PROPOSED AMENDMENTS RELATING TO BUSINESS INCOME

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The finance minister presented the Budget 2022 in the parliament, while the economy is still trying to recover from the havoc caused globally by the pandemic. The budget has proposed amendments to the Income-tax Act, 1961 (the Act), many with the aim of rationalizing the provisions. The budget has also proposed few amendments which are clarificatory in nature.

In this article, I have tried to analyze the proposed amendments in provisions relevant in calculating business income.

All the proposed amendments mentioned below are will take effect from F.Y. 2022-23 (i.e. A.Y. 2023-24) unless otherwise specifically stated, subject to passing of the Finance Bill by both the houses of the Parliament and assent by the President.

I Section 35 - Deduction in respect of expenditure on scientific research

- Sub-section (1) of Section 35 of the Act allows deduction in respect of amounts spent on scientific research.

- Clause (ii) thereof allows deduction in respect of amounts paid to a research association for scientific research or to a university, college, to be used for scientific research. Clause (iia) thereof allows deduction in respect of amounts paid to company formed for scientific research / development. Clause (iii) thereof allows deduction in respect of amounts paid to a research association for research in social science / statistical research, etc.

- Sub-section (1A) to Section 35, inserted with effect from the 1st April, 2021, mandates the research association, university, college or other institution referred to in above clauses [Clause (ii) or (iii) or (iiia) of Section 35(1)] to file the statement of donations received by these entities from the donors and furnish to the donor, a certificate specifying the amount of donation.

- **Thus, the deduction claimed by the donor is sought to be disallowed in cases where the** statement of donations is not filed by the association, institution, etc**.** However, due to an inadvertent drafting error therein, the present language reads that no deduction shall be allowed to the research association, university, college or other institution, if such statement of donations is not filed. **However, that was not the intention of the law, since Section 35(1) allows deduction to donors for amount paid to an** association, university, college, etc. and not to the association or the institution to whom donations are given**.**

- Hence, it is proposed to amend Section 35(1A) to change the language of the Section to provide that the deduction claimed by the donor with respect to the donation given to any research association, university, college or other institution referred to in clause (ii) or clause (iia) or clause (iii) of Section 35(1) shall be disallowed if such research association, college, institution, etc. fails to furnish the statement of donations required to be furnished. **This amendment being curative, will take effect retrospectively from 1st April, 2021.**

II Section 37 – General deductions

- Section 37 of the Act provides for allowability of revenue and non-personal expenditure (other than those falling under sections 30 to 36) laid out or expended wholly and exclusively for the purposes of business or profession. Explanation 1 to sub-section (1) of Section 37 of the Act provides that any expenditure incurred by an assessee for any purpose which is an offence or which is prohibited by law shall not be deemed to have been incurred for the purpose of business or profession and no deduction or allowance shall be made in respect of such expenditure.

- However, the area was subject to litigation since there have been mixed rulings of various courts and tribunals, predominantly in respect of gifts, freebies like Travel facility, Hospitality, Cash or monetary grant, etc. given to medical practitioners by pharmaceutical companies. In certain cases, courts have ruled in favour of the assessees (pharmaceutical companies) holding that Medical Council of India (MCI) Regulations, 2002 provide only limitation/curb/prohibition only for medical practitioners and not for pharmaceutical companies and hence it could not have had any prohibitory effect on assessee. Hence, the expenses incurred by assessees were purely for business purposes and hence, were not hit by Explanation 1 to Section 37(1).

- That not being the intention of the legislation, it is now proposed that Explanation 1 above shall be deemed to have always included the expenditure incurred by an assessee:

  i. For an any purpose which is an offence under, or which is prohibited by, any law for the time being in force, in India or outside India; or

  ii. to provide any benefit or perquisite, to any person and acceptance of such benefit or perquisite by such person is in violation of any law or rule or regulation or guidelines governing the conduct of such person; or

  iii. for a purpose which is an offence or is prohibited or is for compounding an offence under any Indian law or foreign law,

  The above amendment will have wider impact in the business world, in the sense that any expenses, payment of which may not be an offence but if acceptance of the same constitutes an offence as per the guidelines of the governing body (respective institute, association, etc.) shall not be allowed to an assessee. It sets to rest controversies pertaining to legality or otherwise of expenses of the nature described above.

  This amendment being curative, will take effect retrospectively from 1st April, 2022.

III Section 40 – Disallowance of certain expenses

- Clause (a) of Section 40 lists certain expenses which would not be allowed as deduction in computing income under the head business or profession. Sub-clause (ii) thereof states that that any sum paid on account of any rate or tax levied on the profits or gains of any business or profession or is assessed at a proportion of or otherwise on the basis of any such profits or gains shall not be an allowable expenditure in computing the income chargeable under the head "Profits and gains of business or profession."

- Whether the aforesaid sub-clause includes within its sweep education cess levied by the Finance (No. 2) Act, 2004 (and its similar variants levied by various Finance Acts from time to time) has lately been a subject matter of contentious litigation. Certain taxpayers are claiming deduction on account of 'education cess' claiming that the said levy is different from levy of tax and since 'cess' has not been specifically mentioned in section 40(a)(ii), it is not subject to disallowance. Various courts have also ruled in favour of assessees. The Finance (No. 2) Act, 2004 states Education cess to be an additional surcharge.

- It is therefore proposed to insert an Explanation 3 to Section 40(a)(ii) to provide that that for the purposes of sub-clause (ii), the term "tax" shall include and shall be deemed to have always included any surcharge or cess, by whatever name called, on such tax.'

- Since it was never the intention of the law makers to allow Education cess as an expenditure in computing business income, the aforesaid amendment, clarificatory in nature, is applicable **retrospectively from AY 2005-06,** which is the first time since education cess was levied.

IV Section 43B – Deductions allowed only on actual payment

- Section 43B of the Act provides for certain deductions to be allowed only on actual payment basis. Explanation 3C, 3CA and 3D of this section provides that a deduction of any sum, being interest payable on loan or borrowing from specified financial institution/NBFC/scheduled bank or a co-operative bank, etc. under clause (d), clause (da), and clause (e) of this section respectively, is allowed only if such interest has been actually paid. However, interest which is converted into a loan or borrowing or advance is not considered as constructive payment.

- However, certain taxpayers claim deduction of interest on conversion of such **interest payable into debentures, instead of loan.** The same has been upheld by several courts since the existing provisions of Section 43B only disallow deduction in cases where the interest payable is converted into fresh loan / advance and not debentures / any other instrument like zero coupon bonds. Such interpretation is against the intent of legislation.

- Since the section was introduced to curb the mischief of claiming deduction by the assessee, without actual payment of interest to financial institutions/NBFCs/scheduled banks or co-operative banks, an amendment is proposed to amend Explanations 3C, 3CA and 3D to include conversion of interest liability into debentures / any other instruments, along with loan / advance. The impact of the said amendment is that the conversion of interest liability into debentures / any other instruments will not be considered as actual payment and accordingly, shall be liable to be disallowed u/s 43B.

- On analysis of the proposed amendment, question to be pondered is the year of allowability of interest or in other words, when would the interest be considered as 'paid', in the eyes of law – whether it would be allowable only in the year of redemption of debentures or in any earlier year ?

  However, more than that, it needs to be seen if the amendment, in substance overrules the ratio held by hon'ble apex court in the case of M.M. Aqua Technologies Ltd. v. CIT [2021] 129 taxmann.com 145 in which the court has held that on issue of debentures in lieu of conversion of outstanding interest, it was evident that liability to pay interest had been extinguished and it does not tantamount to conversion of interest into loan, as envisaged by the Explanations 3C, 3CA and 3CD of Section 43B. Even after the amendment, the above said fact remains.

- **This amendment being curative, will take effect retrospectively from 1st April, 2022.**

V Section 50 – Computation of capital gains in case of depreciable assets

- From FY 2020-21, goodwill is not considered as a depreciable asset and hence no depreciation is allowed thereon. Correspondingly, the amended provision provided for reduction of WDV of goodwill from the block of intangible assets.

- It is now proposed to be clarified that the reduction of the amount of goodwill from block of intangible assets, in accordance with the provisions of Section 43(6)(c)(ii)(B) (W.D.V. of goodwill) shall be deemed to be transfer for the purposes of Section 50. As a result, provisions of Section 50 would be attracted and capital gains would be calculated in the same manner as applicable for any depreciable capital asset, in the situations covered in Section 50. Thus, this provision only intends to clarify that, in application of provisions of Section 50, the amount of WDV of goodwill reduced from the WDV of block of asset owing to disallowance of depreciation of goodwill on account of amendment in Income Tax Act shall be considered as transfer. Computation of short term capital gains and WDV u/s 50 in cases where depreciation on goodwill has been claimed in the past, shall have to be made after considering newly inserted Rule 8AC vide Notification G.S.R. 472(E) [NO. 77/2021/F. NO. 370142/23/2021-TPL], DATED 7-7-2021.

- Since the amendment to the effect that goodwill of a business or profession is not a depreciable asset has been made applicable w.e.f. A.Y. 2021-2022, the above amendment in Section 50 will take effect **retrospectively from 1st April 2021 and will accordingly apply from A.Y. 2021-22.**

VI Section 68 – Cash credits

- Section 68 of the Act provides that where any sum is found to be 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 satisfactory to A.O, the sum so credited is added as the income of the assessee of that previous year. The onus of satisfactorily explaining such credits remains on the assessee, being the person in whose books such sum is credited.

- Introducing unaccounted money in the books of accounts under the garb of loans / borrowings, share capital is rampant. To bring to tax such unaccounted income, Section 68 was amended by Finance Act, 2012 to provide that the nature and source of any sum credited in the books of a closely held company, in the nature of share application money, share capital or share premium shall be treated as explained only if the source of funds is also explained to the satisfaction of the Assessing Officer, in the hands of the shareholder.

- Loans / borrowings is another popular way of bringing unaccounted money in the books of accounts, next to share capital. However, in case of loan or borrowings, there is a plethora of judicial rulings in favour of assessees holding that an assessee is required to prove identity, creditworthiness of lenders and genuineness of transactions and nothing beyond. Thus, the Section, as it stands now, does not cast an onus on the assessee to explain the source of funds in the hands of creditor.

- To check this unethical practice, it is proposed to amend the provisions of section 68 of the Act so as to bring the transactions of loan / borrowing analogous to share capital money. That is to say, the proposed amendment provides that the nature and source of any sum, whether in form of loan or borrowing, or any other liability credited in the books of an assessee shall be treated as explained only if the source of funds is also explained in the hands of the creditor or entry provider. However, as in the case of share capital, a carve out is provided in cases where the creditor is a well-regulated entity, i.e., a Venture Capital Fund or Venture Capital Company registered with SEBI.

- It is also worth noting that if such source of source is not proved, then it would fall within the scope of Section 115BBE wherein tax is levied @ 60% plus 25% surcharge plus 4% cess.

- Practical implementation of the proposed amendment could be challenging since it needs to be seen, up to which level assessee would have to prove source of source. If the source of source is explained and the Assessing officer has suspicion about the source of such source (third level source), whether the source of source (second level source) proved by the assessee would be satisfactory in the opinion of the officer, has no answer.

- **This amendment being curative, will take effect retrospectively from 1st April, 2022.**

VII Section 80 IAC – Special provisions (tax holiday) in respect of specified businesses

- Currently, a deduction of 100% of the profits derived from eligible business by an eligible start-up is available for any 3 consecutive years out of first 10 years from incorporation, subject to certain conditions. One of the conditions therein is that the start-up is incorporated after 31st March, 2016 but before 31st March, 2022.

- The law makers are aware of the delays in setting up of such units on account of Covid pandemic. Thus, in order to extend the benefit to eligible start-ups, it is proposed to extend the last date of incorporation by one year, from 31st March, 2022 to 31st March, 2023.

VIII Section 115BAB – Special rate of tax for new manufacturing companies

- Currently, a new manufacturing company set-up and registered on or after 1st October, 2019 is eligible for a concessional corporate tax rate of 15% (17.16% including surcharge & cess), subject to certain conditions. One of the conditions is that it shall commence manufacturing/production by 31st March, 2023. Again, considering impact of COVID-19 pandemic, it is proposed to extend the last date for commencement of manufacturing/production from 31st March, 2023 to 31st March, 2024.

IX Section 115BBH – Scheme of taxation of Virtual Digital Assets (VDA)

- There has been a phenomenal increase in transactions in virtual digital assets. The magnitude and frequency of these transactions prompted the law makers to provide for a specific tax regime. Hence, following changes are proposed in respect of tax regime of VDA:

    - Income on transfer of any virtual digital asset (by and large crypto-currencies and Non-fungible token) will be taxed at 30% plus applicable surcharge and cess.

    - While calculating income, only deduction for cost of acquisition shall be allowed and no other deduction of any expenditure or set off of any loss shall be allowed. Owing to lack of clarification, there exists confusion if loss from crypto transactions also would be allowed to be set-off against gains therefrom, the same year.

    - Further, loss arising from transfer of VDA cannot be set off against any other income. Such loss shall also not be allowed to be carried forward to subsequent years.

- To bring transaction of gift of VDA also into the tax net, Section 56(2)(x) is proposed to be amended to include VDA within the definition of 'property'. However, gift received by an assessee in respect of VDA shall be taxable at normal rate of tax subject to the exceptions as provided in the provisions for gifts from relatives. This provision could result into double taxation given that the recipient cannot claim any benefit of cost of acquisition since then same is nil, in the absence of any clarification regarding what constitutes cost of acquisition.

- In order to widen the tax base, it is proposed that payment to a resident on transfer of VDA shall be liable for TDS @ 1% under **section 194 S**. However, **TDS shall not be required to be made** in case the payer is a specified person and the aggregate value of payment to a resident is less than Rs. 50,000 during the F.Y. In any other case, the threshold is Rs. 10,000. However, since the transactions are carried out virtually, it is not possible for a purchaser to identify the seller and deduction of TDS is yet another thing.

- **Specified person' means an individual/HUF:**
  - whose total sales, gross receipts/turnover of business does not exceed Rs. 1 crore or Rs. 50 lakhs in case of profession, during immediately preceding FY.
  - having income under any head other than 'profits and gains of business or profession'.

- In case the payment for such transfer is partly or fully in kind, before making the payment, the payer shall ensure that the tax has been paid in respect of such consideration.

- In case TDS is deducted under this provision, no TDS / TCS is required under any other section.

- **This proposed amendment for TDS will be effective from 1 st July, 2022.**

- Introduction of tax regime for cryptos, as they are popularly called, doesn't legalize them. In fact, to clear the air around the government's stance on cryptos, more so post budget 2022, hon'ble finance minister in her latest statement on February 2, has clarified that cryptocurrencies such as Bitcoin, Ethereum and Non-fungible tokens (NFTs) will never become legal tender since they are not issued by RBI.

- Though digital assets are capital assets, the taxation regime is not at par with the existing scheme of computing capital gains. Head under which the same would be taxed – Capital gains or income from other sources needs clarification.

- There is lack of clarity about the taxation of the crypto gains earned hitherto and there are mixed views about the same. However, it is here worth noting that CBDT chairman has stated that "The taxability of the crypto-currency is certain for this financial year too. Crypto investors should know that the transactions done before April 2022 will not be tax-free." This could be a word of caution to all the stakeholders taking a liberal view on the taxation of gains earned until now and in F.Y. 2021-22.

- All in all, it seems that the prima facie intention of the government is to discourage such kind of transactions / treat them at par with windfall gains and collect revenue from such gains.

- **This amendment being curative, will take effect retrospectively from 1st April, 2022.**

X Section 79A — Set off of loss in search / survey cases

- The provisions contained in Chapter VI of the Act pertaining to set-off and carry forward of losses under various heads allow set-off of losses / unabsorbed depreciation against undisclosed income detected as a result of search & seizure or survey or requisition proceedings. However, the said set-off is not allowed against incomes of similar nature like Section 68, Section 69, Section 69B etc. assessed in scrutiny assessment proceedings in the regular course of assessment.

- The provision of non-adjustment of loss or unabsorbed depreciation against undisclosed income arising out of search or survey proceedings would help in ensuring that proper tax is paid on income detected due to a search or survey and also result in increased deterrence against tax evasion.

- Therefore, it is proposed to insert a new section 79A in the Act to bar the set-off of any loss, whether brought forward or otherwise, or unabsorbed depreciation under section 32(2) against undisclosed income detected in the course of search / survey proceedings. However, the said deterrent shall not apply to TDS / TCS survey u/s 133A(2A).

- Further, for the purpose of this Section, the term 'undisclosed income' is also defined to mean the following:

  i. any income represented, either wholly or partly, by any money, bullion, jewellery or other sactions found in the course of search / survey (other than TDS / TCS survey)

     a. which has not been recorded on or before the date of search or requisition or survey, in the books of account or other documents maintained in the normal course relating to such previous year; or

     b. which has not been disclosed to the concerned income tax authorities (Principal Chief Commissioner or Chief Commissioner etc.) before the date of search or requisition or survey, or

  ii. any income of the previous year represented by any entry in respect of an expense recorded in the books of account or other documents maintained in the normal course which is found to be false and would not have been found to be so, had the search not been initiated or the survey not been conducted or the requisition not been made.

- The definition of undisclosed income also seems to be thoughtfully drafted to ensure no income escapes out of this harsh provision.

- **This amendment will take effect from 1st April, 2022 i.e. wef AY 2022-23.**

XI Section 14A – Expenditure incurred in relation to exempt income

- The small humble Section 14A has also witnessed tremendous litigation in the recent years.
- One such point of litigation is in respect of the issue whether disallowance under section 14A of the Act can be made in cases where there is no exempt income earned during the year.
- In absence of any exempt income during an assessment year Section 14A of the Act provides that no deduction shall be allowed in respect of expenditure incurred by the assessee in relation to exempt income.

- CBDT issued Circular No. 5/2014, dated 11/02/2014, clarifies that Rule 8D read with section 14A of the Act provides for disallowance of the expenditure even where tax payer in a particular year has not earned any exempt income. However, some courts have taken a view that if there is no exempt income during a year, no disallowance under section 14A of the Act can be made for that year.

- However, since such an interpretation defeats the legislative intent of both, section 14A as well as Section 37 of the Act. Therefore, it is proposed to insert an Explanation to section 14A of the Act to clarify that provisions of this section shall apply and shall be deemed to have always applied in a case where expenditure has been incurred to earn exempt income but exempt income has not accrued or arisen or has not been received during the previous year.

- Whether the proposed amendment ends the ongoing dispute or unsettles the law of the land is a question unanswered.

- **This amendment will take effect from 1 st April, 2022 ie wef AY 2022-23.**

Conclusion

Introduction of fiscal measures to tackle the menace of black money has been on the government's agenda since long and just like every year, this budget has also witnessed some tax proposals in the direction. Likewise, relaxation of certain time limits is also a welcome move. The government has also proposed many amendments to the Act with an intention to reduce litigation, though some come at the cost of unsettling the existing law arrived after thoughtful process by the highest judicial forum. However, it is clear that all the government intends is timely, adequate compliance, avoiding excessively aggressive, far-stretched claims in respect of deductions and penalizing the tax evaders, which seems to be just.