No TDS on general provision for expenses, made on estimate basis, at the end of the financial year

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Recently, I was approached by one of my clients for an Opinion regarding TDS liability in respect of general provision made, as on the last day of the financial year (FY), relating to a number of expenses, where the identity of the persons in whose hands such income is includible, is not known and the quantum of payment is also not ascertainable, at the point of time when such general provision is made.

The aforesaid Opinion was sought, because in a number cases, TDS authorities initiate proceedings under sections 201(1) and 201(1A) of the Income-Tax Act, 1961 (the Act), for non-deduction of tax in respect of the aforesaid provision. The initiation of such proceedings is totally erroneous on the part of the TDS authorities, because when the identity of the payee is not known and also the quantum of payment is also not ascertainable at the point of time when such general provision is made, no tax is required to be deducted at source in respect of such a provision.

At the outset, it may be stated in the present context that the aforesaid general provision in respect of expenses is made for accounting purposes. The reason for the same is that there are costs which are visible in foresight, but cannot be quantified with precision. In other words, although the factum of liability is ascertained, its quantum remains unknown. In such a case, general accounting principle mandate, '*a provision*' for expenses. In a sense, it is preparation for future expenses. It is setting aside of funds for the settlement of the forthcoming / future liability. Such an exercise is an acknowledgement of the present liability, based on past experience. Normally, the debit entry in respect of such general provision made in the Profit and Loss Account at the end of the financial year, is reversed on the first day, viz. 1st of April of the next financial year.

In the present context, it is necessary to understand that for deduction of tax at source, the identity of the payee must be known as well as the quantum of payment must also be ascertainable, at the point of time when such general provision is made. It may also be understood that even if one of the aforesaid items is not available then no tax can be deducted at source.

In other words, no tax is required to be deducted at source, in respect of such general provision, relating to a number of expenses, because neither the identity of the person in whose hands such income is includible (the payee) is known, nor the quantum of payment is ascertainable at the point of time when such general provision is made.

In support of the aforesaid legal proposition, reliance may be placed on a number of legal precedents and also relevant provisions of the Income-Tax Act, 1961 (the Act), along with the relevant Circular of the CBDT. The same are discussed as follows :

1. Industrial Development Bank of India Vs ITO [2006] 104 TTJ 230 (Mum)

In this case it was held that tax can be deducted at source only when the payee is known or identifiable. The relevant parts of the Head Note on pages 230 and 231 of the Report are reproduced as follows :-

"Tax deduction at source liability is a sort of substitutionary liability. Sec.191 further makes this position clear when it lays down that in a situation TDS mechanism is not provided for a particular type of income or when the taxes have not been deducted at source in accordance with the provisions of Chapter XVII, income-tax shall be payable by the assessee directly. This provision thus shows that tax deduction liability is a vicarious liability and the principal liability is of the person who is taxable in respect of such income. Sec. 199 makes it even more clear by laying down that the credit for TDS can only be given to the person from whose income the taxes are so deducted. ***Therefore, when tax deductor cannot ascertain beneficiaries of a credit, the tax deduction mechanism cannot be put into service. Sec. 203(1) lays down that for all TDS the tax deductor has to "furnish to the person to whose account such credit is given or to whom such payment is made or the cheque or warrant is issued" which presupposes that at the stage of tax deduction the tax deductor knows the name of person to whom the credit is to be given whether by way of credit to the account of such person or by way of credit to some other account.*** *This again shows that TDS liability is a vicarious liability to pay tax on behalf of the person who is to be beneficiary of the payment or credit, with a corresponding right to recover such tax payable from the person to whom credit is afforded or payment is made.* ***It would be thus seen that the whole scheme of TDS proceeds on the assumption that the person whose liability is to pay an income knows the identity of the beneficiary or the recipient of the income.*** *It is a sine qua non for a vicarious tax deduction liability that there has to be a principal tax liability in respect of the relevant income first, and a principal tax liability can come into existence when it can be ascertained as to who will receive or earn that income because the tax is on the income and in the hands of the person who earns that income.* ***In this view of the matter, TDS mechanism cannot be put into practice until identity of the person in whose hands, it is includible as income can be ascertained.***

It is indeed correct that Explanation to s.193 lays down that even when an income is credited to any account in the books of account of the person liable to pay such income, such crediting shall be deemed to be credit of such income to the account of the payee and the provisions of this section shall apply accordingly, but the fact that the credit to any account is to be deemed to be credit to the payee's account also presupposes that payee can be ascertained. ***Therefore, this deeming fiction can only be activated when the identity of the payee can be ascertained.*** *Explanation to s. 193 is only applicable in situations in which tax deduction liability is sought to be escaped by crediting interest to some other account other than that of recipient of interest. Explanation to s. 193 cannot be invoked in a case where the person who is to receive the interest cannot be identified at the stage at which the provision for interest accrued but not due is made. This position is also accepted by the CBDT, as evident from its letter dt. 5th July, 1996 addressed to the Tata Iron & Steel Co. Ltd."* [Emphasis added]

2. Dishnet Wireless Ltd Vs Dy.CIT [2015] 123 DTR (Trib) 153 (Chennai)

In this case, the issue before the Hon. Tribunal was TDS under section 194C of the Act, in respect of year end provision for estimated expenditure.

The assessee Company engaged various service providers for rendering services like address verification, credit certification, content development, etc. The assessee also had to pay the various other service providers, for providing value added services to its subscribers. The assessee estimated the customer verifications expenditure, on the basis of expenditure incurred in the past and made necessary provision in the account.

It was held that the tax was to be deducted at source, in respect of the payment to be made by the assessee to various service providers, etc, only if the payee was identified and quantum of payment was also ascertainable on the last day of the FY.

In other words, if while making the general provision for expenses, neither the identity of the payee is known, nor the amount payable is ascertainable, then there would be no requirement of TDS, in respect of such provision for expenses.

Besides, in relation to another provision for site restoration expenses, it was held that neither payment was made to any one, nor the amount was credited to the account of any identifiable party and therefore, the provisions requiring deduction of TDS, was not attracted.

3. IBM India P.Ltd Vs ITO [2015] 128 DTR (Trib) 25 (Bang)

In this case, it was stated that the assessee made provision for certain expenses in its books of account, in respect of certain expenses, in relation to which only service / work had been provided / performed by the vendors, but for which the invoices had not been furnished or in respect of which, the payments had not fallen due for the vendors. Thus, a provision for such expenses was made in the books of account, recognizing the liability that had been incurred. The expenses were debited to the Profit and Loss Account and the provisions were credited to a provision account and not to the vendor account, as this had not fallen due for payment. Such expense provision were created on reliable estimates of the payment that was expected to be made on the settlement dates in future that fell in the next accounting year. In the subsequent FYs, the provision entries were reversed and on receipt of invoices in respect of the respective invoices, the same were recorded as liabilities due to the respective parties, at which point in time taxes were withheld at source and paid to the Government in due course.

In respect of provision for such expenses, it was held that there was no default committed by the assessee and therefore, the demand on account of TDS, under section 201(1) would not survive.

4. Karnataka Power Transmission Corporation Ltd Vs Dy.CIT (TDS) [2016] 383 ITR 59 (Karn)

In this case, the assessee made a provision towards contingent payment of interest to suppliers of electricity, when payment of purchase price was delayed by the assessee. Though the provision was made towards contingent interest payable as expenditure, in accordance with the return filed by the assessee, the taxable income was arrived at, after adding back such amount of provision towards contingent interest.

It was held that section 194A of the Act, mandates the tax-deductor to deduct "*income-tax*" on "*any income by way of interest other than income, by way of interest on securities*". The phrase "*any income*" and "*income-tax there on*", if read harmoniously, would indicate that the interest which finally partakes the character of income alone, is liable for deduction of income-tax. If the interest is not finally considered to be an income of the deductee, section 194A(1) of the Act, would not be made applicable.

In other words, if no income is attributable to the payee, there is no liability on the payer to deduct tax at source. It was further held that in view of the fact that interest being not paid to the payees being reversed in the books of account, there would be no liability to deduct tax, as no income

accrued to the payees. The provision which was contingent at no time materialized as income to be liable for payment of income-tax on the provision of interest.

Therefore, the assessee fell outside the scope of section 194A, r.w.s.200 of the Act, during the relevant assessment years (AYs) and consequential provisions of sections 201(1) and 201(1A) were not attracted.

5. Letter of the CBDT, addressed to Tata Iron and Steel Co.Ltd.

In this connection, a reference may also be made to a letter No.275 / 126 / 96-IT(B), dt.5.7.1996, which was addressed to Tata Iron and Steel Co.Ltd. The relevant part of the aforesaid letter is reproduced as follows :

"I am directed to refer to your letter ref. 3A 13-21/1460 dt. 23rd May, 1996, on the above subject, and to say that difference between the issue price of Rs.5,000 and face value of Rs.25,500 is in the nature of interest subject to provisions of ss. 193/193A. Although the company would be making provisions for interest on year to year basis in their books of account, ***there will be no deduction of tax at source in each such year as the payee is not known."*** [Emphasis added]

From the aforesaid letter, it is clear that there will be no requirement of deduction of tax at source, in a case where the payee is not known / identifiable.

6. *Explanation* in relation of a number of sections of Chapter XVII-B of the Act.

After section 194A(1), there is an *Explanation* regarding the credit of the payment, etc and such *Explanation* is there in respect of certain other sections also. The aforesaid *Explanation* after section 194A(1), is reproduced as follows :

"Explanation.—For the purposes of this section, where any income by way of interest as aforesaid is credited to any account, whether called "Interest payable account" or "Suspense account" or by any other name, in the books of account of the person liable to pay such income, such crediting shall be deemed to be credit of such income ***to the account of the payee*** *and the provisions of this section shall apply accordingly."* [Emphasis added]

From the aforesaid *Explanation,* it may be seen that such crediting shall be deemed to be credit of such income to the account of the payee and the provisions of this section shall apply accordingly.

As already pointed out that when the party to whom the payment is to be made or the payee is not ascertainable / identifiable at the time of making the general provision for various expenses at the end of the FY, the provisions of TDS will not apply.

7. Conclusion

In the light of the discussion in the preceding paragraphs, it may be safely concluded that –

(i) No tax is required to be deducted at source from the general provision which is made, in respect of various expenses on estimate basis, as on the last day of the FY.

The details of TDS, in respect of bills relating to the current FY, received during the following FY, will be required to be disclosed in the accounts of the following FY, only.

(ii) Further, if after reversal of the impugned provision on the first day of the next FY, no such bills are received or no expenditure is incurred in relation thereto, then also no tax is required to be deducted at source in respect thereof.

All the tax-payers, CAs and income-tax advisors, are advised to follow the aforesaid guidelines, in case a general provision for expenses, on estimate basis, is required to be made at the end of a financial year.

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