Legal Decisions

DIRECT TAXES

1. Is leave encashment received by an employee while in service eligible for exemption under section 10(10AA)?

(CIT v. Vijai Pal Singh (2005) 144 Taxman 504 (All.)

Relevant section : 10 (10 AA)

Decision: No, leave encashment received by an employee while in service is not eligible for exemption under section 10(10AA).

The assessee, an employee of a co-operative bank, received a certain sum by way of leave encashment while in service from his employer. The assessee claimed exemption in respect of such leave encashment received under section 10(10AA). The ITO disallowed the claim. The Tribunal, however, allowed the claim holding that the words 'or otherwise' in section 10(10AA) clearly indicated that the exemption was to be given to the assessee as and when there was a payment to the assessee in lieu of leave encashment and the words 'or otherwise' did not restrict the purview of exemption to the retiring employees only.

The High Court observed that the words 'or otherwise' would draw the restricted meaning qua the immediately preceding word 'superannuation'. The superannuation is of an employee's severance of relationship of contract of employment with the employer. The phrase 'or otherwise' would cover only such an eventuality when there is severance of relationship of employer and employee and contract of employment. Therefore, the phrase 'or otherwise' will not cover such cases where there is no severance of relationship of employer and employee and the assessee continues to be under the employment of the same employer, and receives leave encashment. The Court held that this interpretation is in consonance with the legislative history of the section and it manifests the intention of the Legislature to give a limited benefit to an employee with respect to the income received by the employee at the time of his retirement or superannuation or severance of relationship.

The High Court, therefore, held that the Tribunal was not correct in granting exemption to the payments received in lieu of leave encashment to the assessee while in service.

Note – Leave encashment paid by an employer to an employee during the currency of the contract of employment is not exempted under the provisions of section 10(10AA), since the word "otherwise" would cover only cases where there is a severance of employer-employee relationship. This decision was upheld by the same court in CIT v. Ram Rattan Lal Verma (2005) 145 Taxman 256 also.

2. Should the head under which any income is to be assessed be determined on the basis of the form of the transaction alone or is it necessary to go into the real substance of the transaction for this purpose?

(Anurag Jain, In re. (2005) 145 Taxman 413 (AAR- N. Delhi)

Relevant sections: 17(3) & 48

Decision: It is necessary to go into the real substance of the transaction to determine the head under which any income is to be assessed.

The applicant is a non-resident, holding a certain number of shares of an Indian company. The Indian company, along with all its shareholders including the applicant, entered into an agreement to transfer its entire business and share capital in favour of some foreign companies. The applicant has also entered into a non-competition agreement/employment agreement under which he would receive a portion of the purchase price in respect of his ownership interest and would also receive substantial and indirect benefits from the transaction contemplated under the agreement, which is for five years' employment as Chief Executive Officer (CEO).

The sale consideration under the share purchase agreement comprises of two components: (1) the fixed amount (closing payment), payable in lump sum; and (2) the contingent payments payable in installments by 31.3.2004, 31.3.2005 and 31.3.2006. The contingent payments are required to be made only if aggregate earnings before interest, tax and depreciation allowance (PBIDT) of the business for the period applicable equal or exceed contingent cumulative threshold PBIDT. The payment would be determined in a manner indicated in the share purchase agreement.

The applicant filed an application seeking advance ruling of the Authority on the following questions:

(1) Whether the gain arising from the transfer of the equity shares is chargeable to capital gains tax in his hands?

(2) If the aforesaid gains are

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liable to be charged to capital gains, in which year of assessment does the said liability arise in respect of –

(i) The initial lump sum payment received in the previous year relevant to the assessment year

(ii) Contingent payments receivable for each of the three different years.

(3) If the said gains is not to be charged as capital gains, then, under what head of income the contingent payments made to/received by the applicant are taxable and in which year of assessment?

The AAR observed that a combined reading of the employment agreement, non-competition agreement and share purchase agreement, which are contemporaneous, leaves no doubt to conclude that contingent payments payable under the share purchase agreement, are in substance and reality, payments for ensuring performance under the employment agreement to achieve the desired object in exceeding PBIDT and have no real nexus to consideration for sale of shares under the purchase agreement. Hence, these contingent payments, which are in the nature of incentives for achieving the target, would be taxable under the head "Salaries" in the hands of the applicant.

Therefore, the consideration mentioned in the purchase agreement is a composite consideration and the closing payment alone represents the full value of consideration for the said agreement for the purpose of section 48. The capital gains would be treated as income of the previous year in which the transfer takes place.

Note – This case is yet another example to prove that substance of the transaction and not merely its form is relevant in determining the real nature of an income. The significance of substance over form has been established by the Apex Court in the following cases –

1. Swadeshi Cotton Mills Co. Ltd. v. CIT (1967) 63 ITR 57.
2. Assam Bengal Cement Co. Ltd. v. CIT (1955) 27 ITR 37.

3. Is the retrenchment compensation paid by a company to its workers on closure of one of its units allowable as business expenditure?

(CIT(Central) Kanpur v. J.K. Cotton Spg. & Wvg. Co. Ltd. (2005) 145 Taxman 591 (All.)

Relevant section: 37(1)

Decision: Since only one unit, which was running in loss, had been closed and not the entire business of the company, the retrenchment compensation paid to the workers of that unit is a business expenditure allowable under section 37(1).

The assessee - company was engaged in manufacturing and sale of television sets also, apart from other businesses. It found the said business to be uneconomical and so it planned to close down this line of business. It started retrenching its workers who were working in the aforesaid Electronic unit and paid them retrenchment compensation, and claimed the same as business expenditure. The Income-tax Officer disallowed the claim of the assessee for deduction as business expenditure on the ground that it was not incurred for carrying on the business but for closing it. However, the Commissioner (Appeals) allowed the claim of retrenchment compensation and the Tribunal upheld the order of Commissioner (Appeals).

The High Court observed that the Tribunal had found as a fact that the entire business of the assessee-company had not been closed down and but only one unit or a division which was running in loss on account of commercial expediency had been closed. Under such circumstances, the compensation paid to the workers had been rightly held as business expenditure allowable under section 37(1).

4. The assessee had advanced loans to a company, which later became sick, and the BIFR order had deferred payment of interest by the sick company to all its creditors, including the assessee. Is there any extinguishment of rights resulting in a transfer in such a case?

(Thirumbadi Rubber Co. Ltd. v. Deputy Commissioner of Income-tax (2005) 144 Taxman 351 / 274 ITR 0549 (Ker.)

Relevant section: 2(47)

Decision: Since the BIFR order had only deferred payment of interest by the sick company to its creditors, including the assessee, there was no extinguishment of the assessee's right to recover the debt in such a case and hence, there was no transfer.

The assessee-company had advanced a certain amount to another company, which later became sick and was referred to BIFR for rehabilitation. The BIFR had ordered deferment of payment of interest under the rehabilitation scheme. However, the assessee chose to write-off the amount due to it from the sick company as a bad debt in the immediately preceding previous year, when the BIFR proceedings were going on, which was disallowed. In the relevant assessment year, on receipt of the order of the BIFR, the assessee made a claim for capital loss on the basis that there was an extinguishment of right to recover the debt due from the sick industry resulting in a transfer of capital asset within the meaning of section 2(47).

The High Court observed that there was no extinguishment of right to recover the debt on account of the order of the BIFR, since the BIFR order had only deferred payment of interest by the rehabilitated sick industry to its creditors, including the assessee. Under the rehabilitation scheme of the BIFR, debts due to creditors from the sick industry under rehabilitation were kept intact. Therefore, the BIFR order had not caused any extinguishment of rights of the assessee, resulting in transfer of capital asset. The capital loss was, therefore, not allowable.

5. Can the expenditure incurred by an assessee to remove an encumbrance, which he has created himself on a property acquired by him without any encumbrance, be allowed as a deduction under section 48?

(CIT v. Roshanbabu Mohammed Hussein Merchant (2005) 144 Taxman 720 / 275 ITR 0231 (Bom.)

Relevant section: 48

Decision: The expenditure incurred by the assessee to remove an encumbrance, which he has created himself on the property acquired by him without any encumbrance, is not an allowable deduction under section 48.

On the above issue, the Bombay High Court pointed out that there is a distinction between the obligation to discharge the mortgage debt created by the previous owner and the obligation to discharge the mortgage debt created by the assessee himself. Where the property acquired by the assessee is subject to the mortgage created by the previous owner, the assessee acquires an absolute interest in that property only after the discharge of mortgage debt. In such a case, the expenditure incurred by the assessee, to discharge the mortgage debt created by the previous owner, to acquire absolute interest in the property is treated as 'cost of acquisition' and is deductible from the full value of consideration received by the assessee on transfer of that property. However, where the assessee acquires a property which is unencumbered, he gets an absolute interest in that property on acquisition. When the assessee transfers that property, he is liable for capital gains tax on the full value realized, even if he has himself created an encumbrance on that property. The assessee is under an obligation to remove that encumbrance for effectively transferring the property. In other words, the expenditure incurred by the assessee to remove an encumbrance, which he has created himself on the property acquired by him without any encumbrance, is not an allowable deduction under section 48.

Note – This case highlights the difference in tax treatment in respect of allowability of the expenditure incurred on removing an encumbrance in two different cases, namely –

(i) in a case where the mortgage is created by the previous owner and

(ii) in a case where the mortgage is created by the assessee himself.

6. Can benefit under section 10(10C) and section 89(1) be claimed by an assessee in respect of the compensation received under a voluntary retirement scheme (VRS)?

(CIT v. G.V. Venugopal (2005) 144 Taxman 784 / 273 ITR 0307 (Mad.)

Relevant sections: 10 (10 C) & 89(1)

Decision: Relief under section 89(1) can be claimed in respect of the taxable portion of VRS compensation i.e. on the balance VRS compensation after excluding the amount claimed as exemption under section 10(10C).

The assessee, an employee of a bank, had opted for voluntary retirement and was paid Rs.5,85,072 by the employer under the special scheme of VRS framed in accordance with the guidelines prescribed under Rule 21A of the Income-tax Rules, 1962, in addition to other retirement benefits like gratuity, leave encashment etc. The assessee claimed exemption of Rs. 5 lakhs under section 10(10C) in respect of the VRS received and offered the balance as income from salary. The assessee, however, claimed relief under section 89(1) on the balance amount by spreading the same in three preceding assessment years as provided in Rule 21A. The Assessing Officer while allowing the claim under section 10(10C), disallowed the relief claimed under section 89(1) on the ground that once exemption was allowed under section 10(10C), no further exemption could be allowed in relation to any other assessment year in view of the second proviso to section 10(10C). On appeal, however, the Commissioner (Appeals) allowed the claim of the assessee, which was also upheld by the Tribunal.

The High Court observed that all the authorities had agreed that the assessee was entitled to exemption to the extent of Rs.5 lakhs as contemplated by section 10(10C). The issue, therefore, was whether the assessee was also entitled to exemption under section 89(1).

The Court opined that the view taken by the Assessing Officer was not correct. The second proviso to section 10(10C) only refers to exemption claimed in any other assessment year. The assessment year in question in the instant case was 2001-02 and the exemption claimed was in respect of the same assessment year,

although exemption granted under section 89(1) has been spread over several assessment years. The mere fact that the relief has been spread over several years does not mean that the relief is not in respect of a particular assessment year.

The High Court concurred with the observation of the Tribunal that there is no prohibition to the twin benefits in respect of the amount received under the VRS. The relief contemplated under section 89(1) is aimed to mitigate hardship that may be caused on account of the high incidence of tax due to progressive increase in tax rates. Hence, the Tribunal was right in holding that the assessee was eligible to claim simultaneous benefit under section 10(10C) and section 89(1) in respect of compensation received under the VRS.

The High Court further observed that the word 'salary' as defined in section 17 includes any profit in lieu of salary which has been defined in section 17(3) to include any amount of compensation due or received by the assessee from his employer or former employer in connection with the termination of his employment. Hence, the payment under the VRS is covered by the word 'salary', which has been given a very wide definition in section 17. Therefore, the assessee is entitled to relief under section 89(1) in respect of taxable VRS.

Note – In respect of VRS receipts, once a portion of the same is excluded from total income under Chapter III, there can be no question of any further relief in respect of the excluded amount. However, to the extent of the balance VRS receipts, which are treated as salary, relief under section 89(1) is available.

7. Can the Assessing Officer issue an intimation under section 143(1) and a notice under section 143(2) simultaneously?

(Indian Aluminium Co. Ltd. v. Union of India (2005) 145 Taxman 125 / (2004) 271 ITR 0073 (Cal.)

Relevant sections: 143(1) & (2)

Decision: No, the Assessing Officer cannot issue an intimation under section 143(1) and a notice under section 143(2) simultaneously.

The Assessing Officer issued intimation under section 143(1) and a notice under section 143(2) simultaneously and on the same date. On writ petition, the assessee challenged the intimation under section 143(1).

The High Court held that when steps are taken u/s 143(1) upon issuance of the intimation, the matter stands concluded insofar as the Assessing Officer is concerned. However, when steps are taken u/s 143(2), the Assessing Officer starts his work to ensure that the assessee has not paid less tax. Therefore, the power exercisable under sub-section (1) stands on a different footing from the power exercisable under sub-section (2). It is possible that after the power has been exercised under sub-section (1), it may occur to the Assessing Officer that while issuing the intimation or the refund, certain things had escaped his attention and, accordingly, in order to ensure that the assessee has not underpaid tax, he may take steps under sub-section (2).

In the instant case, the intimation under section 143(1) and the notice under section 143(2) were issued simultaneously and on the same date, without any just reason. The Assessing Officer, who had been authorized to do either of these acts, had done both of them on the same date. One of his actions concluded the matter and the other commenced the assessment of the liability. The High Court, therefore, held that the intimation issued under section 143(1), which had been challenged in the writ petition, could not be sustained.

8. Is the bar under section 245R(2)(i) attracted, where the questions on which an advance ruling is sought, are not directly and substantially pending before any High Court or income tax authority?

(Rotem Company, In re (2005) 145 Taxman 488 (AAR-New Delhi)

Relevant section: 245R(2)

Decision: No, the bar under section 245R(2)(i) is not attracted in a case where the questions on which an advance ruling is sought, are not directly and substantially pending before any High Court or income-tax authority.

The applicants constituted a consortium and submitted a tender for design, manufacture, supply, testing and commissioning of passenger rolling stock for Delhi Metro Rail Corporation (DMRC). On the acceptance of the tender, the consortium entered into a contract with DMRC, under which a fixed lump sum amount was payable by DMRC, as consideration to the consortium. On these facts, the applicants set out questions in their applications seeking advance ruling of the Authority. The Commissioner raised objection as to the maintainability of the application on the following grounds –

(1) The returns filed by the applicants were pending before the Income-tax Officer, in which substantially the same questions were pending;
(2) The writ petition filed by one of the applicants was pending before the High Court; and
(3) Proceedings under section 197 were pending before the Deputy Director of income-tax (DDIT).

The High Court observed that a perusal of section 245R(2) shows that it confers discretion on the AAR to allow or reject the application after examining it and calling for the records. The discretion cannot be exercised capriciously or arbitrarily; it has to be exercised judicially on well-recognised principles. However, the proviso leaves no option with the AAR except to reject the application where the question raised in the application falls under any of the clauses (i) to (iii) thereof, namely, where the question raised in the application -

(i) is already pending before any income-tax authority or Appellate Tribunal;
(ii) involves determination of fair market value of any property;
(iii) relates to a transaction or issue that is designed prima facie for the avoidance of income-tax.

Regarding the first objection of the Commissioner, namely, pendency of the questions before the Assessing Officer is concerned, the Court held that mere filing of returns by the applicants would not fall within the mischief of clause (i) of section 245R(2). Where, however, a notice is issued under section 143(2) within the statutory period, the situation may warrant an enquiry into the identity of questions before the Assessing Officer and the Authority. In the instant case, no notice u/s 143(2) was issued to the applicants before the date of filing of the applications before the Authority.

With regard to the other objections, the High Court noted that the questions in the writ petition before the High Court and the DDIT related only to determination of rate of tax for TDS. This question was not raised in the application before the AAR. Therefore, the questions raised in the application were not directly and substantially pending before the High Court or income-tax authorities.

The High Court, therefore, held that the bar under section 245R(2) is not attracted and allowed the applications for the purpose of pronouncement of rulings on the questions set forth in the application.

Note – This case highlights two significant aspects relating to allowability of an application made before the AAR –

(1) Mere filing of returns would not be a disqualification for allowing an application.
(2) If the questions raised before the AAR are not the same as pending before any income-tax authority or Tribunal or Court, disqualification is not attracted.

9. Can a non-resident company seek advance ruling on questions relating to a loan transaction between its two Indian subsidiary companies?

(X Ltd., Netherlands In Re. (2005) 145 Taxman 573 / 275 ITR 0327 (AAR-New Delhi)

Relevant section: 245N(a) & 245Q

Decision: A non-resident company cannot seek advance ruling on questions relating to a loan transaction between its two Indian subsidiaries.

The applicant is a non-resident company incorporated under the laws of Netherlands. It is engaged in the business of holding shares of various companies, including two Indian companies 'A Ltd.' and 'B Ltd.', which are its wholly owned subsidiaries. During the previous year, 'A Ltd.' granted interest bearing loans to 'B Ltd.', which paid back the same with interest in the same year. The applicant sought advance ruling of the Authority on various questions relating to the said loan transaction. The Commissioner raised preliminary objection as regards the maintainability of the application on the following grounds –

(a) that both the parties to the said transaction are Indian companies;
(b) there is no transaction between the applicant and the resident companies
(c) that an advance ruling under section 245N(a) can be given only in respect of tax liability of a non-resident arising out of a transaction undertaken or proposed to be undertaken by it.

The AAR observed the definition of 'advance ruling' under section 245N(a). For attracting the provisions of clause (i) of this section, the applicant should be a non-resident and the transaction has to be undertaken or proposed to be undertaken by the non-resident applicant. From the facts of the case, it is evident that the applicant is a non-resident but the loan transaction is between 'A Ltd.' and 'B Ltd.', both of which are residents of India. Therefore, the requirements of clause (i) are not satisfied in this case. Hence, the determination would not fall under clause (i).

For the provisions of clause (ii) of this section to be applicable, the question should relate to determination of tax liability of a non-resident in respect of transactions undertaken or proposed to be undertaken by a resident applicant with such non-resident. In this case, however, the applicant is a non-resident and further, the transaction of loan was undertaken by two resident companies. The question of determination of tax liability of the non-resident also does not arise. Therefore, it follows that no determination under clause (ii) of this section can be made.

The AAR, therefore, rejected the application holding that it was not maintainable due to the aforementioned reasons. ❐