

## Use of Jurisprudence in Tax Audit - Harmonious Approach



*With regard to the importance of jurisprudence in the tax audit it is pertinent to refer to the Para 16.2 of the Guidance note which allows an auditor to rely upon the judicial pronouncements while taking any particular view about inclusion or exclusion of any items in the particulars to be furnished under any of the clauses specified in Form No.3CD. Further if there is a conflict of judicial opinion on any particular issue, he may refer to the view which has been followed while giving the particulars/reporting under any specified clause. In the present e-filing format any view taken on reporting made on any clause can be disclosed in Form 3CA/3CB or can be separately be attached in 'pdf' file along with the audit report. This article mainly deals with the jurisprudence on various important provisions which require reporting in Form 3CD and have unsettled judicial position. Read on...*



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Reporting requirements in Form 3CD are designed to enable self assessment of disallowances and additions to the income of assessee in line with various provisions of the Income-tax Act, 1961. Such provisions in turn have been widely litigated and divergent views have been taken by various judicial fora. In such cases, if the auditors were of the view that the judicial precedent is open to judicial review and not binding precedent, then,

he may indicate such addition or disallowance in Form 3CD which did not prevent the Assessee to claim deduction thereof in the return of income. However Section 143(1) of the Act was amended with effect from Assessment Year 2017-18 to provide in newly inserted clause (iv) that disallowance of expenditure indicated in the audit report but not taken into account in computing the total income in the return would be adjusted in the summary processing of return under Section 143(1) of the Act. Due to this amendment now auditee have adopted a restraining approach in agreeing to indication of disallowance in Form 3CD based on legal views taken by them. Such action by the auditee is possible since the Guidance note on tax audit also provides in Para 16.2 that particulars in Form No. 3CD have to be authenticated and signed by the auditee first and such authentication by auditee may tantamount to his acceptance may cause prejudice to his claim in judicial process. In such situation it is advisable that the auditor indicates his view and disagreement of auditee along with basis of auditee in Form 3CA/3CB.

Let's now deal with the jurisprudence on various important provisions which require reporting in Form 3CD and have unsettled judicial position.

### Turnover with Respect to F&O and Derivative Transactions

Transactions in derivative instruments have increased significantly and Section 43(5)(d) treats the same as normal business income. On the other hand, the ambit of Section 44AD has been widened to cover any business which would include such derivative trading transactions. Section 44AD stipulates that if the actual profit is less than the presumptive profit, the books of accounts would be required to be audited. Guidance note on tax audit prescribes methodology to aggregate the absolute figures of gains and losses in case of derivatives to compute the turnover. However in following judicial pronouncements, trading in derivatives is not considered as 'turnover' in absence of any delivery based on Section 18 of Sale of Goods Act providing that no property in the goods is transferred to the buyer unless and until the goods are ascertained and in legal sense no turnover can

be said to have effected by the assessee:-

- *Growthmore Exports Ltd vs. ACIT (2001) (78 ITD 95)(Mum)*
- *Babulal Enterprises [ITA No. 6031/Mum/1996]*

Based on the proposition upheld by the Tribunals that the transactions in derivatives is not turnover, the foundation of applicability of presumptive provisions which is profit as a percentage of turnover becomes unworkable and a view can be taken that the derivative transactions may not be covered under the ambit of Section 44AD of the Income-tax Act, 1961.

### Valuation of Inventory

Clause 14(a) requires reporting of method of valuation of closing stock employed in the previous year. Section 145A has been retrospectively amended with effect from 1-4-2017 to inter alia provide in clause (i) that the valuation of inventory shall be made at lower of actual cost or net realisable value. This amendment made in Finance Act, 2018 is applicable even for current year tax audits and therefore the reporting in clause 14(a) of Form 3CD would now permit only above method of valuation. In the past, it was noticed that certain entities were valuing the inventory at cost which was permissible based on certain judicial pronouncements. However, the position of law has since changed consequent to the amendment in Section 145A. Needless to mention that the practice of disclosing that '*inventory has been accepted as certified by the management*' is not acceptable as it creates deficiency in audit procedures which mandate the auditor to ensure existence of inventory as well as condition as per (SA-501)- "Audit Evidence – Additional Considerations for Specific Items".

### Section 14A : No Disallowance in Absence of Any Exempt Income

This is one of the most litigated provisions of the Income-tax Act, 1961. This provision disallows any expenses incurred in relation to earning of exempt income. The phrase 'expenses incurred in relation to exempt income' contemplates that once a proximate cause for disallowance is established which is the relationship of the expenditure with income which does not form part of the total

income, a disallowance under Section 14A has to be made. Guidance note in Para 37 has clarified that the Rule 8D is not mandatory to be followed by assessee for computing disallowance and can be invoked by Assessing Officer however the auditor for reporting in Clause 21(h) will have to verify the amount of inadmissible expenditure as determined by the assessee with reference to established principles of allocation of expenditure based on logical parameters like proportion of exempt and taxable income recorded, turnover, man hours spent to earn the relevant income etc. An interesting issue arises in view of following decisions pronounced recently which lay down the proposition that no disallowance under Section 14A is called for in absence of any exempt income received during the year under consideration:

- *Cheminvest vs. CIT 378 ITR 33 (Delhi High Court)*
- *CIT vs. Shivam Motors (230 Taxman 63) (Allahabad High Court)*

In light of aforesaid judicial decisions, the Auditor may accept a view that in absence of any exempt income no amount has to be considered as disallowable under Section 14A of the Act.

### **Section 40(a)(ia): Effect of Second Proviso on Reporting**

Clause 21(b)(ii) of Form 3CD requires auditor to report amount inadmissible under Section 40(a)(ia) for non-deduction or non-payment of deducted tax at source from payments made to residents. Recently to reduce hardship caused by this provision, a remedy is provided in second proviso of that provision that no disallowance would be made if the payer is not considered as 'assessee in default'. He may not be considered an assessee in default if the resident recipient furnishes his return of income under Section 139 taking into account such sum for computing his income in said return and has paid the tax due on the income declared by him in such return of income. These facts have to be furnished in a certificate obtained from an accountant in Form No. 26A.

The auditor has to consider such amounts for reporting under this clause as disallowable on which tax is not deducted at source or on which such

deducted tax is not deposited till specified time. However if the auditee furnishes copy of aforesaid certificate to the auditor before completion of his audit, he may consider the amounts paid as not disallowable under such section.

### **Section 40A(3) : Disallowance of Genuine Cash Payments**

Clause 21(d) of Form 3CD requires reporting of payments made otherwise than by an account payee cheque above specified limit i.e. ₹ 10,000 as disallowable under Section 40A(3) unless the same are exempted under Rule 6DD. The provision was introduced to counter evasion and prohibit circulation of black money. However, this provision covers within its ambit even admittedly genuine payments and call for their reporting in tax audit report. For instance cash payment of electricity bills to Electricity companies which are now independent corporations are undoubtedly genuine but if reported under this clause would get disallowed by virtue of adjustment to be made under Section 143(1) of the Act, even if the same is not considered disallowable in return of income. In this scenario since the requirement is to report amount disallowable under the provision, the auditor may take a view that genuine payments like payment of electricity bill in cash is not disallowable under Section 40A(3) based on following judicial pronouncements -

- *M.R. Soap 32 TITJ 505 (Del)*
- *Padigela Rajeshwar Ginning Ind. ITA 1137/Hyd/2011*
- *Trivedi Corporation (ITA 2844/Ahd/2006)*

If such view is taken it is advisable that the auditor refers to such judicial pronouncements in his report for his view in reporting under the clause.

### **Section 2(24)(x) : Delay in Deposit of Employee's Contribution**

In clause 20(b) of Form 3CD, the auditor is required to report the details of payment made vis-à-vis due date as per relevant statute and actual date of payment of PF / ESIC. Though this clause does not require the auditor to provide the disallowance consequent to delay, however, there have been instances where any amount paid after the relevant

due date is automatically considered for addition by virtue of non-compliance with the condition in Section 36(1)(va) while processing the return under Section 143(1) as per which delayed deposit of contribution of employee is not allowable as deduction even if the delayed payment is not beyond the due date of filing of return of income. Judicial position is unsettled on this issue due to divergent decisions of various High Courts. While Special Leave petition of department against favourable decision of *Rajasthan High Court in case of Rajasthan State Beverages Corporation Ltd.*[TS-268-SC-2017] has been dismissed by Supreme Court holding it devoid of merits, Kerala High Court in decision reported in [TS-378-HC-2018(KER)] and Gujarat High Court in *Gujarat State Road Transport Corporation*(366 ITR 170)(Guj.) have taken a contrary stand considering any delayed deposit beyond statutory due date as income under Section 2(24)(x) of the Act.

As regards this provision, the reporting requirement is to report the due date and actual date and not the tax treatment therefore the auditor has to give such information which are a matter of fact and do not involve taking any legal view. Against any adjustment made in the processing of return under Section 143(1) of the Act the remedy available to the Auditee is to file an appeal as the intimation is an appealable order.

### **Section 40A(2)(b) : Related Party Transactions**

Clause 23 requires reporting of particulars of payments made to persons specified under section 40A(2)(b). At the outset the details of parties covered under said section has to be obtained in Management representation from the auditee. Also the provision requires reporting of all payments made to relatives irrespective of the fact that the same are allowable or not. Another interesting aspect related to reporting in respect of 'persons holding substantial interest' is that only direct interest is to be considered and not indirect interest. For eg. Transactions with subsidiary are covered for reporting but any transaction with subsidiary of subsidiary is not to be covered.

### **Section 50C/43CA : Deemed Sale Consideration**

Clause 17 requires reporting of transactions of transfer of immovable property being 'land or building or both' for a consideration lesser than their stamp duty value. The reporting requirement is with regard to transfer of 'land' or 'building'. It would be relevant to consider that whether 'land or building' would include any rights therein for eg. leasehold rights, tenancy rights, floor space area rights, transferable development rights and transfer of such rights at a value lesser than their stamp duty value would require reporting. Section 50C is held not applicable on such rights in various ruling given below:

*Leasehold rights – CIT vs. Greenfield Hotels and Estates P Ltd* [2016] 389 ITR 68 (Bombay)

*Tenancy rights – Fleurette Marine Novelle Hatam vs. ITO* [2015] 70 SOT 203 (Mumbai - Trib.)

*FSI and TDR – ITO vs. Shri Prem Rattan Gupta* (ITA No.5803/Mum/2009)

On the other hand there are some contrary views also expressed by other courts. On account of such conflicting views, the auditor has to take a view and refer to the relevant judicial pronouncements which he has followed in forming his view.

### **Section 269SS/T and 269ST**

#### **Reporting of repayment of loan/advance**

Last year, clause 31 was amended to introduce requirement to report any repayment of loan/advance/specified sum received by the lender during the year. This has brought a paradigm change in reporting since Section 269SS or 269T is not applicable on lender and the penalty on contravention of such provisions is leviable only on the borrowers. The intention of this amendment is to catch hold of such borrowers who are not covered under the ambit of audit and contravene the provisions of Section 269SS and 269T, as now information of such borrowers would be reported in the audit report of lenders.

#### **'Specified sum' and Real estate business**

Clause 31(b) requires reporting of each 'specified sum' taken or accepted during the previous year.

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The term specified sum refers to any sum of money receivable, whether as advance or otherwise, in relation to transfer of an immovable property, whether or not the transfer takes place. Here it is not necessary that the transfer of immovable property should be a capital asset and even transactions of sale of immovable property in a real estate business would be required to be reported. In other words, all the sale transactions in a real estate business would be required to be reported in this clause. This clause has increased the reporting requirement significantly.

## **Transactions through Journal entries**

Sections 269SS requires that loans, advances and specified sum are accepted by way of account payee cheque or account payee bank draft or ECS through bank account. Section 269T requires that loan, advance and specified advance are repaid by way of account payee cheque or account payee bank draft or by way of ECS through bank account. Otherwise, penalty would be attracted under sections 271D and 271E. Clause 31 requires reporting of whether such loans, advances and specified sum/specified advance are accepted/repaid, as the case may be, by the permitted modes. Many times it is seen that transactions through Journal entries in books of accounts are also considered for reporting under this clause as taken or accepted otherwise than by an account payee cheque, etc. This now may trigger immediate invocation of penal provisions under sections 271D and 271E due to e-processing of returns and audit report and cause undue hardship to the assessee, which may not be in line with the objective of the anti-evasive provision to cover only cash loans and not book entries. The provision has been considered and interpreted by various courts to hold that transaction through book entries would not be contravention and are not liable for penalty in following cases:

- *Natvarlal Purshottamdas Parekh 303 ITR 5 (GUJ)*
- *Noida Toll Bridge Co. Ltd (262 ITR 260) (Delhi HC)*
- *Worldwide Township Projects 2014 (6) TMI 47*
- *Dinesh Jain - 2014 (6) TMI 140 - ITAT DELHI*

If an auditor takes a view that any loan or advance created by way of journal entries should not be considered for the purpose of reporting under this clause, it is advisable that the same may be disclosed

in Form 3CA/3CB. The aforesaid judicial authorities may also be referred to in support of such view.

## **Section 41(1): Remission/Cessation of Liabilities**

Clause 25 of Form 3CD calls for reporting of amount chargeable to tax under Section 41 of Act which includes any remission or cessation of a trading liability, in respect of which a deduction or allowance is claimed and allowed in any of the earlier years. The reporting requirement under this section is very wide and would require the auditor to exercise his judgment in light of judicial precedents on this issue. For eg. there may be unclaimed trade creditors/liabilities outstanding for a long period in balance sheet of auditee and if on calling of confirmations by Auditor in accordance with (SA-505)- "*External Confirmations*" no confirmations are received, the amount may be considered as not payable. In such circumstances, if the management insists that the same are still payable and the liability has been accepted then auditor must obtain a management representation to this effect. The auditor is not required to consider any outstanding liability as reportable under this clause merely since it is older than 3 years and limitation period is expired as observed in case of *Silver Cotton Mills Co Ltd (254 ITR 728) (Guj.)*. Similar views have been taken in case of *Vardhaman Overseas 343 ITR 408 (Del.)*.

## **Conclusion**

Tax Audit involves exercise of judgment by an auditor on various legal issues concerning admissibility and inadmissibility under various provisions of Income-tax Act, 1961 considering existing jurisprudence available. On issues having conflicting views, it is advisable for the auditor to rely on legal views obtained by auditee from experts in accordance with the guidance provided in (SA) 620 (Revised), "Using the Work of an Auditor's Expert". One needs to keep in mind that the reporting accuracy in Form 3CD is higher as the same has to be "true and correct" as against the audit opinion which has to be "true and fair". Therefore to substantiate the certification of information furnished in Form 3CD as correct, one needs to give adequate disclosures on the views taken, basis of such view and available judicial pronouncements thereon. ■