TAXATION OF UNEXPLAINED INCOMES

CA Namrata Dedhia
Email : namrata@shahdedhia.com

Background:

Under the Income-tax Act, 1961, sections 68 and 69 to 69D bring cash credits and unexplained investments, money, expenditure, etc. within the tax net as undisclosed incomes. Having computed the income of any taxpayer under the five heads of income and after including incomes of any other persons, which are liable to be taxed as the taxpayer's incomes, any items that have remained undisclosed or unexplained - such as cash credits in the books of accounts, investments or expenditure or borrowing or repayment of hundi, other than by way of account payee cheque – are liable to be included in the total income of the assessee.

Taxation of Unexplained Incomes:

The manner of taxation of these unexplained incomes is dealt with in two parts – the charge is created in the aforesaid charging sections 68, 69 to 69D and the taxability of the said income is laid down in section 115BBE.

The charging sections, as discussed in detail in the other articles in this newsletter, lay down the conditions when a certain item shall be added to the income of the taxpayer, i.e., when the taxpayer is not able to offer any explanation regarding the nature and source of the cash credits or investments or money, etc. or the explanation offered is not satisfactory in the opinion of the Assessing Officer. Further, these sections also provide the point of time at which such items are included in the income of the taxpayer, i.e., in case of money, bullion, jewellery, etc., the year in which such assets are found, and in other cases, in the year in which the transaction is undertaken.

As regards the machinery section, no specific section existed in respect of taxability of unexplained incomes prior to AY 2013-14. As a consequence, even though an addition was made to the income of a taxpayer on account of unexplained income, the same was taxed as per the applicable slab rates and did not result in any harsh tax liability on the taxpayer. In fact, in case of taxpayers, whose total income did not exceed the basic exemption limit, the addition of explained incomes, had no adverse tax effect. Penalty indeed was leviable, but the same was also discretionary in nature.

In order to deter taxpayers undertaking such transactions without disclosing the same in the return of income, section 115BBE was introduced by the Finance Act, 2012,with effect from AY 2013-14, providing for a special rate of tax of 30% in case of deemed incomes under the aforesaid sections, without allowing for any deduction in respect of any expenditure or allowance to the taxpayer under any provision of the Act. Tax under section 115BBE is further liable to be increased by the applicable surcharge, based on the income slab of the taxpayer and cess.

Section 115BBE has very wide applicability in the sense that–

a) it applies to taxpayers of their legal or residential status, and

b) there is no threshold limit for application of section 115BBE, thereby making it possible to invoke the provisions for an immaterial amount of income, so long as it is unexplained income chargeable under the aforesaid sections.

Finance Act 2016 further amended this section with effect from AY 2017-18 to provide that in addition to the restriction on claiming deduction in respect of any expenditure or allowance, even set off of loss under any provision of the Act shall not be allowed to a taxpayer in respect of the aforesaid unexplained incomes. Thus, if a taxpayer has any loss in respect of the same year under any head of income, or brought forward loss in respect of earlier years, the same cannot be set off against the unexplained income, defeating the purpose of section 115BBE to act as a deterrent for the taxpayers.

This amendment also attempted to address the litigation around whether losses, and more specifically brought forward losses, can be set off against unexplained incomes since the same were not categorized under any head of income under section 14. However, it was made applicable from AY 2017-18 and thus, applies prospectively and would not apply in respect of AY 2016-17 or prior. This view has been upheld in a slew of judgements by various courts and tribunals including the Honourable Rajasthan High Court in the case of *PCIT v. Aacharan Enterprises (P.) Ltd. [2020] 273 Taxman 85 (Rajasthan)* and the Honourable Madras High Court in the case of *Shree Karthik Papers Ltd. V. DCIT [2020] 273 Taxman 546 (Madras)*.

Upon announcement of demonetization of currency on 8th November 2016, under the extant provisions of law, it was possible for taxpayers to suo moto declare the cash deposited into the bank accounts as unexplained income in the return of income and pay a tax liability of 30% (plus applicable surcharge and cess) on the same without any levy of penalty. For taxpayers having undisclosed incomes, this would have been a simple way to declare all such undisclosed income by paying tax at a rate of 30%.

Thus, to prevent the taxpayers from using this window to declare all previously undisclosed income, the provisions of section 115BBE were amended with effect from 1.4.2017, i.e. AY 2017-18 vide Taxation Laws (Second Amendment) Act, 2016 to provide as under –

a) The provisions of section 115BBE shall apply to unexplained incomes under sections 68, 69 to 69D whether the same were reflected by the taxpayer in the return of income filed under section 139, or whether the same was not so disclosed in the return of income, but was determined by the Assessing Officer, and

b) The said unexplained incomes shall be liable to be taxed at a higher rate of 60%.

Although this amendment was introduced in the back drop of the demonetization exercise, this higher rate of 60% was, however, not linked to cash deposits made consequent to demonetization alone. It was rather made applicable for any unexplained incomes includible in the total income under sections 68 or 69 to 69D.

Further, the Taxation Laws (Second Amendment) Act, 2016 also amended the provisions of Finance Act, 2016 to provide that in case of incomes taxable under section 115BBE, the applicable surcharge would be 25% of tax, i.e. 15% of the income. Thus, the effective rate of tax under section 115BBE for AY 2017-18 and AY 2018-19 became 60% tax + 15% surcharge + 2.25% cess, i.e., 77.25% of the unexplained income (as aggregate rate of cess was 3% for these assessment years). For AY 2019-20 onwards, the rate of cess is increased to 4% and accordingly, the effective rate of tax under section 115BBE now stands at 78% of the unexplained income.

The impact of the aforesaid amendments is not only that unexplained incomes are taxable at a much higher rate than the normal incomes without deduction of any expenditure, allowance or set off of loss, but also that where the taxpayer has suo moto offered to tax any ad hoc income in the return of income, for which he is unable to provide any satisfactory explanation, the same can also be considered as unexplained income and attract the higher rate of tax under section 115BBE.

Penalty Provisions:

Taxation Laws (Second Amendment) Act, 2016 also introduced new penalty section 271AAC for levy of penalty at the rate of 10% of the tax payable on unexplained incomes liable to be taxed as per section 115BBE. This penalty is in addition to the tax liability under section 115BBE. The first proviso to section 271AAC(1), however, provides that the said penalty shall not be levied if such income has been included by the taxpayer in his return of income furnished under section 139 and the tax computed as per section 115BBE has been paid within the previous year, i.e., on or before 31st March of the previous year.

In other words, penalty under section 271AAC can be levied by the Assessing Officer if –

a) The said unexplained income is not disclosed by the taxpayer in the return of income, but is instead determined by the Assessing Officer during the course of any proceedings, or

b) The said unexplained income is disclosed by the taxpayer in the return of income, but tax on the same has not been paid on or before the end of the previous year.

It is worth noting that the requirement for payment of tax on or before the end of the previous year as per section 271AAC is not correlated with the provisions for advance tax. This would imply that even where the taxpayer is suo moto offering any unexplained income to tax in the return of income, he would be required to pay the entire tax on the same, i.e. 60% tax + 15% surcharge + 3% cess as advance tax, failing which he could be liable to penalty under section 271AAC. In other words, payment of 90% of the tax liability as advance tax as per the usual norms, would save the assessee from interest on delayed payment of tax under section 234B, but would not help him escape the penalty provisions.

Section 271AAC also provides that penalty under section 270A for under-reporting or mis-reporting of income shall not be levied on such unexplained income.

Issues:

Certain issues that arise from the provisions of section 115BBE and section 271AAC as under –

Chapter VI-A Deductions -

Section 115BBE prohibits claim of deduction of any expenditure or allowance or set off of any loss against the unexplained incomes. However, deductions under Chapter VI-A are not necessarily deductions in respect of "any expenditure or allowance" and thus, it may be possible to claim such deductions against the unexplained incomes.

Unexplained income offered suo moto -

Clause (a) of sub-section (1) of section 115BBE refers to a situation where the unexplained incomes under sections 68, 69 to 69D is suo moto offered to tax by the taxpayer in the return of income filed under section 139. While this clause has no relevance for the rate of tax applicable under section 115BBE, it becomes relevant for the applicability of the penalty section 271AAC, wherein as discussed above, it is provided that penalty would not be applicable in such cases if the applicable tax is paid on or before the end of the previous year.

As section 115BBE(1)(a) makes a reference to section 139, it would thereby include belated return under section 139(4), revised return under section 139(5), or even an updated return filed under section 139(8A). Further, as a return filed under section 153A is treated to be a return filed under section 139, a view can be taken, that the same would be covered by the first limb of section 115BBE(1). A return filed in response to a notice issued under section 148, however, would not enjoy the same benefit and it is likely to be considered under the second limb and thus, open to penalty provisions.

Invoking of Section 68 –

It is observed that the Assessing Officers often invoke section 68 in the assessment orders to tax incomes, which are otherwise dealt with in other provision of the Act. For instance, where investment in received by a private company, not only is the valuation of the same examined under section 56(2)(viib), but where the company is unable to furnish income tax returns and bank statements of investors, the same is also considered as unexplained cash credit under section 68, despite the powers of the Assessing Officer to call for information under section 133(6). Such situations can be very precarious, as the higher rate of tax under section 115BBE acts as an incentive for the Assessing Officers to apply the provisions of section 68, even when the same may not be relevant or where specific provisions exist in the Act.

Further, in light of the amendment to section 68 by Finance Act 2022, which places the onus of proof to demonstrate the "source of source" on the taxpayer, despite sufficient powers available to the Assessing Officers to investigate such "source of source", the scope of this section and thereby the higher rate of tax under section 115BBE becomes far too wide.

Conclusion:

Time and again, attempts have been made by the authorities to deter taxpayers from evading taxes, first by legislating provisions for chargeability of unexplained incomes, cash credits, money, investments, etc., thereafter by taxing the same at the maximum marginal rate under section 115BBE and further by increasing the tax rate to a whopping 60% plus a higher surcharge, cess and penalty. This, coupled with recent amendments in Finance Act 2022 to section 68, nearly incentivizes the Assessing Officers to blindly apply these provisions. Where such a high rate of tax is sought to be levied, it would only be rational to cast some burden of discharging the onus of proof on the Assessing Officers, failing which, the taxpayers are left to the subjectivity of the "satisfaction" of the Assessing Officer. In the bid to curb evasion of taxes and generation of black money, such provisions can potentially cause more than just discomfort to a much wider mass of honest and small taxpayers and the same needs to be addressed urgently.