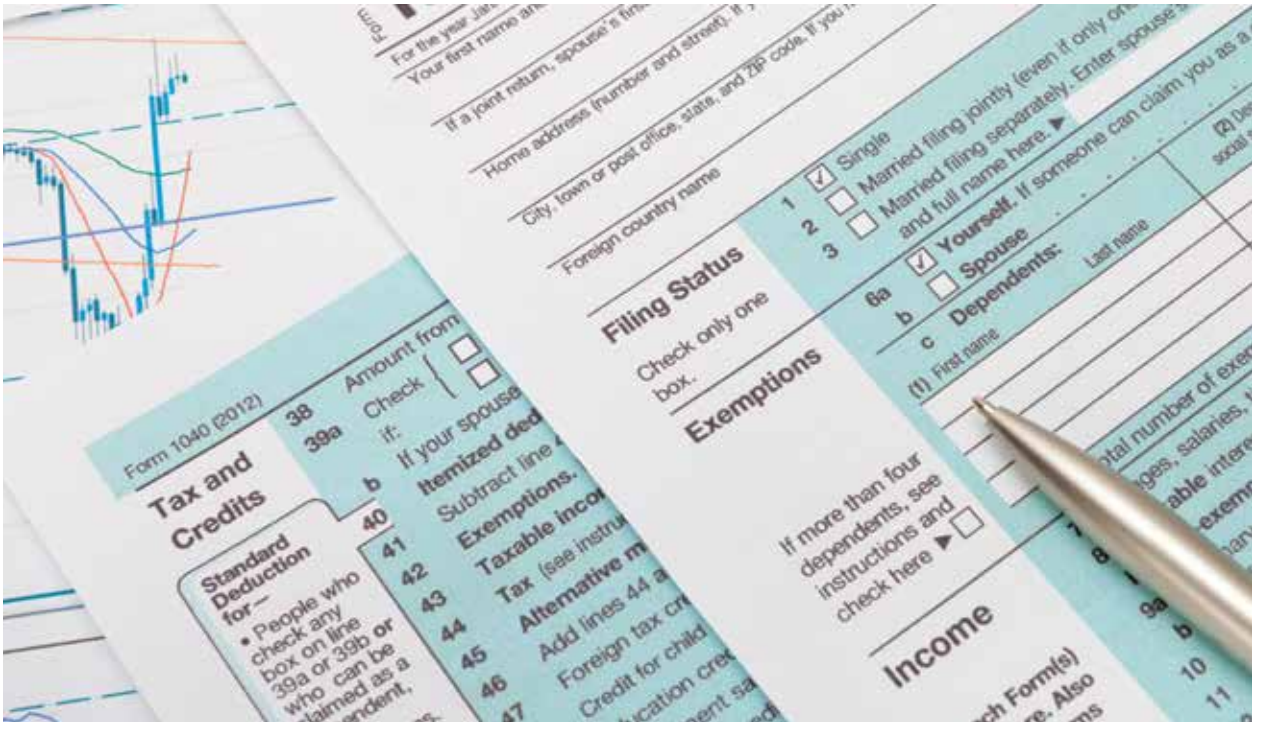
Settlement of Loans and Liabilities - Taxability under Income Tax Act



Business houses and groups invariably obtain and depend on loans, since they obtain the same in order to set up their businesses and subsequently require it to run their business operations. Such loans could be term loans, working capital loans, bridge loans, export limits, unsecured loans and so on. In case of emergencies and crises, usually loan providers request the business organisations for a settlement of the loan amount by way of waivers of certain portion of principal loan amount and interest, i.e. one-time settlement. The author duo in this article discusses the taxability aspect of such settlements i.e. of loans and liabilities, as taxability varies from case to case depending on the terms and conditions and facts of individual cases. Therefore, it will be interesting to analyse this complexity in the light of unique tax treatment of waived amount of loan and interest in an individual case. The author duo checks the Section 28(iv) and the Section 41(1) of the Income-tax Act to discuss the objectives of their article. Read on…

Introduction

Business organisations obtain loans for setting up of business and for running the same. These loans are in the form of term loans, working capital loans, bridge loans, export limits, unsecured loans, *etc.*

When business is in trouble, not doing well or closed, usually banks and financial institutions request for settlement of loan accounts by a waiver of certain portion of principal amount of loan and interest which is popularly called as 'one time settlement'. Tax treatment of such settlement is a very important aspect which varies as the terms and conditions and the facts of each case differs. The separate tax treatment of waived amount of loan and interest further complicates the process. The Taxman makes an effort to hold the amount of loan and interest

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waived as an income under Section 28(iv) or Section 41(1) of the Income-tax Act. At the outset, attention is invited to the provision of Section 41(1) which reads:

"41(1) *Where an allowance or deduction has been made in the assessment for any year in respect of loss, expenditure or trading liability incurred by the assessee (hereinafter referred to as the first mentioned person) and subsequently during any previous year—*

(a) the first mentioned person has obtained, whether in cash or in any other manner whatsoever, any amount in respect of such loss or expenditure or some benefit in respect of such trading liability by way of remission or cessation thereof, the amount obtained by such person or value of benefit accruing to him shall be deemed to be the profits and gains of business or profession and accordingly chargeable to income tax as the income of that previous year, whether the business or profession in respect of which the allowance or deduction has been made is in existence in that year or not; or ……."

The definition of income includes amount chargeable under Section 41 (1) of the IT act and the provisions of Section 41 fall under the chapter for computing income from business and profession. Primarily, addition under Section 41(1) would be triggered in respect of amount for which a deduction or allowance is claimed and allowed in any of the earlier years.

I. Judgments Laying Down Basic Principles of Taxation

1. Normally, waiver of principal amount of loan cannot be regarded as income when the amount originally received by an Assessee is in the nature of loan which is not in the normal course of trading and no deduction was claimed or allowed in the past in respect of the liability that is waived. Hence, a receipt which is not in the first instance, a trading receipt, cannot become trading receipt by any subsequent process. In this regard, attention is invited to two *English decisions in the case of Morley vs. Tattersall (7 ITR 316) and British Mexican Petroleum Company Limited vs. Jackson (16 TC 570)(HL).*

   In the case of *Morley vs. Tattersall,* the following principles have been laid down:

Normally, waiver of principal amount of loan cannot be regarded as income when the amount originally received by an Assessee is in the nature of loan which is not in the normal course of trading and no deduction was claimed or allowed in the past in respect of the liability that is waived.

- Statue of Limitations does not apply to such liability
- If Initial receipts are not trading receipts, subsequent operations cannot turn them into a trading receipt and
- The quality and nature of receipts for tax purposes is fixed once and for all.

Indian Courts have time and again followed the above decisions and upheld the law that debt forgiven or waived cannot be held as income.

2. The Supreme Court in the case of *Polyflex (India) Pvt. Ltd. vs CIT 257 ITR 343* has examined the constitution of Section 41(1). The court has pointed out that Section 41(1) consists of two main ingredients (a) loss or expenditure and (b) trading liability. The two ingredients of Section 41(1), the court held, have to be read independently. As the first ingredient relates to loss or expenditure and the second ingredient relates to remission or cessation of trading liability, the court has categorically ruled that the words "remission or cessation thereof " shall apply only to a trading liability.

   The Delhi High Court in the case of *CIT vs. Phool Chand Jiwan Ram (1981) 131 ITR 37* and Bombay High Court in the case of *Mahindra and Mahindra Ltd vs. CIT 261 ITR 501* have held that Section 41(1) would be applied only if the assessee has obtained any deduction or allowance in respect of any expenditure or loss. If the assessee has not obtained any such allowance or deduction, Section 41(1) would not be applicable at all.

3. The High Court of Kerala in the case of *CIT vs. Cochin Co. Ltd.– 81 CTR 115* has specially held that payments of loan taken to purchase machinery cannot be reduced from the cost of machinery as remission or loss will not amount to remission of depreciation within the meaning of Section 41(1). It means remission of capital liability cannot be brought under the purview of Section 41(1).

4. In the case of *Mahindra and Mahindra vs. CIT (261 ITR 501),* it was held by the Bombay High Court that the loan which was originally taken for capital expenditure, if waived, will not give rise to taxable income. The relevant extract of the said decision read as under:
"The income which can be taxed under Section 28(iv) must not only be ***referable to a benefit or perquisite, but*** *it must be arising from business. Secondly, Section 28(iv) does not apply to benefits in cash or money. Secondly, in this case we are concerned with the purchase* ***consideration relating to capital asset.*** *The toolings were in the nature of dies. The assessee was a manufacturer of heavy vehicles and jeeps. It required these dies for expansion. Therefore, the import was that of plant and machinery. The consideration paid was for such import. In the circumstances, Section 28(iv) is not attracted. In our case, the most fundamental fact which is required to be borne in mind is that there was no deduction given to the assessee in earlier years and, therefore, ₹57,74,064 could not be included as income under Section 41(1) of the Act. Lastly, it is important to bear in mind that the toolings constituted capital asset and not stock-in-trade. Therefore, taking into account all the above facts, Section 41(1) of the Act is not applicable".*
Further, the above issue as regards non-taxability of waiver of a loan used for capital purpose was carried by the tax department to Supreme Court in the case of *Tosha International vs. CIT* and the apex court had dismissed the department S.L.P reported in 319 ITR(ST)7.
5. In the case of *Accelerated Freeze & Drying Co. Ltd vs. DCIT (2009) 31 SOT 442 (Cochin)* where waiver of loan under a scheme was formulated by the Reserve Bank of India known as "One time Settlement Scheme", assessee credited the waiver amount in the general reserve account, the Tribunal held that loan amount waived could not be treated as its income either under Section 28(iv) or under Section 41(1). Loans availed by assessee from Banks were not in the nature of trading liability but were in the nature of capital liability and, therefore waiver of loan liability was not waiver of any trading liability. Hence the provision of Section 41(1) was not applicable.
6. In an appeal filed by Revenue, the Hon'ble MP High Court in the matter of *CIT vs. Dholgiri Industries (P) Ltd. (2014) 99 DTR 359/266 CTR 111/125 (MP)(HC)* has categorically held that as the assessee never claimed the principal amount as deduction, the AO was not justified in assessing the said amount as income. The Court affirmed the view of the Tribunal.
7. In cases where the loan had been utilised for trading purpose, the said loan would be regarded as a trading liability of the assessee and therefore, the cessation of such trading liability by any waiver would attract the provision of Section 41(1), discussed above, to the effect that, the entire part of the principal liability so waived, would become chargeable to tax, as income. The precedents on this issue are:
   - *Solid Containers Limited (308 ITR 407) (Bom HC)*
   - *Logitronics (P.)(Ltd)(333 ITR 386)(Del HC)*
   - *Hindustan Fibres Ltd vs. DCIT (ITA NO 5263/Del/2011)*
8. However, in the case of APR Ltd. vs. *DCIT (87 ITD 618) (HYD),* it is held, after considering the decision of *CIT vs. TV Sundaram Iyengar and Sons Limited (222 ITR 344)(SC),* that the loan does not lose its capital nature even when it is renounced by the lender and becomes money of the assessee, and therefore, the mere fact of its transfer to profit and loss account does not invest it with revenue character.
9. Therefore, while dealing with the waiver of principal liability, one needs to further decipher the utilisation pattern of the loan so waived. In other words, the implications of the waiver of the principal loan liability would depend on whether the loan had been utilised for capital purpose or for trading purpose, by the assessee. In case of general purpose loan, only thefinal use of the loan amount would show whether it was for capital or trading purpose.

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II. Rigours of Section 28(iv)

Now we come to the question of the taxability of the principal amount waived under Section 28(iv) which reads:

> *The value of any benefit or perquisite, whether convertible into money or not, arising from business or the exercise of a profession;*

The moot question which arises from reading the above is whether the waiver of loan would amount to a perquisite so as to be taxable under Section 28 of the Act. The Bombay High Court in the case of Mahindra and *Mahindra Limited vs. CIT-261 ITR 501* has considered this very issue. While rejecting the Revenue's stand, the court explained that Section 28(iv) seeks to charge the value of any benefit or perquisite, meaning thereby that the benefit must be in kind whereas the waiver of loan was in cash. Hence, clause (iv) of Section 28 was not applicable at all. While arriving at that conclusion, the Bombay High Court in fact referred to the decision of the Gujarat High Court in the case of *CIT vs. Alchemic Pvt. Ltd. 130 ITR 168.* The Gujarat High Court in the said case has held that the benefit or perquisite arising from business as construed in Section 28(iv) will not include cash receipt.

The Hon'ble Delhi Bench of the Tribunal, in the case of *Velocient Technologies Ltd. vs. ITO (120 TTJ 659),* has held that the primary requirement for treating an amount as business income of an assessee is that the same should have arisen out of ordinary trading transactions, and that the loan availed for capital purposes, cannot be equated to transactions in the nature of normal trade, and therefore, the waiver of such loans cannot be treated as an item taxable under Section 28(iv) of the Act.

If the assessee is engaged in manufacturing or trading of any product or commodity and thereby not engaged in the business of finance, waiver of loan amount in such cases, would not be a benefit or perquisite arising from its business and cannot be taxed under Section 28(iv).

III. One-Time Settlement Inability in Bifurcation of Waived Amount

In the case of one time settlement, it is required to first bifurcate the amount of principal loan waived off and the amount of interest outstanding on the principal liability waived. Interest waived would be regarded as income under Section 41(1) provided the same was allowed as a deduction in any of the earlier years. As regards the waiver of principal liability, if the loan was availed to be used for capital purpose, the waiver would not be taxable in the hands of the assessee. However, if the loan was acquired to be used for the purpose of business of the assessee, the same, being regarded as a trading liability, its waiver would be taxable as business income in the hands of the assessee.

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However, in the case of lump sum settlement of a loan account, a possibility may arise that the total amount waived cannot be bifurcated between the waiver of principal liability and interest due. Taxability of the waiver, in such a case, has been dealt with by the Bombay High Court in the case of *Akay Organics Limited vs. ITO (IT appeal No5481 of 2010)* wherein the High Court, while dismissing the appeal filed by the assessee, has held that in a case where the assessee is not able to produce any rational basis for the apportionment of the one-time settlement amount between the principal liability and the interest outstanding, one cannot assume that the principal liability and interest are waived on a proportionate basis. The High Court observed:

> *"The assessee has not produced any evidence to indicate the apportionment of the OTS amount of ₹91 lacs towards principal and interest. It is obvious that a part of above amount was towards interest for the OTS amount was admittedly more than ₹72 lacs (principal amount). The working of the proportionate amount by the assessee is not based on what infact transpired between SICOM and itself. The basis is merely hypothetical. It is not inconceivable that the interest was waived and/or reduced. The reliance upon the rule that any amount received by creditors must first be adjusted towards interest and then towards principal cannot come to the assistance of the assessee."*

Thus, the Bombay High Court has laid down the principle that when the amount paid as "one-

time settlement" cannot be separated as that paid towards the principal loan liability and that towards the interest, in such a case, it is to be assumed that the whole of such sum is first paid in settlement of principal loan amount outstanding and the balance towards the interest.

IV. Taxability of Interest Waived

1. In case of waiver of the loan by way of "one-time settlement", in so far as it relates to the waiver of the interest liability being in the nature of trading liability, it would be regarded as income, provided that earlier such interest was allowed to be claimed as expenditure under Section 36(1)(iii) of the Act. *Solid Containers Ltd vs. DCIT (2009)178 Taxman 192(Bombay HC).*
2. Conversely, if such interest was not claimed by the assessee or allowed to him during anytime during any of the previous years as expenditure in the profit and loss account, or the same was disallowed to the assessee by virtue of Section 43B of the Act, no income can be said to be chargeable in the hands of the assessee upon its waiver. *ACIT vs. Spel Semiconductor Ltd. (2013) 59 SOT 114 (Chennai Tribunal).*
3. In a particular case, the assessee had originally availed the loan and had incurred interest liability thereon, had never claimed interest as expenditure, but the same was debited to the Capital Work in Progress account in the books. Since no expenditure was claimed by the assessee in its income, in respect of the interest liability, waiver of such liability cannot be made taxable, in this case.

V. Time of Taxability

1. A question would arise as to the point of time when the taxability of such waiver needs to be examined in case of 'one time settlement', more precisely, whether at the time when the settlement is done or when the conditions required to be satisfied for eligibility to such 'one time settlement' are complied satisfactorily. In this regard, our view based on legal decisions is that the question of determining the taxability of the waiver of the loan shall arise only when all the conditions of 'one-time settlement' are satisfactorily complied with. This view is on the basis that, if the conditions are not fulfilled, the loan liability remains and the one-time settlement gets abated. Prior to fulfillment of the eligibility criteria put forth by the creditors, it is a mere contingency that the loan liability shall stand waived off.
2. This view has been upheld by the Mumbai Tribunal in the case of *Lalit Profiles and Steel Industries Limited vs. ACIT (ITA no. 4487/Mum/08)* wherein the Tribunal held:
   "In the present case, the waiver by the bank of principal sum was subject to certain conditions and only upon fulfillment of those conditions the assessee would become entitled to the benefits of waiver. Admittedly the time for fulfillment of the conditions for waiver is beyond the previous year relevant to A.Y. 2005-06. There was therefore no occasion to either apply section 41(1) or section 28(iv) or Sec 56. of the act in the case of the assessee in A.Y. 2005-06."
3. Thus, taxability or waiver of the loan or interest should be determined only in the year in which the conditions stipulated in the one-time settlement agreement are fulfilled and not in the year in which a conditional one time settlement agreement is merely executed signed.

VI. Early Waiver Of Unsecured Loans

If the waiver of an unsecured loan is within three years from the date when it was obtained for capital purpose, then it may create a suspicion in the mind of the Department about the genuineness of the loan, and may trigger the provision of Section 68 of the Act, where, under the amended law, even the source of the creditors needs to be established.

Normally before a waiver takes place, the creditor would have to be convinced that there is no chance of recovering the amount. One would therefore observe in such cases, extensive correspondence, negotiation, settlement or arbitration (if so provided in the loan agreement) or legal action, *etc.* before a loan is waived. This would establish the genuineness

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of the loan, as well as the action of waiver of loan by the creditor.

It would therefore be proper, if the debtors start corresponding with the party, firstly, for its inability to pay interest, and then later on the principal amount. There could also be a settlement or some negotiation before the loan is partly or fully waived.

VII. Case Studies

1. ***Waiver Of Share Application Money***

   Where an amount is invested by way of share application money and the recipient company uses such amount for procurement of capital items and purposes. On a write-back of such share application money, in our view, it would remain capital receipt and not take the character of revenue income and would remain in the nature of capital.

   On this issue, the Delhi Tribunal in *Impsat (P) Ltd. vs. ITO (91 ITD 354)* has held that by waiving their right to get back capital contribution made by them or any part of it, the collaborator was only giving up its right over capital contribution. That, by any stretch of imagination, could not result in the assessee retaining the share application monies as its income. The original receipt was undoubtedly capital and its waiver did not have quality of charging same into revenue receipt.

2. ***Waiver/Forefeiture of Security Deposit vis-à-vis Trading Deposit***

   If deposits received by a businessman in substance partake more of the nature of trading receipts than of security deposits, such deposits, if unreturned, would be taxable as income. But a receipt which is not, in the first instance, a trading receipt, cannot become a trading receipt by any subsequent process. In *Morley vs. Tattersall,* a firm of auctioneers had large unclaimed balances of their clients in their hands. Several years' accumulations of those balances were divided by the firm among the partners. It was held on such facts, that they were not trading receipts and could not be taxed as income. The quality and nature of a receipt for income-tax purposes is fixed once and for all when it is received. The unclaimed balances, when first received from the auction-purchasers, were obviously liabilities, and no subsequent operation or alteration in the accounts could turn them into trading receipts."

3. ***Unclaimed Trade Creditors***

   In the case of *CIT vs. Aries Advertising Pvt. Ltd.– (255 ITR 510)* before the Madras High Court, the assessee had transferred unclaimed credits to the general reserve. The credit balances considered by the court in that case were not in the nature of term loans availed for capital purposes. It is in such circumstances that the court has relied on the judgment of the Supreme Court in the case of *T.V. Sundaram Iyengar and Sons Ltd.– 222 ITR 344* and held that the credit balances written off and transferred to general reserve could be chargeable as profit under Section 41(1).

VIII. Accounting Entries in Books Not Decisive for Tax Purposes

In this regard, attention is invited to the decision of the Hon'ble Supreme Court in the case of *CIT vs. Shoorji Vallabhdas & Co., (1962) 46 ITR 144 (SC)* where it was held that a mere bookkeeping entry did not give rise to income increase unless it could be shown that income had actually resulted from it. It is a trite law that the nomenclature given by an assessee to a particular account in its books of accounts is not the sole test to decide the real character of that account. The Hon'ble Supreme Court in the case of *Punjab Distilling Ltd. vs. CIT (35 ITR 519)(SC)* has held that an assessee may credit an amount to capital account what should have otherwise been credited to revenue account but that does not make it taxable. Again, the Supreme Court in case of *Kedarnath Jute Mfg. Co. Ltd vs. CIT (82 ITR 363)* has observed that bad accounting affects neither in favour of the assessee nor against the revenue.

IX. Conclusion

The taxability of the waiver of loan and interest amount in individual cases will depend on the facts of the case and will be finally decided in terms of the provision of Sections 41(1) and 28(iv), to be interpreted in the light of the judgments of various courts. The courts have followed uniform logic and principles while deciding the issue of waiver/settlement of loan and hence, there remains very little controversy regarding tax treatment of these transactions. However, the complex nature of the present finance arrangements and the use of tailor made debt instruments, may raise certain debatable issues which will be finally addressed on the basis of basic principles laid down by the Indian courts. ■