CASH CREDIT – FUNDAMENTAL PRINCIPLES

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Background

Generation of black money and its stashing abroad in tax havens and offshore financial centers have dominated discussions and debate in public foram during the past several years. Members of Parliament, the Supreme Court of India and the public at large have unequivocally expressed concern on the issue, particularly after some reports suggested estimates of such unaccounted wealth being held abroad.

There are several measures taken at an International level over the years to combat the menace of generation of black money and its round tripping. Some of the measures taken at an international level includes Establishment of Financial Action Task Force on money laundering ("FATF") in 1989, Establishment of Eurasian Group on Combating Money Laundering at an International level and Financing of Terrorism in 2004.

The international consensus on the need for coordinated action in the fight against the menace of black money requires parallel action at country level. Accordingly, a number of proactive steps have been taken by GOI in order to create an appropriate legislative framework for preventing the generation of black money and for its detection, in addition to Introduction of Prevention of Money Laundering Act, 2002 ("PMLA"), Entering into Tax Information Exchange Agreement ("TIEA")and Demonetization.

Section 68 –An anti-abuse provision to curb black money and its round tripping

Section 68 of the Income-tax Act, 1961 ("the Act") is one such anti-abuse provision introduced for the first time by Finance Act, 1961 in the Income-tax Act, 1961 ("the Act") w.e.f. 1 April 1962, which had no corresponding provision in the erstwhile Act, i.e. Income-tax Act, 1922. However, cash credit has been a subject matter of tax litigation in India much before the introduction of section 68.

Objective of section 68

As mentioned above, the intention behind introduction of section 68 was to investigate and prevent any sort of money laundering and conversion of black money and to prevent generation and circulation of unaccounted money and clamp the prevailing practices like (a) Concealment of unaccounted cash by showing the same as lent or deposited with them by third parties; (b) Showing of unaccounted cash as their own capital contribution; (c) Showing the alleged loan as repaid and other illegal practices.

Conditions for applicability of section 68

The existing provisions of the aforesaid section 68 provides that *"where any sum is found credited in the **books of an assessee** maintained for any previous year, and the assessee offers no explanation about the nature and source thereof or the explanation offered by him is not, in the opinion of the assessing officer, satisfactory, the sum so credited may be charged to income-tax as the income of the assessee of that previous year….."*

Therefore, section 68 can be enforceable only when following conditions are satisfied:

a) The assessee maintains books of accounts; and

b) Credit entry occurs in such books; and

c) No explanation or absence of satisfactory explanation by the assessee about the nature and source of such credit;

Each condition is explained in detail below:

a) The assessee maintains books of accounts:

- The word "Books" is defined under the Section 2(12) of the Act. The existence of the books is the foremost condition for applicability of section 68.
- The expression "books of the assessee" appearing in section 68 refers to the assessee whose books show the credit entry. A perusal of this section would show that in relation to the expression "books", the emphasis is on the word "assessee" meaning thereby that such books have to be the books of the assessee himself and not of any other assessee[1].
- In the assessment of a partner, the mere fact that the cash credit entries had been found in the books of the firm of which he was a partner was held immaterial, because the books in which such entries had been found were those of a different assessee[2].
- The passbook of the bank is not regarded as a valid account books under the section 68[3].
- Rough books are also books[4].
- Loose sheets are not books. Where loose sheets are found, there is usual inference of the AO that they represent concealed transaction. Such inference does not readily follow. It can be positively made only after identification of papers and after due verification[5].

b) <u>Credit entry occurs in such books:</u>

- Section 68 may cover credits other than cash. Credits under section 68 has to be understood to include all amounts met for payments found in assessee's books and not merely for cash receipts as loans.
- The section does not make any distinction between commercial loans[6] and non-commercial loans or between amounts credited to an account of a third party and those credited to the assessee's own capital account[7].
- The language of section 68 shows that it is general in nature and applies to all credit entries in whomsoever name they may stand, i.e., whether in the name of assessee or a third party[8].
- ***<u>Not confined to cash credits</u>*** – Though section 68 deals with cash credits, it is not confined to credits in cash. Other credits by way of liabilities also requires explanation as stipulated under section 68, so that when they are not satisfactorily explained, they are bound to be added[9].

[1]Shanta Devi v CIT (1988) 171 ITR 532 (P&H)
[2]Sunder Lal Jain v CIT (1979) 117 ITR 316 (All)
[3]CIT v Bhaichand H Gandhi (1983) 141 ITR 67 (Bom)
[4]Haji Nazir Hussain v ITO (2004) 271 ITR (AT) 14 (Del.)
[5]Goyal (S.P.) v DCIT (2004) 269 ITR (AT) 59 (Mum)
[6]Kant & Co (C) v CIT (1980) 126 ITR 63 (Cal)
[7]Dharmavat Provision Stores v CIT (1983) 139 ITR 700 (Bom)
[8]Gumani Ram Siri Ram v. CIT [1975] 98 ITR 337 (Punjab & Haryana High Court)
[9]V I S P (P) Ltd v CIT (2004) 265 ITR 202 (MP)

c) <u>No explanation or absence of satisfactory explanation by the assessee about the nature and source of such credit:</u>

- **Burden of proof**: Section 68 places the burden of proof on the taxpayer to explain the nature and the source of any credit found in the books. Once the assessee produces evidences about identity and creditworthiness of the lender and genuineness of transaction, the burden of proof shifts to the revenue[10].

- **Expression "assessee offers no explanation"**: The expression "assessee offers no explanation" means where the assessee offers no proper, reasonable and acceptable explanation as regards the sum found credited in the books maintained by the assessee. The opinion of the AO for not accepting the explanation offered by the assessee as not satisfactory is required to be based on proper appreciation of material & other attending circumstances available on record. The opinion of the AO is required to be formed objectively with reference to the material available on record. Application of mind is the sine qua non for forming the opinion[11].

- **No burden on the tax officer to locate the exact source**: Where the assessee has failed to prove satisfactorily the source and nature of the credit entry in his books and it is held that the relevant amount is the income of the assessee, it is not necessary for the department to locate the exact source[12]. No further burden lies on the revenue to show that the income is from any particular source[13].

- **Contrary evidence provided by tax officer**: If the explanation offered by the assessee about the nature and source of credit is not satisfactory in the opinion of the AO and produces some prima facie evidence against the explanation of the assessee or not matching with the explanation given by the assessee the assessee has to rebut the same. If assessee fails to do so, the said evidence being unrebutted can be used against him by holding that it is a receipt of income in nature[14].

- **Prerequisites to satisfy the AO**: The prerequisites to satisfy the Assessing Officer as explained by Delhi High Court in case of CIT v. Lovely Exports Pvt Ltd (2008) 299 ITR 268 (Delhi) are as under:

"In the case of a company the following are the propositions of law under section 68. The assessee has to prima facie prove:

1) *the identity of the creditor/subscriber;*
2) *the genuineness of the transaction, namely, whether it has been transmitted through banking channel or other indisputable channels;*
3) *the creditworthiness or financial strength of the creditor/subscriber;*
4) *if relevant details of the address of PAN identity the creditor/subscriber along with copies of the shareholders register, share application forms, share transfer register, etc., it would constitute acceptable proof or acceptable explanation by the assessee;*
5) *the Department would not be justified in drawing an adverse inference only because the creditor/subscriber fails or neglect to respond to its notice;*
6) *The Assessing Officer is duty bound to investigate into the credit worthiness of the creditor/subscriber, the genuineness of the transaction and the veracity of the repudiation."*

[10]ITO v. Anant Shelters (P.) Ltd. [2012] 20 taxmann.com 153/51 SOT 234 (Mum.)
[11]CIT v. P. Mohanakala [2007] 291 ITR 278 / 161 Taxman 169 (SC)
[12]CIT v. M. Ganapathi Mudaliar [1964] 53 ITR 623 (SC)
[13]Roshan Di Hatti v. CIT [1977] 107 ITR 938 (SC)
[14]Sumati Dayal v. CIT [1995] 80 Taxman 89/214 ITR 801 (SC)

The Hon'ble Delhi High Court in CIT v. Oasis Hospitalities Pvt. Ltd.[2011] 9taxmann.com 179/198 Taxman 247/333 ITR 119 (Delhi), held that:

"The initial onus is upon the assessee to establish three things necessary to obviate the mischief of Section 68. Those are:

i. identity of the investors;

ii. their creditworthiness/investments; and

iii. genuineness of the transaction

The departments exercise starts only when these three ingredients are established prima facie, by the assessee and the department is required to investigate into the facts presented by the assessee."

- Assessee not bound to prove source of the source: Once the assessee is able to establish that he has in fact received money from a third party, he cannot be burdened with a further onus of establishing the source from which such third party had been able to obtain the moneys[15].

- **Genuineness of transaction in case of gifts**: The inference of genuineness of gifts does not readily follow merely on identification of the donor or on receipt of money through banking channels. His capacity to make a gift is equally relevant. In fact, the credibility of such gifts, except where it is proved beyond doubt, would appear to be relevant as held by Supreme court[16].

Special provision for closely held company - Share application money

- Certain judicial pronouncements have discussed on the scope of onus of proof and the requirements of section 68 in cases where the sum is credited as share capital, share premium, etc.

- For instance, in the case of *CIT* v. *Lovely Exports (P.) Ltd.* [2008] 216 CTR 195, the Supreme Court held that if share application money was received by the assessee-company from alleged bogus shareholders, whose names were given to the Assessing Officer, then the Department was free to proceed to reopen their individual assessments in accordance with the law but this amount of share money could not be regarded as undisclosed income under section 68 of the assessee-company. Similar rulings are given in cases of CIT v. Steller Investment Ltd. [2001] 115 Taxman 99 (SC), *CIT* v. *Kamdhenu Steel & Alloys Ltd.* [2012] 206 Taxman 254.Thus, the courts have held that assessee is not required to prove source of source of the creditor.

- In order to overcome these decisions, at least in those cases where share application money is received through private placements, an additional onus, needed to be placed to prove the source of money in the hands of such shareholder or persons making payment towards issue of shares before such sum is accepted as genuine credit, the provision of section 68 was amended by Finance Act, 2012 and two provisos were added which strengthened the burden on closely held companies to establish the source of the funds received by it while exempting money received from venture capital funds and venture capital company from the ambit of the provision.

- The Memorandum to the Finance Bill, 2012 explained the need for the addition of these 2 provisos to Section 68 of the Act as below:

[15]CIT vs Daulat Ram Rawatmull (1973) 87 ITR 349 (SC)
[16]CIT vs Mohanakala (P) (2007) 291 ITR 278 (SC)

"In the case of closely held companies, investments are made by known persons. Therefore, a higher onus is required to be placed on such companies besides the general onus to establish identity and creditworthiness of creditor and genuineness of transaction. This additional onus needs to be placed on such companies to also prove the source of money in the hands of such shareholder or persons making payment towards issue of shares before such sum is accepted as genuine credit. If the company fails to discharge the additional onus, the sum shall be treated as income of the company and added to its income."

- The Proviso to section 68 inserted by the Finance Act, 2012 w.e.f. 1 April 2013 reads as under-

"Provided that where the assessee is a company (not being a company in which the public are substantially interested), and the sum so credited consists of share application money, share capital, share premium or any such amount by whatever name called, any explanation offered by such assessee-company shall be deemed to be not satisfactory, unless –

a) the person, being a resident in whose name such credit is recorded in the books of such company also offers an explanation about the nature and source of such sum so credited; and

b) such explanation in the opinion of the Assessing Officer aforesaid has been found to be satisfactory:

Provided further that nothing contained in the first proviso shall apply if the person, in whose name the sum referred to therein is recorded, is a venture capital fund or a venture capital company as referred to in clause (23FB) of section 10."

- A reading of the above Proviso indicates that it will be applicable to-
  - A closely held company, i.e. a company in which public are not substantially interested and receiving in its books the credit from a resident.
  - The sum so credited should be of the nature of share application money, share capital, share premium or any such amount by whatever name called.
  - Explanation about the nature and source of the credit would not be deemed to be satisfactory, unless-
    - Person in whose name such credit is recorded offers an explanation about the nature and the source of such credit; and
    - Explanation by such person is to the satisfaction of AO
  - Where the creditor is not able to satisfactorily explain nature and source of the credit in the books of the assessee, then such sum shall be treated as income of the assessee.
  - The above Proviso will not be applicable in following cases:
    - Credits in the books of a company, which is not closely held company.
    - If the person in whose name the sum is credited is a venture capital fund or a venture capital company, as referred to in section 10(23FB) of the Act.
    - Credits in the books of closely held companies in the name of non-residents.
    - Credits in the books of closely held companies where credits are not in the nature of share application money or share capital or share premium.

Amendment by Finance Act 2022

- The additional burden on the assessee u/s 68 to prove source of source is quite specific and is applicable only in case of closely held companies and that to in case of sum received in the form of share application money or share capital from non-resident. Prior to A.Y. 2023-24, there was no such similar additional burden in case of sum received in the form of loan or borrowing.
- As per the memorandum to Finance Bill, 2022, it was noticed that there was a pernicious practice of conversion of unaccounted money by crediting it to the books of assesses through a masquerade of loan or borrowing.
- In view of the above, Finance Act 2022 has inserted additional proviso to section 68 to provide that the additional burden of proving source of source will also be applicable in case of loan or borrowing received by a taxpayer from any person (resident or non-resident), while exempting money received as loan or borrowing from venture capital funds and venture capital company from the ambit of the provision.
- The additional proviso to section 68 as inserted by Finance Act, 2022 reads as under:

  "Provided that where the sum so credited consists of loan or borrowing or any such amount, by whatever name called, any explanation offered by such assessee shall be deemed to be not satisfactory, unless, –

  a) the person in whose name such credit is recorded in the books of such assessee also offers an explanation about the nature and source of such sum so credited; and

  b) such explanation in the opinion of the Assessing Officer aforesaid has been found to be satisfactory"

- The conditions for applicability of the aforesaid proviso are as under:
  - Sum credited should be by way of loan or borrowing or any such amount by whatever name called;
  - Sum may be credited in the books of any taxpayer, whether or not a company and in case of company, whether or not a closely held company;
  - Credit can be in the name of any person, whether or not a resident;
  - Explanation about the nature and source of the credit would not be deemed to be satisfactory, unless-
    - Person in whose name such credit is recorded offers an explanation about the nature and the source of such credit; and
    - Explanation by such person is to the satisfaction of AO
  - The above Proviso will not be applicable If the person in whose name the sum is credited is a venture capital fund or a venture capital company, as referred to in section 10(23FB) of the Act.

Practical issues in applying the new proviso:

✓ It is to be noted that the Finance Act 2022 has provided exemption from the ambit of the applicability of section 68, to the money received from Venture Capital company and Venture capital fund only.

- ✓ There is no similar exemption provided to the money received in the form of loan or borrowing from any banking company or any financial institution or a Government Company or a corporation established by a Central, State or bank or Provincial Act; in line with the exemption provided under section 269SS, 269ST and 269T.

- ✓ In the absence of any such exemption, it would become difficult to comply with the aforesaid section practically. For instance, in case of a loan taken from a bank by an assessee, it would be difficult to explain/prove the nature and source of money received by such lender bank.

Taxability of income determined - Section 115BBE

- As per white paper on "Black money" issued by Ministry of Finance, Department of Revenue, CBDT in May 2012, "A number of other significant changes have been proposed in the Income Tax Act through the Finance Bill 2012 which includes - To create greater deterrence against black money, unexplained amounts deemed as income of a taxpayer under sections 68, 69, 69A, 69B, 69C and 69D of the Income Tax Act 1961 are proposed to be taxed at the maximum marginal rate without any allowance or deduction."

- As per section 115BBE, if the total income of the assessee includes any income referred to in section 68 of the Act, then tax on such income shall be calculated at the tax rate of 60%. Surcharge @25% and Cess @4% shall be levied separately.

- No deduction in respect of any expenditure or allowance or set-off of any loss shall be allowed to the assessee in computing the income u/s 68 of the Act.

Conclusion

Financial crimes, including tax crimes, money laundering, and terrorist financing, undermine jurisdictions' political and economic interests and pose a serious threat to national security. By their very nature, tax crimes are closely linked to other financial crimes and it is well recognized that tax authorities have a central role to play in identifying and reporting money laundering.

Hence, it is very essential to have stringent provisions in order to protect the economy of the country. Though section 68 of the Income Tax Act, 1961 does well in this regard and there is a clear message from Government to combat the practice of generation of black money, there are practical challenges relating to amendment made by Finance Act 2022 to prove source of source in case of loan or borrowing from financial institution. Some relaxation in this regard from CBDT will be a need of an hour!!

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