

## Issues on Tax Audit

### I. Section 44AB

As per section 44AB (d),

“Every person carrying on the business shall, if the profits and gains from the business are deemed to be the profits and gains of such person under section 44AD and he has claimed such income to be lower than the profits and gains so deemed to be the profits and gains of his business and his income **exceeds the maximum amount which is not chargeable to income-tax in any previous year**” get his accounts of such previous year audited by an accountant before the specified date.

As per section 44AB (d), 3 basic conditions need to be fulfilled for a person to get his accounts audited;

1. The business carried on by the assessee must be covered by section 44AD,
2. The assessee claims his income to be lower than the profits and gains so deemed to be the profits and gains of his business as per section 44AD, and
3. The assessee's income **exceeds the maximum amount which is not chargeable to income-tax**

Example:

Mr. ABC proprietor of ABC & Sons has a retail business of readymade garments. The turnover of the business for the financial year 2010-11 is Rs. 50 lacs. Profit for the year is Rs. 1.50 lacs being less than 8% of total turnover of Rs. 50 lacs. Mr. ABC does not have any other source of income other than business profit. Is Mr. ABC liable to Audit as per section 44AD?

Explanation

To assess whether section 44AB is applicable we test the 3 basic conditions of section 44AB (d):

1. Whether the business carried on by the assessee is covered by section 44AD
2. Whether assessee claims his income to be lower than the profits and gains so deemed to be the profits and gains of his business as per section 44AD, and
3. Whether the assessee income **exceeds the maximum amount which is not chargeable to income-tax**

Using the above test in our example;

The business of readymade garments is covered u/s 44AD

Also the profit as claimed by the assessee is lower than the profits and gains so deemed to be the profits and gains of his business as per section 44AD

But the total income of the assessee of Rs. 1.50 lacs does not **exceeds the maximum amount which is not chargeable to income-tax i.e. Rs. 1.60 lacs**

Hence Mr. ABC is not liable to audit u/s 44AB (d) of the Income Tax Act.

## **II. Section 40(a)(ia)**

Clause 16(f) of Form 3CD requires to state, the amount of expense inadmissible under Section 40(a)

Section 40(a) includes various sub sections viz (i), (ia), (ic), (ii) etc... under which Section 40(a)(ia) specifies cases where tax is deductible at source under Chapter XVII-B and such tax has not been deducted or, after deduction, has not been paid on or before the due date specified in sub-section (1) of section 139, shall not be allowed as deduction. Provided that where in respect of any such sum, tax has been deducted in any subsequent year, or has been deducted during the previous year but paid after the due date specified in sub-section (1) of section 139, such sum shall be allowed as a deduction in computing the income of the previous year in which such tax has been paid.

On understanding of section 40(a) (ia) following gist can be framed,

- a. Expenses on which tax is deductible at source and tax has not been deducted, or
- b. After deduction has not been paid on or before due date specified in sub-section (1) of section 139

shall not be allowed as deduction

### Issue relating to section 40(a) (ia)

The Statutory Audit for Assessment Year 2011-12 of LMN Ltd. had been finalized on 31/05/2011. During the month of August, 2011, in the course of conducting Tax Audit of LMN Ltd., the auditors noticed an expense for which no tax had been deducted. As the accounts of LMN Ltd. were finalized before the commencement of the tax audit, TDS on the said expense was deducted and paid in the month of August, 2011, however the same is not reflected in the audited accounts. Since the tax was deducted and paid before the due date specified in sub-section (1) of section 139 i.e. 30/09/11, assessee contended that the expense is deductible during the A.Y. 2011-12.

### Explanation

As per section 40(a) (ia) following two basic conditions need to be fulfilled for an expense to be deductible.

- a. Tax needs to be deducted at source during the relevant assessment year and
- b. The same needs to be paid on or before due date specified in sub-section (1) of section 139

In the case of LMN Ltd. since the statutory audit was finalized before the commencement of its Tax Audit, tax was deducted in the next Financial Year i.e. 2011-12. As per section 40(a) (ia) in cases where tax was deductible but not deducted the same shall not be allowed as deduction in the year under reference but the same shall be allowable in the year when the said tax was deducted and paid. Hence for LMN Ltd. expense shall be disallowed in A. Y. 2011-12 and shall be allowed in A. Y. 2012-13 when tax has been deducted and paid.

### **III. Section 14A**

As per section 14A,

- (1) No deduction of expenses shall be allowed in respect of Income not forming part of Total Income.
- (2) The Assessing Officer can also determine the amount of disallowance in accordance with prescribed method if he is not satisfied with the claim of the assessee.

Section 14A has given the power to assessing officer to determine the amount of disallowance as per Rule 8D being the prescribed method if he is not satisfied with the claim of the assessee. Rule 8D prescribes the method for determining amount of expenditure in relation to income not includible in total income.

As per Rule 8D, The expenditure in relation to income which does not form part of the total income shall be the aggregate of following amounts, namely:-

(a) the amount of expenditure directly relating to Exempt Income;

(b) If Interest expended is not directly attributable to such income, then;

$(\text{Amount of Interest expended}) \times (\text{Avg. value of Investments as on 1st \& last day of the year})$

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*Avg. of the Total Assets as on 1st & last day of the previous year*

(Total Assets = All Assets excluding the increase on account of revaluation of assets but including the decrease on account of revaluation of assets.)

(c)  $0.005 \times (\text{Avg. value of Investment on which Exempt Income is earned})$

Following example elaborates the section in deep;

#### Example

Unrealized Exports Pvt. Ltd. is having the business of manufacturing and exporting of readymade garments. During the financial year 2010-11 Unrealized Exports Pvt. Ltd. invested in the shares of Reliable Ltd. and gained a dividend income of Rs. 50,000/-. Before the end of the financial year, Unrealized Exports Pvt. Ltd. sold the shares invested in Reliable Ltd. No direct expense has been incurred by Unrealized Exports Pvt. Ltd. to earn such exempt income. Also there was no opening and closing balance of investment in the books of Unrealized Exports Pvt. Ltd. Unrealized Exports Pvt. Ltd. claims that since no expense is incurred for earning dividend income no disallowance is to be done u/s 14A. Is the contention of the assessee valid in law?

#### Explanation

Considering the above rule, in the absence of direct nexus the assessing officer can disallow only based on the method prescribed under Rule 8D.

In the present example, assessee has not disallowed any amount u/s 14A, hence the assessing officer at best can apply the provisions of Rule 8D.

Based on the method specified under Rule 8D aggregate of following shall be the disallowance,

Sr. No.	Particulars	Amount of Disallowance
(a)	Amount of Expenditure directly related to Exempt Income	NIL
(b)	Interest Expended	NIL*
(c)	0.5% of Avg. Stock of Investments	NIL*

\* Since value of Average investment is NIL during the year the amount of disallowable shall also be NIL.

Based on the above observations it can be concluded that the basic condition for disallowance is that there should be either opening or closing stock of investments, failing which the method of disallowance will not be relevant.

Hence even if the assessee has claimed an income from investment being exempt from tax and no direct expenses have been incurred to earn the same there shall be no disallowance u/s 14A if average investment of the assessee is NIL.

#### **IV. Section 145A**

Clause 12 (a) and (b) of Form 3CD requires the details regarding method of valuation of closing stock employed in the previous year and the details of deviation, if any, from the method of valuation prescribed under section 145A and the effect thereof on the profit or loss.

As per section 145A, the valuation of purchase and sale of goods and inventory for the purposes of determining the income chargeable under the head "Profits and gains of business or profession" shall include the amount of any tax, duty, cess or fee (by whatever name called) actually paid or incurred by the assessee to bring the goods to the place of its location and condition as on the date of valuation.

Whereas as per AS 2 "Valuation of Inventories" issued by the ICAI, "cost of inventories" and "cost of purchases" cannot include duties and the taxes which are subsequently recoverable from the taxing authorities. Hence the input tax which is refundable should not be included in the "cost of inventories" and "cost of purchases".

The main question that arises in everyone mind is whether adjustment to Section 145A is Tax neutral?

Explanation

Section 145A of the Income Tax Act requires valuation of purchase and sale of goods and inventory for the purposes of computation of income from business or profession, in case of any deviation on the method of accounting as required by section 145A, assessee needs to prepare reconciliation or adjustment statement for its effect thereof on the profit or loss as required under clause 12 (b) of form 3CD.

Accordingly as per the Guidance note on Tax Audit issued by ICAI, the adjustment envisaged by section 145A will not have any on the "Trading, Profit & Loss Account" of the assessee. The same can be elucidated with the following example:-

Anonymous Pvt. Ltd. is following the "Exclusive method" of accounting in accordance with AS 2 "Valuation of Inventories" issued by the ICAI. Based on the "Exclusive method" of accounting the Trading, Profit and Loss account of Anonymous Pvt. Ltd. is stated as below:

**Trading, Profit and Loss account on "Exclusive method"**

<u>Particulars</u>	<u>Qty</u>	<u>Rate</u>	<u>Amount</u>	<u>Particulars</u>	<u>Qty</u>	<u>Rate</u>	<u>Amount</u>
Opening Stock	10	1000	10,000	Sales	40	1600	64,000
Purchases	50	1200	60,000				
				Closing Stock	20	1200	24,000
Gross Profit			18,000				
			<b>88,000</b>				<b>88,000</b>
Other Expenses			6,000	Gross Profit			18,000
Net Profit			12,000				
			<b>18,000</b>				<b>18,000</b>

If the assessee had followed "Inclusive method" of accounting in accordance with section 145A of the Income Tax Act, Trading, Profit and Loss account would be stated as below:

**Trading, Profit and Loss account on "Inclusive method"**

<u>Particulars</u>	<u>Qty</u>	<u>Rate</u>	<u>Amount</u>	<u>Particulars</u>	<u>Qty</u>	<u>Rate</u>	<u>Amount</u>
Opening Stock	10	1050	10,500	Sales	40	1680	67,200
Purchases	50	1260	63,000				
Less: VAT credit availed on cost of goods sold			2,300				
			71,200				
				Closing Stock	20	1260	25,200
Gross Profit			21,200				
			<b>92,400</b>				<b>92,400</b>
Other Expenses			6,000	Gross Profit			21,200
VAT Paid on Sales			3,200				
Net Profit			12,000				
			<b>18,000</b>				<b>18,000</b>

Based on the above working it can be seen that irrespective of the method of accounting followed by the assessee there is no impact on the "Trading, Profit & Loss Account" of the assessee.

The statutory adjustments required under section 145A can be explained as below:

<b><u>Sr. No.</u></b>	<b><u>Particulars</u></b>	<b><u>Increase in Profit (Rs.)</u></b>	<b><u>Decrease in Profit (Rs.)</u></b>
1.	Increase in Opening Stock on inclusion of VAT		500
2.	Increase in Purchases on inclusion of VAT		3,000
3.	Increase in Sales on inclusion of VAT	3,200	
4.	Increase in Closing Stock on inclusion of VAT	1,200	
5.	VAT credit availed on cost of goods sold	2,300	
6.	VAT Paid on Sales		3,200
		6,700	6,700

### **Conclusion**

Based on the Guidance note on Tax Audit issued ICAI, the net impact on the "Trading, Profit & Loss Account" is NIL.

#### **Disclaimer :**

The information contained in this write up is to provide a general guidance to the intended user. The information should not be used as a substitute for specific consultations. We recommend that professional advice is sought before taking any action on specific issues.