CBDT clarifies that deduction under Chapter VI-A is admissible on profits enhanced by way of disallowance

Background

Recently, the Central Board of Direct Taxes (CBDT) has issued a Circular\(^1\) clarifying that where a disallowances made under Sections 32, 40(a)(ia), 40A(3), 43B, etc., of the Income-tax Act, 1961 (the Act) and other specific disallowances, related to the business activity against which the Chapter VI-A deduction has been claimed, result in enhancement of the profits of the eligible business, deduction under Chapter VI-A is admissible on the profits so enhanced by the disallowance.

CBDT Circular

Chapter VI-A of the Act states that while computing the profits and gains of business, the Assessing Officer (AO) may make certain disallowances, such as disallowances pertaining to Sections 32, 40(a)(ia), 40A(3), 43B, etc., of the Act. At times disallowance out of specific expenditure claimed may also be made. The effect of such disallowances is an increase in the profits. Doubts have been raised as to whether such higher profits would also result in the claim for a higher profit-linked deduction under Chapter VI-A of the Act. Courts have held that if the expenditure disallowed is related to the business activity against which Chapter VI-A deduction has been claimed, the deduction needs to be allowed on the enhanced profits.

The Gujarat High Court in the case of Keval Construction\(^2\) and the Bombay High Court in the case of Sunil Vishwambhamath Tiwari\(^3\) held that if an expenditure incurred by the taxpayer for the purpose of developing a housing project were not allowable on account of non-deduction of tax, such disallowance would ultimately increase taxpayer’s profits from business of developing a housing project. The ultimate profits of the taxpayer after adjusting disallowance under Section 40(a)(ia) of the Act would qualify for deduction under Section 80-IB of the Act. Further, the Allahabad High Court in the case of Surya Merchants Ltd.\(^4\) held that if a deduction under Section 40A(3) of the Act is not allowed, the same would have to be added to the profits of the undertaking on which the taxpayer would be titled for deduction under Section 80-IB of the Act.

The above views have attained finality as these judgments of the High Courts have been accepted by the tax department.

In view of the above, CBDT has accepted the settled position that the disallowances made under Sections 32, 40(a)(ia), 40A(3), 43B, etc., of the Act and other specific disallowances, related to the business activity against which the Chapter VI-A deduction has been claimed, result in enhancement of the profits of the eligible business, the deduction under Chapter VI-A is admissible on the profits so enhanced by the disallowance.

Accordingly, CBDT instructed that the appeals may not be filed on this ground by tax officers and appeals already filed in Courts/Tribunals may be withdrawn/not pressed upon.

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\(^1\) CBDT Circular No. 37/2016, dated 2 November 2016  
\(^2\) ITO v. Keval Construction [2013] 354 ITR 13 (Guj)  
\(^3\) CIT v. Sunil Vishwambhamath Tiwari (ITA No. 2 of 2011, dated 11 September 2015)  
\(^4\) PCIT v. Surya Merchants Ltd. [2016] 387 ITR 105 (All)
Our comments

The issue of whether income enhanced by AO on account of various disallowances, is eligible for deduction under Chapter VI-A of the Act, has been a subject matter of debate before courts.

On the one hand, the Gujarat, Bombay and Allahabad High Courts⁵ have held that deduction under Chapter VI-A is admissible on the profits enhanced by way of the disallowance. On the other hand, the Rajasthan High Court in the case of Harshwardhan Chemicals⁶ denied the deduction on the enhanced income since it was not derived from industrial activities of the taxpayer.

CBDT accepted decisions of the Bombay, Gujarat, and Allahabad High Court and directed that appeals may not be filed on this ground by tax officers and appeals already filed in Courts/Tribunals may be withdrawn/not pressed upon.

In line with government’s recent initiative of issuing a clarification on litigative matters, CBDT has issued this clarification to attain the finality on this matter and reduce litigation on the same. This clarification would provide relief to the taxpayers who are facing similar issues.

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⁵ Keval Construction, Sunil Vishwambhamath Tiwari and Surya Merchants Ltd.
⁶ CIT v. Harshwardhan Chemicals [2003] 131 Taxman 813 (Raj)
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