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The only receipt that remains tax-exempt

The receipt, which is still exempt, is compensation for giving up the right to sue

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For a receipt to be taxed, it has to be an income, either in the normal sense or as specifically defined in the tax laws, under the extended definition. If the receipt does not fall within either of these categories, it cannot be taxed at all. Photo: iStock

Today, under our tax laws, almost every conceivable receipt is taxable, unless there is a specific exemption in the law. Even gifts, which are normally not considered as income, are taxable, on account of a specific provision taxing all amounts received without

consideration, excepting those specified in that provision. However, a recent tribunal decision has highlighted the fact that there is still one category of receipt which continues to remain not taxable, in spite of the fact that there is no specific exemption under the tax laws for such receipt. This receipt, which is still exempt, is compensation for giving up the right to sue.

In a recent decision before the Mumbai tribunal, a film actor had invested in a company, where the other shareholders desired to sell their shares. The actor was not willing to sell his shares, and refused to sign the mandate to be given to the merchant bankers to sell the shares at the best possible price. He, however, found later that his signature was forged on a sale mandate given to the merchant bankers, and filed a criminal complaint with the economic offences wing of the police in respect of such forgery.

Subsequently, the matter was settled, with the actor receiving a compensation for withdrawal of the criminal complaint, only on withdrawal of the complaint. He claimed that such compensation was not taxable, as it was a capital receipt. The tax authorities, however, sought to tax such compensation as his income.

The tribunal confirmed that the receipt by the actor was a capital receipt, being in the nature of damages or compensation for settlement of the dispute relating to forgery of his signature. Such a receipt did not fall within the definition of income under the tax law and was, therefore, not taxable at all. The tribunal relied on certain earlier decisions of the Bombay high court and the Mumbai tribunal, where a similar view had been taken.

The tribunal, however, did not consider the applicability of the provision relating to taxability of receipts without consideration. Can such compensation be regarded as taxable under that provision? In this case, the compensation was received for withdrawal of the criminal complaint. Therefore, the consideration for receipt of the compensation was the act of withdrawal of the criminal complaint; i.e., the compensation was for giving up the right to prosecute or sue. Therefore, the compensation was received for a consideration, and such provision would not apply.

A capital receipt may be taxable as a capital gain. However, for a capital gain to be taxable, there has to be transfer of a capital asset. A capital asset is defined as property of any kind, and, under the Transfer of Property Act, the right to sue is not property. Therefore, there being no transfer of a capital asset on giving up the right to sue, such compensation is not chargeable to tax at all.

The principle of this decision would also apply to various other kinds of personal receipts, such as compensation received in respect of a consumer complaint, compensation granted by the Motor Accidents Claims Tribunal in respect of an accident, compensation

received from airlines for deficiency in service or loss of baggage, etc. All such receipts would continue to be exempt under our tax laws, as they would not be in the nature of income at all.

In the earlier Mumbai tribunal decision also, compensation was received by a non-resident from his power of attorney holder, who had fraudulently sold certain assets of the non-resident, and misappropriated the proceeds. The criminal complaint which was filed against her by the non-resident was settled by payment of the misappropriated amount, and compensation or damages. The tribunal held that the compensation received was not taxable, as it was not an income, being for personal damage caused to the non-resident due to breach of trust or fraud.

The Bombay high court decision related to a company, which had sued its employees, who had left and joined a competitor, for divulging confidential information relating to technical knowhow of the company to the competitor. The suit by the company against the employees and the competitor for damages was settled, with the competitor paying compensation to the company. The receipt was held to be a capital receipt by the high court.

Therefore, for a receipt to be taxed, it has to be an income, either in the normal sense or as specifically defined in the tax laws, under the extended definition. If the receipt does not fall within either of these categories, it cannot be taxed at all. Capital receipts are taxable only if they arise on account of transfer of a capital asset, and are taxable as capital gains.

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