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Newsletter

Sharp View

November 2022

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November 2022

November is dry and sunny throughout India with low humidity levels and marks the beginning of winter. It is a good time for tourists to visit India for 4 months, starting from November till the end of February.

Rabi crops are sown around mid-November, the harvesting of which takes place in summer.

Every year, November 9 is celebrated as 'National Legal Services Day' in India, to observe the enactment of the Legal Services Authorities Act, 1987. The National Legal Services Authority (NALSA) was constituted under the Legal Services Authorities Act, 1987 to provide free legal services to the weaker sections of society and to organise 'Lok Adalats' for amicable settlement of disputes.

NALSA aims to promote an inclusive legal system to ensure fair and meaningful justice to the marginalised and disadvantaged sectors. This is achieved by

- Providing free legal aid and advice
- Spreading legal awareness
- Promoting settlement of disputes through alternative dispute resolution mechanisms



DID YOU KNOW



- **The Chief Justice of India serves as the executive chairman of NALSA. On 17 October 2022, Dhananjay Chandrachud was appointed as the Chief Justice of India, and he will assume the office from 9 November 2022.**
- **He is the son of 16th Chief Justice, Y.V. Chandrachud, the longest-serving Chief Justice of India.**



TAXATION

Delayed payment of employees contribution towards PF/ESI not deductible: Supreme Court

Section 43B of the Income-tax Act, 1961 allows certain expenses to be deducted on the basis of actual payment irrespective of the accounting system employed by the assessee. Ms Aarti Joshi (Vadodara office) discusses the present case where the employer claimed that the employee's, as well as the employer's contribution to the EPF account, is deductible on payment basis under section 43B.

Case name:
Checkmate Services Pvt. Ltd. V Commissioner of Income Tax.

The question under consideration

The assessee (employer) has deducted employees' share of provident fund (EPF) and employees' state insurance scheme (ESI) contribution and has paid the sum in the respective funds after the specified due date of those funds, but before filing its own income tax return (ITR).

- Whether the employer (appellant in this case) is entitled to a deduction under section 36(1)(va) of the Act in such a situation?
- The assessee also sought clarification on the interpretation of section 36(1)(va) and section 43B in regard to the said amount.

Facts of the case

- The assessee had deposited the employees' share of contribution i.e., the contribution towards EPF and ESI belatedly, i.e., after the due dates specified under the relevant acts and regulations. However, such sums were deposited in the EPF/ESI account before the due date of filing the income tax return (ITR) under the Act.
- The assessee relied on section 43B, which allows a deduction of certain expenses on the basis of actual payment made before the due date of the ITR and evidence of such payment is accompanied with the ITR.
- The assessing officer (AO) rejected the deduction claimed under section 36(1)(va) because the sums were deposited in the welfare funds after the specified due dates mentioned in the respective regulations.
- The assessee preferred an appeal before the income tax appellate tribunal (ITAT), which also rejected the appeal.
- Thereafter the appellant represented its case before the Gujarat High Court (HC) which was dismissed because such sums were paid beyond the due dates as prescribed under the respective acts, and the right to claim such sums as allowable deduction while computing the income was lost forever.
- The assessee then noticed that in similar situations the Mumbai, Kolkata, Delhi, Himachal Pradesh and Guwahati HCs have taken a contrary view, i.e., they have ruled in the favour of the assesseees, and hence the appellant decided to approach the honourable Supreme Court (SC) of India.
- The question involved was whether the appellant assessee is entitled to a deduction of the employees' share as well as its share (employer's contribution) which was deposited before the date of filing the ITR.

The Law

Employer's share of contribution to a recognised provident fund (RPF)/EPF/ESI

- This is essentially a contribution made by an employer out of his income and deposited in the employee's RPF/EPF/ESI account under section 36(1)(iv). This is a charge against his profit and loss account (P&L) account. This is an allowable deduction while computing the profits and gains of business/profession.

- The purpose of section 43B was to curb the practices of the assessee delaying the payments towards statutory dues, contributions to employees' welfare accounts, payment of interest on loans taken from financial institutions, taxes payable to the government, etc. These expenses were claimed by them as a deduction on mercantile system of accounting (i.e., on an accrual basis), but were hardly paid or were withheld for longer periods.
- To avoid such practices, section 43B was inserted to claim deduction under the respective heads (i.e., under sections 28-36) only when the actual payment of these expenses was made irrespective of the accounting system employed by the assessee.
- Hence, it is very clear that section 43B allows the deduction of expense to an employer of his own contribution to employees EPF/PF if actually paid in cash/other mode.

Employee's share of contribution to a recognised provident fund (RPF)/EPF/ESI

- The Act treats the employee's contribution to the RPF/EPF/ESI as a deemed income in the hands of the employer under section 2(24)(x).
- This is because the employer receives the sum (by deducting it from the employee's salary) and then deposits it in the RPF / EPF / ESI accounts. Till the amounts are deposited, the monies are held by the employer as a trustee and he is under legal obligation not to use the employee's money so received, but to deposit it in the specified fund on or before the due date of the fund.
- If the employee's contribution is deposited by the employer within the due date of the specific funds, then and then only he can claim a deduction against the deemed income.
- Thus the employee's contribution is first included as a deemed income and then allowed as a deduction under section 36(1)(va).
- Default on making a timely deposit of employee's contribution in the employee's RPF/EPF/ESI is strict violence under the Act and the deduction is lost forever, even if it is paid later.

Supreme Court Verdict

- The employer is in a fiduciary position when he holds the employee's money deducted from salary/wages. The employer cannot hold such money beyond the date specified under the RPF/EPF/ESI acts and regulations. Such money, if not deposited under the time specified by those acts, gets permanently disallowed while computing the business profits.
- Section 43B should not be applied to such payments. 43B is only applicable to the employer's contribution which he takes aside from his income and pays in the employee's account.
- The AO, the ITAT and the Gujarat HC were correct in interpreting the meaning of section 36(1)(va) and they have rightfully disallowed the deduction even though such contributions were paid by the employer after the relevant due dates of those funds and before the date of filing the ITR.

Conclusion

The recent Supreme Court ruling will settle the issue of allowance of certain expenses which are specifically allowed under section 43B on 'payment' basis. Till date, there were various contradictory verdicts of different High Courts on the allowability of employer's and employees' contributions which led to confusion and a scope for argument between the revenue and the assessee. With the honourable Supreme Court ruling (which is based on various similar cases) the issue has been settled permanently. As such the assessee across the country will be able to give appropriate treatment in the Return of Income for delay in payment of employee's contribution to the social welfare schemes (like PF, ESI etc.) and file the same, so as to avoid further litigations, interest and penalties, etc.





CONSULTING

Concept of Central Bank Digital Currency in India

The Reserve Bank of India ('RBI') recently brought out a concept note on central bank digital currency ('CBDC') in India. Ms Aarti Joshi (Vadodara office) briefs the readers on this concept note and discusses some issues which will be at the centre point when the digital rupee is formally circulated as a legal tender.

Recently on 7 October, the Reserve Bank of India ('RBI') brought out a concept note on central bank digital currency ('CBDC') in India. The concept note aims to create awareness about CBDC, known as the 'digital rupee' and explains the RBI's approach towards creating the digital rupee. Key considerations like technology and design aspects, issuance of CBDC and its implications on the economy and financial stability are discussed. We have attempted to brief the readers on this concept note and discuss some issues which will be at the centre point when the digital rupee is formally circulated as a legal tender.

Background

India has made remarkable developments in the digital payments ecosystem. The present state-of-the-art payment systems being affordable, accessible, convenient, efficient, safe, secured, and available 24X7, 365 days a year are a matter of prestige for the nation. In addition, the launch of IMPS, UPI, mobile-based payment systems have earned international recognition for India due to their facilitation as an alternative for cash and paper-based payments coupled with zero loss of time in the payment process.

On the other hand, we have witnessed a boom in virtual digital assets, known as cryptocurrencies which are exchanged for the settlement of liabilities and have posed threat to legal money. Cryptocurrencies have no intrinsic value and are not regulated by RBI. The inherent design of cryptocurrencies bypasses the regulatory framework of legal tender and the central bank money which ensure the integrity and stability of the country's monetary ecosystem.

CBDC worldwide scenario

As per the results of the 2021 Bank for International Settlements ('BIS') survey on CBDCs conducted on 81 central banks, 90% of them are engaged in some form of CBDC work and more than half are developing CBDCs or running concrete experiments. RBI constituted a working group (WG) in 2020 to determine the design and implementation architecture of CBDC.

How will digital currency be? Following are the recommendations of the WG to RBI

- The WG has referred the CBDC in India as e rupee (e₹).
- To enhance the scope of the term 'bank note' to include the term 'e₹' (in the Reserve Bank of India Act, 1934.)
- Need for a robust legal framework to back the issuance of e₹ as another form of currency.
- The design of the e₹ should be compatible with the objectives of monetary and financial stability.
- The currency segment is divided into two sections:
 - Retail currency ('CBDC – R') should be used to pay for things, send money to friends and family, and receive government incentives and subsidies.
 - Wholesale currency ('CBDC – W') should be used by financial institutions to buy and sell financial assets and interbank settlements.

Motivations behind the issue of CBDC

- Avoiding the increasing use of private virtual currencies and their damaging consequences to the economy.

- Ensuring settlement finality and reducing settlement risk in the financial system.
- Factoring international dimension to the e₹ will enable seamless integration of cross-border payments, especially in the wholesale CBDC segment.
- Achieving less cash economy.
- Reducing the cash-management cost.
- Bolstering India's digital economy, enhancing financial inclusion, and making the monetary and payment systems more efficient.
- Supporting competition, efficiency and innovation in payments.
- Accessing digital money which is free from credit and liquidity risk (as opposed to cryptocurrencies).

Design considerations of CBDC

A. Three important principles in designing the CBDC

1 Do no harm principle

- CBDC should not interfere with the banking function of economic stability and their public policy objectives.

2 Co-existence principle

- Can be used with the existing forms of money.

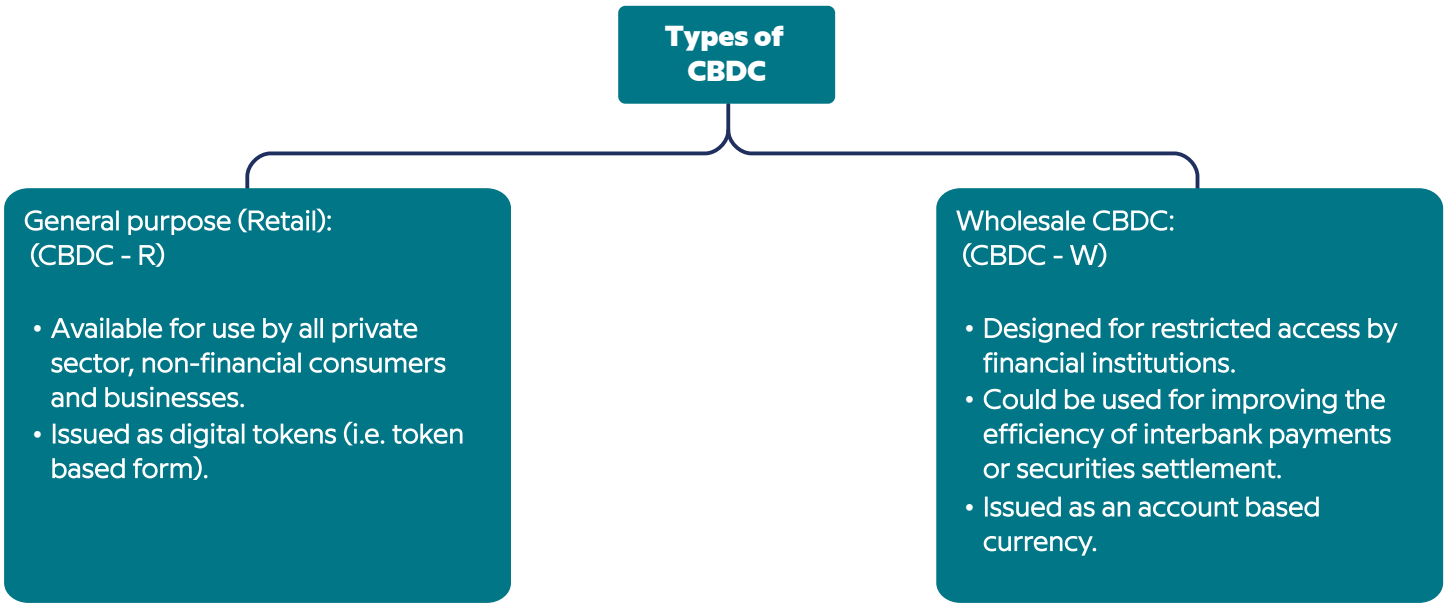
3 Innovation and efficiency principle

- Capable of promoting innovations to boost the payments system.

B. Design of CBDC

A well-functioning CBDC will require an extremely resilient and secure infrastructure that can be scalable to support users on a massive scale.

Two broad categories of CBDC are recommended based on the usage and functions performed.



C. Working model

There are 2 models for the issuance and management of CBDCs globally. The key differences lie in the structure of legal claims and the record kept by the central bank.

The following table summarises the 2 models with their advantages and disadvantages.

Model	Advantages	Disadvantages
Single tier		
The central bank interacts directly with the end customers and is responsible for e₹ issuance, accounting and transaction verification.	It is a very robust system since the central bank has complete knowledge of retail account balances which allows it to honour the claims easily.	It marginalises private sector involvement and hinders innovation in the payment system. More burden on the central bank which may be cost and effort-consuming.
Two-tier (intermediate model)		
<u>Indirect model:</u>		
The obligation to provide CBDC on demand falls on the intermediary instead of the central bank. The central bank tracks only the wholesale CBDC balances of the intermediaries and ensures that the wholesale CBDC balances are identical with all the retail balances available with the retail customers.	Central bank is relieved from maintaining the central ledger and backups of all the transactions.	-
<u>Hybrid model:</u>		
The central bank issues CBDC to commercial entities (payment service providers (PSPs)) which shall make them responsible for all customer-associated activities. However, the central bank retains a ledger of retail transactions.	The central bank keeps a central ledger and thus can restart the payment system in case the intermediary runs insolvent.	-

Design and technology considerations

Considering the Indian scenario, RBI is working on several aspects like the anonymity of the users, denominations to be issued, covering the non-internet users and security aspects.

Anonymity: Maintaining complete anonymity (like cash) is highly impossible, but RBI can balance the maintaining of anonymity upto a certain value and incorporate the traceability of users beyond a particular value of transactions.

Offline functionality: Approximately 42% of the total Indian population has no/very low internet connectivity. RBI will have to consider the offline (non-internet-based) functionality for better penetration and reach of the e₹.

Security: Strong cyber-security, business continuity plan, resilience and sound technical governance will assume a key role. Technology plays a vital role in determining security. The law and policy may change depending on the technology used. Hence, RBI may adopt an open-ended and a flexible approach while devising the technology. Having done so, the policy framework, levels of security can be better fitted in the system.

Conclusion

The concept of CBDC is new and at a very nascent stage. Other central banks (Bahamas, China, Canada, ECCU, Sweden and Uruguay) are at the experimenting/exploring stages of developing their digital currencies on certain parameters like the CBDC architecture, form, design aspects and technology features. The decision on most of these parameters is yet to be concluded.

Considering the Indian scenario, the RBI is working on several aspects like the anonymity of the users, denominations to be issued, covering the non-internet users and the security aspects.

Shifting to CBDC will change the Indian (and global) business and payments landscape. Various laws like information technology, monetary laws, consumer laws, accounting and auditing, regulatory laws (Income-tax laws, Companies Act, Negotiable Instruments Act, and other related legislations like foreign exchange laws) will witness major amendments to accommodate the functioning of digital currency.

Many countries are developing the concept of CBDC, and it is certain that digital currency will assume a global role shortly. However, we wait and watch to witness who would be the first nation/group of nations to launch the CBDC!



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