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Withholding tax compliance by tenant cannot be sole reason for taxability of rent

The Mumbai Bench of the Income-tax Appellate Tribunal (ITAT) rendered its decision that rental income could be brought to tax only when the taxpayer has actually received it or is likely to receive or has certainty of receiving it in the near future; the fact that tenant has deducted tax cannot be the sole reason for taxability of rent.

Background:

- The taxpayer[1] is engaged in the business of leasing commercial properties to earn lease rentals and maintaining properties for capital appreciation.
- The taxpayer had entered into a rental agreement with the tenant (for its property at Vashi, Navi Mumbai), who made the payment of rent as well as reimbursement of electricity expenses regularly up to Financial Year (FY) 2009-10, corresponding to Assessment Year (AY) 2010-11.

  Thereafter, due to financial constraints / problems, the tenant did not make any payments towards rent from FY 2010-11, corresponding to AY 2011-12. After lot of persuasion, the tenant paid some portion of the rent for FY 2010-11, corresponding to AY 2011-12.

  The tenant vacated the premises in November 2011.
- Though the tenant had made TDS deduction and deposited the same into the government account, no rent was received by the taxpayer for FY 2011-12, corresponding to AY 2012-13. Therefore, the taxpayer did not disclose such rental income in its income-tax return for FY 2011-12, corresponding to AY 2012-13. The taxpayer also took support of Rule 4 of the Income-tax Rules, 1962 (Rules).

  As per Rule 4 of the Rules, the amount of rent which the owner cannot realise shall be equal to the amount of rent payable but not paid by a tenant of the taxpayer and so proved to be lost and irrecoverable where:

  a) the tenancy is bona fide;

  b) the defaulting tenant has vacated, or steps have been taken to compel him to vacate the property;

  c) the defaulting tenant is not in occupation of any other property of the taxpayer;

  d) the taxpayer has taken all reasonable steps to institute legal proceedings for the recovery of the unpaid rent or satisfies the Assessing Officer (AO) that legal proceedings would be useless.
- During the audit proceedings for the assessment year 2012-2013, the AO rejected the taxpayer's submission with the following observations:

[1] Vishwaroop Infotech Pvt. Ltd. v. ACIT (I.T.A. No. 633/Mum/2019) (Mumbai ITAT)

- The taxpayer was following mercantile method of accounting, therefore income had to be disclosed on accrual basis.
- The tenant was deducting tax at source (TDS) at the time of crediting the amount of rent and depositing the same into the government account.
- The taxpayer had taken into account the claim of TDS in the income-tax return.
- Though the taxpayer satisfied the first 3 conditions of Rule 4 of the Rules, the taxpayer had not satisfied the fourth condition as the taxpayer had neither furnished any documentary evidences for instituting any legal proceedings against the tenant for recovery of outstanding rent, nor proved that institution of legal proceedings was useless.

Based on the above, the AO added the unrealised rent to the total income of the taxpayer.

- On appeal the Commissioner of Income-tax (Appeals) [CIT(A)] upheld the AO's order. Further, the CIT(A) directed the AO to tax the security deposit retained by the taxpayer on vacation of the premises by the tenant.
- Aggrieved by the CIT(A)'s order, the taxpayer filed an appeal before the Mumbai Bench of the Income-tax Appellate Tribunal (ITAT).

Decision of the ITAT:

- The ITAT noted the following:
  - From the material placed on record, since the taxpayer could not recover the rent for the period under consideration (viz. FY 2011-12, corresponding to AY 2012-13), the taxpayer did not declare the rental income in its income-tax return.
  - The taxpayer had to safeguard its interest and initiating litigation against the big business house (i.e. tenant) that too having financial problem would have been fruitless and it would have been at huge cost.
  - It was also in the interest of the taxpayer, if it could recover the rent. The reason disclosed by the taxpayer to close the dispute amicably and recovering certain amount from the tenant, which was having financial problem itself, was a huge task.
  - The tenant had not paid the rent to the taxpayer and the taxpayer had no certainty of receiving any rent.
  - Any security / rental deposit available was to be adjusted first for old outstanding (i.e. outstanding for FY 2010-11, corresponding to AY 2011-12) and if there was any amount remaining unadjusted, the extra rental advance was to be adjusted against the outstanding for current AY (viz. AY 2012-13).
- In view of the above, the ITAT held that:

- The situation in the present case amply displayed that institution of legal proceedings would have been useless and the AO had failed to understand the situation and failed to appreciate the settlement reached by the taxpayer.
- The rental income could be brought to tax only when the taxpayer had actually received or was likely to receive or had certainty of receiving in the near future. In the given case, the taxpayer had no certainty of receipt of any rent. When the taxpayer reached an agreement to settle the dispute, it was equal to satisfying the fourth condition in the Rule 4 of the Rules. Therefore, the addition of rent was unjustified and was to be deleted.
- The fact that tenant had deducted TDS and declared the same in the TDS return, alone could not be the reason to sustain the rental income.

Accordingly, the ITAT directed the AO to delete the addition of unrealised rent. Further, considering that the taxpayer had taken credit of the TDS, the ITAT directed the AO to tax the same as income from house property. The security deposit was to be adjusted against the outstanding rent and accordingly, was not to be taxed separately in the hands of the taxpayer.

Comment:

This ruling lays down the principle that rental income could be brought to tax only when the taxpayer has actually received it or is likely to receive or has certainty of receiving it in the near future; and the fact that tax has been deducted by the tenant cannot be the sole reason for taxability of rent. Taxpayers with similar facts may want to evaluate the impact of this ruling to the facts of their case.

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