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Article

Taxing compensation receipts – Whittling away the relief?

By **Subhashree R**

While taxing of long term capital gains and insertion of the Income Computation and Disclosure Standards (ICDS) have been some of the major talking points post presentation of Budget this year, the apparently innocuous insertion in Section 28 has not received much attention. *'A rose by what other name called would smell as sweet'.* It is usually difficult to find lyrical beauty or logic in a levy. Since the income tax law would be incorporating these words in Section 28, it is worth taking a closer look at the proposed amendment.

Introduction

Finance Bill, 2018 proposes to insert new sub-clause (e) in Clause (ii) of Section 28 of Income Tax Act, 1961 ('the Act') as follows:

Section 28 (i) Any compensation or other payment, due to or received by …

'(e) *any person, by whatever name called, <u>at or in connection</u> with the <u>termination or the modification</u> of the terms and conditions, of <u>any contract relating to his business</u>' (*emphasis supplied))

As per the Memorandum to the Finance Bill ('the memorandum'), the amendment will enable the tax authorities to tax compensation received or receivable in connection with the termination or modification of the terms of any contract shall be taxable as business income. Thus, by way of this amendment, compensation, even if capital in nature, is sought to be taxed if it arises on termination or modification of a contract relating to business.

What is sought to be taxed?

The liberal interpretation of the term 'income' and 'business' has not been wide enough to bring into the tax net certain receipts like compensation on termination of managing agency, profit from transfer of DEPB scrip, non-compete fee, etc., and a number of such items were inserted in the Act specifically as being taxable.

In respect of sum received on termination of contract due to breach, non-performance, deficiency in performance, etc., an argument that has often been taken is that the sum received is a capital receipt and hence is not taxable as income. Though there is no express exclusion from the definition of income, the courts have generally held that capital receipts to be outside the scope of the term 'income'.

In *Navinchandra Mafatlal,* (1955) 1 SCR 829, the Supreme Court held that the word 'income' had to be given the broadest connotation and hence the levy on capital gains was valid and within the powers of the government. It stated that (Entry 82 in List I) 'Taxes on income other than agricultural income') is wide enough to cover capital gains. However, in *Navnit Lal Jhaveri v. K K Sen,* (1965) 1 SCR 909, though the Supreme Court held in favour of the Revenue Department that the deemed dividends could be subject to income tax, it was observed that '*there must be some rational connection between the item taxed and the concept of income liberally construed'*.

Another argument against taxation of such compensation is that it is not 'profits or gains from business' but is only a compensation for injury caused to the other party. The obligation to compensate the other party may arise out of the terms of contract itself or under other laws like

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the Contract Act, 1872. Since the sum received as compensation or liquidated damages etc., could not be described as income falling under any of the heads, such sums were claimed to be not taxable under the Act. In *Commissioner of Income Tax, Gujarat v. Saurashtra Cement Ltd,* 2010 192 Taxmann 300 (SC), the Apex Court held that where amount received by the assessee is towards compensation for the sterlisation of the profit-making apparatus rather than a receipt in the course of the profit-earning process, it would be a capital receipt and hence not taxable. The Apex Court also observed that there cannot be a single infallible test to decide between capital and income. There have been other cases where it has been held that compensation received on termination of a contract (of agency) is a revenue receipt [*CIT v. Best & Co. (P) Ltd.,* (1966) 60 ITR 11*, Gillanders Arbuthnot And Co., Ltd v. The Commissioner Of Income-Tax,* 1965 AIR 452]. The reasoning in these cases was that as part of normal operations of a business some contracts may be terminated and new ones entered into, but the assessee continues to do business unaffected by such cancellations.

Is the clause wide enough to cover every payment in connection with contracts?

If we analyse the various parts of the proposed insertion, it is clear that it appears to be very wide and may include not just capital receipts but a host of other payments which may not be income.

Any compensation or other payment, due to or received by [Section 28(ii)]; 'any person, by whatever name called' [sub-clause (e)]

This provision seeks to cover any compensation or payment received or due to a person. 'By whatever name called' - these words are wide enough to include payments due and actual receipts and compensation and any payment irrespective of nomenclature given to it by parties, treatment in books and so on.

At or in connection with

It is interesting to note that sub-clause uses the word 'at termination' rather than on termination/modification or for termination/ modification. It appears that any payment at the time of termination even if it is not a consideration to terminate the contract will be taxable. The ambit of the provision is made wider with the use of 'in connection with'. Thus, even if some payment arises after termination but can be said to be in connection with the termination/ modification, the sum may be taxable.

Termination or the modification of the terms and conditions

The provision seeks to tax any payment or compensation arising on modification of the terms of the contract. If a contract relating to business is modified by mutual consent, it is presumed that the business continues though rights and obligations under the contract are varied. Any income arising out of such modification may be taxable even without this amendment. Perhaps the intention is to tax those receipts which may have a character of changing the profit-making apparatus or source of income.

The terms may also be varied by unilateral action of one party which is later accepted by the other in consideration of additional payment. Such payments which are not in fact income from business - sale of goods or services - may also fall within the ambit of this sub-clause.

Parties to a contract may be discharged from their obligations under the contract by mutual consent, by breach of either party or by frustration, impossibility of performance etc. The use of word 'termination' implies that the contract

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comes to an end by action of one or both the parties. The contract itself may provide for payment of compensation, damages etc. However, if a contract becomes void, impossible to perform due to factors beyond the control of the contracting parties like war or destruction of property etc., any party who has obtained some benefit under the contract is bound to return it. Such payments flowing from principle of equity cannot be rightly described as income of the other party. For instance, a party may return the advance received from the other goods, or a party avoiding a voidable contract may return any sum received by it.

Any contract relating to his business

The payment received in connection with any contract – agreement enforceable by law - 'relating to' the business of the assessee is proposed to be covered. The word 'relating to' has been held to be one of comprehensiveness and equivalent to 'pertaining to' and 'in relation to' [*Doypack Systems (Pvt) Ltd v. UOI, 1988 (36) E.L.T. 201 (S.C.)]*. The words presuppose a different subject matter and can have direct and indirect significance depending on the context. It would thus appear that if a contract has some kind of nexus with the business of the assessee though it may not be in course of the profit-earning activity or the main business of the assessee.

Implications on certain payments

It is not possible to draw up an exhaustive list of payment which may arise in course of business and attract the proposed sub-clause. Let us look at certain receipts which may arise at termination or breach of a contract and their taxability in terms of the proposed sub-clause (e).

Receipt	**Present position**	**Coverage under proposed sub-clause (e)**
Receipt of sums pursuant to Arbitration (award and interest)	Interest received on arbitration award has generally been held to be revenue in nature but there are contrary rulings on whether the award itself is capital receipt [(2010) 42 SOT 1 (Mumbai), (2010) 123 ITD 153 (Mumbai)]	Being an amount received 'in connection with' and 'at termination of a contract' relating to business, the award might be taxable as a business receipt
Court awarded damages	Where the Court awarded damages after specific performance of contract to transfer factory land was denied, the receipt is not taxable as capital gains [(2015) 58 taxmann.com 199 (Bombay)]	This could be an amount received at termination of a contract relating to business
Compensation for loss without contractual obligation to do so	Where the parent company compensated the subsidiary	The amount is received as a measure of restitution. It does not arise

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Receipt	Present position	Coverage under proposed sub-clause (e)
	for loss sustained without any contractual obligation, the amount represented causal no recurring receipts and was not taxable as business income [(1987) 165 ITR 416]	out of the contract between the subsidiary and the other party and the payment is made by a third party.

To conclude

The proposed amendment seeks to overrule many judicial rulings, particularly the concept of capital receipts being outside the ambit of income tax. Though the amendment is quite wide in its scope, there is still a need to closely examine the taxability of compensation/ amounts received under different circumstances in the light of existing jurisprudence.

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Key amendments proposed in Finance Bill 2018

Finance Bill 2018 was introduced in the Indian Parliament by the Finance Minister on 01st February 2018 proposing a host of amendments to Income-tax Act, 1961, seeking to ensure tax compliance, providing relief to start-ups as also aligning the provisions of the IT Act with the recommendations of OECD in BEPS reports and with provisions of Multilateral Instrument (MLI) signed by India in June 2017.

Some of the key changes proposed are: -

Taxation of Long Term Capital Gains (LTCG) on transfer of certain securities

An amendment is proposed to tax capital gains made by the transferor on sale of such securities under LTCG tax if gains exceed INR 1 lakh (INR 100,000) in a year. The rate of taxation is proposed to be at 10% without any benefit of indexation (calculation of cost of acquisition of asset after taking into account indexed inflation). However, this tax will be applicable only on transfers made on or after 1st April, 2018. Provisions have been proposed to grandfather all capital gains accrued on past investments upto 31st January, 2018. In terms of the proposed amendment, the cost to acquisition of an asset acquired before 1-2-2018 will be the higher of actual cost of acquisition and lower of the fair market value and full value of consideration of the transfer of the asset.

Presently Long Term Capital Gains (LTCG) on transfer of listed equity shares, units of equity oriented fund and units of business trusts (held for more than twelve months) do not attract LTCG tax provided Securities Transaction Tax (STT), as applicable, is paid on such transfers. According to the Memorandum to Finance Bill 2018 (the

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Memorandum), this amendment seeks to minimise economic distortions and curb erosion of tax base.

Tax benefits to transactions in International Financial Service Centre (IFSC)

Section 47 listing transactions not regarded as transfer for purposes of capital gains is proposed to be amended by inserting clause (viiab) to include transfer of bond or GDR or rupee denominated bond made by a non-resident on a recognised stock exchange located in any International Financial Service Centre (IFSC) in India. The condition is that consideration for such transaction is paid or payable in foreign currency. Benefit will also be available in cases of transfer of derivatives by non-resident on floor of recognised stock exchange in IFSC.

Currently if any transfer of bonds, Global Depository Receipts (GDR) or rupee denominated bond of an Indian Company (bond issued outside India) is made outside India by a non-resident to another non-resident, such transfer is considered as tax neutral transfer and is not subject to capital gains tax.

Reduction in corporate tax rate for domestic companies having turnover upto INR 250 crores (INR 2.5 Billion)

The rate of corporate tax for domestic companies whose total turnover or gross receipts do not exceed INR 250 crores in financial year 2016-17 is proposed to be reduced from 30% to 25% (exclusive of surcharge and cess). No similar reduction in tax rate has been proposed in respect of foreign companies.

Amendments proposed as regard provisions of Minimum Alternate Tax (MAT)

Non-applicability in case of certain foreign companies opting for presumptive taxation

An amendment is proposed to be made to Section 115JB by inserting Explanation 4A to clarify that MAT provisions would not be applicable to a foreign company engaged in certain specified business which opts for presumptive taxation in respect of income. The specified businesses include operation of ships, provision of services or facilities in connection with prospecting for or extraction or production of mineral oil, operation of aircraft or civil construction etc. in turnkey power projects. This amendment is proposed to be applicable retrospectively from 1st April 2001.

Benefits for companies seeking rehabilitation under Insolvency law

An amendment is proposed to be made to allow deduction of both brought forward losses and unabsorbed depreciation for calculation of book profits on which MAT rate is applied. This benefit will be available if application for insolvency resolution process has been admitted under Insolvency and Bankruptcy Code, 2016 (IBC, 2016). Currently, for purposes of computation of 'book profits' of a company under MAT, deduction of either loss brought forward or unabsorbed depreciation, whichever is less is allowed. Also, another amendment is proposed to be made for allowing carry forward and set off of losses even if there is change in shareholding provided such change in such shareholding is in pursuance of an approved resolution plan under IBC, 2016.

Widening of scope of business connection to tax income in India

An important amendment pertains to the proposed substitution of Clause (a) in Explanation 2 to Section 9(1) and insertion of Explanation 2A to include the concept of 'Significant Economic Presence' (instead of physical presence) to constitute business connection of foreign enterprise in India.

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As per proposed Clause (a) business activity carried out through a person who is acting on behalf of a non-resident and who has the authority or habitually concludes contracts or habitually plays the principal role on conclusion of contract by the non-resident wherein:

- the contracts are in the name of the non-resident or
- for the transfer of ownership
- for provision of services by the non-resident

Explanation 2A (Proposed) clarifies that significant economic presence of a non-resident will constitute business connection in India. Significant economic presence will mean:

i. any transaction in respect of any goods, services or property carried out by a non-resident in India including provision of download of data or software in India if the aggregate of payments arising from such transaction or transactions during the previous year exceeds the amount as may be prescribed; or
ii. systematic and continuous soliciting of its business activities or engaging in interaction with such number of users as may be prescribed, in India through digital means.

The transactions or activities shall constitute significant economic presence in India, whether or not the non-resident has a residence or place of business in India or renders services in India.

The scope of 'business connection' defined under the domestic law is sought to be amended to bring the same in line with the provisions of the Multilateral Convention to Implement Tax Treaty Related Measures ('MLI') and DTAAs. MLI has widened the scope of Dependent Agent Permanent Establishment ('DAPE'). Whereby if a person, acting on behalf of an enterprise, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, subject to other conditions, will lead to constitution of Permanent Establishment. However, it is significant to note unless any corresponding amendment is made in DTAAs, the benefit of DTAAs will be available to foreign enterprises.

Deemed Dividend taxation in hands of payer company

An amendment is proposed to be made to charge Dividend Distribution Tax (DDT) on any dividend in form of loan or advance by a company to its shareholder to the extent of accumulated profits ('deemed dividend'), in the hands of the company giving advance or loan. The rate of DDT will be a 30% on deemed dividend in the form of advances or loans to shareholders. This is higher than normal rate of DDT applicable on other forms of dividend/ deemed dividend which is 15%.

The memorandum states that the present provision of taxing such in the hands of recipient shareholder has been subject of extensive litigation and has posed serious problems in collection. Thus the changes have been proposed in Section 115-O to tax this dividend.

Taxation of compensation

Amendments are proposed to Section 28 and Section 56 to tax compensation received on termination or modification of terms of any contract relating to business as also compensation received by a person in connection with termination or modification of the terms of his employment. The memorandum states that these amendments will enable taxation of compensation irrespective of their nature being capital or revenue in nature.

Conversion of stock in trade

Amendments are proposed to Section 2(24), Section 2(42A), Section 28 and Section 49 to tax profits from conversion of stock-in-trade into

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capital asset. As per the proposed amendment, any profits or gains arising from conversion of stock-in-trade as capital asset will be taxed as profits and gains of business or profession. The profits will be the difference between the purchase price of the stock-in-trade and the fair market value of the same on the date of conversion. The profits will be taxable in the year of conversion.

Further, after the conversion into capital asset if there is subsequent transfer of such capital asset, the fair market value on the date of conversion will be considered as cost of acquisition and the period of holding such capital asset will be reckoned from the date of conversion.

Section 80JJAA

An amendment is proposed to Section 80JJAA to extend the benefit of additional deduction of 30% in respect of emoluments paid to eligible new employees in footwear and leather products industry who have been employed for a minimum period of 150 days during the year (instead of 240 days in normal cases). Currently, the relaxation of 150 days is available to manufacturing of apparel industry only.

Further, the benefit of additional deduction will be allowed even if the new employee is employed for less than the minimum period i.e. 150 days/240 days as applicable in the previous year but continues to be employed for the minimum period in the subsequent year.

Tax neutral transfers

An amendment is proposed to be made in Section 56 to exclude transfer of a capital asset from a Holding Company to its Wholly Owned Indian Subsidiary and a transfer by a Wholly Owned Indian Subsidiary to its Holding Company from ambit of taxation under this provision. These transfers are already not considered as transfers for purposes of capital gains tax.

New scheme for scrutiny assessment

An amendment is proposed to Section 143 to restrict the scope of adjustments allowed while computing total income or loss. The amendment proposes to provide that no adjustments can be made in respect of addition of income appearing in Form 26AS of Form 16A of Form 16 which has not been included in computing the total income in the return.

It is also proposed to eliminate interface between the Assessing Officer and the assessee in the course of proceedings to the extent technologically feasible and to introduce a team-based assessment with dynamic jurisdiction. The central government will prescribe the new scheme for scrutiny assessments by notification in the Official Gazette.

ICDS

Finance Bill proposes to insert new provisions and amend existing provisions in respect of Income Computation and Disclosure Standards (ICDS). Some of the significant changes are discussed below:

- Amendment to Section 36 to allow deduction in respect of marked to market loss or other expected loss computed in accordance with ICDS;
- Amendment to Section 40A to restrict the scope of deduction in respect of marked to market losses only to deduction under the newly inserted clause (xviii) of Section 36(1);
- Insert a new section 43AA to provide that subject to Section 43A, any gains or loss arising on account of effects of changes in foreign exchange rates in respect of specified foreign currency transaction shall be computed in manner provided in ICDS;
- Insert a new section 43CB to provide that the profits arising from a construction contract or

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a contract for providing services shall be determined on percentage of completion method except for certain service contracts, and that the contract revenue shall include retention money, and contract cost shall not be reduced by incidental interest, dividend and capital gains

- Amendment to Section 145A to provide that value of inventory shall be made at lower of actual cost or net realizable value computed as per ICDS;
  - To provide that value of purchase and sale of goods or services and of inventory shall be adjusted to include amount of any tax, duty, cess or fees actually paid or incurred to bring the goods or services to the place of location and condition as on the date of valuation;
  - To provide that the inventory being securities not listed or listed but not quoted on recognized stock exchange shall be valued at actual cost recognized in the manner provided in ICDS;
  - value of inventory, being listed securities shall be made at lower of actual cost or net realizable value computed as per ICDS and for this purpose the comparision of actual cost and net realizable value shall be done category-wise
- Insertion of new Section 145B to provide that
  - Interest received on compensation or enhanced compensation shall be deemed as income of the year in which it is received;
  - Claim for escalation of price in a contract or export incentives shall be deemed to be the income of the previous year in which certainty of realization is achieved;
  - Subsidy or grant or cash incentive or duty drawback or waiver or concession or reimbursement as specified in Section 2(24)(xviii) received by a person shall be deemed as income of previous year in which it is received, if not charged to income-tax for any earlier previous year.

Time limit for filing of Country by Country Reporting (CbCR)

An amendment is proposed to be made in provisions relating to furnishing of CbCR.

The due date for furnishing of CbCR is proposed to be extended to 12 months from the end of reporting accounting year. This provision will apply to parent entity or Alternative Reporting Entity (ARE), resident of India, and also to constituent entity in India, having a non-resident parent entity.

It also proposes to clarify that constituent entity in India is required to furnish CbCR if the non-resident parent entity, is not furnishing such report in its jurisdiction. These changes will be effective from 1st April, 2017.

Ratio Decidendi

No TDS on salary paid in India to employees deputed abroad

Authority for Advance Ruling has held that the employer would not be obliged to withhold tax, at the time of payment in India, from the salary of employees sent abroad for rendering services to a foreign company. It was held that salaries received in India by the assignees (employees) but accrued outside India, would not be taxable in India. Considering various provisions of the DTAA and Income Tax Act, it was observed that income earned by employees from services rendered abroad would be chargeable to tax

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abroad and not in India, for the period of their deputation.

In respect of the period when the employees become Indian residents on return to India, it was also held that the Indian company may consider credit for taxes paid outside India in terms of provisions of respective DTAA, after verification as required by Income Tax s.192(2). The Authority noted that that when payments are received by these employees from more than one source during a particular year, the provisions of Section 192(2) will apply, and the present employer can give credit for the taxes deducted during their deputation outside India. [In Re: *Hewlett Packard India Software Operation Private Limited* – Order dated 29-1-2018 in A.A.R. No. 1217 of 2011, Authority for Advance Rulings]

TDS liability on purchase from foreign vendor

In a case where the person in India (assessee) had not deducted tax under provisions of Section 195 of the Income Tax Act, 1961, ITAT Hyderabad has held that liability of the assessee precedes the liability of the vendors from whom the assessee had purchased the property. The Tribunal in this regard was also of the view that the liability of the assessee under said provisions is different from the liability of the vendors to admit the capital gains in their hands.

Assessee's claim that since he has paid the sale consideration to the GPA holder in India, he is not required to deduct tax, was rejected by the Tribunal holding that GPA holder is only a conduit between the assessee and the owners of the property and therefore, in true sense, the payment was made to the non-residents only. Article 26 of the India-USA DTAA, relating to non-discrimination with non-residents, was also found not applicable by the Tribunal here. The assessee voluntarily paid the tax on long term gains. But the Assessing Officer disputed the amount holding that Section 50C would be applicable and the value for stamp duty purposes has to be taken as consideration. But the Tribunal held that for purposes of deduction of TDS, actual consideration paid is relevant and Section 50C should not be invoked. It was also held that the assessee cannot be treated as an "assessee in default" under Section 201(1) of the Income Tax Act, but would only be liable to interest under Section 201(1A) till the date of payment of taxes by him. [*Bhagwandas Nagla* v. *ITO (International Taxation)* – Order dated 25-1-2018 in ITA No. 143/Hyd/2017, ITAT Hyderabad]

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