

Revision of Guidance Note on Tax audit under section 44AB of the Income-tax Act, 1961

The Guidance Note on Tax audit under section 44AB of the Income-tax Act, 1961 was revised in the year 2005 taking into consideration the amendments made by the Finance Act, 2005. Thereafter, a Supplementary Guidance Note was issued in the year 2006, which was a part of Guidance Note on audit of fringe benefits under the Income-tax Act, 1961. This Supplementary Guidance Note took into consideration the amendments made in Form No.3CD by Circular No.208/2006 dated 10th August 2006. Further Guidance in regard to reporting requirement in Form No.3CD in respect of changes brought about by State-Level VAT Acts in the context of section 145A was placed on the website on 12.10.2007.

To enable the members to efficiently discharge their onerous responsibility, the Council in its 280th meeting held from 7th to 9th August 2008, considered the integration of the Supplementary Guidance Note on tax audit with the main Guidance Note on tax audit under section 44AB of the Income-tax Act, 1961 and further revision thereof.

Apart from the changes, which are required to be made due to change in law, the Council considered the appropriate guidance to be given to the members in regard to clause 17(l) of Form No.3CD.

Notification No.208/2006 dated 10th August 2006 inserted a new clause 17(l) in Form No. 3CD wherein the amount of deduction inadmissible in terms of section 14A in respect of the expenditure incurred in relation to income which does not form part of the total income is required to be mentioned. The Finance Act, 2006 inserted sub-section (2) and sub-section (3) in the section 14A to the effect that having regard to the books of account of the assessee the Assessing Officer shall determine the amount of expenditure incurred in relation to such income which does not form part of the total income under the Act in accordance with the method as may be prescribed. Recently, the CBDT has through Income-tax (Fifth

Amendment) Rules, 2008 inserted a new Rule 8D which lays down the method for determining the amount of expenditure in relation to income not includible in total income.

The appropriate guidance approved by the Council in regard to clause 17(l) of the Form No.3CD is as under:-

“40. Clause 17(l) - Amount of deduction inadmissible in terms of section 14A in respect of the expenditure incurred in relation to income which does not form part of the total income;

40.1 This clause was inserted by the notification number 208/2006 dated 10th August 2006. Section 14A was inserted in Chapter IV – Computation of total income by the Finance Act, 2001 with retrospective effect from 1.4.1962 i.e. A.Y. 1962-63. Accordingly, for the purposes of computing the total income under Chapter IV of the Act, no deduction shall be allowed in respect of expenditure incurred by the assessee in relation to income which does not form part of the total income under the Act. The Finance Act, 2002 added a proviso to section 14A to the effect that nothing contained in the section shall empower the Assessing Officer either to reassess under section 147 or pass an order enhancing the assessment or reducing a refund already made or otherwise increasing the liability of the assessee under section 154, for any assessment year beginning on or before the first day of April, 2001.

40.2 The Finance Act, 2006 has inserted sub-sections (2) and (3) w.e.f. A.Y. 2007-08. Under sub-section (2) the Assessing Officer shall determine the amount of expenditure incurred in relation to such income, which does not form part of the total income under the Act. Such determination should be in accordance with the method as may be prescribed. Such power of the Assessing Officer can be exercised only when he, having regard to the accounts of the assessee, is not satisfied with the correctness of the claim of the assessee.

40.3 Sub-section (3) provides that the provisions of sub-section (2) shall also apply in relation to a case where an assessee claims that no expenditure has been incurred by him

in relation to income which does not form part of the total income under this Act.

40.4 The expenditure which is relatable to the income which does not form part of the total income is not allowed as a deduction in terms of section 14A of the Act. Such income are dealt with in Part III- Incomes Which Do Not Form Part Of Total Income. Section 10 deals with Incomes not include in total income. Sections 10A to 10C deals with the special provisions in respect of the specified undertakings. In general an assessee may have besides his business income, income from agriculture which is exempt under sub-section (1), share of profit in a partnership firm which is exempt under sub-section (2A), income from dividends referred to in section 115-O which is exempt under sub-section (34), long term capital gains on the transfer of equity shares which is exempt under sub-section (38) etc. In all such cases the expenditure relating to the income which is not included in total income is inadmissible under section 14A. In case of an investment in a partnership firm, while the interest and the salary received by the partner are taxable, the share of profit is exempt. The amount of inadmissible expenditure depends on the facts and circumstances of each case.

40.5 The Central Board of Direct Taxes, has through Income-tax (Fifth Amendment) Rules, 2008 inserted a new Rule 8D which lays down the method for determining the amount of expenditure in relation to income not includible in total income. Sub-rule (1) of Rule 8D provides that having regard to the accounts of the assessee of a previous year, if the Assessing Officer is not satisfied with the correctness of the claim of expenditure made by the assessee or with the claim made by the assessee that no expenditure has been incurred, in relation to income which does not form part of the total income under the Act for such previous year, he shall determine the amount of such inadmissible expenditure in accordance with the method of computation laid down in sub-rule (2) of Rule 8D.

Sub-rule (2) of Rule 8D provides for the method of computation of the expenditure in relation to income not forming part of the total income. The disallowance shall be the aggregate of the following:

- i) the amount of expenditure directly relating to income which does not form part of total income;
- ii) in a case where the assessee has incurred expenditure by way of interest during the previous year which is not directly attributable to any particular income or receipt, an amount computed in accordance with the following formula, namely :

$$\frac{A \times B}{C}$$

Where A = amount of expenditure by way of interest other than the amount of interest included in clause (i) incurred during the previous year;

B = the average of value of investment, income from which does not or shall not form part of the total income, as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year;

C = the average of total assets as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year;

- iii) an amount equal to one-half per cent of the average of the value of investment, income from which does not or shall not form part of the total income, as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year.

“Total Assets” for the purpose of Rule 8D shall mean, total assets as appearing in the balance sheet excluding the increase on account of revaluation of assets but including the decrease on account of revaluation of assets.

40.6 The method prescribed under sub-rule (2) of Rule 8D is applicable when the Assessing Officer is not satisfied with the correctness of the claim of expenditure made by the assessee or with the claim made by the assessee that no expenditure has been incurred. Normally this situation would arise at the time of assessment i.e. after the tax audit has been completed and the return has been filed. Therefore, at the time of

tax audit the tax auditor will have to verify the amount of inadmissible expenditure as determined by the assessee. The method under sub-rule (2) of Rule 8D is to be adopted by the Assessing Officer when he is not satisfied with the amount as determined by the assessee. Rule 8D does not mandate that the assessee should necessarily compute the disallowance as per the method prescribed under sub rule (2). Therefore, the assessee may or may not adopt the same.

40.7 It is primarily the responsibility of the assessee to furnish the details of amount of deduction inadmissible in terms of section 14A i.e. in respect of the expenditure incurred in relation to income, which does not form part of the total income. The tax auditor shall examine the details of amount of inadmissible expenditure as furnished by the assessee. While carrying out such examination the tax auditor is entitled to rely on the management representation. However, attention is invited to para 5 of Standard on Auditing -580, “Representation by Management” (earlier known as Auditing and Assurance Standard-11) which is as under:-

“During the course of an audit, management makes many representations to the auditor, either unsolicited or in response to specific enquires. When such representations relate to matters which are material to the financial information, the auditor should;

- (a) seek corroborative audit evidence from sources inside or outside the entity;
- (b) evaluate whether the representations made by management appear reasonable and consistent with other audit evidence obtained, including other representations; and
- (c) consider whether the individuals making the representation can be expected to be well informed on the matter.”

40.8 The tax auditor will verify the amount of inadmissible expenditure as estimated by the assessee with reference to established principles of allocation of expenditure based on

logical parameters like proportion of exempt and taxable income recorded, turnover, man hours spent to earn the relevant income etc. For allocation of interest between taxable and non-taxable income, the quantum of investment, the period and the rate of interest are generally the relevant factors to be considered. This requires proper estimates to be made by the assessee. The tax auditor is required to audit such estimates. Attention is invited to Standard on Auditing-540 (earlier known as AAS-18)“ “Audit of Accounting Estimates”. In accordance with this Standard the auditor should adopt one or a combination of the following approaches in the audit of such accounting estimates:

- review and test the process used by the assessee to develop the estimate;
- use an independent estimate for comparison with that prepared by the assessee; or
- review subsequent events which confirm the estimate made.

40.9 An assessee may claim that no expenditure has been incurred by him in relation to income which does not form part of the total income under the Act. Even in such a case the provisions of section 14A will apply. Accordingly, the tax auditor is required to verify such contention of the assessee.

40.10 As stated before the method prescribed under sub-rule (2) of Rule 8D is to be adopted by the Assessing Officer when he is not satisfied with the correctness of claim made by the assessee. As per clause (i) of sub-rule (2) the expenditure which is directly relatable to income which does not form part of total income is inadmissible expenditure. Besides such expenditure there may be expenditure such as interest, which is relatable to both taxable and non-taxable income which needs to be properly allocated while calculating the inadmissible amount. Interest which, can be directly attributable to any particular income or receipt chargeable to tax needs to be excluded while determining the inadmissible amount. Clause (ii) of sub-rule (2) of rule 8D deals with allocation of interest which, is not directly

attributable to any particular income or receipt. However the variable A used in the formula in clause (ii) of sub- rule (2) is said to be equal to the amount of expenditure by way of interest other than the amount of interest included in clause (i) incurred during the previous year. It may be seen that what is proposed to be allocated as per clause (ii) is interest which is not directly attributable to any particular income or receipt. Therefore, variable A is the amount of expenditure by way of interest other than the amount of interest directly attributable to any non taxable income as per clause (i) and also interest which may be directly attributable to any taxable income. Interest on term loan may be an example of such interest which is generally related to taxable income and is therefore excluded.

40.11 The broad principles enunciated in para 16.3 may be kept in mind while verifying the amount of inadmissible expenditure. After verifying the amount of inadmissible expenditure, if the tax auditor:

- (a) is in agreement with the assessee, he should report the amount with suitable disclosures of material assumptions, if any.
- (b) is not in agreement with the assessee with regard to the amount of expenditure determined, he may give:

- **A qualified opinion:**

A qualified opinion can be given when the auditor is of the opinion that the effect of any disagreement with the assessee is not so material and pervasive as to require an adverse opinion or limitation on scope is not so material and pervasive as to require a disclaimer of opinion.

- **An adverse opinion:**

The auditor in rare circumstances may come across a situation where the impact of his disagreement about the computation of such inadmissible expenditure is so material and pervasive that it affects the overall opinion. In such a case the tax auditor may give an adverse opinion.

- **The disclaimer of opinion:**

When the assessee has neither provided the basis nor the supporting documents, for the claim of such inadmissible expenditure, then due to limitation on the scope of auditors work, the auditor can give disclaimer of opinion.”