

Deduction On Actual Payment Under Section 43 B – Certain Issues

Section 43 B of the Income-tax Act continues to be an interesting facet of Income Tax law even two decades after its introduction. The special feature of the provision is that it completely ignores the method of accounting of the assessee. But it too is not free from controversies. This article takes a comprehensive overview of the various provisions of this Section from the professional perspective.

Section 43B of the Income-tax Act, 1961 has direct application, without taking into account the method of accounting consistently followed or adopted by the assessee. This section was inserted by the Finance Act, 1983 effective from the assessment year 1984-85.

The section starts with non-obstante clause by the use of expression “notwithstanding anything contained in any other provision of this Act”. Hence, certain deductions covered by this section are available only on actual payment. The method of accounting has no role to play in the allowance or otherwise of the expenditures covered by this provision.

Section 43 B of the Income-tax Act continues to be an interesting facet of income tax law even after two decades of its introduction. The special feature of the provision is that it completely ignores the method of accounting of the assessee and the extended time period for remittance of the amount up to the “due date” mentioned in section 139(1) add further colour and contrast for tax planning, and in the process, leads to some controversies as well. Nevertheless the practitioners of law continue to find it fascinating to indulge in its interpretation and do tax planning by applying this provision.



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Historical Perspective

The Finance Act, 1983 inserted section 43 B and it was meant for allowance of deduction on actual payment in respect of (a) tax or duty and (b) employer's contribution to any provident fund or superannuation fund or gratuity fund or any other fund for the welfare of employees. In clause (a) the coverage was extended to “cess or fee” by the Finance Act, 1988 effective from the assessment year 1989-90.

The objective behind the introduction of section 43 B was explained in Circular No.372 dated 08-12-1983 in the following words:

“Several cases have come to notice where taxpayers do not discharge their statutory liability such as in respect of excise duty, employer's contribution to provident fund, Employees' State Insurance Scheme, etc., for long periods of time, extending sometimes to several years. For the purpose of their income-tax assessments, they claim the liability as deduction on the ground that they maintain accounts on mercantile or accrual basis. On the other hand, they dispute the liability and do not discharge the same. For some reason or the other, undisputed liabilities also are not paid.

To curb this practice, the Finance Act has inserted a new section 43B to provide that deduction for any sum payable by the assessee by way of tax or duty under any law for the time being in force or any sum payable by the assessee as an employer by way of contribution

to any provident fund or superannuation fund or gratuity fund or any other fund for the welfare of employees shall irrespective of the previous year in which the liability to pay such sum was incurred, be allowed only in computing the income of that previous year in which such sum is actually paid by the assessee”.

A bare reading of the circular would show that the section was inserted to allow deduction only on actual payment and/or to deny deduction based on book entries, passed in the mercantile system of bookkeeping.

The Finance Act, 1987 inserted first proviso to section 43 B whereby payments covered by this section, if made on or before the “due date” applicable for furnishing the return of income under section 139(1), would be eligible for deduction. The first proviso extended the time to take notice of the actual payment after the end of the previous year, for allowance of deduction.

The Direct Tax Laws (Amendment) Act, 1987 inserted clause (c) to cover expenditures of the nature referred to in section 36(1)(ii) viz. any sum paid to the employees as bonus or commission for services rendered by them.

Clause (d) to section 43 B dealing with payment of interest on any loan or borrowing from any public financial institution or State financial corporation or State industrial investment corporation was inserted by the Finance Act, 1988 applicable from the assessment year 1989-90.

Clause (e) of section 43 B dealing with payment of interest on any loan or advances obtained from a scheduled bank was inserted by the Finance (No.2) Act, 1996 effective from the assessment year 1997-98. Originally it covered “term loan” but the Finance Act, 2003 enlarged the coverage by use of expression “loans or advances”. Now it covers wide gamut of bank finance availed by assesseees such as term loans, cash credits, over drafts etc.

Clause (f) of section 43 B dealing with any sum payable by the employer towards leave salary of the employees eligible for deduction only on actual payment, was inserted by the Finance Act, 2001 applicable from the assessment year 2002-03.

Impact of Finance Act, 2003

The first proviso gave extended time for making payment and allowance of deduction for the preceding financial year. It covered all the payments except clause (b) viz. employer’s contribution to provident fund or superannuation fund or gratuity fund. The specific reference to various clauses of section 43 B was omitted by the Finance Act, 2003 and hence from the assessment year 2004-05, all payments covered by section 43 B, if made before the “due date” specified in section 139(1), satisfied the eligibility for deduction.

The second proviso which provided that the contribution of the employer to provident fund or superannuation fund or gratuity fund etc to be paid on or before the “due date” mentioned in section 36(1)(va) has been omitted by the Finance Act, 2003. Hence, from the assessment year 2004-05, employers’ contribution to the welfare funds of the employees is eligible for deduction even though remitted belatedly.

Present Coverage

Section 43 B as it stands today has six clauses as shown in the table on the next page.

The Finance Act, 2006 inserted Explanation 3C to cover that any interest payable on loans or borrowings from any public financial institution or state financial corporation or state industrial investment corporation shall not be allowed as a deduction for the reason that such interest has been converted into loan or borrowing subsequently.

Similarly, Explanation 3D to section 43 B inserted by the Finance Act, 2006 denies the allowance of deduction upon conversion of

Clause	Nature of Expenditure	Assessment Year	Condition for Deduction
a	Any sum payable by way of tax, duty, cess or fee.	1984-1985	If paid before the "due date" for filing the return of income.
b	Employer's contribution to provident fund, superannuation fund or gratuity fund or any other fund for the welfare of employees.	1984-1985	If paid before the "due date" for filing the return of income from the assessment year 2004-05 onwards.
c	Payment of bonus or commission paid to employees for services rendered.	1989-1990	Explanation 3 to the section says that if the amount of bonus or commission is allowed as a deduction for any earlier assessment year preceding the assessment year 1989-90, the actual payment subsequently is not eligible for deduction again.
d	Interest on any loan or borrowing from any public financial institution or state financial corporation or state industrial investment corporation paid in accordance with the terms and conditions of the agreement governing such loan or borrowing.	1989-1990	Explanation 3 to the section says that if any interest payable was allowed as a deduction for any assessment year preceding the assessment year 1989-90, such expenditure is not deductible again upon actual payment. Conversion of unpaid interest into loan will not be treated as discharge of interest. Hence, arrear interest cannot be claimed as a deduction upon conversion into a loan.
e	Any sum payable by way of interest on any loan or advance from scheduled bank paid in accordance with the terms and conditions of the agreement governing such loan or advance.	1997-1998	As per explanation 3A any expenditure, which was allowed as a deduction in any assessment year preceding the assessment year 1997-98, will not be eligible for deduction upon its actual payment. Earlier it covered "term loan" and from the assessment year 2004-05 it covers "any loan or advance". Hence it covers cash credit, over draft and other working capital facilities. Any interest already claimed as deduction would not be eligible for deduction again on actual payment.
f	Any sum payable towards leave salary standing to the credit of the employee.	2002-2003	As per explanation 3B where provision for leave salary is allowed as a deduction for any assessment year preceding the assessment year 2002-03, such expenditure upon actual disbursement will not be allowed under this section.

arrear interest on any loan or advance (taken from a scheduled bank), into a loan or advance subsequently.

Court Decisions

The constitutional validity of section 43 B was upheld in *Mysore Kirloskar Ltd v. Union of India (1986) 160 ITR 50 (Karn)*.

The Explanation to section 36(1)(va) and the provisos to section 43 B are held as not violative of the Article 14 of the Constitution in *Hitech (India) (P) Ltd v. Union of India (1997) 227 ITR 446 (AP)*.

The Finance Act, 1987 inserted first proviso to section 43 B, extending the time limit for remittance of the expenditures debited to

profit and loss account. This insertion was interpreted as retrospective and should be applied from the date of introduction of section 43B. In other words, the first proviso to section 43 B was held as applicable from the assessment year 1984-85, though it was inserted by the Finance Act, 1987. (Refer *Allied Motors (P) Ltd v. CIT (1997) 224 ITR 677 (SC)*). It may be noted that while deciding the case, the apex court took into account, various court decisions rendered in this context and decided the retrospective application of the first proviso to section 43B. (Recently, followed in *CIT v. Alembic Glass Industries Ltd (2005) 279 ITR 331 (Guj)*).

For making payment of the nature covered

by section 43 B if the assessee makes a deposit or bank guarantee, such deposit or bank guarantee would not entitle him to claim deduction under section 43 B as actual payment or discharge of liability. (Refer *CIT v. Udaipur Distillery Co Ltd (2004) 134 Taxman 398 (Raj)*).

Interest paid under the Customs Act for the delayed clearance of goods is not covered by section 43 B. (*Hindustan Motors v. CIT (218 ITR 450)*).

In *CIT v. Express Hotel (P) Ltd (2006) 281 ITR 160 (Guj)* it was held that the tribunal can apply section 43 B for the first time even though the lower authorities have not considered the statutory provision for taxing a receipt or disallowing a deduction claim.

Interest paid on delayed payment of purchase tax was held as not a "tax" covered by section 43 B. *CIT v. Padmavati Raje Cotton Mills*

Ltd (1999) 239 ITR 355 (Cal). However, in *Mewar Motors v. CIT (2003) 260 ITR 218 (Raj)* it was held that interest on sales tax is also part of sales tax and hence is governed by section 43 B.

Royalty payable to the Government for extraction of limestone is a "tax" and hence covered by section 43 B. (*Gorelal Dubey v. CIT (2001) 248 ITR 3 (SC)* and *CIT v. Popular Minerals (2002) 258 ITR 593 (Raj)*).

In *India Carbon Ltd v. IAC (1993) 200 ITR 759 (Gau.)* the limited question of applicability of section 43 B, when no expenditure claim is made in the profit and loss account was discussed. The court held that where the assessee has neither claimed a deduction nor any charge was made to the profit and loss account, no disallowance could be made by taking recourse to the balance sheet of the assessee for taxing the sales tax collection by applying section 43 B. The court, however, did

not answer whether such sales tax collection has to be taken as trading receipt chargeable to tax as income by applying the rationale of the decision rendered in the case of *Chowringhee Sales Bureau P. Ltd. v. CIT* [1973] 87 ITR 542 (SC). The court observed: "the question is whether section 43B shall apply and not the question whether or not the sales tax collected formed part of the business or trading receipts. What would be the effect of showing such sum as payable by way of tax on the liabilities side in the balance sheet without actually paying the same is a different question. That question is not before me".

In *George Williamson (Assam) Ltd v. CIT* (1997) 228 ITR 343 (Gau) the deductibility of provision for gratuity without actual payment was discussed. The court held that section 40A(7) and section 43 B are mutually exclusive and contradictory and any provision made for such gratuity is deductible under section 40A(7). However, if the provision is made for transfer to the fund (covered by clause (b) of section 43 B) then it is deductible only upon actual transfer of funds.

Section 43 B covers only employer's contribution to gratuity fund or superannuation fund or provident fund, meant for the welfare of employees. Employees' contribution (by way of deduction from their salary) would be income of the employer under section 2(24)(x) and if the payment is made before the "due date" mentioned in Explanation below section 36(1)(va), then a corresponding deduction would apply. If the payment is delayed in terms of section 36(1)(va), the deduction would be denied and the amount recovered from employees' salary would be chargeable to tax as income of the employer. (*Gallium Equipment (P) Ltd v. Dy.CIT* (2002) 81 ITD 358 (Del-Trib); *CIT v. Madras Radiators & Pressings Ltd* (2003) 264 ITR 620 (Mad).

Advance payment of interest to financial institution referred to in section 43 B, whether it would be deductible was discussed in *Gopi*

Krishna Granites (India) Ltd v. Dy.CIT (2001) 251 ITR 337 (AP). The court held that where the assessee has not incurred any liability for interest during the previous year, payment of the same in advance cannot be claimed under section 43 B. A similar decision can be found in *Maruti Udyog Ltd v. Dy.CIT* (2005) 92 ITD 119 (Del-Trib).

In addition to the actual liability provided in the books, if the assessee had to pay more such excess if attributable to the liability incurred for the previous year, it is eligible for deduction. *CIT v. Chackolas Spinning & Weaving Mills Ltd* (2004) 266 ITR 623 (Ker). The SLP of the Revenue was dismissed by the Apex court (See (2004) 266 ITR (St.) 2).

In *Kalpna Lamps & Components Ltd v. Dy. CIT* (2002) 255 ITR 491 (Mad) the assessee contested for allowance of arrear interest converted into loan by the financial institution under section 43 B. The court held that the conversion of arrear interest into loan cannot be treated as discharge of interest and hence the Circular No.674 (covering conversion of sales tax liability into loan) will not apply.

The Chennai Bench of the Tribunal in *Kwality Milk Foods Ltd v. Asst. CIT* (2006) 100 ITD 199 (Chennai) (SB) has held that the amendment in proviso to section 43 B brought in by the Finance Act, 2003 is curative in nature and has retrospective effect. This decision took into account (a) Hayden's rule of interpretation of statutes (b) reasoning given by the apex court for the proviso inserted by the Finance Act, 1987 in the case of *Allied Motors (P) Ltd* (224 ITR 677). On parity of reasoning, the Tribunal held that the amendment brought in by the Finance Act, 2003 in the first proviso to section 43 B as having retrospective effect. This decision may aid the tax payers for allowance of payments made to employees welfare funds after the end of the previous year and after the 'due date' mentioned in the Explanation below section 36(1) (va) for the assessment years preceding the assessment year 2004-05, if remitted before the 'due date' mentioned in section

139(1). Similar decision could be found in *CIT v. George Williamson (Assam) Ltd (2006) 284 ITR 619 (Gau)*.

Circulars

Where the State Governments allow deferral scheme for sales tax collected by the dealers and to be remitted after some years without interest, the CBDT Circular No.496 dated 25.9.1987 provides for deduction under section 43 B for the sales tax so deferred for payment in the future years:

“Representations have been received from various State Government and others that cases of deferred sales tax payments should be excluded from the purview of section 43B as the operation of this provision has the effect of diluting the incentive offered by the deferral schemes.

“The matter has been examined in consultation with the Ministry of Law and various State Governments. The Ministry of Law has opined that if the State Governments make an amendment in the Sales Tax Act to the effect, the sales tax deferred under the scheme shall be treated as actually paid, such a deeming provision will meet the requirements of section 43B.

“The Government of Maharashtra has by the Bombay Sales Tax (Amendment) Act, 1987 made the amendment accordingly. The Board has decided that where the amendments are made in the sales tax law on these lines, the statutory liability shall be treated to have been discharged for the purpose of section 43B.”

Again the CBDT in Circular No.674 dated 29-12-1993, has stated as under:

“It has since been brought to the notice of the Board that some State Governments, instead of amending the Sales Tax Act, have issued Government orders notifying schemes under which sales tax is deemed to have been actually collected and disbursed as loans. Such Government orders also provide that entries shall be made in the Government accounts

giving effect to deemed collections by crediting the appropriate receipt heads relating to sales tax collections and debiting the heads relating to disbursement of loans. It has therefore, been represented that, as such conversion of the sales tax liability into loans have similar statutory effect as can be achieved through amendments of Sales Tax Act, the amounts covered under the scheme should be allowed as deduction for the previous year in which the conversion has been permitted by the State Governments.

The Board has considered the matter and is of the opinion that such deferral schemes notified by the State Governments through Government Orders meet the requirements of the Board’s Circular No.496 dated 25-09-1987, in effect though in a different form. Accordingly, the Board has decided that the amount of sales tax liability converted into loans may be allowed as deduction in the assessment for the previous year in which such conversion has been permitted by or under Government orders.”

Recent Circular

The CBDT Circular No.7 of 2006 dated 17-07-2006 is the outcome of the Explanations 3C and 3D to section 43 B inserted by the Finance Act, 2006. The Explanations provide that the conversion of arrear interest into loan by public financial institution or scheduled banks (referred to in clause (d) and clause (e) of section 43B) are not eligible for deduction unless and until such interest is actually paid by the assessee. This amendment would have prompted one to understand that it is confirmation of the court decision rendered in the case of *Kalpna Lamps & Components Ltd (Supra)*.

The Circular, however, now gives a way out for claiming such arrear interest by the taxpayers. The table on the next page depicts various situations detailed in the circular.

The circular says that there may be innumerable variations in repayment arrangements/schedules entered into between the lenders and borrowers. The circular says that it is not possible to visualise

	Case I	Case II	Case III	Case IV
Name of the assessee	ABC	XYZ	PQR	XYZ
Loan taken on	31.3.2003	Feb.2003	May 2002	
Amount of loan	Rs. 237.81 lakhs	Rs. 34.21 lakhs	Rs. 14.95 crore	Rs. 100 crore
Interest unpaid	Rs. 35.90 lakhs	Rs. 10.93 lakhs		Rs. 33 crore
Interest unpaid up to	31.3.2005	31.03.2005	From April to June 2004	31.03.06
Unpaid interest converted into	Funded Interest Term Loan (FITL)	Running Cash Credit Account and balance converted into Funded Interest Term Loan	Funded Interest Term Loan (FITL)	Arrear interest is not merged but retained separately
Deduction U/s.43 B	As and when the funded interest term loan is paid by the assessee	Payment of FITL is deductible as and when paid.	Both payment of Funded Interest Term Loan and interest on FITL are deductible on actual payment	The payment will be proportionately apportioned between principal and arrear interest and that arrear interest payment is eligible for deduction

all kinds of arrangements that may be entered into between the borrowers and the lenders in this regard. The fundamental principle, however, remains that once an amount has been determined as interest payable to the banks or financial institutions, any subsequent change of nomenclature of interest will not affect its allowance and deduction in terms of section 43 B upon actual payment. The Assessing Officers are instructed to seek a certificate of the lender bank or financial institution as evidence of actual payment of interest for allowance of deduction.

Conclusion

Where the assessee enters into an agreement or arrangement for rescheduling the loan or advance with arrear interest, the appropriation of the payments by the lender would provide the key or clue for claim of deduction under section 43 B by the payer or borrower. In practice, the recoveries would be appropriated first towards arrear interest and thereafter to the current period interest by the banks and financial institutions. This appropriation and certificate from such lending institutions would lend support to the assessee for claim under section 43B. The treatment of arrear interest in the books of account is not a decisive factor for allowance or disallowance of claim under section 43 B.

In the following situations, payments covered by section 43 B could be arranged in such a manner as to have some tax benefits / savings.

Where the assessee has income below taxable limit or loss under the head 'business or profession' and no income tax is payable on his total income.

Where the depreciation claim of the assessee is more than the taxable income before depreciation and deduction under section 43 B.

Where the assessee has huge brought forward losses and the current year income is less than the brought forward loss, the benefit of claim under section 43 B can be postponed to future years.

Where the assessee has income which is eligible for tax incentives such as section 10A or section 10 B or section 10 BA or section 10 C or section 80-IA or section 80-IB or section 80-IC or section 80-IBA, the remittance of the payments covered by section 43 B may be used for optimal tax benefits.

In the case of companies while computing book profit tax under section 115JB no adjustment is required to be made for section 43B payments and hence assessee can compare the income as per the regular provisions of the Income-tax Act vis-a-vis the book profit tax and accordingly plan disbursement of outflows covered by section 43B. □