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Sacked employees paid off a lump sum will now have to pay tax on compensation received

BY ET BUREAU | FEB 03, 2018, 07.16 AM IST

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MUMBAI: [Sacked employees](#) receiving compensation, business tycoons collecting fat no-compete fee, and trade partners who were paid off a lump sum after their contracts were scrapped often ended up having spats with the tax office over the taxability of such payments.

Several disputes boiled over to [tax tribunals](#) and higher courts, where men and women who were compensated argued that the amount should not be taxed as they have lost their source of earnings. However, assessing officers found grounds to contest the claim.

They said earnings were not entirely or permanently extinguished as many took up new jobs and some pursued related activities after an interval. Situations differing from case to case.

But from next year, such court feuds will come to an end. "As per the proposed amendment every type of compensation received by an assessee in connection with the termination of contract, even if it relates to compensation for loss of source of income will be chargeable to tax. So far, by an arrangement or agreement the assessee was able to avoid payment of tax if the compensation was attributed to loss of source of income," said senior chartered accountant Dilip Lakhani.

According to Sanjay Sanghvi, Senior Tax Partner, Khaitan & Co, the amendment (proposed in the Budget) intends to expand the scope of taxability of compensation received in connection with termination or modification of terms of employment, or terms and conditions of a contract relating to business, as 'revenue income'.

"This is to overcome some judicial rulings where it was held that such receipts may not be taxable being capital in nature," said Sanghvi.



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The legal disputes took various forms: one of the large liquor companies had claimed a revenue expenditure of Rs. 5.31 crore on account of lease foreclosure payment made to its distributor who did not declare this gain in its annual tax return. As per the memorandum of agreement, the distributor had agreed to transfer the running concern to the liquor company and receive "reasonable compensation". On appeal, the first [Appellate Authority](#) held that the compensation received by the assessee cannot be brought under tax even as capital gain. In another case, the court ruled in favour of a partner in a consultancy firm who was compensated after the businesses of firm was transferred to one of the Big Four consultants.

Section 28 (ii) of the [Income-tax Act](#) taxes certain compensations received by any person for any change in terms or termination of agency, management of an office or management of a company.

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"However, there was no explicit provision regarding compensation for termination or modification of a contract during his business or profession. There were several rulings which used to treat such amount as capital receipt, hence were out of the tax net. The proposed amendment in Section 28 in Finance Bill, 2018 seeks to widen the base and intends to tax such receipts as business income," said Amit Maheshwari, Partner at chartered accountants Ashok Maheshwary & Associates LLP.

On a matter related to invocation of land acquisition law, the district collector in a southern state had acquired a part of the land from a company for the purpose of construction of a railway siding and a compensation was awarded to the party. On appeal, the compensation was recognised as capital receipt.

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