

Handbook on Disallowance of Expenses under the head Income from Business and Profession



Direct Taxes Committee

The Institute of Chartered Accountants of India

(Set up by an Act of Parliament)

New Delhi



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Foreword

The Direct Taxes Committee (DTC) of the Institute of Chartered Accountants of India (ICAI) is engaged in updating the knowledge of its stakeholders in the area of direct taxation. This is done through workshops, seminars, and particularly through publications from time to time covering pertinent topics which are relevant in the emerging era. There are various provisions in the Income Tax Act, 1961 which are relevant and need special attention in order to comply and take benefits.

As per the provisions of the Income Tax Act, 1961, there are two kinds of provisions for expenses, - one in respect of what is allowable and other in respect of what is not allowable. Considering relevance of these provisions, I am happy to note that the Direct Taxes Committee of ICAI has come out with this publication namely “**Handbook on Disallowance of Expenses under the head Income from Business and Profession**” to provide the basic knowledge on the above subject and other related information.

I appreciate the efforts of CA. Chandrashekhar V. Chitale, Chairman, Direct Taxes Committee, CA. Raj Chawla, Vice-Chairman, Direct Taxes Committee and all members of the Committee and resource persons who have made invaluable contribution in the finalisation of this publication.

I am confident that the members will find this handbook of immense use in discharging their responsibilities in an efficient and effective manner.

Date: 06.02.2023

CA. (Dr.) Debashis Mitra

Place: New Delhi

President, ICAI

Preface

Direct taxation is one of the important areas for the Chartered Accountants. Various Amendments in the Income Tax law makes the nature of the subject dynamic and hence important to bring perspective on the pertinent topics.

One important topic is Disallowance of expenses under the Income Tax Act, 1961. As per the provisions of the Income tax Act, 1961, while determining under the head 'Income from Business or Profession' whether a particular expenditure is deductible or not, the first requirement must be to enquire whether the deduction is expressly denied under any provision of the Income tax Act, 1961. If it is not so denied, then alone the allowability may be considered under Section 28 or Section 37(1). Section 40 and 40A provide for a list of nondeductible expenses or payments that are disallowed while computing income under that head. Under Section 43B certain deductions are allowed only on making actual payment.

To provide guidance on this matter to the members, this handbook shall be very useful. We hope, it would enable the members to better understand the said provisions.

The Direct Taxes Committee is publishing this brief book viz “**Handbook on Disallowance of Expenses under the head Income from Business and Profession**” as a handy tool to assist the fraternity to make proper computation of Income under this head.

We are sincerely thankful to CA. (Dr.) Debashis Mitra, President, ICAI and CA. Aniket Sunil Talati, Vice-President, ICAI for being guiding force behind all initiatives being taken by the Committee.

We appreciate and thankful to CA Aishwarya H R for her efforts in providing valuable inputs for this handbook. We are pleased to place on record our sincere gratitude for the involvements and contributions by CA. Cotha S. Srinivas, Central Council member and all the Committee members and our dear Council Colleagues of ICAI. We are sure that this effort of DTC of ICAI

would go a long way in assisting our members in making utmost compliance of the provisions.

CA. Raj Chawla
Vice-Chairman,
Direct Taxes Committee, ICAI

CA. Chandrashekhar V. Chitale
Chairman,
Direct Taxes Committee, ICAI

Date: 06.02.2023

Place: New Delhi

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I. Introduction to Disallowance of Expenses

DISALLOWANCE OF BUSINESS EXPENDITURE

Introduction

- Expenditure means a cost relating to the operations of an accounting period or to the revenue earned during the period or the benefits of which do not extend beyond the period.
- There are two kinds of provisions wrt expenditure in Income Tax Act i.e.,
 1. **Allowable Expenditure-** Those expenses which are allowed/ deducted while computing the taxable income under the head “Profits and Gains from Business or Profession”.
 2. **Disallowed Expenditure-** Those expenses which are not allowed/ cannot be deducted while computing the taxable income under the head “Profits and Gains from Business or Profession”. It means such expenses will be added to the income on which tax needs to be remitted.
- The provisions of disallowance of expenditure should be applied first as they are overriding provisions.
- While determining whether a particular expenditure is deductible or not, the first requirement must be to enquire whether the deduction is expressly prohibited under any other provision of the Income tax Act. If the same is not prohibited, then such expenditure can be claimed while computing the taxable income.
- If any expenditure is not allowable due to any provisions, then that expenditure is not allowable. There are specific as well as general provisions which do not allow the expenditures.
- **Reasons for disallowance of Expenditure**

There are various reasons why expenditure will be disallowed. Few of them are mentioned below:
- Non- Compliance with the provisions of law:
 - Expenditure on which TDS should have been deducted and paid, has not be deducted and paid.
 - Incurring cash payments exceeding Rs.10,000-00

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- Certain expenditure are allowed on payment basis
- Interest on delay in payment of TDS
- Delay in remitting ESI and PF contributions to the government
- Personal expenses cannot be claimed as business expenses
- No proper maintenance of documents like vouchers, invoices for the expenses incurred.

Implications:

- If a particular expense is disallowed, then such amount shall be treated as income and will be taxed @ 30% + Surcharge + Cess.
- This becomes an additional burden for Assessee. Therefore, it will be the duty of the Assessee to comply with the provisions of the law and make sure that he can claim the expenses.

II. Specific provisions for Disallowance of Expenses

Sec 40- Amounts not deductible

Sec 40(a)(i)- Payments/ Credits made to Non- Resident, not being a Company or to a foreign Company

Overview:

- If there is default in the TDS deduction or payment by the payer in respect of the payment/ credit of interest, Royalty, Fee for technical Services or any other sum chargeable under this Act (Other than Salary) to non-Resident, not being a Company or to a foreign Company, then 100% of such expenditure is disallowed in the hands of the payer.
- The meaning of the word 'interest' is very wide and would include interest on unpaid purchase price payable in any manner which would include any means of irrevocable letter of credit. Interest is not part of purchase price and is assessable as interest. Failure to deduct tax on such interest payable outside India shall not entitle the assessee to claim deduction of interest. Sec. 2(28A) defining "interest" does not include the discounting charges on discounting of Bills of Exchange.

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Example:- X Company discounted its export sales bills with a company in Singapore and received a payment net of discounting charges. The Assessing Officer disallowed such expenses under Sec. 40(a)(i), for not deducting tax at source under Sec. 195. As the discounting charges cannot be analogous to interest expenses, the obligation to deduct tax under Sec. 195 would not arise and the X Company cannot be denied deduction of such expenses.

Illustrations:

1. When shall the payments be allowed and disallowed..??

In the given situations, assume Payer is Resident and Payee is Non-Resident

Situation	Disallowance in Current Year	Subsequent allowance of such expenditure which was disallowed
Case 1- TDS is deductible but not deducted	100% of such expenditure is disallowed in Current Year	If tax is deducted in any subsequent year, the expenditure (which is disallowed in the current year) will be deducted in the year in which TDS will be deposited by the assessee with the Government
Case 2- TDS is deductible (and is so deducted) during the current financial year but it is not deposited on or before the due date of submission of return of income under section 139(1)	100% of such expenditure is disallowed in Current Year	If tax is deposited with the Government after the due date of submission of return of income as per the provisions of Sec 139(1), the expenditure (which is disallowed in the current year) will be deductible in that year in which tax will be deposited

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Case 3- TDS is deductible (and is so deducted) during the current financial year and it is deposited on or before the due date of submission of return of income under section 139(1)	There will be no disallowance	Not Applicable as the expenditure was fully allowed in the Current Financial Year
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Sec 40(a)(ia)- Payments/Credits made to Resident

- If there is default in the TDS deduction or payment by the payer in respect of the payment/ credit on which tax is deductible at source under Chapter XVII-B to Resident, then 30% of such expenditure is disallowed in the hands of the payer.

Illustrations

1. When shall the payments be allowed and disallowed..??

In the given situations, assume Payer is Resident and Payee is also Resident

Situation	Disallowance in Current Year	Subsequent allowance of such expenditure which was disallowed
Case 1- TDS is deductible but not deducted	30% of such expenditure is disallowed in Current Year	If tax is deducted in any subsequent year, the expenditure (which is disallowed in the current year) will be deducted in the year in which TDS will be deposited by the assessee with the Government
Case 2- TDS is deductible (and is so deducted) during the	30% of such expenditure is disallowed in Current	If tax is deposited with the Government after the due date of

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current financial year but it is not deposited on or before the due date of submission of return of income under section 139(1)	Year	submission of return of income as per the provisions of Sec 139(1), the expenditure (which is disallowed in the current year) will be deductible in that year in which tax will be deposited
Case 3- TDS is deductible (and is so deducted) during the current financial year and it is deposited on or before the due date of submission of return of income under section 139(1)	There will be no disallowance	Not Applicable as the expenditure was fully allowed in the Current Financial Year

FAQs for Sec 40(a)(i) and (ia)

1. Whether disallowance provisions is applicable only to the payments which are "Payable" as the word "Payable" is mentioned in the said Section..??
 - No, disallowance provisions are applicable to the cases irrespective of whether the payment is either paid or payable.
 - Refer Circular No. 10/2013 dated 16.12.2013.
2. Is Sec 40(a)(ia) attracted when the amount is not payable but has been actually paid..??
 - Deduction of TDS is mandatory and is applicable irrespective of the method of accounting followed by the Assessee.
 - Assessee should deduct TDS at the time of credit or payment, whichever is earlier.
 - Therefore, provisions of disallowance attracts even if the amount is not payable but paid.
 - Refer Palam Gas Service Vs CIT (2017) 394 ITR 300 (SC)

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3. Whether disallowance U/s 40(a)(i) and (ia) can be avoided..??
- Yes, disallowance U/s 40(a)(i) and (ia) can be avoided if all the below mentioned conditions are satisfied cumulatively:
The Payee has
 - Furnished his Return of Income U/s 139(1)
 - Taken such amount in his total income
 - Paid tax on such amount
 - Payer furnishes a certificate of a Chartered Accountant in Form 26A stating that the payee has fulfilled the above mentioned conditions.
4. Whether payments made to transporters would be disallowed for non-deduction of TDS..??
- Payments made to transportation, freight, clearing and forwarding would not be disallowed if:
 - The transporter should not own more than ten goods carriages at any time during the year and
 - The Assessee has obtained declaration and PAN from such transporter as required U/s 194C(6) and 194C(7) and
 - The Assessee has reported the same in Form 26Q.
5. Whether provisions of Sec 40(a)(ia) can be invoked while computing income under the head "Capital Gains"..??
- The provisions of Sec 40(a)(ia) cannot be invoked while computing income under the head "Capital Gains". Therefore, disallowance cannot be made.
 - Refer 126 taxmann.com 19 (Bangalore-ITAT) – R K Associates vs ITO Ward-(2)(2)(3), Bengaluru.
6. Whether delay in filing TDS returns attracts disallowance..??
- No, delay in filing TDS returns doesnot attract disallowance U/s 40(a)(i)/ (ia).

Sec 40(a)(ib)- Equalisation Levy

Overview:

- Any amount paid or payable to Non- Resident on which Equalisation Levy is deductible is not deducted or has been deducted but not remitted to on or before filing Return of Income U/s 139(1).
- 100% of such expense shall be disallowed.

Sec 40(a)(ii)/(iia)- Disallowance of Income Tax, Wealth Tax, etc

Overview:

- Payment of Income tax like TDS, Self Assessment Tax and Wealth tax is not allowed as deduction while computing Profits and Gains from Business or Profession.
- Income tax also includes interest on delayed payment of Income Tax, interest paid on delayed filing of Income Tax and TDS Returns, tax paid in any other country for which relief is available U/s 90, 90A and 91.

FAQs:

1. Whether cess or surcharge on income tax paid by businesses can be allowed as a deduction...??
 - Rule 132 has been introduced for this purpose, which clarified that while calculating the net taxable profit of a business, deduction for such cess and surcharge on income tax is not an allowable deduction from the taxable profit.

The clarification was made by way of amendment of the income tax act with retrospective effect from 2005.
 - The Government provided a one-time window, allowing those taxpayers who had claimed the cess or surcharges as a deduction from their taxable profits, to recompute their taxable profits after removing such cess or surcharge and deposit the tax on such income by filing Form 69 on or before 31st March, 2023.
2. What is the impact of Rule 132 for those Assessees who have claimed cess and surcharge on Income Tax as deduction..??
 - Rule 132 is a beneficial clause allowing assessees to comply with the provision of Section 155 which allowed Assessing Officers to

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re-compute the total income for such previous years in which the assessee would have claimed deduction of surcharge or cess which will be disallowed u/s 40(a)(ii).

- This recomputation will attract provisions of section 270A (3) wherein this disallowed surcharge is treated as under-reported income.
- As per the new Rule, an assessee can suo moto submit an application in the prescribed form for re-computation of income, without claiming a deduction for surcharge or cess and on payment of appropriate taxes (if any) in that case it would not be deemed as under-reported income hence no penalty will be levied U/s 270A(3).

Sec 40(a)(iib)- Payment made to State Government

Overview:

Payer	Payee	Nature of payment	% of disallowance
State Government Undertaking (Refer Note 1)	State Government	Royalty, license fee, service fee, privilege fee, service charge or any other fee or charge	100%

FAQs:

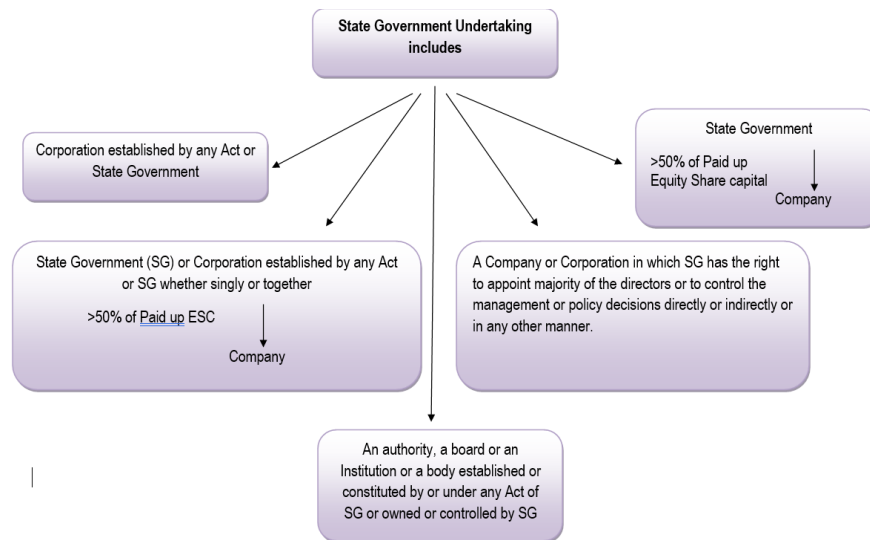
1. When is disallowance not attracted..??

No disallowance under this section shall attract if:

- The said payment are made to Central Government or
- The said payments are non-exclusive in nature i.e., similar payments are also made to parties other than State Government.

Note 1: State Government Undertaking includes:

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Sec 40(a)(iii)- Payment of Salary

Overview:

- Any Salary payable
 - Outside India or
 - To a Non- Resident in India

shall be disallowed, if tax has not been deducted or paid on or before the due date prescribed for such deductions.

Period	Timelines for payment of TDS
For the period from April to Feb	On or before 7th of subsequent month. For Ex: TDS for the month of April 2022 should be remitted on or before 7th of May 2022
March	On or before 30th April

FAQs:

1. Whether TDS on Salary to Non-Resident should be deducted as per Sec 195 or Sec 192..??
- Sec 195 specifically excludes Salary. Therefore, TDS on payment of Salary to Non- Resident should be deducted as per Sec 192.

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2. Mr A (Non-Resident) was employed by XYZ Ltd. XYZ Ltd was liable to deduct TDS on Salary paid of Rs.2,00,000-00 to Mr A for the month of June 2022. XYZ Ltd remitted TDS to government on 8th July 2022. Whether such expense is disallowed to XYZ Ltd..??
 - As per the provisions, TDS should be remitted on or before 7th of the subsequent month.
 - In the given scenario, TDS has been remitted on 8th July which is not within the due date.
 - Therefore, salary of Rs.2,00,000-00 shall be fully disallowed i.e., it shall be fully taxable in the hands of XYZ Ltd.

Sec 40(a)(iv)- Payment to Provident Fund and other Funds

Overview:

- Any payment to a provident or other fund established for the benefit of the employees shall be disallowed unless the employer 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".

Sec 40(a)(v)-Tax paid by Employer on Non-Monetary perquisites

Overview:

- Any tax on non-monetary perquisites borne by the employer on behalf of the employee which is exempt U/s 10(10CC) in the hands of the Employee shall be disallowed.

FAQs

1. What is Non-Monetary perquisites..??

Free facility or benefit provided by Employer to the Employee.
2. What are the examples of Non-Monetary perquisites..??
 - Rent free accomodation
 - Medical facilities
 - Recreational facilities
 - Education to children of Employee

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Sec 40(b)- Disallowance in case of partnership firms/LLP

Overview:

- This Section determines the maximum amount of remuneration and interest on capital paid/payable to a partner under the Income Tax Act, 1961. The amount over the specified limit shall be disallowed.
- **Remuneration to Partners:**
 - Remuneration shall include salary, bonus, commission or by whatever name called.

FAQs

1. What are the conditions to be satisfied for claiming deduction of remuneration paid/payable to partner..??

Following are the conditions to be satisfied cumulatively for claiming deduction of remuneration paid/ payable to partner:

- It has to be paid to Working partner and
- It has to be authorized in partnership deed and
- It should relate to the period falling after the date of partnership deed i.e., it should not be with retrospective effect and
- It should be within the limits i.e.,

Book Profits	Remuneration allowed
On the first Rs.3,00,000 of Book Profits or in case of loss	Rs.1,50,000 or 90% of the Book Profits, whichever is higher
On the balance of Book Profit	60% of the Book Profits

2. How to calculate Book Profits..??

Particulars	Amt
Net Profit/(Loss) as per Profit & Loss Account	XXX
Add: Items debited to Profit and Loss Account	
Total Interest Paid to Partners	XX
Remuneration to Partners	XX
Salary to partners	XX

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Bonus to partners	XX
Commission to partners	XX
Depreciation	XX
Interest paid to partners and other disallowances	XX
Profit before interest, depreciation & remuneration	XXX
Less: Interest on capital to partners @ 12% pa	(XX)
Depreciation as per Income Tax Act	(XX)
Book Profit	XXX

3. ABC and firm, incorporates the clause relating to the payment of remuneration to the working partners, by making amendment to the partnership deed on 1st Nov, 2022 but with effective from 1st Sep, 2022. Whether remuneration shall be allowed as deduction from 1st Sep, 2022..??

No, remuneration will be allowed as deduction from 1st Nov, 2022 as the amendment to partnership deed was done on 1st Nov, 2022. Remuneration shall not be allowed with retrospective effect.

4. What are the conditions to be satisfied for claiming deduction of interest paid/ payable to partner..??

Following are the conditions to be satisfied cumulatively for claiming deduction of interest paid/ payable to partner:

- It has to be authorized in partnership deed and
- It should relate to the period falling after the date of partnership deed i.e., it should not be with retrospective effect and
- Maximum of 12% pa simple interest.

5. Illustrations wrt the interest allowed as deduction

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Interest Rate are as follows:

As per Partnership Deed	Max. as per Income Tax Act	Interest allowed	Interest disallowed	Remarks
10%	12%	10%	Nil	As the interest is well within the limit
15%	12%	12%	3%	As the interest exceeds 12%, therefore excess interest of 3% shall be disallowed

6. XYZ and firm files its Return of Income as per Sec 44AD. Whether it can claim deduction of remuneration and interest paid to its partners from the net profit..??

No, Assessee cannot claim deduction of remuneration and interest paid to its partners from the net profit if it has opted for presumptive taxation.

7. Whether interest should be computed first or remuneration..??

In order to calculate the allowable remuneration, we need to compute the Book Profits. To arrive at the book profits, we need to make suitable adjustments wrt the interest.

Therefore, interest should be computed first and then remuneration shall be computed and allowed.

8. ABC and Associates, a partnership firm consisting of 2 partners, reports a net profit of Rs.50,00,000-00 **before deduction** of following items:
- Salary of Rs.1,50,000-00 pm to each partner as authorized by partnership deed
 - Depreciation as per Sec 32 is Rs.2,00,000-00
 - Interest on capital at 15% pm (as per deed). The amount of capital eligible for interest is Rs.5,00,000-00

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Compute the interest and remuneration allowed and disallowed.

Computation of interest allowed and disallowed:

Particulars	Amt
Net Profit/(Loss) as per Profit & Loss Account	50,00,000.00
Less: Depreciation as per Sec 32	2,00,000.00
Less: Interest on capital to partners @ 12% pa (Interest allowed)	60,000.00
Book Profit	47,40,000.00

Therefore, interest disallowed is Rs.15,000-00 (Rs.5,00,000*15%-60,000).

Computation of remuneration allowed and disallowed:

Particulars	Amt
On the first Rs.3,00,000 of Book Profits	2,70,000.00
On the remaining Book Profits (47,40,000-2,70,000)	26,73,000.00
Remuneration	29,43,000.00

Actual remuneration is Rs.36,00,000-00 (Rs.1,50,000*12 months * 2 partners)

Therefore, remuneration allowed is Rs.29,43,000-00 and disallowed is Rs.6,57,000-00 (Rs.36,00,000- 29,43,000).

9. Whether remuneration needs to be quantified in partnership deed in order to claim deduction..??

As per Circular No. 739 dated 25-3-1996 no deduction under section 40(b)(v) will be admissible unless the partnership deed either specifies the amount of remuneration payable to each individual working partner or lays down the manner of quantifying such remuneration.

10. Whether bonus, commission also needs to be quantified in partnership deed in order to claim deduction..??

The word "remuneration" includes salary, bonus, commission or by any other name. Therefore, even bonus, commission also needs to be quantified in partnership deed in order to claim deduction.

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11. Whether payments to partners for specified services rendered by them which is not in the capacity of partners will be allowed as deduction..?

In case where payments are made for specific services rendered by the partners to the firm not in the capacity of partners, but because of contractual relationship undertaken by the partners for specific services will be allowed as deduction. Refer CIT Vs Raja Ramaswamy & Sons (2008) 298 ITR 325 (Madras)

12. Whether rent paid to partners is covered U/s 40(b)..?

No, Sec 40(b) includes only remuneration and interest. Therefore, rent paid to partners is not included in Sec 40(b) and therefore not subject to any disallowance U/s 40(b).

13. What are the circumstances in which Section 40(b) not applicable wrt the payments of interest..?

- If any individual is a partner in a firm on individual capacity and receiving interest on Representative capacity, then Sec 40(b) is not applicable on such interest
- If any individual is a partner in a firm on Representative capacity and receiving interest on individual capacity, then Sec 40(b) is not applicable on such interest.

14. XYZ and Associates is a partnership firm in which Mr A is appointed as partner in Representative capacity i.e., on behalf of and for the benefit of ABC HUF. Mr A is a Karta in ABC HUF. XYZ and Associates pays interest to Mr A at the rate of 15%. Whether it shall be disallowed...?

Since, Mr A is appointed as a partner in XYZ and Associates on Representative capacity, Sec 40(b) is not applicable for any interest paid.

Therefore, entire interest paid shall be allowed as deduction.

15. In continuation to above question, XYZ and Associates has paid remuneration to Mr A (who is appointed in Representative capacity) which is more than the allowed remuneration. Whether such excess remuneration shall be allowed as deduction..?

Explanation to Sec 40(b) is only wrt the interest. Therefore, excess remuneration shall be disallowed as per Sec 40(b).

Sec 40(ba)- Disallowance in case of Association of Persons and Body of Individuals

Overview:

- Payment of any interest, salary, commission, bonus or remuneration by Association of Persons or Body of Individuals to its members will be disallowed in computing the income of the Association or Body.
- In case, where the member who received the interest from the AOP or BOI also pays interest to the AOP or BOI during the same previous year, only the excess interest paid by the AOP or BOI to such member shall be disallowed.

FAQs:

1. During the FY 2022-23, AOP has paid interest of Rs.75,000-00 to its member. Member had also paid interest of Rs.50,000-00 to AOP. How much is the interest disallowed to AOP in the FY 2022-23...??

As per Sec 40(ba), only the excess interest paid by AOP to its member i.e., Rs.25,000-00 (Rs.75,000- 50,000) shall be disallowed in the hands of AOP.

2. What are the circumstances in which Section 40(ba) not applicable wrt the payments of interest..??
 - If a person is a member in individual capacity and receiving interest in Representative capacity, then Sec 40(ba) is not applicable on such interest.
 - If a person is a member in Representative capacity and receiving interest in individual capacity, then Sec 40(ba) is not applicable on such interest.

Sec 40A- Expenses or Payments not deductible in certain circumstances

Sec 40A(2) - Excessive Payments to Related Party Transactions

Overview:

- If Assessee incurs any expenditure towards goods supplied, services rendered or facilities provided by related persons, the Assessing Officer can disallow such expenditure to the extent it is excessive or unreasonable.

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FAQs:

1. On what basis the Assessing Officer will decide that the expenditure is excessive or unreasonable..??

Assessing Officer shall determine whether the expenditure is excessive or unreasonable having regard to the following:

- The Fair Market Value of the goods, services or facilities for which payment is made
- The legitimate needs of the business or profession of the Assessee
- The benefit derived by or accruing to the Assessee from the payment.

It is to be noted that the disallowance under this Section is not automatic and will be disallowed only if Assessing Officer finds such expenditure as unreasonable or excessive in nature.

2. Who are the related persons covered under this Section..??

Assessee (Who makes the payment)	Related Persons
Individual	Any relative of such individual
	any person in whose business or profession the assessee (i.e. individual) himself or any relative of such individual has a substantial interest
Company, firm, AOP or HUF	Company-Any director of the company Any relative of such director Firm- Any partner of the firm Any relative of such partner AOP/HUF Any member of the AOP/HUF Any relative of such member
	any person in whose business or profession the assessee (i.e. Company,

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Assessee (Who makes the payment)	Related Persons
	firm, AOP or HUF)-itself, or any director, or any partner, or any member, or any relative of above persons, has a substantial interest.
All Assesseees	Any individual who has substantial interest in Assessee's business or profession, or any relative of such individual
	A Company, firm, AOP or HUF having substantial interest in Assessee's business or profession, any director, partner or member of any such entity or any relative of any such director, partner or member or any other company carrying on business or profession, in which the first mentioned company has substantial interest
	As Company, firm, AOP or HUF of which a director, partner or member has substantial interest in Assessee's business or profession or any director, partner or member of any such entity or association or family or any relative of any such director, partner or member of any such entity or Association or family or any relative of any such director, partner or member

The term "relative" means:

1. Where the assessee is **an individual** shall include:
 - Spouse of the individual
 - Brother or Sister of the individual

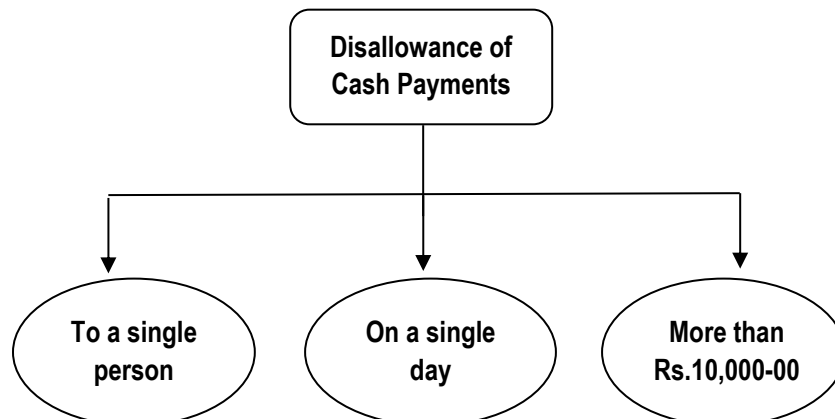
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Lineal Ascendant or lineal descendent of the individual

2. Where the assessee is a **Firm/ HUF/ AOP**- the relationship shall be determined with reference to the partners or members or persons having substantial interest in such Firm/ HUF/ AOP.
3. Where the assessee is a **Company**- the relationship shall be determined with reference to the directors or persons having substantial interest in the Company.
4. A person who is the beneficial owner of shares, carrying not less than 20% of the voting power/ share of profits in such business or profession at any time during the previous year shall be considered to be having '**substantial interest**'.

Sec 40A(3)- Disallowance in case of payments made by modes other than the prescribed modes

Overview:



- Where the assessee incurs any expenditure in respect of which a payment or aggregate of payments made to a person in a day, otherwise than by an account payee cheque drawn on a bank or account payee bank draft, or use of electronic clearing system through a bank account or through such other electronic mode as may be prescribed, exceeds Rs.10,000-00, no deduction shall be allowed in respect of such expenditure.
- The limit of Rs.10,000-00 shall be substituted with Rs.35,000-00 in case of payment made for plying, hiring or leasing of goods carriages.

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- Other electronic modes has been prescribed in Rule 6ABBA.

FAQs:

1. Sec 40A(3) deals with the expenditures which are debited to Profit and Loss Account. What is the treatment to be given if an Assessee purchases the Fixed Asset say, Furniture otherwise than the prescribed modes which exceeds Rs.10,000-00..??

Sec 43(1) deals with the actual cost of Capital Asset. Accordingly, even in case of purchase of furniture exceeding Rs.10,000-00 for which payment is made otherwise than the prescribed modes, depreciation shall not be allowed as such payment shall not form part of actual cost of capital asset.

2. Sec 40A(2) and Sec 40A(3) can be applied for same expenditure. However, if disallowance is attracted U/s 40A(2), then the same shall not be considered again for the purpose of disallowance U/s 40A(3).

Example: Mr A purchased goods worth Rs.70,000-00 (Market value is Rs.55,000-00) from Mrs B (Spouse of Mr A) in cash.

In the given case, Rs. 15,000-00 (i.e., 70,000-55,000) will be disallowed as per Sec 40A(2) as it is excessive in nature. Further Rs.55,000-00 will be disallowed as per Sec 40A(3).

3. What if an expense is allowed on due basis and is paid in cash in the next year..??

As per Sec 40A(3A) when an expense is allowed on due basis and in the subsequent year if the Assessee makes the payment exceeding Rs.10,000-00 otherwise than the prescribed modes, then such payment shall be deemed to be the business income in the subsequent year and will be charged to tax.

4. Whether there are any cases for which disallowances would not be attracted..??

Cases where disallowances would not be attracted:

- Loan transactions- As advancing or repayment of loans would not form part of computing the income of the asseesee. However, interest paid on loan would be under the perview of Sec 40A(3).
- Payments made by Commission Agents- This requirement

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does not apply to payments made by commission agents for the goods received by them for sale on commission or consignment basis because such a payment is not an expenditure deductible in computing the taxable income of the commission agent.

5. Whether there are any exceptions for cash payments..??

Exceptions for Cash payments is explained in Rule 6DD i.e., no disallowance U/s 40A(3) is attracted. Following is the list of payments:

- (a) where the payment is made to—
 - (i) the Reserve Bank of India or any banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);
 - (ii) the State Bank of India or any subsidiary bank as defined in section 2 of the State Bank of India (Subsidiary Banks) Act, 1959 (38 of 1959);
 - (iii) any co-operative bank or land mortgage bank;
 - (iv) any primary agricultural credit society or any primary credit society as defined under section 56 of the Banking Regulation Act, 1949 (10 of 1949);
 - (v) the Life Insurance Corporation of India established under section 3 of the Life Insurance Corporation Act, 1956 (31 of 1956);
- (b) where the payment is made to the Government and, under the rules framed by it, such payment is required to be made in legal tender;
- (c) where the payment is made by—
 - (i) any letter of credit arrangements through a bank;
 - (ii) a mail or telegraphic transfer through a bank;
 - (iii) a book adjustment from any account in a bank to any other account in that or any other bank;
 - (iv) a bill of exchange made payable only to a bank;
- (d) where the payment is made by way of adjustment against the amount of any liability incurred by the payee for any goods supplied or services rendered by the assessee to such payee;

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- (e) where the payment is made for the purchase of—
 - (i) agricultural or forest produce; or
 - (ii) the produce of animal husbandry (including livestock, meat, hides and skins) or dairy or poultry farming; or
 - (iii) fish or fish products; or
 - (iv) the products of horticulture or apiculture,
to the cultivator, grower or producer of such articles, produce or products;
- (f) where the payment is made for the purchase of the products manufactured or processed without the aid of power in a cottage industry, to the producer of such products;
- (g) where the payment is made in a village or town, which on the date of such payment is not served by any bank, to any person who ordinarily resides, or is carrying on any business, profession or vocation, in any such village or town;
- (h) where any payment is made to an employee of the assessee or the heir of any such employee, on or in connection with the retirement, retrenchment, resignation, discharge or death of such employee, on account of gratuity, retrenchment compensation or similar terminal benefit and the aggregate of such sums payable to the employee or his heir does not exceed fifty thousand rupees;
- (i) where the payment is made by an assessee by way of salary to his employee after deducting the income-tax from salary in accordance with the provisions of section 192 of the Act, and when such employee—
 - (i) is temporarily posted for a continuous period of fifteen days or more in a place other than his normal place of duty or on a ship; and
 - (ii) does not maintain any account in any bank at such place or ship;
- (k) where the payment is made by any person to his agent who is required to make payment in cash for goods or services on behalf of such person;

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- (l) where the payment is made by an authorised dealer or a money changer against purchase of foreign currency or travellers cheques in the normal course of his business.

6. Mr A made the below mentioned payments. Whether disallowance U/s 40A(3) is attracted or not..??

Case	To Party	Date of payment	Invoice No	Invoice Value	Cash payment	Disallowance U/s 40A(3)	Reason
1	B	01-04-2022	1	15,000.00	15,000.00	15,000.00	Cash payment exceeds Rs.10,000 to a single person in a single day towards single invoice
2	B	01-04-2022	2	9,500.00	9,500.00	NIL	Cash payment doesnot exceed Rs.10,000 on a single day
3	D	15-04-2022	3	20,000.00	5,000.00	20,000.00	Multiple payment exceeds Rs.10,000 to a single person in a single day towards single invoice
					6,000.00		
					9,000.00		
4	E	17-04-2022	4	27,500.00	6,000.00	NIL	Cash payment doesnot exceed Rs.10,000 on a single day
		18-04-2022			7,000.00		
		05-05-2022			5,500.00		
		10-05-2022			9,000.00		

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7. Whether disallowance U/s 40A(3) is attracted for payment of excess money received from customers..??

Since, the refund is on account of excess money received on sale of goods, disallowance U/s 40A(3) cannot be invoked and proper documentation for the same is to be maintained by the Assessee.

Refer ACIT Vs Kishore Singh Gehlot (HUF) (ITAT Jaipur)

8. What are the various types of situations for which disallowance U/s 40A(3) is attracted..??

Cash payments exceeding Rs.10,000 in a single day to a single person

Below is the various situations which needs to be looked into;

Case	Nature of payment	Whether disallowed U/s 40A(3)	Remarks
1	Expenses debited to Profit and Loss Account	Yes	NA
2	Purchase of Fixed Asset	Yes	Depreciation will be disallowed
3	Loan Repayment	No	Sec 269T will be attracted
4	Interest on loan repayment	Yes	If debited to Profit and Loss Account

Reporting Requirement:

Details of the payments for which Sec 40A(3) attracts needs to be disclosed in Clause 21(d) of Form 3CD.

Sec 40A(7)- Disallowance in case of provision for unapproved Gratuity Fund

Overview:

- Gratuity is a liability which normally arises based on the term of service of the employees of the assessee. Deduction U/s 40A(7) is allowable on account of provision for gratuity when:

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- ✓ The amount of gratuity has actually become payable during the previous year to the employees or
- ✓ when a provision has been made for payment of a sum by way of any contribution towards an approved gratuity fund.
- In other words, any provision for unapproved gratuity fund (for meeting future liability) is not deductible.

Example: A company has 50 employees. To meet future liability to pay them gratuity at the time of retirement, a gratuity fund is created and the employer makes contribution every year. Employers' contribution to this fund is deductible only if the fund is an approved gratuity fund.

Table showing the Amount Deductible in different Cases :

Cases	Remarks
Mr A retires from the service of Y Ltd. on May 31, 2022. The company pays gratuity of Rs. 2,60,000. Y Ltd. does not maintain any provision for gratuity account.	Rs. 2,60,000 is allowed as deduction in the FY 2021-22.
ABC Ltd. maintains an approved gratuity fund. A sum of Rs. 1,00,000 being the employer's contribution towards the gratuity fund, is debited to the profit and loss account for the year ending March 31, 2022.	Where any provision is made for the purpose of payment of a sum by way of any contribution towards an approved gratuity fund, it is allowed as deduction. It is assumed that provisions of section 43B are satisfied .

Sec 40A(9)- Contributions by Employers to funds, trusts, etc

Overview:

- No deduction shall be allowed in respect of any sum paid by the assessee as an employer towards the setting up or formation of, or as contribution to, any fund, trust, company, association of persons, body of individuals, society registered under the Societies Registration Act, 1860 (21 of 1860), or other institution for any purpose.
- However, where such sum is paid in respect of funds covered U/s 36(1)(iv), 36(1)(iva) and 36(1)(v) or any other law, then deduction shall not be denied.

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- This has been introduced to curb the practice amongst the Employers to claim deductions of contributions made from which, no benefits flows to the Employees.

Sec 43B- Certain deductions to be only on actual payment

Overview:

- This Section provides a list of expenditures which is allowed as deduction only in the year of on actual payment i.e., within the due date of furnishing Return of Income U/s 139(1) irrespective of the method of accounting followed and not in the year when the liability arises.
- List of expenditures are as follows:
 - Any tax, duty, cess or fee under any law
 - Contribution to Employee Benefits
 - Bonus or commission to Employees
 - Interest on any loan or borrowings from PFI, State Financial Corporation, State Industrial Investment Corporation, Deposit taking NBFC, Systematically Important non-deposit taking NBFC
 - Interest on any loans or advances from scheduled bank, co-operative bank
 - Leave encashment
 - Indian Railways for use of railway assets.
- Employer's contribution to ESI, PF, etc- Deduction for such payments shall be allowed if it is paid well within the due date of furnishing Return of Income U/s 139(1).
- Employees contribution to ESI, PF, etc- Deduction for such payments shall be allowed while computing the income of Employer under the head "Profits or Gains from Business or Profession" if it is paid well within the due date of specified under the respective welfare acts.
- If Employees contribution to ESI, PF, etc is paid within the due date of furnishing Return of Income U/s 139(1), then the deduction of such payment shall be disallowed as per Sec 36(1)(va) in the hands of the Employer. It means such disallowance is permanent and thus even if the payment is made belatedly deduction shall not be allowed in the year of actual payment.

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- Interest on loans or advances to the above mentioned Financial Institutions/Scheduled Banks- There may be instances where in case of default of payment of interest by the assessee, such unpaid interest is converted into loan by the Financial Institutions/ Scheduled Banks. Such conversion of unpaid interest into loan shall not be deemed to be payment of interest for the purpose of Sec 43B and hence disallowance U/s 43B shall apply. It shall be allowed as deduction in the year of actual payment of such converted loan.

FAQs:

1. Is TDS included in the list of expense provided in Sec 43B..??
TDS is not an expense but a tax which is deducted and deposited to the government. Hence TDS is not included in Sec 43B and hence cannot be claimed as an expense.
2. Can expenditure mentioned U/s 43B can be claimed on an advance payment..??
Section 43B covers a list of expenses that can be claimed on actual payment. In pursuant to this, an advance payment can also be claimed as per section 43B.
3. Is electricity duty/ charges considered as fees U/s 43B...??
No, refer Sarvaraya Textiles Ltd. [TS-5339-ITAT-1994(HYDERABAD)-O]
4. Whether disallowance can be invoke if return is filed as per presumptive taxation..??
Yes, disallowance can be made by invoking the provisions of Sec 43B in respect of the statutory liabilities when the Assessee's income has been assessed U/s 44AF of the Income Tax Act, 1968.
Refer Good Luck Kinetic Vs ITO (ITAT Panaji)
5. Whether discharging liability by way of book adjustment be considered as actual payment..??
Facts of the case- The Company was entitled to receive subsidy from Bihar State Financial Corporation (BSFC). Also, the Company had borrowed loan from BSFC and was liable to pay interest on it. BSFC made a book entry and adjusted the amount of interest receivable with subsidy payable to the Company.

Observation

The Revenue contended that the interest payable by the Company was paid by way of a book entry and hence did not constitute "Actual Payment" for the purpose of Sec 43B and accordingly it was disallowed.

Conclusion

Actual payment doesnot mean actual receipt and delivery of currency by the two parties transacting when they are both creditor and debtor for each other. Hence, discharging of liability by way of book adjustment is allowable expenditure U/s 43B.

Refer Shakti Spring Industries Pvt Ltd Vs CIT (Jharkhand HC)

6. Whether Royalty payable to Government comes under the perview of Sec 43B..??

Royalty payable to government for extraction of limestone is a tax for all purposes including Sec 43B. Therefore, unpaid liability for royalty within the due date prescribed U/s 43B shall be disallowed.

Refer Gorelal Dubey Vs CIT (SC)

Reporting Requirements:

Details should be disclosed in Clause 26 of Form 3CD.

III. Conclusion

Therefore, it shall be the duty of the Assesee to claim the expenses which are allowable. If a particular expense is disallowed, then such amount shall be treated as income and will be taxed @ 30% + Surcharge + Cess.

This becomes an additional burden for Assessee. Therefore, it will be the duty of the Assessee to comply with the provisions of the law and make sure that he can claim the expenses.



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