Deduction of Surcharge and Education Cess to be disallowed u/s. 154 of the Act and made liable for penalty

1) As per S. 40(a)(ii) of the Income-tax Act, the payment of income-tax is not allowed as deduction from the total income. It is generally understood that education cess and secondary and higher education cess are also not allowable deductions. However, the Bombay High Court in the case of Sesa Goa Ltd. (423 ITR 426) has held that education cess and secondary and higher education cess are allowable as deductions from the total income.

2) Subsequently, vide Finance Bill, 2022, it was proposed to clarify that surcharge and cess would not be considered to be deductible expenditure. This came by way of a clarification and made effective from A.Y. 2005-06 as according to the legislature, this was always the intention.

3) While moving the Bill in the Lok Sabha on 25.03.2022, the Finance Minister has proposed certain amendments in the Finance Bill, 2022. Vide one such amendment, it has been proposed to introduce **sub-section (18) to S. 155 of the Income-tax Act**. The proposed sub-section (18), which has since become part of the Income-tax Act reads as under;

> "*(18) Where any deduction in respect of any surcharge or cess, which is not allowable as deduction under section 40, has been* ***claimed and allowed*** *in the case of an assessee in any previous year, such claim shall be* ***deemed to be under-reported income***

of the assessee *for such previous year for the purposes of sub-section (3) of section 270A, notwithstanding anything contained in sub-section (6) of section 270A,* ***and*** *the Assessing Officer shall* ***recompute the total income of the assessee*** *for such previous year and make necessary amendment; and the* ***provisions of section 154*** *shall, so far as may be, apply thereto, the period of four years specified in sub-section (7) of section 154 being reckoned from the end of the previous year commencing on the 1st day of April, 2021*

Provided that in a case where the assessee makes an application to the Assessing Officer in the prescribed form and within the prescribed time, requesting for recomputation of the total income of the previous year without allowing the claim for deduction of surcharge or cess and pays the amount due thereon within the specified time, such claim shall not be deemed to be under-reported income for the purposes of sub-section (3) of section 270A"

(emphasis supplied)

4) Since the above sub-section has been added vide subsequent amendment and not as a part of the Finance Bill, it has not received the requisite attention. The implication of sub-section (18) is twofold;

i) Where surcharge or cess has been claimed and allowed in any previous year, the Assessing Office shall recompute the income after disallowing the same by passing an order u/s. 154 of the Act and the time limit for the said purpose would be up to 31.03.2026. Thus, there would not be any need of reopening the assessment u/s. 148 or revising the assessment u/s. 263 of the Act. Even those cases where return of income has not been picked up for scrutiny, the modification order can be passed;

ii) If any such deduction has been claimed and allowed, such claim shall be deemed to be under reported income and the penalty u/s. 270A of the Act would be imposed. Simultaneously, immunity has been provided in a case where assessee makes necessary application in the prescribed form and within the prescribed time and pays the amount due after disallowing the claim of surcharge and cess.

5) Certain issues arising out of the above are discussed hereinbelow.

Cases where deduction has not been allowed, the provisions would not be applicable

6) As sub-section (18) uses the phrase 'claimed and allowed', the provisions would not be applicable in a case where deduction has been claimed but not allowed and the matter is pending before the appellate authorities. In such cases, obviously, the Assessing Officer would not be passing any modification order and the action of making the claim would not be deemed to be under-reporting of the income. The fate of the penalty proceedings would be decided on the merits of the case either u/s. 271(1)(c) of the Act (up to A.Y. 2016-17) or u/s. 270A of the Act (from A.Y. 2017-18). It is opined that this being purely a legal issue and the decisions of the High Court in favour of the assessee being available, there should not be any penalty u/s. 271(1)(c) of the Act (as there is no concealment of income, or furnishing of inaccurate particulars of income) or u/s. 270A of the Act (the claim being bonafide).

If deduction has been claimed and allowed, penalty would be levied

7) However, where the deduction has been claimed and allowed, the assessee would be deemed to have under-reported its income for the

purposes of S. 270A(3) of the Act. The provision further states that provisions of S. 270A(6) of the Act would not apply. The provisions of S. 270A(6) of the Act provide that certain cases would not be considered as cases of under-reporting of income for the purpose of S. 270A of the Act. Clause (a) of S. 270A(6) provides as under:

> *"(a)the amount of income in respect of which the assessee offers an explanation and the Assessing Officer or the Commissioner (Appeals) or the Commissioner or the Principal Commissioner, as the case may be, is satisfied that the* ***explanation is bona fide*** *and the assessee has disclosed all the material facts to substantiate the explanation offered*
> *……"* **(emphasis supplied)**

8) It is evident from the above that if the assessee offers an explanation in respect of under-reported income and the Assessing Officer is satisfied with the explanation, then the same would not be considered as under-reported income. However, by virtue of S. 155(18) of the Act, the Legislature has taken away this benefit available to the assessee u/s 270A(6) of the Act. However, the levy of penalty is subject to the immunity provided in the proviso to S. 155(18).

9) It is interesting to note that even in these cases the legislature deems the same to be cases of 'under reporting of the income' and not 'concealment' or 'furnishing of inaccurate income'. Therefore, there would not be automatic levy of penalty in respect of assessment years prior to A.Y. 2016-17.

10) As stated above, disallowance of a claim, which has been found to be in order by the High Court cannot result in levy of concealment penalty. This is more particularly so when disallowance has been made on account of

retrospective amendment in the Act. Disallowance made by virtue of insertion of Explanation 3 to S. 40(a)(ii) of the Act with retrospective effect from 01.04.2005 (A.Y. 2005-06) could not result in to levy of penalty.

Immunity from penalty - Proviso to S. 155(18) of the Act

11) The proviso to S. 155(18) of the Act states that in a case where the assessee makes an application to the Assessing Officer in the prescribed form and within the prescribed time (such prescription are yet to be made), requesting for re-computation of the total income of the previous year without allowing the claim for deduction of surcharge or cess and pays the amount due thereon within the specified time, such claim shall not be deemed to be under-reported income for the purposes of S. 270A(3) of the Act.

12) On perusal of the proviso, it is amply clear that the Legislature wants the assessees to come forward and point out the years in which they have claimed deduction on account of surcharge and cess while computing 'Business Income' and the same has been allowed. This is a carrot and stick approach by the income tax department.

Assessee should avail the benefit of Proviso but will the department wait?

13) Considering that the department is seeking to levy penalty, the assessees must avail the benefit of the proviso. The department, at the earliest (hopefully) would prescribe a form wherein the application can be made by the assessee to the Assessing Officer and also prescribe a reasonable time limit within which the application can be made. The assessee must avail this opportunity at the earliest and not wait for the

department to pass the order u/s 154 of the Act to avoid penalty u/s 270A of the Act. However, till such form is prescribed and the time limit to make application to the Assessing Officer in such form does not expire, the department should wait and not start rectifying orders u/s 154 of the Act. If the department does so, it would deprive the assessee from taking benefit of the Proviso.

Can the amendment be given retrospective effect?

14) While the Legislature intends to give the amendments retrospective effect, a question remains as to whether such an intention is in accordance with the well settled principles of law. It is an unexceptionable principle of law that if an amendment proposes to make substantive changes to the law, it ought to be given prospective effect, even if such an amendment is proposed to be made retrospective by the Legislature [MM Aqua Technologies Ltd. vs. CIT (2021) (436 ITR 582) (SC), Sedco Forex International Inc. vs. CIT (2017) (399 ITR 1) (SC), Virtual Soft Systems Ltd. vs. CIT (2007) (289 ITR 83) (SC)]. The proposed amendments seeking to undo various judgements of the Hon'ble High Courts which had held that education cess is an allowable expenditure are certainly substantive in nature. Applying the test of the aforesaid judgements, a view could possibly be taken that the same cannot be given retrospective effect.

15) Further, the provisions of section 40(a)(ii), as they stood prior to the amendment, have been interpreted by several Courts as permitting for deduction of education cess. Hence, the amendment providing for imposition of penalty for such deductions claimed in the preceding years

may fall foul of Article 20 of the Constitution thereby raising a question as to whether the amendment is constitutionally valid or not?