Under-reporting and misreporting of income - Proposed penalty regime

By Sumeet Khurana

Introduction

With the Finance Bill 2016, the penalty regime in income-tax law is proposed to undergo a major overhaul. Earlier system provided for a levy of penalty, for concealment of income or furnishing inaccurate particulars of income, of an amount between 100% to 300% of the tax sought to be evaded. The newly proposed system classifies all variations made in the income into two categories – ‘under-reporting’ and ‘misreporting’. The penalties are now pegged at 50% and 200% of the prescribed tax base computed on under-reported or misreported income respectively. The changes are proposed to be implemented from Assessment Year 2017-18.

Dissection

Penalty may be levied by Assessing Officer, Commissioner Appeals, Commissioner or Principal Commissioner (hereinafter referred to as AO for short). By using the word ‘may’ in the new section the legislature seeks to retain the existing fundamental feature of penalty that it should not be levied unless the conduct of assessee has been contumacious.

Under-reporting and its quantum

<table>
<thead>
<tr>
<th>Situation</th>
<th>Under-reporting</th>
<th>Quantum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assessment of a return filed</td>
<td>If, Income assessed (A) is greater than summary assessment amount (B)</td>
<td>A – B</td>
</tr>
<tr>
<td>Assessment without return (Individual)</td>
<td>If, Income assessed (A) is greater than minimum exemption slab (C)</td>
<td>A – C</td>
</tr>
<tr>
<td>Assessment without return (Non-Individual)</td>
<td>Note 1</td>
<td>A</td>
</tr>
</tbody>
</table>

1 Amount of income determined by processing the return under section 143(1)
<table>
<thead>
<tr>
<th>Re-assessment</th>
<th>If, income reassessed (D) is greater than income assessed earlier (A)</th>
<th>D − A</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum Alternate Tax - MAT (Assessment) [Sec. 115JB and 115JC ]</td>
<td>If, MAT profits assessed (A-I) is greater than summary assessment of MAT profits (B-1)</td>
<td>[Total income assessed − (total income assessed minus under-reported income^2)] plus [MAT profits assessed − (MAT profits assessed − under-reported income^3)]</td>
</tr>
<tr>
<td>MAT (reassessment)</td>
<td>If, MAT profits re-assessed (D-1) is greater than summary assessment of MAT profits (B-1) (Note 2)</td>
<td>[MAT profits assessed − (MAT profits assessed − under-reported income^3)]</td>
</tr>
<tr>
<td>Loss reduced or converted into income</td>
<td>If, returned loss (E ) got reduced on assessment (F)</td>
<td>E − F</td>
</tr>
<tr>
<td></td>
<td>If assessed loss (F) got reduced on reassessment (G)</td>
<td>F − G</td>
</tr>
</tbody>
</table>

Note 1: Sub-section (3) of Section 270A prescribes quantum of under-reported income and provides that in case of assessment without a return having been furnished by a company, firm etc the income assessed would be the income under-reported. However sub-section (2) which defines under-reporting does not contain a corresponding clause for non-corporate assesses. It simply states that if income assessed is greater than maximum amount not chargeable to tax then the case will be of under-reporting of income.

---

^2 The phrase under-reported income here can be understood as per section 270A(3)(i)/(ii)
^3 The phrase under-reported income here has to be understood by applying common-sense else there will be a circular loop
In case of company, firm, or local authority, one view is to take the maximum amount not chargeable to tax as NIL. Alternatively, one can explore the argument that the definition of ‘under-reporting’ in sub-section (2) does not cover the case of non-filing of return by these assessees and the machinery fails on that count. Further, there is no similar clause for Association of Persons.

Note 2: Logically speaking, in case of re-assessment of a MAT case the comparison of re-assessed amount should be made with the earlier assessed amount. One can hope that this inconsistency is ironed out by the time of enactment of Finance Bill.

Exclusions from under-reporting

Sub-section (6) of the proposed Section 270A provides following situations where despite addition to the income during assessment / reassessment the assessee would not be treated as having under-reported his income. (This does not apply in case of misreporting)

   a) Bona-fide explanation: If an assessee offers a bona-fide explanation in respect of the relevant income (alleged to be under-reported) and substantiates such explanation by disclosing all material facts. For example if assessee adopted a legal interpretation which is not accepted by department;

   b) Cases of estimation of income: Where the AO determines the income on the basis of estimate provided the account are correct and complete however method (of accounting?) is such that income cannot be properly deduced therefrom;

   c) Estimated self disallowances: Where the Assessee had himself made a disallowance in return of income (e.g. under section 14A) while the AO enhances the disallowance;

   d) TP addition: TP addition would per se not be treated as under-reporting. This is subject to the condition that assessee had (a) maintained all documentation (b) declared the transaction and (c) disclosed material facts pertaining to the transaction; and

   e) Undisclosed income admitted during search as per section 271AAB

Mis-reporting

Of the cases of under-reported income as above, the taxpayer would be said to have ‘misreported’ income, if he has:

- Misrepresented or suppressed facts
- Failed to record any investments in the books of account
- Claimed any expenditure not substantiated by evidence
- Failure to record receipts in books of account
- Recording of any false entry in the books of account
• Failure to report international transaction (including a deemed one) or any specified domestic transaction, to which transfer pricing provisions would apply

This will be an area of concern because an assessee may adopt a legal view that two entities are not Associated Enterprises or a transaction between them is not in the nature of an International transaction and therefore not report the same. Even in such case the benefit of a bona-fide belief would not be available to the assessee and in case of adjustment to income on account of TP provisions penalty of misreporting will get attracted.

**Under-reporting as well as misreporting**

It may so happen that in a case that on one stream of income the AO alleges under-reporting and for another element of income or expense the AO alleges misreporting. In order to implement the provisions of this section it would be desirable to compute the amount of under-reporting and misreporting separately. Sub-section (2) and (3) seek comparison between income assessed and income determined under section 143(1)(a). The expression ‘income assessed’ accordingly would need to be understood as income of particular nature that is enhanced during assessment. This interpretation is also supported from the fact that expression ‘total income assessed’ is used only in first proviso to clause (ii) section 270(3).

This interpretation however poses its own challenges. Namely, the case of disallowance of expense would be difficult to fit into any clause because though that reflects its effect on the ‘total income assessed’, the expense itself cannot be said to fall under the expression ‘income assessed’ as understood in previous paragraph.

The balance needs to be struck between the case of (A) making the section un-workable when there is both under-reporting and misreporting and (B) making the section unworkable for expense disallowance.

**Base tax for levy of penalty**

For individuals, the tax base for levy of penalty is 30% of under-reported income. For Firm, Company and Local Authority, the regular tax rate would be applied to the under-reported income as if it were the total income of such firm etc.
This provision has serious consequences as it is not linked to tax sought to be evaded. For example, in case of an income earned by an individual in the nature of royalty from Indian patent taxable @ 10% under the proposed section 115BBF while the tax underpaid would be 10% of the under-reported income, the tax base for levy of penalty would still be 30% of the under-reported income.

To sum-up

It is worth appreciation that the essential elements of the penal provision as (a) not being a mandatory levy and (b) containing room for a bona-fide conduct, have been retained. The provision seeks to provide clear demarcation between un-intended under-reporting and a malicious under-reporting and thereby treat the latter harshly. This is also a step in good direction. In this process the proposed provision uses certain expressions like ‘misrepresentation or suppression of facts’, ‘false entry’ etc. for understanding which one may look at jurisprudence developed under various other tax laws. The effect of loose ends like (a) implication of bona-fide explanation for non-reporting of international transaction and (b) penalty for MAT cases, merit attention to avoid undesirable litigation around this.

[The author is a Director, Direct Tax Practice, Lakshmikumaran & Sridharan, Bangalore]