

# Tax Audit – Few Problem Areas and Impact of Recent Amendments



Tax audit season is round the corner now. So, it is important to clear few problem areas faced by tax auditors and the impact of recent amendment in few sections which a tax auditor should know. In the given article, few problem areas have been covered like comparison between Persons covered u/s 40A(2)(b) and Related Party Disclosures under AS 18; Interpretation of information to be furnished under Clause 21 regarding Section 43B; and a possible case of applicability of Clause 17(h)(B). Also the impact of domestic transfer pricing and amendment in Section 40(a)(ia) on the tax audit has been ascertained.



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## Clause 18 - Payment made to persons u/s 40A(2)(b)

Under Clause 18 of Form 3CD, the entity is required to disclose the payment made to persons specified in Section 40A(2)(b). The Tax Auditor has to verify whether such information has been properly disclosed. Normally tax audit is conducted after statutory audit. So, the information to be disclosed in clause 18 can be found easily from the Related Party Disclosures under AS 18 in the Notes to Accounts of Audited Financial Statements. However, the related parties as per AS 18 and the persons covered u/s 40A(2)(b) are

not completely the same. It is important that the tax auditor should know the differences between the two. The same is given below:

Sl No.	Party	Whether Related Party as per AS 18	Whether covered under Section 40A(2)(b)
1	Holding, Subsidiary, Fellow Subsidiaries	Yes	Yes. Fellow subsidiary covered w.e.f. AY 01.04.13
2	Associate, Joint venture or Other party whose associate or joint venture is the reporting entity	Yes	Yes
3	Individuals having control or significant influence over the reporting entity and their relatives	Yes	Yes
4	Key Management Personnel or their relatives	Yes	Yes
5	Enterprises over which persons specified in 3 or 4 above have significant influence	Yes	Yes
6	Directors and their relatives of the entity where such entity has substantial interest in the reporting enterprise	No	Yes
7	Fellow Associates, i.e., the Investing party has substantial interest in the reporting enterprise as well as in other company	Yes	Yes w.e.f. AY 01.04.13
8	All directors of a company where any director of such company has substantial interest in the reporting enterprise and their relatives	No	Yes

**The definition of the term “relative” in Income Tax Act is wider than as given in AS 18. As per AS 18, the term relatives include spouse, brother, sister, father, mother, son and daughter. However, in Income Tax Act, the term relatives include all the above persons. In addition it includes any lineal ascendant or descendant, i.e., even grandfather, grandmother, great grandfather or grandmother, grandchildren or great grandchildren and so on. So, this has to be considered by the Tax Auditor for the purpose of Clause 18.**

#### Related Party as per AS 18 Vs Persons specified under section 40A(2)(b)

From the above, we can observe that Fellow Subsidiaries and Fellow Associates shall be covered from the AY 13-14. So, these have to be reported in Clause 18 of Form 3CD. Further, since Fellow Associates are not covered under AS 18, the same cannot be found in the Notes to accounts of Audited Financial Statements. Rather the Tax Auditor has to look at the shareholding pattern of the reporting company, find out who are the shareholders owning 20% or more of the voting power or profit and then to find out the other companies where such shareholder has 20% or more of the voting power. In case any payment has been made to such fellow associates, these have to be reported under Clause 18 from the FY 13-14.

#### Substantial Interest for Section 40A(2)(b) Vs. Significant Influence for AS 18

It is to be noted here that in Section 40A(2)(b), the words “substantial interest” have been given for determination of relationship of parties. Substantial interest refers to beneficial ownership of such shares which give 20% or more voting power to the investor or being beneficially entitled to 20% or more of profits of that enterprise. Whereas in AS 18, the words “Significant Influence” is of importance which comes not only from substantial interest but also from statute or agreement and it means participation in financial/operating policy decisions of the enterprise. These factors have to be taken into account by the tax auditor for disclosure under Clause 18.

#### Definition of Relatives for Clause 18 Vs. AS 18

It is also to be noted that the definition of the term “relative” in Income Tax Act is wider than as given

in AS 18. As per AS 18, the term relatives include spouse, brother, sister, father, mother, son and daughter. However, in Income Tax Act, the term relatives include all the above persons. In addition it includes any lineal ascendant or descendant, i.e., even grandfather, grandmother, great grandfather or grandmother, grandchildren or great grandchildren and so on. So, this has to be considered by the Tax Auditor for the purpose of Clause 18.

### Impact of Domestic Transfer Pricing w.r.t Payment to persons specified u/s 40A(2)(b)

Transfer Pricing regulations have been made applicable to certain Specified Domestic Transactions with effect from 01.04.12. Under these regulations the Company entering into Specified Domestic Transactions has to maintain certain documents and has to ensure that the transactions are made at Arm's Length Price. Specified Domestic Transactions *inter alia* include expenditure in respect of which payment has been made or to be made to a person specified u/s 40A(2)(b) provided the aggregate amount of all the specified domestic transactions exceed ₹5 Crore in the financial year. Under these regulations, the Company to whom the provisions of Domestic transfer Pricing applies, would be required to obtain a report from Chartered Accountant in form 3CEB before the specified due date i.e., 30<sup>th</sup> November.

Under Section 40A, the Assessing Officer has been given power to disallow so much of expenditure as appears excessive or unreasonable having regard to fair market value, legitimate needs of business or benefit derived by the assessee as a result of such expenditure. However, Finance Act 2012 has inserted a proviso to sub section 2(a) which says that no disallowance shall be made for expenditure in respect of Specified Domestic Transactions if such transaction is at Arm's Length Price.

A question may arise about the duty of Tax Auditor in respect of such amendment in Section 40A with respect to applicability of Domestic Transfer Pricing regulations. Whether the Tax Auditor has to take into account the Arm's Length Price in respect of Payment to Persons specified u/s 40A(2)(b) is a question which might be of interest to Tax Auditor. It is to be noted that the information given in form 3CD is as per the books of accounts of the assessee and such audit is conducted after Statutory Audit. As per transfer pricing regulations, the company has to keep and maintain documents regarding nature of such transactions, record of uncontrolled transactions for comparability,

determination of Arm's Length Price, record of method used to calculate Arm's Length Price, etc. The duty of tax auditor is not to check the Arm's Length Price but to ensure that all the persons covered u/s 40A(2) (b) have been disclosed and the amount as given in Audited Financial Statements have been disclosed in Clause 18. Of course, if there is some omission or error noted which was not disclosed in Audited Accounts, these can be disclosed by the Tax Auditor. The Arm's Length Price of such transactions are to be checked by the Chartered Accountant while providing form 3CEB and the same is to be submitted to the department.

Therefore, there is no extra duty on the Tax Auditor with respect to Clause 18 after amendment of Section 40A and introduction of Domestic Transfer Pricing regulations.

### Clause 27 and amendment in Section 40(a)(ia)

Under Clause 27 of Form 3CD, the tax auditor has to report whether the assessee has complied with provisions of Chapter XVII-B regarding deduction of tax at source and also to report on instances of Tax deductible and not deducted at all under sub clause (b)(i). It is to be noted that As per Section 40(a)(i) and 40(a)(ia), certain expenditure is not allowed as deduction if TDS is not deducted or after deduction not paid to the credit of the government before the due date. However, a proviso has been added to Section 40(a)(ia) with retrospective effect from 1st April, 2010, which states that the expenditure on which tax has not been deducted shall be allowed as deduction if the payee furnishes the return of income before due date and also pays tax on such amount to the department. Section 40(a)(ia) is applicable for interest, commission, brokerage, rent, royalty, fees for professional services or technical services payable to resident or amount payable to contractor or sub

**It is to be noted that as per Section 40(a)(i) and 40(a)(ia), certain expenditure is not allowed as deduction if TDS is not deducted or after deduction not paid to the credit of the government before the due date.**

**However, as per the proviso to Section 40(a)(ia) inserted with retrospective effect from 1st April, 2010, the expenditure on which tax has not been deducted shall be allowed as deduction if the payee furnishes the return of income before due date and also pays tax on such amount to the department.**

contractor being the tax resident of India. It is to be noted that such new proviso to Section 40(a)(ia) is not applicable to expenditure on payment to non resident. So, if tax which is deductible as per provisions of Income Tax Act but not deducted on payment to non resident, the amount of such expenditure is disallowed.

A question may arise whether such cases where the assessee has not deducted tax which was required to be deducted is to be reported under sub clause (b) (i) of Clause 27. The answer is to be examined from the perspective of objective of Clause 27. This Clause was inserted with a view to determine the violation of Chapter XVII-B of the Act so as to determine the disallowability of any expenditure. Consequent upon amendment in Section 40(a)(ia), if the assessee can establish that the payee has paid tax and filed return before the due date, the expenditure incurred by assessee shall be allowed inspite of the fact that tax has not been deducted on the same. Considering this in view, the same need not be reported in sub clause (b) (i) of Clause 27 since the expenditure is allowed. It is the duty of the tax auditor to be satisfy in such case that the payee has paid tax and filed return before the due date so as to ensure that the assessee has complied with

provisions of Chapter XVII-B. The same is applicable for Clause 17(f) as well.

#### Clause 21 - Interpretation of table

Under Section 43B, certain payments are allowed as deduction in the year in which these are actually paid or if these are paid on or before the due date of furnishing returns. These are the following:

- Tax, duty, cess, fee
- Employer's contribution to PF, superannuation fund, gratuity fund or employee welfare fund
- Bonus or commission to employees
- Interest on loan or borrowing from Public Financial Institution, State Finance Corporation, State Industrial Investment Corporation or Scheduled Bank
- Leave Encashment

In Clause 21 of Form 3CD, certain information is required to be disclosed. However, the Tax Auditor sometimes faces difficulty in understanding the manner and form in which the information is to be disclosed. For better understanding of the information to be disclosed under this clause, we can refer to the following table:

Nature of liability	Pre-existed on the first day of the previous year but was not allowed in the assessment of any preceding previous year			Incurred in the previous year		
	Balance	paid during the previous year	Not paid during the previous year	Balance	paid on or before the due date for furnishing the return of income of the previous year under section 139(1)	not paid on or before the aforesaid date
	A	B	C	D	E	F
Interpretation	This is not balance as at the beginning of the year. Rather it is the balance at the beginning of the year as reduced by amount paid and deduction already claimed in the previous year.	This is the amount paid out of amount in Column A from the return date (i.e., which was not claimed earlier) to the close of the financial year.	This is the amount as on close of the financial year out of opening balance which has not been claimed. So, it can be claimed only in next year if the same is paid. C=A-B	This is current year liability incurred and remaining outstanding at the close of the year. This does not include previous year's liability since the same is already included in A if the same is not claimed earlier.	This is amount paid out of D between the date from the close of financial year and date of filing return of income so that the same can be claimed in the current year.	This is the balance out of the current year's liability which cannot be claimed in the current year as deduction. D-E=F

It is to be noted that C+D should be total closing liability as on close of the financial year.

The reason for such bifurcation in opening liability and current year liability is that in case of opening liability the amount can be claimed as deducted only if the same is paid by the end of the previous year. No deduction is allowed in the current year out of this opening liability if these are paid after close of financial year but before due date of furnishing return. However, in case of current year's liability, the deduction can be claimed even if these are paid after close of financial year but before due date of furnishing return.

### Ensuring Completeness in Clause 21

Clause 21 is an important clause of Form 3CD. Its area of coverage is wide. Sub section (a) of Section 43B states includes in its coverage "any sum payable by the assessee by way of tax, duty, cess or fee, by whatever name called, under any law for the time being in force". Thus, it includes all kinds of taxes and duties by whatever name called. In a company, there are a number of statutory dues which are covered under this sub section. It is not an easy job of tax auditor to ensure that all such items have been disclosed in Clause 21.

So, the tax auditor has to ensure that all such items have been disclosed. To ensure this, the tax auditor has to scrutinise all the liability items in the Balance Sheet and determine which are covered in Section 43B. Also the individual items cannot be found from the Balance

Sheet. So, the ledger of such statutory dues has to be scrutinised carefully by the tax auditor to ensure that all such items have been disclosed individually. Sometimes, any particular fee or duty is included in some other payables which may not be part of statutory dues in the balance sheet but may be relevant to Clause 21. So, the ledger of other payables also has to be scrutinised carefully to ensure completeness of information to be disclosed under this Clause.

### Clause 17(h)(B) – Whether payment to Hotel for different employees of a Company in cash more than 20,000 allowed u/s 40A(3)?

Under Clause 17(h)(B), the tax auditor has to report amount inadmissible under Section 40A(3). Section 40A(3) reads as under:

*"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, exceeds twenty thousand rupees, no deduction shall be allowed in respect of such expenditure".*

Let's take a case. A Company pays ₹90,000 for its 6 employees to a Hotel as boarding and lodging expenses of such employees for some conference. The Company pays the amount in Cash to the Hotel. The Hotel gives 6 bills each amounting to ₹15,000. So, the individual bills are less than ₹20,000 and these are in respect of a particular employee. Here a question may arise whether such expenditure of ₹90,000 should be allowed or not considering that the payment of individual amount of ₹15,000 is in respect of separate bills and separate employee.

To consider the allowability of such expenditure, one must closely scrutinise Section 40A(3) given above. From the above Section, it is clear that what is important is the person to whom the payment is made and also it should be for a particular expenditure. It is immaterial whether such payments are made in respect of different employees or against different bills. The main criterion is payment made to same person on single day against same head of expenditure. If such payment is made more than ₹20,000 in, then it should be disallowed.

Therefore, in the present case, the amount of ₹90,000 shall be disallowed and the tax auditor should disclose the same under this clause.

References: (i) Income Tax Act, 1961

(ii) Accounting Standard 18 . ■

