REPORT

Background

The Taxation Laws (Amendment) Bill, 2005 proposes to carry out certain amendments in the Income Tax Act, 1961, the Customs Act, 1962, the Customs Tariff Act, 1975, the Central Excise Act, 1944 and the Central Sales Tax Act, 1956 with the object of rationalising and simplifying certain procedures, widening of tax base and plugging loopholes leading to leakage of revenue.

2. The Finance Minister, in his Budget speech, while introducing the Finance Bill, 2005 had stated:

> " I have received many suggestions on amendments to the direct tax laws and the indirect tax laws. I have decided to accept some suggestions that require to be acted upon immediately, but I do not propose to burden the Finance Bill with those changes. Instead, I intend to introduce a separate Bill for that purpose during this session. In due course, I intend to place before Parliament a revised and simplified Income Tax Bill.

3. The Taxation Laws (Amendment) Bill, 2005 was introduced in Lok Sabha on 12 May, 2005 and referred to the Standing Committee on Finance by the Hon'ble Speaker on 13 May, 2005 for examination and report thereon.

4. On the purport of introducing the Bill and the current status in regard to formulation of the revised simplified Income Tax Bill mentioned about by the Finance Minister in the Budget Speech (2005-06), the Ministry, in their written reply to queries raised by the members of the Committee, inter alia, states as under:

> "…certain consequential and procedural provisions have been introduced in the Taxation Laws (Amendment) Bill, 2005. The new simplified Income-tax Bill is only intended to be a simplified form of the existing Act. Therefore, these provisions have been proposed through the Taxation Laws (Amendment) Bill, 2005."

Overview of the provisions

5. Some of the provisions of the Taxation Laws (Amendment) Bill, 2005 pertaining to Direct Taxes (Income Tax) as well as Indirect Taxes (Customs and Central Excise) and the rationale and purpose of introducing the provisions, as seen from the Notes furnished by the Ministry and the Statement of Objects and Reasons of the Bill, are briefly delineated as under:

a) Direct Taxes:

i) Clause 2

6. As per the existing provisions of the Income Tax Act, "Tax Recovery Officer" means any Income-tax Officer who may be authorised by the Chief Commissioner or Commissioner, by general or special order in writing, to exercise the powers of a Tax Recovery Officer. The amendment proposal under Clause 2 of the Bill seeks to provide that the Tax Recovery Officer may also exercise or perform such powers and functions which are conferred on, or assigned to, an Assessing Officer under the Income-tax Act, and which may be prescribed.

ii) Clause 3

7. Tax exemptions that are provided to various entities under the Income Tax Act inter alia, include :

(i) Charitable fund or institution having importance throughout India or throughout any State or States – Section 10 (23C) (iv);

(ii) Trust or legal obligation or institution wholly for public religious purposes or wholly for public religious and charitable purposes – Section 10(23C) (vi);

(iii) University or other educational institution existing solely for educational purposes and not for purposes of profit if the aggregate annual receipts of such university or educational institution exceed the prescribed amount of Rs. 1 crore - Section 10(23C) (v);

(iv) Hospital or other medical institution existing solely for philanthropic purposes and not for purposes and profit if the aggregate annual receipts of such hospital or other medical institution exceed the prescribed amount of Rs. 1 crore – Section 10 (23C) (via).

8. As the procedure of periodic renewal of approval has proved to be cumbersome and is also resulting in considerable delays, with the amendment proposals under Clause 3, the requirement of renewal for entities claiming exemption under section 10(23C) (iv), (v), (vi) and (via) is sought to be done away with. Once the approval is granted/notification issued, the same will be valid till it is withdrawn or rescinded, as the case may be. Further, it is proposed to provide a one year time limitation for grant/refusal of the approval or issue of notification, and simultaneously make it mandatory for entities claiming exemption under section 10(23C) (iv), (v), (vi) and (via) to get the accounts audited by an accountant, obtain an audit report and file a copy of such audit report along with their return of income.

9. The universities or other educational institutions or hospitals or other medical institutions whose aggregate annual receipts do not exceed the prescribed amount of Rs. 1 crore are given unconditional exemption without requirement of any approval or renewal under section 10(23C) (iiiad) and (iiiae) of the Income-tax Act. There is no stipulation for these entities to file their tax returns or get their accounts audited. With a view to enable the department to ascertain whether the aggregate annual receipts of such entities is below Rs. 1 crore and are established solely for educational/medical/philanthropic purposes, as the case may be, and not for the purpose of profit, the Income-tax Act, 1961, is proposed to be amended to make it mandatory for the entities to file their returns of income, if the income exceeds the basic exemption limit.

iii) Clauses 5 and 10

10. Under the existing provisions contained in the provisos to clause (ii) and clause (iii) of sub-section (1) of section 35 of the Income-tax Act, the Central government grants approval to an association, university, college or

other institution donations to which are entitled to a deduction to the extent of 125% of the sum donated. With the proposals under Clause 5, the provisos to clause (ii) and clause (iii) of sub-section (1) of section 35 are inter alia sought to be amended so as to empower the Central Board of Direct Taxes to lay down, by rules, the manner in which an association, university, college or other institution is to be granted approval and the guidelines and conditions to be fulfilled for grant of such approval by the Central Government. It is further proposed to do away with the requirement of renewal of approval for such institutions and to provide a time limit of one year, from the end of the month in which the application is received, within which the Central Government may grant approval in suitable cases.

11. With the amendments proposed to be carried out in Section 143 of the Income Tax Act, 1961 (in terms of Clause 10) the assessment procedure would be used as a check-point against any malpractice in the absence of any requirement for renewal. In a case of contravention found during the assessment proceedings, the Assessing Officer would be required to intimate the contravention to the Central Government and thereupon, the Central Government may withdraw the Notification rescinding the approval granted earlier.

b) Indirect Taxes (Customs and Central Excise)

iv) Clause 18

12. Presently, Section 18 of the Customs Act, which provides for provisional assessment of duty does not provide for various issues arising from the finalisation of provisional assessment. The proposals of Clause 18 seek to insert sub-section (3), sub-section (4) and sub-section (5) to section 18 of the Customs Act, 1962 to provide for a mechanism to regularise the payments of duty short levied and interest thereon and duties that are to be refunded on finalisation of a provisional assessment.

v) Clause 19 (Amendment of Section 28 of the Customs Act) and Clause 32 (Amendment of Section 11A of the Central Excise Act)

13. An optional scheme for enabling voluntary payment of duty by assesses, in full or in part, in cases involving fraud, mis-statement etc. along-with interest and 25% of the duty amount as penalty within 30 days of the receipt of the show-cause-notice is proposed to be introduced by amending Section 28 of the Customs Act, 1962 in terms of the proposals under Clause 19. This scheme is intended to be an additional facility to the Trade to settle disputes at an early stage and is independent of the existing Section 114 A of the Act, which inter alia allows a reduction in the penalty by 75% of the duty determined if all the dues are paid within 30 days of the communication of the adjudication order.

14. With the proposals under Clause 32, a similar optional scheme for enabling voluntary payment of duty by assessees, in full or in part within 30 days of the receipt of the show cause notice is sought to introduced in the Central Excise Act, 1944 by amending Section 11A of the Act. As in the case of the Customs Act, the proposal is independent of the existing Section 11A of the Central Excise Act, which allows a reduction in the penalty by 75% of the duty determined if all the dues are paid within 30 days of the communication of the adjudication order.

vi) Clause 20 (Insertion of a new Section 28BA in the Customs Act)

15. Whereas the proposals of Clause 20 seek to insert a new section 28BA in the Customs Act, 1962, Clause 33 aims to insert a new Section 11DDA in the Central Excise Act, 1944 to provide for provisional attachment of property during the pendency of proceedings relating to the determination of Custom duty or Excise duty evaded as the case may be.

16. The Committee received written views /suggestions on the various provisions of the Taxation Laws (Amendment) Bill from (i) Confederation of

Indian Industry, (ii) Shri R.N. Lakhotia, Senior Tax Consultant and Advocate, (iii) Shri K. Vijay Kumar, Editor-in-Chief, Taxindiaonline.com Pvt. Ltd., (iv) Shri Krishnan, (v) Shri S. Sampath, (vi) Shri P.N. Mittal, (viii) Shri Vijay Mathur and (viii) Shri A.N. Prasad.

17. The Committee took oral evidence of the representatives of the Ministry of Finance (Department of Revenue) to further enlighten themselves on various aspects of the proposed legislation.

18. The Committee note that the amendments proposed in the Income Tax, Customs and Central Excise Acts are mainly intended to rationalise and simplify certain procedures, widen the tax base and plug loopholes, that lead to leakage of revenue. While some of the proposals, which *inter-alia* include streamlining the approval and monitoring processes for Charitable Institutions, Scientific Research Institutions etc. under the Income tax Act; and issuance of 'speaking order' within 15 days in the event of contradictory views on valuation of import and export goods under the Customs Act have been generally welcomed by the Experts and other interested bodies, certain other provisions have been viewed with an element of skepticism.

19. Upon considering the provisions of the Taxation Laws (Amendment) Bill, 2005 in the light of the views expressed by Experts and other interested bodies, and the clarifications furnished by the Ministry of Finance, the Committee endorse the same for enactment subject to the observations/recommendations as detailed in the subsequent paragraphs of the report.

Clause 2 (Amendment of section 2)

20. The Clause reads as under:

> In section 2 of the Income-tax Act, 1961 (hereafter in this Chapter referred to as the Income-tax Act), in clause (*44*), after the words "powers of a Tax Recovery Officer", the following shall be inserted, namely:—
>
> "and also to exercise or perform such powers and functions which are conferred on, or assigned to, an Assessing Officer, under this Act and which may be prescribed".

21. Questioned about the rationale or the justification for seeking to confer certain powers of the Assessing Officer (AO) on the Tax Recovery Officer (TRO), the representative of the Ministry stated as under during the briefing meeting:

> "…what we noticed and what was happening was that the TRO was being asked by the Assessing Officer to make recovery. When he issues the notice and the assessee comes to him and says that he has already made the payment or some rectification is required or some appeal effect has not been given, the TRO says him to go to the Assessing Officer and get this done, or he does not listen to him at all and says: "No. No, you are making misrepresentation, you make the payment right now." That was happening. The TRO himself did not have any power to provide instant relief to the person. Suppose a TRO has issued a notice and somebody comes to him and explains him that that amount is not due, he should have the power to pass an order, stating that he has seen the receipts, he has seen the evidence. That is what is being provided here."

22. Questioned further whether the proposal intend to confer upon the TRO the powers of imposing 'punishment' in addition to providing relief to the assessees, the representative stated as follows:

> "It is only a power to give relief. It is because whenever assessees come to TRO, they only say that they have already paid it or some adjustment is required, some appeal effect is pending or rectification is

pending. But the TRO did not have the power to do it. He used to tell them to go to the Assessing Officer and get the same done. That created some problems. That is why in order that these things get done expeditiously, this provision is put here."

23. The individual experts, who gave their views on the provisions of the Bill have been generally skeptical on the proposal to confer additional powers of the Assessing Officer on the TRO in terms of the provisions of clause 2. It was inter-alia pointed out that the move would be practicable or effective only if the TRO has easy access to the assessment records for carrying out rectifications; problems relating to co-ordination between the TRO and the Assessing Officer would arise owing to the proposal; and the issue of conferring additional powers, as may be needed on the TRO, could be achieved through administrative means rather than the proposed amendment.

24. Asked to respond to these view points expressed before the Committee, the Ministry, in a written reply stated as follows:

"Clause 2 of the Bill seeks to enable a Tax Recovery Officer (TRO), to exercise limited functions of an Assessing Officer (AO) as may be prescribed. Such limited functions shall be like carrying of rectification of apparent mistakes, giving effects to order of appellate authorities, etc. Such power will enable a TRO to expeditiously determine the demand to be collected by him in cases where a claim is made before him that demand referred to him for collection needs some adjustments. The delay in giving appeal effects, etc. in such cases, may not be solved administratively, because TRO has to refer the matter back to the Assessing Officer. Therefore, it is appropriate to assign such powers to TRO himself. Further, as a TRO will have to act upon in respect of application made to him, there will be no problem in fixing responsibility for delay in disposing off such application by him. There is also no legal conflict in assigning the limited functions of AO to TRO."

25. In this regard, a representative of the Ministry *inter-alia* stated as follows during oral evidence:

> "It was felt by the Committee that most probably the role which we are assigning to the TRO may not be in line with the functional requirement of the work. It was also felt that the TRO is given only the work of recovery, and, with much more functional specialization, he may be able to perform better. But our experience has been that sometimes, the TRO is not effective. The point is that when he proceeds to recover the demand dues, the point that comes is that some rectification is pending or sometimes it is found that some other appeal effect is not given. We want to give a limited powers to the TRO. We are not giving all the powers of the Assessing Officer but only a limited power."

26. By way of conferring additional powers of the Assessing Officer on the TRO – which are proposed to be limited to rectification of mistakes in the assessment orders, giving effect to orders of appellate authorities etc., it is intended to enable speedy and effective settlement of the demands/applications of the assessees. Though the proposal enabling for speedy settlement of assessment related issues would be tax payer friendly, the Committee feel that for achieving the intended purpose it may be essential to comprehensively address the prevailing norms, procedures and regulations relating to the functioning of the 'Tax Administration'. The Committee, therefore, desire that the administrative instructions/regulations relating to the additional powers proposed to be conferred on the TRO are clear and specific on confining such powers to rectification of mistakes in assessment orders, effecting orders of Appellate Authorities etc. The Committee also expect the Government to ensure that the proposal would, in no way, affect the co-ordination in the hierarchy of Income Tax authorities.

27. The Committee find that the Government are bringing in amendments to the Income Tax Act very frequently, which cause difficulties in comprehending the law by various people concerned. The Committee, therefore, urge the Government to come out with a comprehensive simplified single legislation at the earliest.

Clause 5 (Amendment of section 35) and clause 10 (amendment of section 143)

28. Clause 5 of the Bill which relates to 'Expenditure on Scientific Research' reads as follows:

"In the Income-tax Act, in section 35, in sub-section (*1*), with effect from the 1st day of April, 2006,—

(*a*) in clause (*ii*), for the proviso, the following proviso shall be substituted, namely:—

"Provided that such association, university, college or other institution for the purposes of this clause—

(A) is for the time being approved, in accordance with the guidelines, in the manner and subject to such conditions as may be prescribed; and

(B) such association, university, college or other institution is specified as such, by notification in the Official Gazette, by the Central Government,";

(*b*) in clause (*iii*), for the proviso, the following proviso shall be substituted, namely:—

"Provided that such university, college or other institution for the purposes of this clause—

(A) is for the time being approved, in accordance with the guidelines, in the manner and subject to such conditions as may be prescribed; and

(B) such university, college or other institution is specified as such by notification in the Official Gazette, by the Central Government,";

(*c*) in the second proviso, for the word "authority", the word "Government" shall be substituted;

(*d*) in the third proviso, for the words, brackets and letters "notification issued by the Central Government under clause (*ii*) or clause (*iii*) shall, at any time, have effect for such assessment year or years, not exceeding three assessment years", the words, brackets, figures and letters "notification issued, by the Central Government under clause (*ii*) or clause (*iii*), before the date on which the Taxation Laws (Amendment) Bill, 2005 receives the assent of the President, shall, at any time, have effect for such assessment year or years, not exceeding three assessment years" shall be substituted;

(*e*) after the third proviso, the following proviso shall be inserted at the end, namely:—

"Provided also that where an application under the first proviso is made on or after the date on which the Taxation Laws (Amendment) Bill, 2005 receives the assent of the President, every notification under clause (*ii*) or clause (*iii*) shall be issued or an order rejecting the application shall be passed within the period of twelve months from the end of the month in which such application was received by the Central Government:".

29. Clause 10, which relates to 'withdrawal' of approval to institutions referred to under the provisions of clause 5 of the Bill reads as follows:

In section 143 of the Income-tax Act, in sub- section (*3*), after the proviso, the following proviso shall be inserted, with effect from the 1st day of April, 2006, namely:—

"Provided further that where the Assessing Officer is satisfied that the activities of the university, college or other institution referred to in clause (*ii*) and clause (*iii*) of sub-section (*1*) of section 35 are not being carried out in accordance with all or any of the conditions subject to which such university, college or other institution was approved, he may, after giving a reasonable opportunity of showing cause against the proposed withdrawal to the concerned university, college or other institution, recommend to the Central Government to withdraw the approval and that Government may by order, withdraw the approval and forward a copy of the order to the concerned university, college or other institution and the Assessing Officer.".

30. Giving the rationale behind the proposals made under clause 5 of the Bill, a representative of the Ministry stated as follows during the briefing meeting:

"Under the present provisions, even if approval is granted in any case, it has to be renewed again after three years. It was observed that there were great delays both in grant of approval and in renewal. It is proposed, therefore, to do away with the requirement of renewal of approval. This will make it possible for us to use our manpower resources more effectively in grant of approvals. We have, therefore, provided a time-limit of one year, from the end of the month in which the application is received, within which the Central Government may grant approval in suitable cases.

However, it is necessary to maintain constant vigil to ensure that this concession is not misused. We are, therefore, proposing to amend the Income Tax Act to ensure that all entities furnish their returns of income, irrespective of whether their income is taxable or below the taxable limit. If

the Assessing Officer finds any case of contravention during the assessment procedures, he would be required to inform the Central Government whereupon a notification may be issued rescinding the approval granted earlier."

31. The written submission made by an expert on the proposals relating to 'granting' and 'rescinding' of approvals to research institutions in terms of the provisions of clause 5 and 10 of the Bill *inter-alia* reads are as follows:

> "Clause 10 seeks to insert another proviso in sub-section (3) of Section 143 of the Act to require an Assessing Officer to satisfy himself whether a university/college/institution referred to in Section 35(1)(ii) and 35(1)(iii) is carrying out its activities in accordance with the guidelines and conditions set out at the time of according approval and, if necessary to recommend to the Central Government, withdrawal of the said approval.
>
> Two questions arise for consideration:
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> First why have the persons covered under Section 10(23C) been left out? The second revolves round the competence and adequacy of the Assessing Officer to conduct an objective evaluation, if the shortcomings relate to matters other than financial norms. There may also be a charge of bias or vindictiveness. It may, therefore, be advisable, that he be assisted by experts of repute and integrity, in arriving at his conclusion."

32. The written submission, made by yet another expert on these issues reads as follows:

> "….one problem faced by associations applying for approval as a research unit is that they have to satisfy first the Department of Science and Technology and then the Income-tax Department. The nodal agency for determining as to whether an association is carrying on or is capable of carrying on scientific research is the Department of Science and Technology. Once this is accorded by this department, the Income-tax Department should thereafter make no enquiries in this regard. The parameters of enquiry by the Income-tax Department should be limited to examine only the accounts of the institution. The functions of the department of Science and Technology and the Income-tax Department/DG exemptions should be prescribed in the rules."

33. He added:

> "….the person claiming the deduction in the computation of business income in respect of the payments made to the University, College or other institutions should not be denied such deduction because of the withdrawal of the approval of an organisation. The expenditure by way of payment to the organisation would have been made in good faith and only after the approval has been granted by the Central Government. Specific

provision in this regard should be enacted for protecting the interest of the taxpayer incurring an expenditure in this regard."

34. In the course of personal hearing, the following viewpoint was expressed by an expert on the proposed amendment of section 143(3) in terms of the provisions of clause 10:

"I am apprehensive about this particular provision. The reason for that is the exemption is granted by very high authority, that is, Director General, in coordination with the Ministry of Finance by way of a notification. If the assessing officer is supposed to go into the aspects of the society's or the institution's activities and try to frame a conclusion and withdraw that exemption, then it is not fair."

The views expressed before the Committee have generally been in favour of ensuring a system of consultation or co-ordination, particularly with other departments in deciding on 'approvals' and rescinding of the approvals.

35. Questioned whether it was appropriate to confer the assessing officer with the power to recommend for withdrawal of approvals granted under the Section, the Ministry in a written reply stated as follows:

"The Assessing Officer under the Income-tax Act is equipped with technical knowledge which enables him to notice shortcomings and requisition necessary details from the applicants. Assessing Officer, therefore, will not need any external expertise to assist in the assessment proceedings by virtue of his competence to examine the evidence produced before him and to see the compliance of the provisions of the Act."

36. Asked whether it would not be appropriate to give the aggrieved party an opportunity of being heard before an order is issued rejecting the applications made under the proviso to Section 35, the Ministry, in a written reply, stated as under:

"The prevailing practice is that an opportunity of being heard is always given in accordance with the principles of natural justice. There is no proposal in the Taxation Laws (Amendment) Bill, 2005,

which dilutes this principle of natural justice. Administrative instructions can be issued once again to reiterate the prevailing practice."

37. Asked further whether any provision could be made to provide for an appeal mechanism if an applicant is aggrieved of the decision, the Ministry in a written reply stated as follows:

"The power to pass an order rejecting the application has been vested in the Central Government. Orders passed by the Central Government are not appealable under the Income-tax Act, 1961. The applicant may, however, take recourse to writ jurisdiction of the High Court against the order of rejection by the Central Government. Further, the assessee may also file an application for review of the order rejecting his application."

38. On the role of the Income Tax Department vis-à-vis other government bodies/agencies such as the Department of Science and Technology in recognising research institutions, the Ministry, in a written response, *inter-alia* stated as follows:

"As per the existing provisions of section 35(1)(ii), a scientific research association is approved by the Central Government which would mean the Ministry of Finance. The Department of Science and Technology (DST) is not the nodal agency for approval of a scientific research association for the purposes of section 35(1)(ii). Since the authority granting the approval is the Central Government, the withdrawal and rescinding of the approval is also by the Central Government. In fact, as per sub–section (3) of section 35, the Central Government is the final authority to decide to what extent an activity constitutes or constituted or any asset is or was being used for scientific research. Therefore, there is no overlap of functions between DST and the Income Tax Department, as the former is not the nodal agency for rescinding/withdrawing approvals."

39. Section 35(2)AB of the Income Tax Act provides as follows:

"[(2AB)(*1*) Where a company engaged in the business of [bio-technology or in the business of] manufacture or production of any drugs, pharmaceuticals, electronic equipments, computers, telecommunication equipments, chemicals or any other article or thing notified by the Board incurs any expenditure on scientific research (not being expenditure in the nature of cost of any land or building) on in-house research and development facility as approved by the ***prescribed authority**, then, there shall be allowed a deduction of [a sum equal to one and one-half times of the expenditure] so incurred.

[*Explanation.*For the purposes of this clause, expenditure on scientific research, in relation to drugs and pharmaceuticals, shall include expenditure incurred on clinical drug trial, obtaining approval from any regulatory authority under any Central, State or Provincial Act and filing an application for a patent under the Patents Act, 1970 (39 of 1970).]

(*2*) No deduction shall be allowed in respect of the expenditure mentioned in clause (*1*) under any other provision of this Act.

(*3*) No company shall be entitled for deduction under clause (*1*) unless it enters into an agreement with the prescribed authority for co-operation in such research and development facility and for audit of the accounts maintained for that facility.

(*4*) The prescribed authority shall submit its report in relation to the approval of the said facility to the Director General in such form and within such time as may be prescribed.]

[(*5*) No deduction shall be allowed in respect of the expenditure referred to in clause (*1*) which is incurred after the 31st day of March, **[** [*2005*]**]**.]

*(Prescribed authority is Secretary, Department of Scientific & Industrial Research, Government of India)

40. The Committee find substantial credence in the viewpoints expressed that matters relating to granting of approvals to research institutions for tax exemption purposes, as well as rescinding of such approvals or recognition should also involve such authority concerned with the activity of the institution. They are of the opinion that the assessing officer may not be competent enough to recommend either for according approval or withdrawal of the licence of the institutions. In terms of the present provisions of Section 35(2)AB, deduction is allowed to institutions only after approval by the prescribed authority. On similar analogy, the Committee feel that the guidelines to be formulated and prescribed for approval of research institutions should involve the consent of the authority concerned.

41. The Committee perceive the proposal to fix a time limit of one year for considering applications of research institutions as a step in the right direction which would put an end to the inordinate delays presently witnessed in considering the applications. This move, as well as the proposal to do away with renewal of approvals, and making it mandatory for the institutions to file their tax returns, would help in streamlining the approval and monitoring process.

42. The committee are further of the view that a donee who is entitled for tax deduction on sums donated to a 'recognised' research institution should not be deprived of such benefit owing to the subsequent rescinding of the recognition within the same financial year. The Committee therefore, desire that suitable provisions be made to protect the interests of the taxpayer/donee in such instances.

Clause 7 (Amendment of Section 40A)

43. Clause 7 of the Bill reads as follows:

In section 40A of the Income-tax Act in sub-sections (3) and (4), for the words "a crossed cheque drawn on a bank or by a crossed bank draft", wherever they occur, the words "an account payee cheque drawn on a bank or account payee bank draft" shall be substituted.

44. On the proposals of clause 7 of the Bill, the Background Note of the Ministry, states as follows :

"Under the existing provisions of sub-section (3) of section 40A of the Income-tax Act, where any sum exceeding Rs. 20,000/- is paid by a business or professional concern otherwise than by a crossed cheque or crossed bank draft, 20% of such sum is disallowed in the computation of income. A crossed cheque or a crossed bank draft can, however, be endorsed to any third person any number of times. An account payee cheque or account payee bank draft can be deposited only in the account of the person named in the cheque or draft and therefore, helps in verification of expenditure. This would help to put a stop to claims of bogus expenditure resulting from endorsement of crossed cheque or crossed bank draft."

45. An expert, in the course of personal hearing, expressed the following viewpoint on the issue of negotiability or transferability of account payee cheques:

"I just happened to go through the Negotiable Instruments Act and I find that account payee cheque is not defined whereas the crossed cheque is. Secondly, the account payee cheque according to certain commentaries, it has been stated that it would not restrain negotiability. Negotiability can be only restrained if you write non-negotiable or not negotiable. So, if the purpose is to see that there should be no negotiation or no discounting of the cheque or the cheque is used by somebody else, then it would be best served by writing not-negotiable."

46. Questioned whether it was essential to add the words 'not negotiable' to the 'crossing' on a cheque to restrict the negotiability or transferability of account payee cheques, the Ministry in a written reply *inter-alia* stated as follows:

> If 'Account Payee' cheques can be negotiable/transferable, the purpose of preventing bogus claims of expenditure may not be served. The Reserve Bank of India has, however, issued a circular vide DBOD.No.BC.193/ 17.04.001/93 dated 18th November, 1993, as per which an account payee cheque should be credited only to the account of the payee. The RBI, in this circular at paragraph 3, addressed to the Chief Executives of all commercial banks (other than RRBs), has stated the following:
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> *"3. In this connection, a reference is invited to our circular DBOD.No.GC.BC.62/C.409 (A)-87 dated 11th November, 1987 and subsequent circulars issued from time to time on the subject. We also invite your attention to paras 1.10, 1.11 and 1.13 to 1.15 (Part II) of Ghosh Committee report indicating precautions to be taken by the banks in regard to opening and conduct of deposit accounts. We are, however, constrained to observe that despite our repeated instructions/guidelines issued to the banks, instances of fraudulent encashment of instrument either through opening of accounts in fictitious names* ***or irregularly collecting such 'Account Payee' instrument through the third party accounts are on the increase*** *which goes to prove that these instructions are not being followed by the banks scrupulously at the operating level (i.e. branches) and no punitive action is taken by bank management for such gross violation of the instructions by the erring officials."*

47. The Ministry also informed that the issue was referred to the Reserve Bank for their advice in the matter. Subsequently, in a post-evidence reply, the Ministry informed that the Reserve Bank had advised as follows:

> "As advised to you vide our letter dated October 4, 2005, even if the words "not transferable" are inscribed in the crossing of cheques or drafts, it would not restrict the negotiability/transferability of a cheque or a draft as there is no provisions under Negotiable Instruments Act,

1881 restricting the transferability/negotiability of a cheque or a draft. However, it is mentioned in Bhashyam and Adiga's Negotiable Instruments Act, 1881 [17th edition, Page 667] that "to have the effect of thus restricting the negotiability, it is necessary that the words 'not negotiable' should appear on the instrument and as part of crossing. It is said that they must occur in close proximity to the lines or to the name of the bank. It must be noticed that there is clear distinction between a cheque crossed 'not negotiable' and a cheque in its origin not transferable, as where it is drawn payable to "AB only" and having the words 'bearer' or 'order' struck out.

Thus if a cheque is crossed "not negotiable" and drawn payable to "AB only" i.e. "payee only" and the words "bearer" or "order" are struck out, the cheque would be paid to the payee only and no one else and no endorsement or transfer can be recognised."

48. On the need to enlarge the scope of modes of payment permissible under section 40A(3) to cover payments made through credit cards and Electronic Clearance System (ECS) etc., the Ministry in a written reply inter-alia stated as follows:

"Payments made by using credit cards though verifiable may have been issued by companies which do not exist for long. In such cases verification of the expenditure claimed by the assessee will not become possible. As regards payments by the electronic clearance system, sub-clause (iii) of clause (d) of rule 6DD of the Income-tax Rules, 1962 reproduced below apparently covers such payments:

"(d) where the payment is made by –

(i) any letter of credit arrangements through a bank;

(ii) a mail or telegraphic transfer through a bank;

(iii) a book adjustment from any account in a bank to any other account in that or any other bank;

(iv) a bill of exchange made payable only to a bank."

….suitable clarifications may be issued that payments by electronic clearance system through banks would be covered under the exceptions laid down at sub-clause (iii) of clause (d) of rule 6DD and, therefore, shall not attract any disallowance in the computation of income."

49. From the information furnished by the Ministry, the Committee note that the proposal to replace the words "a crossed cheque or crossed bank draft" with "an account payee cheque or account payee draft" in Section 40A is intended to prevent bogus claims of expenditure on account of third party endorsement of crossed cheques or bank drafts. However, the Committee note from the Reserve Bank's Circular cited by the Ministry that despite their repeated instructions/guidelines issued to the banks, 'instances of fraudulent encashment of instrument either through opening of accounts in fictitious names or irregularly collecting such 'Account Payee' instrument through the third party accounts are on the increase.' The Committee, therefore, expect the Government to address this issue in clear terms so that the intended purpose of preventing bogus claims of expenditure on account of third party endorsement of cheques and drafts is achieved.

50. The Committee find that as per the amendments proposed in section 40A, the modes of payment permissible for the purpose of deduction in computation of income are sought to be confined to the instrument of account payee cheques/drafts. The Committee are of the opinion that in the present day circumstances, payments made through other modes or instruments, inclusive of Electronic Clearance System (ECS), that may be offered or made available by banking companies, should be made permissible for purposes of deduction in computation of income in clear and unambiguous terms. The Committee, therefore, recommend the government to seriously consider enlarging the scope of section 40A to include bonafide payments made through such instruments.