***ANALYSIS OF PROVISION OF DISALLOWANCE UNDER SECTION 40A(3) OF THE INCOME TAX ACT, 1961 ALONGWITH SOME LATEST JUDGEMENTS ON THIS ISSUE***

The provision of Sec 40A(3) was incorporated in the Income Tax Act to disallow claim of certain expenses if payment is made otherwise than prescribed mode in excess of limit laid down in the said section. The section was enacted as one of the measures for countering evasion of tax. It was found from experience, that deductions were being claimed for payment made from unaccounted money in the computation of business or professional income. This provision was enacted to enable the assessing authority to ascertain whether the payment was genuine or whether it was out of the income from undisclosed sources. Genuine and bona fide transactions are taken out of the sweep of the sub- section. It is open to the assessee to furnish to the satisfaction of the Assessing Officer the circumstances under which the payment in the manner prescribed in sub-section (3) was not practicable or would have caused genuine difficulty to the payee.

It is also open to the assessee to identify the person who has received cash payment. The provisions of sub-section (3) and [rule 6DD](file:///C%3A%5CCTRSETUP%5Chtml%5CRULEIT6DD) are intended to regulate business transactions and to prevent the use of unaccounted money or to reduce the chances to use black money for business transactions. The restraint that has been imposed is to curb the chances and opportunities to use or create black money and the same should not be regarded as curtailing the freedom of trade or business [see [Attar Singh Gurmukh Singh vs. ITO](file:///C%3A%5CCTRSETUP%5Chtml%5C191%20ITR%20667) *(1991) 191 ITR 667 (SC)*.

The provision of S. 40A(3) as well as r. 6DD has been amended many times. ***There has been a lot of litigation on the interpretation of this subject. Some of the interesting and land mark judgements interpreting the provision of Sec. 40A(3) r.w.r. 6DD are discussed hereunder.***

1. ***The instances provided under Rule 6DD are only illustrative and not exhaustive :***
2. ***The Gujarat High Court in Anupam Tele Services TA No. 556/2013 dated 22.01.2014* has held that No s. 40A(3) disallowance can be made for cash payments even if Rule 6DD(j) exception does not apply if there is no dispute as to genuineness of payment and business compulsion. The High Court reversed the order of ITAT and held in favour of the assessee as under :**

S. 40A(3) and Rule 6DD are not intended to restrict business activities. The terms of s. 40A(3) are not absolute. Considerations of business expediency and other relevant factors are not excluded. Genuine and bona fide transactions are not taken out of the sweep of the section. It is open to the assessee to furnish to the satisfaction of the AO the circumstances under which the payment in the manner prescribed in s. 40A (3) was not practicable or would have caused genuine difficulty to the payee. It is also open to the assessee to identify the person who has received the cash payment. On facts, though the case of the assessee did not fall within the exclusion clause in Rule 6DD (j), s. 40A(3) will not apply because (a) there is no doubt as to the genuineness of the payment nor the identity of the payee, (b) the assessee was compelled to pay cash owing to the insistence of its principal and if it had not abided by the direction, the business would have suffered & (c) the exceptions in Rule 6DD are not exhaustive and the rule must be interpreted liberally (**Attar Singh Gurmukh Singh** 191 ITR 667 (SC), **Hynoup Food & Oil Industries**  290 ITR 702 (Guj) & **Harshila Chordia** 298 ITR 349 (Raj) referred)”

1. The above view was also taken by Delhi HC in the case ***Basu Distributor 206 TM 45.***
2. The interpretation of above latest judgements is that the list provided under r. 6DD is only illustrative and not exhaustive. If the assessee can demonstrate other genuine causes for making payment in cash, disallowance u/s 40A(3) can be avoided. The provision and judgements thereon in respect of older provision of R. 6DD(j)(1)/(2) can be safely applied here too.
3. ***Provision u/s 40A(1) starts with a non-obstante clause :***
4. Section 40A(1) contains a non-obstante clause and hence it is an overriding provision which operates irrespective of anything contrary contained in any other provision of the Act. In [Shree Sajjan Mills Ltd. vs. CIT](file:///C%3A%5CCTRSETUP%5Chtml%5C156%20ITR%20585) *(1985) 156 ITR 585 (SC),* the Supreme Court while dealing with restriction contained in sub-section (7) of section 40A referred to the marginal note and heading of section 40A, which according to the Supreme Court, were relevant factors to be taken into consideration in construing the ambit of the section and observed that actual payments or provisions for payment which could have been eligible for deduction under [section 28](file:///C%3A%5CCTRSETUP%5Chtml%5CSECIT28) and [section 37](file:///C%3A%5CCTRSETUP%5Chtml%5CSECIT37) of the Act would be subject to the provisions of section 40A which had an overriding effect and that expenditure or allowances which are deductible under any other provision relating to the head "Business or profession" would be disallowed in cases to which the provisions of section 40A apply.
5. ***Restrictions contained in section 40A(3) would apply to those expenses which are otherwise allowable :***
6. Restrictions and limitations contained in section 40A would apply to those expenses which are otherwise allowable under other provisions of the Act. If the expenses are not allowable under other provisions of the Act no question of examining the provisions of section 40A would arise [[N.M. Anniah & Co. vs. CIT](file:///C%3A%5CCTRSETUP%5Chtml%5C101%20ITR%20348) *(1975) 101 ITR 348 (Kar)*. Similar view was taken in [CIT vs. Motilal Khatri](file:///C%3A%5CCTRSETUP%5Chtml%5C218%20CTR%20602) *(2008) 218 CTR (Raj) 602*
7. ***Provisions of Sec 40A(3) are applicable to illegal business and also business carried out outside books of accounts :***
8. Since the profits and gains derived from an illegal business like smuggling are liable to be taxed in accordance with the provisions of the Act including section 40A(3) the fact that in a business like smuggling it is not practicable to comply with provisions of section 40A(3) of making payments by crossed cheque or bank drafts in respect of purchases made of smuggled goods would not prevent operation of the said section and the fact that it was not possible to establish identity of the parties from whom purchases were made would not exempt the assessee from obligation to establish such identity under [rule 6DD(j)](file:///C%3A%5CCTRSETUP%5Chtml%5CRULEIT6DD) [[S. Venkata Subbarao vs. CIT](file:///C%3A%5CCTRSETUP%5Chtml%5C173%20ITR%20340) *(1988) 173 ITR 340 (AP).*
9. In [CIT vs. Maddi Venkataratnam & Co. P. Ltd.](file:///C%3A%5CCTRSETUP%5Chtml%5C144%20ITR%20373) *(1983) 144 ITR 373 (AP),* the assessee made an illegal cash payment of Rs. 2.95 lakhs to a party in the course of lawful business of export of tobacco and the High Court held that said expenditure was not allowable as deduction under [section 37](file:///C%3A%5CCTRSETUP%5Chtml%5CSECIT37) or [section 28](file:///C%3A%5CCTRSETUP%5Chtml%5CSECIT28) and that in the alternative said expenditure was disallowable under section 40A(3) and that an illegal payment cannot be brought within the exception under [rule 6DD(j)](file:///C%3A%5CCTRSETUP%5Chtml%5CRULEIT6DD). The Supreme Court has affirmed the decision in[Maddi Venkataraman & Co. (P) Ltd. vs. CIT](file:///C%3A%5CCTRSETUP%5Chtml%5C144%20CTR%20214) *(1998) 144 CTR (SC) 214.*
10. In [CIT vs. Hynoup Food & Oil Ind. (P) Ltd.](file:///C%3A%5CCTRSETUP%5Chtml%5C199%20CTR%20350) *(2005) 199 CTR (Guj) 350* it was held that where income from an undisclosed business is brought to tax, provisions of s. 40A(3) and all other relevant provisions come into play—Evidence of genuineness of the payment and the identity of the payee are the first and foremost requirements for the applicability of r. 6DD(j)—When these two factors are established, only then the question as to whether the payment in cash was made in exceptional or unavoidable circumstances can be examined.
11. **REJECTION OF ACCOUNTS, ESTIMATION OF PROFIT VIS-A-VIS SECTION 40A(3)**
12. In [CIT vs. Banwari Lal Bansidhar](file:///C%3A%5CCTRSETUP%5Chtml%5C148%20CTR%20533) *(1998) 148 CTR (All) 533* it was held that where the income is assessed at G.P. rate by rejecting the books of accounts of the assessee under s. 145(1), proviso, no disallowances can be made separately under s. 40A(3).
13. Above view was affirmed In [CIT vs. Purshottamlal Tamrakar Uchehra](file:///C%3A%5CCTRSETUP%5Chtml%5C184%20CTR%20349) *(2003) 184 CTR (MP) 349 and* [CIT vs. Smt. Santosh Jain](file:///C%3A%5CCTRSETUP%5Chtml%5C296%20ITR%20324) *(2008) 296 ITR 324 (P&H).* The adoption of gross profits rate takes care of expenditure otherwise than by crossed cheque or bank draft.
14. However, in ***Sai Metal Works ITA 125/2004 dtd. 10.03.2011 (P&H),*** it was held that disallowance u/s 40A(3) can be made in block assessment even if profit is estimated by applying GP Rate.

**6. PAYMENTS TO SUB-CONTRACTORS**

**i.** Payment made by assessee-principal contractor to the sub-contractor pursuant to an agreement would not attract provisions of s. 40A(A)(3) r/w r. 6DD. [CIT & Anr. vs. Balaji Engineering And Construction Works](file:///C%3A%5CCTRSETUP%5Chtml%5C323%20ITR%20351) *(2010) 323 ITR 351 (Kar).*

**7. Payment jointly by cash and post dated bearer cheque**

1. Where assessee paid cash and gave a post-dated bearer cheque to the party and when the cash paid did not exceed two thousand five hundred rupees but cash paid together with amount represented by post-dated bearer cheque exceeded two thousand five hundred rupees, it was held that section 40A(3) was not attracted because amount represented by post-dated cheque could not be regarded to have been paid on the day in question in view of the fact that payment by post-dated cheque could be regarded to have been made on the date of its maturity and encashment. It was also held that payment by post-dated cheque was a recognized method of making payment in business circles and was not a device to defeat any provision of law [[H.A. Nek Mohd. & Sons. vs. CIT](file:///C%3A%5CCTRSETUP%5Chtml%5C135%20ITR%20501) *(1982) 135 ITR 501 (All)*

*8.* **Scope of cl. (e) of** [**rule 6DD**](file:///C%3A%5CCTRSETUP%5Chtml%5CRULEIT6)

1. There is limited area within which payments by book adjustment can be considered to fall within the exception to the rule of prohibition contained in section 40A(3). According to cl. (e) of [rule 6DD](file:///C%3A%5CCTRSETUP%5Chtml%5CRULEIT6) it is the expenditure in respect of which the payment by way of book adjustment is made to the payee who directly supplied the goods or services to the assessee, that falls outside the mischief of rule of prohibition in section 40A(3). The payments by book adjustments in the accounts of third parties would be hit by the prohibition contained in section 40A(3) [[CIT vs. Kishanchand Maheshwari Dass](file:///C%3A%5CCTRSETUP%5Chtml%5C121%20ITR%20232) *(1980) 121 ITR 232 (P&H)*.
2. According to [CIT vs. Muthoot Bankers](file:///C%3A%5CCTRSETUP%5Chtml%5C162%20CTR%20414) *(2000) 162 CTR (Ker) 414*, s. 40A(3) has no application where interest is credited to creditor’s account and there is no cash payment.

**9. Payment to Government Rule 6DD(b)**

1. Cash payments made by the assessee to the State Government who was granted the contract to collect royalty on behalf of the Government cannot be disallowed under s. 40A(3) in view of r. 6DD(b). [[CIT vs. Kalyan Prasad Gupta](file:///C%3A%5CCTRSETUP%5Chtml%5C239%20CTR%20447) *(2011) 239 CTR (Raj) 447*]
2. Cash payments by assessee for scarp purchase from railway being part of Union of India has to treated as legal tender and payment cannot be disallowed u/s 40A(3) of the Act. Devendrappa Kalal vs CIT ITA  5018/2012 (18/9/2013) (Kar. HC).

10. In the case of ***CIT V Vijay Kumar Goel, 324 ITR 376*** ***(Chhatisgarh)*** it was held that Bill of exchange is covered under negotiable Instrument Act so no disallowance u/s 40A(3).

11.Cash deposit directly into the account of the creditor do not absolve Assessee from clutches of S. 40(A)(3). **Venkatadhri Constructions (Mad. HC) TC No. 122/2003 dtd. 29.06.2012.**

In view of above Interpretations by Various Courts of the Country on provisions of Sec 40A(3), (3A), (4) and Rule 6DD, there has been a sea change in the perception of looking at the expenses paid in cash or paid otherwise than account payee cheques. I believe that though the payment made through cash be restricted and penalized but if the assessee can demonstrate the genuine cause of making cash payment, the disallowance u/s 40A(3) should not be made since the list of situations under Rule 6DD is only illustrative and not exhaustive as laid down by Hon’ble Gujarat High Court in 2014.