause (ia)	Relevant provisions of TDS
(a) Salary	Section 192
(b) Dividends	Section 194
(c) Winnings from lottery or crossword puzzle	Section 194B
(d) Winnings from horse race	Section 194BB
(e) Insurance Commission	Section 194B
(f) Commission on sale of lottery tickets	Section 195B
(g) Rent	Section 194I

These expenses, therefore, will be allowed as deduction in computing the income from business or profession without being hit by the provisions of Section 40(a) of the I. T. Act, 1961.

### **3.10 Sub-clause (iii) of Clause (a)**

This provision, before amendment by Finance Act, 2003 effective from 1<sup>st</sup> April 2004, corresponds to Section 10(4)(a) of 1922 Act. It dealt with any payment, which is chargeable under the head 'Salaries', if it is payable outside India and the tax has not been paid thereon nor deducted therefrom under Chapter XVIIIB. The Finance Act, 2003 amended this provision and from 1<sup>st</sup> April 2004, to include the payments made to a non-resident, which are chargeable under the head 'Salaries'.

### **3.11 Sub-clause (iv) of Clause (a)**

This Sub-clause deals with the payment to a provident or other fund where the assessee has not made "effective arrangements to secure the deduction of tax at source from any payment made from such fund and, which is chargeable under the head 'Salaries'". This corresponds to provisions of Section 10(4)(c) of 1922 Act. The making of "effective arrangement to secure that tax shall be deducted at source" required by Section 40(a)(iv) is very different from an obligation cast by an statute to deduct the tax and is a voluntary act of assessee conditioned by his volition. To satisfy the requirement of Section 40(a)(iv), there must be an effective arrangement in addition to the duty imposed by the law. There are different views of different Court on this issue and while the Allahabad High Court in **Hindustan Commercial Bank Ltd. v. C.I.T. (1962) 46 ITR 910 (All)** held that where no effective arrangements had been made in the deed constituting the Provident Fund or Funds, the deduction of contribution to such fund would not be allowed as deduction, the contrary view has been taken by various other courts, which incidentally been affirmed by the Hon'ble Supreme Court also. In **CIT v. Delhi Cloth & General Mills Co. Ltd. (1981) 127 ITR 11 (Del)** : special leave petition dismissed by the Supreme Court : **(1983) 142 ITR (St.) 3-4 (SC)**, it was held that when the Statute itself provide that tax has to be deducted at source from any payments made out of the provident fund, the absence of an enabling clause in Trust Deed would not affect the assessee's claim for deduction. Similar views have been taken in **CIT v. Laxmi Rattan Cotton Mills Co. Ltd. (1976) 104 ITR 319 (All)**, **Maysore Spng. & Mfg. Co. Ltd. v. CIT (1966) 61 ITR 572, 595 – 6 (Bom)** later affirmed by Supreme Court, **(1970) 78 ITR 4 (SC)**.

## **4. IMPLICATIONS OF THE PROVISIONS**

The implications of these provisions in tax administration are far-reaching and multi-dimensional and some of these aspects are discussed, in brief, as under: -

### **4.1 Implications of delayed or non-payment of TDS**

The delayed or non-payment of TDS, except in the circumstances provided in *proviso to* Sub-clauses (i) and (ia) of Clause (a) of section 40, will lead to disallowance of the entire expenditure with respect to which such default has been committed. This may lead to certain situations, which will not only be anomalous but even lead to absurdity while computing the income of the concerned assessee. Some examples are being given hereunder to demonstrate the issue: -

**(1) Illustration – 1:**

A contractor assessee engages a sub-contractor for the execution of some work assigned to him and throughout the previous year makes running payments of, say, Rs. 5 Crore, in advance after deducting the TDS of Rs. 5,61,000/-, including surcharge and cess thereon. Since the contract is continuing for the subsequent year also, the contractor has made the provisions of Rs. 5.5 Crore for the entire work executed upto the last date of accounting year on 31<sup>st</sup> March 2005 and also makes provisions for the TDS thereon to the extent of Rs. 6,17,100/-, including surcharge and cess. After adjustment for the payments already made to sub-contractor and the TDS already paid, the balance figure of Rs. 50 lacs towards payment to sub-contractor and Rs. 56,100/- towards TDS payable remained outstanding on 31<sup>st</sup> March 2005. The corresponding accounting entries were made in the books of account on the last date of accounting year and, accordingly the contractor was liable to deposit the balance amount of TDS latest by 31<sup>st</sup> May 2005 as per the provisions of section 200(1) read with Rule 30. Due to certain unavoidable circumstances, the contractor could not make the payment of Rs. 56,100/- by 31.05.2005 and the same was paid only in the next month.

A default has been committed as per the provisions of Section 200(1) read with Rule 30 and in the light of provisions of section 40(a)(ia), the following questions will emerge:

- (a) Whether the sum of Rs. 5.5 Crore payable to sub-contractor is allowable as deduction while computing income for previous year 2004-05, merely because the balance sum of Rs. 56,100/- or will be disallowed could not be paid due to reasons beyond control of the assessee, though he has deducted and paid Rs. 5,61,000/- during the previous year?
- (b) Whether the entire amount of Rs. 5.5 Crore payable to contractor during Financial Year 2004-05 will be allowed in the Financial Year 2005-06 as the payment of balance sum have been made therein?
- (c) Whether the deduction could be allowed proportionately on the basis of payments made in relevant previous years?

**(2) Illustration – 2:**

Taking the same example as *Illustration 1*, what will be the position when the entire value of contract receivable by contractor during previous year 2004-05 is only Rs. 6.00 Crore

and there is practically no receipt or very nominal receipt in subsequent Financial Year 2005-06.

- (a) Whether the entire receipts of Rs. 6 Crore in the hands of contractor will be treated as income after disallowing the sub-contract payable Rs. 5.5 Crore for Assessment Year 2005-06 taking the net profit rate to 100%?
- (b) Whether the provisions of Chapter IVD regarding computation of profit and gains of business or profession from section 28 to 44DA could be interpreted and implemented in such a way to give absurd assessable income giving the net profit of 100% or even more?
- (c) Whether these payments could be allowed in subsequent year merely because the payment of TDS has been made in subsequent year even in the circumstances where there is no receipt or income and the assessee is carrying on no business whatsoever in the subsequent year?

## **4.2 The implications in cases of short payment of TDS**

There are various rates of TDS as well as varying rates of surcharge depending upon the nature of payment and the status of assessee and under these circumstances, there is every possibility of some short payment of TDS due to inadvertence or mistake of the person calculating the amount of TDS. Whether due to such mistakes leading to some short charge and short payment of TDS, which could be detected at the time of preparing the return of TDS, the entire sum will be disallowed while computing the income?

It is worthwhile to mention that despite the cream of the brains employed in the Department and the best software being used by them, a large number of mistakes could be found invariably leading to rectification u/s 154 of the I. T. Act, 1961. Whether the assessee could be penalized for the lesser degree of mistakes by its employees who are not so qualified leading to some short charge or short payment of TDS due to frequently changing rates?

## **4.3 TDS could not be deposited due to non-allotment of TAN**

In the current year, large numbers of assessee have faced this problem when the Banks refused to accept Challan and payments of TDS merely because the TAN was not quoted on Challan and it was written as 'applied for', on the basis of Form No. 49B furnished in this respect. Initially when the assessee were required to obtain TAN by applying with the Department, it was promised that ten digit TAN will be allotted automatically but the promise made was not adhered to and the assessee were forced to apply again. It takes lot of time to get the TAN allotted from Unit Trust of India, NSDL and other agencies and there are various mistakes therein, the correction of which is also taking lot of time. The Banks are invariably refusing to accept payments of TDS on account of non-availability or incorrect TAN, although there is no mistake on part of the assessee. Whether it is just and proper to punish the assessee by disallowing the entire expenditure on account of delay in payment of TDS due to these reasons not attributed to him?

## **4.4 Jurisdiction of Assessing Officer *vis-à-vis* TDS**

In present administrative structure of Income Tax Authorities, the jurisdiction of Assessing Officer and the Income Tax Officer (TDS) are distinct and different and both operate in isolation of each other. These provisions are bound to lead to the encroachment by one officer into the jurisdiction of other.

#### **4.5 Implications of surcharge and cess**

Apart from the rate of TDS, there are provisions for payment of surcharge as well as educational cess, which are quite complex. It may not be possible to completely segregate the amounts of TDS, surcharge and educational cess paid under various provisions of TDS and that may lead to opening of Pandora's Box of litigations as the officers having jurisdiction or otherwise may try to disallow the expenditure on account of such situation.

#### **4.6 TDS in cases of disputes**

Under various circumstances, the payments with respect to various expenses itself become disputed and it is not possible to work out the correct sum payable and consequently the TDS thereon. It may be determined at much later stage by the Court of Law and under these circumstances the correct working of TDS and deposit the same within the stipulated time becomes very difficult. The deposit of TDS on provisional basis may lead to further loss when it is decided by the Court that the sum was not payable to the payee, while the TDS paid is treated as income of the payee. Such types of anomalies are bound to come in a large number of cases.

#### **4.7 TDS is merely an Estimate**

In most of the circumstances, the TDS amount are deducted and paid on the basis of an estimate, which are finalized at later stage but this may lead to default in payment of TDS so as to attract the provisions of Section 40(a) of the I. T. Act, 1961.

#### **4.8 Double Taxation**

Expenditure in one hand is the income in other and the books of account and the scheme of taxation are more or less based on this basic principle. The expenditure, which may be disallowed by virtue of the provisions of this section, will be treated as income in the hands of the person incurring the same, while the same is already being taxed in the hands of the recipient as his income of the previous year. This not only violates the principle that the same income cannot be taxed in two hands but also the charging provisions of section 4, providing for the charge of tax on the income of the previous year. Such types of provisions are contrary to the basic charge and the overall scheme of the Act and deserve to be deleted.

### **5. RATIONALITY OF THE PROVISIONS**

## 5.1 Aims & Objects of TDS provisions

The provisions relating to deduction of tax at source are part of the provisions relating to **“Collection & Recovery of Tax”** as contained in Chapter XVII. Sub-chapter – B relating to **“Deduction at source”** is part of this Chapter and is spread from section 192 to 206A of the I. T. Act, 1961. There are two main ways of collection and recovery; one is direct from the subject and other through deduction at source of generation or payment of income. While Section 190 provides for the deduction and collection of tax at source at the time of payment, Section 191 provides for the direct payment by the assessee in case of provisions of TDS are not being made as per this Chapter. There are basically four sets of provisions for the collection and recovery of tax, which are as under: -

- (a) Indirect recovery provisions
  - These are in form of provisions of tax deduction and collection at source
- (b) Direct recovery provisions
  - (i) Advance tax
  - (ii) Self Assessment Tax
  - (iii) Payment of tax on regular assessment

## 5.2 Provisions to enforce the compliance of TDS

To enforce these provisions regarding collection and recovery of taxes, various other provisions in form of interest, penalty and prosecution have been provided under the scheme of the Act.

So far as the TDS provisions are concerned, the legislature has already made proper arrangements for the enforcement of these provisions in form of interest, penalty and prosecution, which are much more stricter than the direct recovery provisions. For the ready reference, these provisions are referred as under: -

- (a) Interest : as per the provisions of section 201(1A)
- (b) Penalty : as per provisions of section 201(1) read with section 221
- (c) Penalty for failure to deduct tax at source : as per section 271C
- (d) Penalty for failure in furnishing TDS returns and certificates: section 272A
- (e) Penalty for failure of section 203A regarding TAN : section 272BB
- (f) Prosecution and fine for failure to pay to the credit of Central Government any tax deducted at source : section 276B
- (g) Prosecution and fine for failure to pay to the credit of Central Government any tax collected at source : section 276BB

These provisions, in form of interest to compensate the loss, if any, and penalty and prosecution to ensure timely compliance of TDS provisions are much more lethal than the similar provisions regarding direct recovery of tax.

## 5.3 For this purpose section 40(a) unwarranted

The aim and object of section 40(a) is to augment compliance of TDS provisions as is evident from the following text of Memorandum explaining provisions of Finance (No. 2) Bill, 2004: -

*“With a view to **augment compliance of TDS provisions**, it is proposed to extend the provisions of Section 40(a)(i) to payments of interest, commission or brokerage, fees for professional services or fees for technical services to resident and payment to resident contractor or sub-contractor for carrying out any work.”*

(Full Text given in **Appendix – III**)

When so many provisions providing for levy of interest and penalty and for initiating prosecution to enforce the compliance of TDS provisions are already in existence and the share of collection of TDS in the entire direct tax collection is already the maximum, such provisions are wholly unwarranted and irrational.

#### **5.4 Rules of double jeopardy**

Article 29(2) of the Constitution says that no person shall be prosecuted and punished for the same offence more than once. This is prohibition against double jeopardy. However, the trial for separate and distinct offence is not barred as per Article 20(2). Without entering into the controversy as to what is “offence” and what extent is the punishment in this context, there is no doubt whatsoever that despite providing various provisions in form of interest, penalty and prosecution to augment the compliance of TDS provisions, the disallowance of entire expenses is nothing but more than punishment multiplier for the same purpose. It is much harsher and may inflict irreparable damage to an assessee under given circumstances than the other provisions to enforce the compliance.

#### **5.5 Tax Collector vs. Tax Collector**

The Income-tax Act, 1961 provides for taxation of total income of an assessee and he is liable to pay tax on his income in form of Advance-tax, Self-assessment and demand created in pursuance of regular assessment. The liability of a person responsible for deducting or collecting tax at source is not akin to the liability of an assessee with respect to tax on his total income. Here the person responsible for deducting TDS acts as a Tax Collector without having any privilege and the Public Account Committees reports show that the contribution of this class of Tax Collectors is several times higher than the Tax Collectors bestowed with all the powers of collection and recovery of tax. Unfortunately the statute has failed to offer any reward or incentive to these honorary Tax Collectors who, apart from paying tax on their own income, are also collecting the tax from the others and paying to Government from the expenditure incurred by them. There can be no other example of rampant discrimination of two classes of persons doing the same job.

#### **5.6 The provisions are unconstitutional**

In order that the law imposing tax is regarded as constitutionally valid it must, *firstly*, be within the competence of legislature to levy the tax, *secondly*, it should not violate Article 13

regarding fundamental rights, *thirdly*, it must not deny equality before law as per Article 14 and must not be discriminatory or arbitrary, *fourthly*, it must not constitute an unreasonable restrictions upon the right of business provided in Article 19(1)(g) and *lastly*, the other provisions of Article 27, 285, 289, 286 and 287 must be kept in mind.

Article 265 of the Constitution of India provides in explicit term that “*no tax shall be levied or collected except by authority of law*”. Entry 82 of List – 1 of Schedule – VII of Constitution provides for “*Taxes on income other than Agricultural income.*” Section 199 of the I. T. Act, 1961 provides that any payment of TDS shall be treated as payment of tax on behalf of person from whose income the deduction was made. Whether the power to levy and collect any tax of one person from the other in form of TDS is well within the ambit of Article 265 read with Article 246 has not been specifically decided and in the parlance of these provisions the issue deserves to be examined and tested by the Apex Court.

One may be held responsible for his own deeds and the liability of a citizen to pay tax on his income is also understandable but to compel a person to collect tax for and on behalf of other person and get penalized and prosecuted for the same, and now even pay tax on the expenditure otherwise allowable only for this reason, is certainly violation of ones fundamental rights.

The provisions are not only arbitrary but are even discriminatory in more than several ways as is evident from the following facts:-

- (1) The provisions of Section 40(a) are discriminatory as it only applies to certain class of assessee leaving many others under the similar class out of its ambit. Under the similar circumstances Hon'ble Guahati High Court in context of Section 27 of the Assam General Sales Tax Act, 1993 has held that provisions requiring public companies to deduct tax at source is discriminatory and *ultra vires* as it violates Article 14 of the Constitution of India- ***Makum Tea Co. (India) Ltd. v. State of Assam (1998) 109 STC 353, 364-65 (Guahati)***
- (2) The provisions provide for disallowances of expenses only for default of TDS while no such provisions have been made with respect to defaults on account of payment of Advance tax, Self-assessment tax and tax on regular assessment. This is blatantly discriminatory and is, therefore, unconstitutional.
- (3) The provisions regarding interest, penalty and prosecution being already in place, these provisions disturbing the basic principles of computation of income are neither in accordance with the aims and objects declared nor in accordance with the principle of tax on the real income. The provisions being arbitrary and unreasonable are against the basic principles of Constitution.

- (4) It discriminates between two classes of tax collectors one bestowed with enormous power to levy and collect the taxes and other with enormous liabilities to collect, deduct and pay taxes on income of others without any power whatsoever and get penalized for the same. While the first category of tax collectors are remunerated and even rewarded without being accountable to grievous mistakes committed in course of their work, this mute class of tax collectors is subjected to all kinds of penalty, punishment and harassment for even much lesser and trivial mistakes. Putting this class to further punishment in form of provisions of Section 40(a) is highly discriminatory.

The provisions are aimed to tax the legitimate business expenditures incurred in course of normal business activities and are in the nature of unreasonable restrictions upon the right of business guaranteed in Article 19 of Constitution. The provisions are *ultra vires* the Constitution on this ground as well.

## **6. RAY OF HOPE AND OTHER REMEDIES**

Now when the provisions have become part of statute and one has no alternative but to abide by these provisions till the same are deleted on account of public polity and good governance or nullified by the Court of law. Under these circumstances the assessee has to explore the way outs and seek remedy within the framework of law. Some of such remedies and planning instruments are discussed as under:-

### **6.1 Whether proportionate deduction possible**

The first logical question which come up to the mind is related to the cases where the default is not absolute and there is only some shortfall in payment of TDS due to so many obvious reasons. Under these circumstances whether the assessee is entitled for the proportionate deduction of expenditure with respect to the tax paid? The provisions are silent about this or at least are not explicit. The bar on deduction is also not explicit once it provides that the deduction will be allowed with respect to the delayed payments made within the previous year. Under these circumstances the provisions should be interpreted liberally and one, which is favourable to the assessee in view of, settled law in this respect. In my considered opinion the deduction should be allowed on proportionate basis in view of the amendments made by the Finance (No.2) Act, 2004 whereby the payment "*during the previous year, or in the subsequent year before the expiry of time prescribed u/s.200(1)*" have been made allowable by amending the provisions of Finance Act, 2003 in this respect. Further the terms "*in accordance with other provisions of Chapter XVII –B* " have been omitted by Finance (No.2) Act, 2004 effective from 1<sup>st</sup> April, 2005 and, therefore, the strict compliance of provisions of Chapter XVII-B have been deliberately omitted to enable the deduction on the basis of actual payment. This amendment being intentional, the deduction of expenditure in proportion to the TDS

paid during the previous year should be allowed in computing income of the previous year in which the payment has been made.

This view get further support from the liberal interpretation of term “paid” used in Section 40(a)(i) as has been adopted by Hon’ble Rajasthan High Court in case of ***Addl. CIT v. Farasol Ltd. (1987) 163 ITR 364 (Raj.)*** wherein the Court has held that the word “paid” used in sub-clause (i) of Clause (a) of Section 40 should not be construed to mean only the voluntarily payment only but it also includes payment made by the assessee in recovery proceeding initiated against it.

## **6.2 Postponement of deduction**

The assessee may plan the deduction of its expenses mentioned in Section 40(a) by slating it to subsequent year on the basis of nominal planned delay in deduction in payment of TDS to avail the deduction in the year of higher income by planning the payment in the subsequent year at the cost of nominal interest and penalty for default of TDS.

## **6.3 Deduction allowable under other heads**

The provisions of Section 40(a) are confined only to the computation of business income and, therefore, these expenses would easily be claimed while computing income under other heads like income from house property and income from other sources etc.

## **7. CONCLUSION**

The provisions of this Section, in my opinion, are arbitrary in the parameters of reasoning, irrational in the parameters of logic and pragmatism, illegal constitutionally, unsound economically and repugnant morally. In the light of foregoing discussions, the one and only conclusion, which could reasonably be drawn, is that these provisions must be removed from the statute to make the provisions of Income tax more civilized and pragmatic. In the meantime the rigorous impact of the provisions could be mitigated to some extent by amending the provisions in the lines of amendments in Section 43B providing for deduction if the payments are made before the filing of return of Total Income.

In the last, the agony of taxpayer reminds the words of noted jurist Late N. A. Palkhiwala which he wrote while dedicating his book “WE, THE PEOPLE” to his countrymen. Learned jurist wrote as –

TO MY COUNTRYMEN

who gave unto themselves the Constitution  
but not the ability to keep it,

who inherited a resplendent heritage  
but not the wisdom to cherish it,

who suffer and endure in patience  
without the perception of their potential.

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**CHAPTER IV**  
**COMPUTATION OF TOTAL INCOME**

**D. – Profit and gains of business or profession**

**Amounts not deductible**

**40.** Notwithstanding anything to the contrary in sections 30 to <sup>1</sup>[38], the following amounts shall not be deducted in computing the income chargeable under the head “Profits and gains of business or profession”, —

(a) in the case of any assessee—

<sup>2</sup>[(i) any interest (not being interest on a loan issued for public subscription before the 1st day of April, 1938), royalty, fees for technical services or other sum chargeable under this Act, which is payable,—

(A) outside India; or

(B) in India to a non-resident, not being a company or to a foreign company,

on which tax is deductible at source under Chapter XVII-B and such tax has not been deducted or, after deduction, has not been paid during the previous year, or in the subsequent year before the expiry of the time prescribed under sub-section (1) of section 200 :

**Provided** that where in respect of any such sum, tax has been deducted in any subsequent year or, has been deducted in the previous year but paid in any subsequent year after the expiry of the time prescribed under sub-section (1) of section 200, such sum shall be allowed as a deduction in computing the income of the previous year in which such tax has been paid.

Explanation.—For the purposes of this sub-clause,—

(A) “royalty” shall have the same meaning as in Explanation 2 to clause (vi) of sub-section (1) of section 9;

(B) “fees for technical services” shall have the same meaning as in Explanation 2 to clause (vii) of sub-section (1) of section 9;

(ia) any interest, commission or brokerage, fees for professional services or fees for technical services payable to a resident, or amounts payable to a contractor or sub-contractor, being resident, for carrying out any work (including supply of labour for carrying out any work), on which tax is deductible at source under Chapter XVII-B and such tax has not been deducted or, after deduction, has not been paid during the previous year, or in the subsequent year before the expiry of the time prescribed under sub-section (1) of section 200 :

1 Substituted for “39” by the Direct Tax Laws (Amendment) Act, 1987, w.e.f. 1-4-1989

2. Sub-clauses (i), (ia) and (ib) substituted for sub-clause (i) by the Finance (No. 2) Act, 2004, w.e.f. 1-4-2005. Prior to its substitution, sub-clause (i), as substituted by the Finance Act, 1988, w.e.f. 1-4-1989 and the Finance Act, 2003, w.e.f. 1-4-2004, read as under :

(i) any interest (not being interest on a loan issued for public subscription before the 1st day of April, 1938), royalty, fees for technical services or other sum chargeable under this Act, which is payable,—

(A) outside India; or

(B) in India to a non-resident, not being a company or to a foreign company,

on which tax has not been deducted or, after deduction, has not been paid before the expiry of the time prescribed under sub-section (1) of section 200 and in accordance with other provisions of Chapter XVII-B:

**Provided** that where in respect of any such sum, tax has been deducted under Chapter XVII-B or paid in any subsequent year, such sum shall be allowed as a deduction in computing the income of the previous year in which such tax has been paid.

Explanation.—For the purposes of this sub-clause,—

(A) “royalty” shall have the same meaning as in Explanation 2 to clause (vi) of sub-section (1) of section 9;

(B) “fees for technical services” shall have the same meaning as in Explanation 2 to clause (vii) of sub-section (1) of section 9;

**Provided** that where in respect of any such sum, tax has been deducted in any subsequent year or, has been deducted in the previous year but paid in any subsequent year after the expiry of the time prescribed under sub-section (1) of section 200, such sum shall be allowed as a deduction in computing the income of the previous year in which such tax has been paid.

Explanation.—For the purposes of this sub-clause,—

- (i) “commission or brokerage” shall have the same meaning as in clause (i) of the Explanation to section 194H;
- (ii) “fees for technical services” shall have the same meaning as in Explanation 2 to clause (vii) of sub-section (1) of section 9;
- (iii) “professional services” shall have the same meaning as in clause (a) of the Explanation to section 194J;
- (iv) “work” shall have the same meaning as in Explanation III to section 194C;
- (ib) any sum paid on account of securities transaction tax under Chapter VII of the Finance (No. 2) Act, 2004;]

**The following sub-clause (ic) shall be inserted after sub-clause (ib) of clause (a) of section 40 by the Finance Act, 2005, w.e.f. 1-4-2006:**

- (ic) any sum paid on account of fringe benefit tax under Chapter XII-H;
- (ii) any sum paid on account of any rate or tax levied on the profits or gains of any business or profession or assessed at a proportion of, or otherwise on the basis of, any such profits or gains;
- <sup>3</sup>[(iia) any sum paid on account of wealth-tax.

Explanation.—For the purposes of this sub-clause, “wealth-tax” means wealth-tax chargeable under the Wealth-tax Act, 1957 (27 of 1957), or any tax of a similar character chargeable under any law in force in any country outside India or any tax chargeable under such law with reference to the value of the assets of, or the capital employed in, a business or profession carried on by the assessee, whether or not the debts of the business or profession are allowed as a deduction in computing the amount with reference to which such tax is charged, but does not include any tax chargeable with reference to the value of any particular asset of the business or profession;

- <sup>4</sup>[(iii) any payment which is chargeable under the head “Salaries”, if it is payable—
  - (A) outside India; or
  - (B) to a non-resident,and if the tax has not been paid thereon nor deducted there from under Chapter XVII-B;
- (iv) any payment to a provident or other fund established for the benefit of employees of the assessee, unless the assessee has made effective arrangements to secure that tax shall be deducted at source from any payments made from the fund which are chargeable to tax under the head “Salaries”;
- (v) any tax actually paid by an employer referred to in clause (10CC) of section 10

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3 Inserted by the Income-tax (Amendment) Act, 1972, with retrospective effect from 1-4-1962 subject to savings prescribed by sections 4 and 5 of that Act

4. Substituted by the Finance Act, 2003, w.e.f. 1-4-2004. Prior to its substitution, sub-clause (iii) read as under :  
‘(iii) any payment which is chargeable under the head “Salaries”, if it is payable outside India and if the tax has not been paid thereon nor deducted there from under Chapter XVII-B;’

**CIRCULAR NO. 528 DATED 16.12.1988 EXPLAINING SCOPE AND EFFECT  
OF SECTION 40(a)(i) AS SUBSTITUTED BY FINANCE ACT, 1988**

**Provisions for disallowance of payments to non-residents if no deduction  
of tax at source: -**

**20.1** Under the existing provisions of clause (a) of section 40 of the Income-tax Act, any interest not being an interest on loan issued for public subscription before 1-4-1938, which is payable outside India on which tax has not been paid or deducted and in respect of which there is no person in India who may be treated as agent under section 163 of the Income-tax Act is not deductible in the computation of income chargeable under the head "Profits and gains of business or profession". In order to ensure effective compliance of the provisions of section 195 of the Income-tax Act relating to tax deduction at source in respect of payments outside India, the scope of the above provision has been extended to cover payments in respect of royalty, fees for technical services or other sum chargeable under the Income-tax Act. Further, under the existing provisions, disallowance can be made only if there is no person who can be treated as an agent of the non-resident. The Finance Act, 1987 had amended these provisions to secure that even when a person paying is himself an agent of the non-resident, the tax should be deducted. Consequently, even if there is an agent, non-deduction of tax at source will be in contravention of the law, which will now result in disallowance. The condition of there being agents is not necessary as it provides an escape route to the persons making these payments. Consequently, the words "and in respect of which there is no person in India who may be treated as an agent under section 163", have been omitted from sub-clause (i) of clause (a) of section 40 of the Income-tax Act.

**20.2** It has been provided by the Amending Act that if, in any subsequent year, tax is deducted at source or paid, such sum will be allowed as a deduction in computing the income chargeable to tax of that year.

**20.3** These amendments will come into force with effect from 1st April 1989 and will, accordingly, apply in relation to assessment year 1989-90 and subsequent years.

[Section 11 of the Finance Act, 1988]

**MEMORANDUM EXPLAINING PROVISIONS IN THE  
FINANCE (NO. 2) BILL, 2004**

**Enforcing compliance of provisions of TDS**

Under the existing provisions of Sub-clause (i) of section 40, failure to make deduction at source from payment of interest, royalty, fees for technical service or any other sum which is payable outside India, or in India to a non-resident or to a foreign company or failure to make payment to the account of the Central Government, attract disallowance of such payments in the hands of the payer. Deduction of such sum is, however, allowed in the computation of income if tax is deducted, or after deduction, paid in any subsequent year in computing the income of that year.

With a view to augment compliance of TDS provisions, it is proposed to extend the provisions of section 40(a)(i) to payments of interest, commission or brokerage, fee for professional services or fees for technical services to residents, and payments to a resident contractor or sub-contractor for carrying out of any work (including supply of labour for carrying out any work), on which tax has not been deducted or after deduction, has not been paid before the expiry of the time prescribed under sub-section (1) of section 200 and in accordance with the other provisions of Chapter XVII-B. It is also proposed to provide that where in respect of payment of any sum, tax has been deducted under Chapter XVII-B or paid in any subsequent year, the sum of payment shall be allowed in computing the income of the previous year in which such tax has been paid.

The proposed amendment will take effect from 1<sup>st</sup> day of April, 2005 and will, accordingly, apply in relation to the Assessment Year 2005-06 and subsequent years.

[Clause 11]