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Direct Tax Alert

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Supreme Court upholds disallowance upon failure to deduct tax at source under Section 194C

In a recent decision[1], the Supreme Court has upheld the disallowance made under Section 40(a)(ia) of the Income-tax Act, 1961 ('the Act') on failure to deduct tax at source under Section 194C of the Act, while making payments to transporters

Background

- Shree Choudhary Transport Company ('the taxpayer') had entered into a contract with its customer for transporting cement to various places in India. The taxpayer did not own any transport vehicles and hence it had engaged the services of various truck owners / operators. The taxpayer received payment towards transportation charges from the customer ('the consignor') after deduction of tax at source.
- The taxpayer filed its income tax return for Assessment Year ('AY') 2005-06, declaring total income of INR 289,633 from the transport contract. During the assessment proceedings, the Assessing Officer ('AO') examined various records and observed that the taxpayer was responsible for transporting of goods of the consignor as per the contract with the consignor. The taxpayer in turn paid truck owners / operators without deduction of tax at source under Section 194C of the Act while making payments to the truck operators / owners. The difference was shown as commission income.
- The AO held that it was the responsibility of the taxpayer to deduct tax at source while making payments to the truck operators /

[1] Shree Choudhary Transport Company v. ITO (Civil Appeal No. 7865 of 2009)

owners under Section 194C of the Act read with Circular No. 715 of 1995, where the amount so paid exceeded INR 20,000.

- The AO further observed that the taxpayer had shown payments exceeding INR 20,000 on the same date in two parts under two different vouchers. The AO held that merely because the payments had been made in parts, the requirement to deduct tax at source under Section 194C and consequent disallowance under Section 40(a)(ia) of the Act cannot be absolved.
- The AO disallowed a sum of INR 57,11,625 under Section 40(a)(ia) of the Act, being the amount paid to truck owners / operators on which tax was not deducted at source.
- On appeal, the Commissioner of Income Tax (Appeals) ['CIT(A)'] observed that there was no nexus between the consignor and the truck owners / operator and there existed a contract or a sub-contract between the taxpayer and the truck owners / operators. The CIT(A) rejected the contentions of the taxpayer and held that the payments by the taxpayer are covered by the provisions of Section 194C.
- Before the appeal Income Tax Appellate Tribunal ('ITAT'), the taxpayer submitted the agreement executed between the consignor and itself. The ITAT observed that the agreement was made on a principal to principal basis.
- The taxpayer raised a plea before the ITAT that Section 40(a)(ia) of the Act was introduced by the Finance (No. 2) Act, 2004, and that the circular for the same was issued only on July 15, 2005, by which date the time for payment of tax at source had expired. The taxpayer further argued that Section 40(a)(ia) would only be applicable from AY 2006-07 and not from AY 2005-06. The ITAT rejected this plea by stating that the amendment came before the close of the financial year ended on March 31, 2005 in the statute books, and therefore the taxpayer cannot be held ignorant of its requirement to deduct tax at source.
- The contention of the taxpayer that expenditure was not charged to the profit and loss account and that only commission income was shown was also rejected by the ITAT. In its result, the ITAT upheld the order of AO and CIT(A).
- The Hon'ble Rajasthan High Court ('HC') summarily dismissed the appeal stating that there was no privity to direct contract between the truck owners and the consignors and that it was responsibility of the taxpayer to transport the goods, for which it hired the services of the truck owners. Thus, the HC held that there was no error in the order of the ITAT.
- Thereafter, the taxpayer filed an appeal before the Hon'ble Supreme Court ('SC'), which framed three questions as discussed below.

Issue 1: Is Section 194C applicable in the present case?

Revenue's contentions	Taxpayer's contentions
• Hiring trucks for transportation constituted a separate contract and therefore tax had to be deducted under Section 194C of the Act. On failure to do so, the expenditure is to be disallowed under Section 40(a)(ia) of the Act.	• There had been no specific contract with the truck operators / owners, as the vehicles were operated on a freelance and need basis. Thus, there were no payments made to a 'sub-contractor in pursuance of contract'. • Reliance was placed on the case of *CIT v. Hardarshan Singh (2013) 350 ITR 427*, wherein it was held that when the assessee merely acted as a facilitator or intermediary in the process of transportation of goods, there was no liability to deduct tax under Section 194C of the Act.

Judgement of the SC

- The nature of the contract between the taxpayer and the consignor make it clear that the taxpayer was to transport the good of the consignor company; How to accomplish this task was a matter exclusively within domain of the taxpayer.
- Engaging the truck operators / owner for the transportation of the goods amounted to a 'contract' and it was not relevant as to whether the terms of the said contract have been reduced into writing.
- The decision in the case of the *Hardarshan Singh* (supra) can be distinguished on facts; the assessee therein was merely acting as a facilitator or intermediary and had no privity to contract between the consignor and the transporter; In the present case, the taxpayer did not act as a facilitator or intermediary as the consignor and the transporter had no privity to contract between them;
- Section 194C of the Act is applicable in the given case and it was the responsibility of the taxpayer to deduct tax at source at the time of making payments to truck operators / owners.

Issue 2: Is disallowance under Section 40(a)(ia) confined / limited to the 'amount payable' and not to amount 'already paid' and does the decision in the case of *Palam Gas Service v. CIT (2017) 394 ITR 300* requires reconsideration?

Revenue's ontentions	Taxpayer's contentions
• Similar contentions were considered and specifically rejected by the SC in the case of *Palam Gas Service* (supra)	• While introducing Section 40(a)(ia), Finance (No. 2) Bill, 2004 used the expressions 'credited or paid', but only the words 'payable' were enacted. Thus, it is clear that the coverage of the provision is restricted and is not applicable to the amount already paid. • Section 194C of the Act applies to both the situations i.e. 'paid' and 'payable'. However, Section 40(a)(ia) of the Act would be applicable only in situation where the amount is 'payable'. The scope of Section 40(a)(ia) of the Act cannot be expanded beyond its

	language merely because of Section 194C of the Act. • The decision of the SC in the case of *Palam Gas* (supra) needs to be reconsidered because: a) Taxing provision for disallowance has to be strictly construed; b) The change in words from 'credited or paid' to 'payable' has been ignored; c) The intent of the provision to only disallow the outstanding or payable amounts has not been considered; and d) The scope of Section 40(a)(ia) of the Act has been expanded on the basis of Section 194C of the Act.

Judgement of the SC

- Section 40(a)(ia) of the Act provides for consequences in case of non-deduction of tax at source. The intent of the legislature in introducing such provision is to ensure strict and punctual compliance with the requirement to deduct tax at source.
- The term 'payable' used in Section 40(a)(ia) of the Act is only used to indicate the nature of the payments to the payees referred therein. The term 'payable' is used in a descriptive sense and the semantical suggestion of the taxpayer, (i.e. that it has to be read in contradistinction to the tern 'paid') is without merit.
- Following the ruling in the case of *Palam Gas Services* (supra), it was held that the term 'payable' used in Section 40(a)(ia) of the Act includes the term 'paid' and therefore disallowance under Section 40(a)(ia) of the Act was upheld.
- Reconsideration of the ruling in the case of *Palam Gas Service* (supra) was not required.

Issue 3: Is Section 40(a)(ia) of the Act, which was inserted by Finance (No. 2) Act, 2004 with effect from April 1, 2005, applicable from financial year 2005-06 and hence not applicable to financial year 2004-05 and to the payment by taxpayer?

Revenue's contentions	Taxpayer's contentions
• The introduction of Section 40(a)(ia) in the Finance (No. 2) Act, 2004 w.e.f. April 1, 2005 applies to AY 2005-06 (i.e. the assessment year under consideration). • The amendment made in Section 40(a)(ia) of the Act by Finance (No. 2) Act, 2014 restricting disallowance to 30% of the expenditure does not apply to the given case	• Section 40(a)(ia) would apply only from FY 2005-06 and will not apply to the present case of FY 2004-05. • Reliance was placed on the case of *PIU Ghosh v DCIT (2016) 386 ITR 322 (Cal)*. • The assent of the president was received on September 10, 2004 and therefore the provisions of Section 40(a)(ia) cannot be applied before the date of assent. • Alternatively, the amendment made in Section 40(a)(ia) of the Act by Finance (No. 2) Act, 2014, restricting disallowance to 30% of the expenditure has to be applied retrospectively, being curative in nature. Reliance was placed on *CIT v. Calcutta Export Company (2018) 404 ITR 654 (SC).*

Judgement of the SC

- The provision in question having come into effect from April 1, 2005 would apply from and for AY 2005-06 and therefore will apply to the assessment year in question.
- It was further stated that the requirement of deducting tax at source was already extant as per Section 194C of the Act, and Section 201 of the Act was also extant and dealt with defaults in deduction of tax at source. It therefore cannot be contended that the taxpayer would have honored such a requirement only in the event of its being aware of the drastic consequence of non-compliance
- The proviso to Section 40(a)(ia) of the Act takes care of the bonafide assesses who fail to deduct tax at source, by allowing a deduction in the year in which such tax is deducted and paid. The proviso has escaped the attention of the Calcutta High Court in the case of *PIU Ghosh* (supra). Section 40(a)(ia) of the Act and has further been modulated by way of various subsequent amendments to mitigate genuine hardships. Therefore, the judgement in case of *PIU Ghosh* cannot be regarded as correct in law.
- The amendment made in Section 40(a)(ia) of the Act by the Finance (No. 2) Act, 2014 restricting the disallowance to 30% of the expenditure cannot be stretched so as to reach AY 2005-06. The case of the *Calcutta Export Company* (supra) relates to a situation where an amendment was made in 2008 to mitigate genuine hardships caused due to the insertion of Section 40(a)(ia) of the Act. However, even after an amendment in 2008, there was a class of assessees who still faced the hardships, which was sought to be remedied by the amendment in 2010. The Calcutta High Court held that the amendment in 2010 was curative in nature and therefore would apply retrospectively. However, the above ruling cannot be applied in the case of amendments made by the Finance (No. 2) Act, 2014, which restrict the disallowance to 30% of expenditure.

Dhruva Comments

- The judgement confirms applicability of withholding tax provisions irrespective of the manner in which transaction is recorded by the taxpayer. The taxpayer can be said to be acting as intermediary only if there were a privity of contract on a principal to principal basis between the service recipient and service provider.
- The SC has reconfirmed the principles laid in the case of *Palam Gas Service* (supra) that the disallowance provisions under Section 40(a)(ia) covers the amount 'already paid'
- The SC also held that the amendment to Section 40(a)(ia) restricting disallowance to 30% is prospective in nature.

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