



Tax alert: Compensation for non-renewal of contract is capital receipt, not taxable

24 September 2024

The Delhi Bench of the Income-tax Appellate Tribunal (ITAT), based on facts, has rendered its decision that the taxpayer being a freelancer, the compensation received from the taxpayer's contracting company for non-renewal of contract would be a capital receipt, neither taxable as 'Income from business or profession' under section 28(ii)(e) of the Income-tax Act, 1961 (ITA) nor as 'Income from other sources' under section 56(2)(xi) of the ITA.

In a nutshell



The word 'business' occurring in section 32(1)(iv) of the ITA cannot not be said to include the profession as well. By the same analogy, reference to business in section 28(ii)(e) of the ITA would not amount to reference to 'profession'.



Non-renewal does not mean 'termination'. Further, non-renewal of any contract does not amount to 'retrenchment' under section 2(zh) of the Industrial Relations Code, 2020.



Provisions of sections 28(ii)(e) and 56(2)(xi) of the ITA would not be applicable on compensation received by taxpayer (in course of its 'profession') on account of non-renewal of contract.



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Background:

- The taxpayer¹ is an individual freelance journalist.
- The taxpayer:
 - Had entered into a contract with a company (C Co) which was not renewed and came to an end.
 - The taxpayer raised a labour dispute and later, the parties arrived at an amicable settlement whereby C Co paid an amount (say INR X) to the taxpayer in full and final settlement and the dues arising out of the labour dispute raised by the taxpayer.
 - Filed her income-tax return for the Financial Year (FY) 2019-20 relevant to the Assessment Year (AY) 2020-21 without including a compensation received from a company (C Co) amounting to say INR X on the basis that the same was a capital receipt and exempt under section 4 of the Income-tax Act, 1961 (ITA) [relating to charge of income-tax].

However, the taxpayer, out of abundant precaution and to avoid future levy of interest, paid self-assessment tax and accordingly, claimed refund in its return of income.

- During the course of audit proceedings for the year under consideration, the Assessing Officer (AO) held that the said compensation was taxable under section 28(ii)(e) of the ITA [relating to certain compensation received taxable as business income] read with earlier circular² issued by the Central Board of Direct Taxes (CBDT), as income from business.

The AO relied upon the provisions of section 28(ii)(e) of the ITA and also drew support from the provisions of section 56(2)(xi) of the ITA [relating to certain compensation received taxable as 'Income from other sources'] and held that the exemption claimed by the taxpayer in respect of the said receipt on termination of contract should be treated as taxable receipt and added back to the taxpayer's total income.

- Aggrieved, the taxpayer filed an appeal and in the course of the appellate proceedings, the matter reached before the Delhi Bench of the Income-tax Appellate Tribunal (ITAT).

Relevant provisions in brief:

Extracts of sections 28(ii)(e) and 56(2)(xi) of the ITA:

"Section 28: Profits and gains of business or profession.

The following income shall be chargeable to income-tax under the head "Profits and gains of business or profession",—

.....

(ii) any compensation or other payment due to or received by-

.....

(e) any person, by whatever name called, at or in connection with the termination or the modification of the terms and conditions, as the case may be, of any contract relating to his business"

"Section 56: Income from other sources.

56(2) In particular, and without prejudice to the generality of the provisions of sub-section (1), the following incomes, shall be chargeable to income-tax under the head "Income from other sources", namely :—

.....

¹ Ms. Padma Rao vs. CIT 61(1), New Delhi [2024] ITA No. 2759/Del/2023 (Delhi- Trib.)

² Circular No. 8/2018 dated 26 December 2018

(xi) Any compensation or other payment due to or received by any person by whatever name called in connection with termination of his employment or modification of the terms and conditions relating thereto.

Decision of the ITAT:

The ITAT noted / observed as follows:

Whether 'Business' would include 'Profession'?

- As per provisions of section 28(ii)(e) of the ITA, any compensation received by any person **on termination** or modification of the terms and conditions of any contract **relating to his business** is taxable under the head 'Profits and gains of business or profession'. Hence, whether reference to **'business'** includes 'profession'?
- Wherever the Legislature thought of referring to both 'Business' and 'Profession', it used both the words in the enactment which means that wherever the word only 'Business' is used, it does **not** include 'Profession'.
- Reference to section 28(va) of the ITA which provides as under:
*"any sum, whether received or receivable in cash or kind, under an agreement for –
(a) not carrying out any activity in relation to **any business; or profession** -----"*
- The phrase 'or profession' was inserted by the Finance Act, 2016 w.e.f. 1 April 2017 which makes the intent of the Legislature absolutely clear that the Legislature wanted the insertion of the word 'Profession' along with 'Business'. This was fortified by an earlier ruling³ of the Supreme Court (SC) which, *inter-alia*, held that:
"If the expression "business" is interpreted to include within its scope "profession" as well, it would be doing violence to the provisions of the Act. Such interpretation would amount to first creating an imaginative lacuna and then filling it up, which is not permissible in law."
- The SC, in the above case, made it clear that the word 'business' occurring in section 32(1)(iv) of the ITA could not be said to include profession as well. By the same analogy, reference to business in section 28(ii)(e)⁴ of the ITA would not amount to reference to profession.

Interpretation of word 'termination'

- Whether the compensation was received on 'termination' or 'modification of terms and conditions of any contract' as per section 28(ii)(e) of the ITA?
- The word 'termination' is used in reference to any on-going contract whereas the case of the taxpayer was non-renewal of contract. Non-renewal did not mean 'termination'. The taxpayer was a freelance journalist and not under employment of C Co. Therefore, there was no employer-employee relationship. As per relevant clauses of the agreement, since the contract was not renewed, it came to an end.
- Compensation received by the taxpayer was by way of mutual agreement between C Co and the taxpayer.
- It would be pertinent to refer to section 2(zh) of the Industrial Relations Code, 2020 which, *inter-alia*, provides as follows:
"retrenchment" means the termination by the employer of the service of a worker for any reason whatsoever, otherwise than as a punishment inflicted by way of disciplinary action, but does not include...
...(iii) termination of the service of the worker as a result of the non-renewal of the contract of employment between the employer and the worker concerned on its expiry or of such contract being terminated under a stipulation in that behalf contained therein; or ..."

³ G.K. Choksi & Co. (2007) 295 ITR 376 (SC)

⁴ The ruling mentions the same as 32(ii)(e) which seems to be a typographical error.

- Hence, based on the above non-renewal of any contract did not amount to 'retrenchment'. Further, as per section 56(2)(xi) of the ITA reference is given to 'termination of employment'.

In view of the above, the ITAT held that provisions of sections 28(ii)(e) and 56(2)(xi) of the ITA did not apply in the taxpayer's case and accordingly the compensation received was on capital account and not taxable.

Comments:

Professionals may contract as a freelancer. In certain cases, they may receive certain compensation on non-renewal of contract or termination of contract. Based on factual aspects of each case, a controversy may arise as to the taxability of such compensation received.

The ITAT in this ruling, while specifically dealing with the taxability of compensation received by taxpayer on non-renewal of contract, has held as follows:

- The word 'business' occurring in section 32(1)(iv) of the ITA cannot not be said to include profession as well. By the same analogy, reference to business in section 28(ii)(e) of the ITA would not amount to reference to 'profession'.
- Non-renewal does not mean 'termination'. Further, non-renewal of any contract does not amount to 'retrenchment' under section 2(zh) of the Industrial Relations Code, 2020.
- Provisions of sections 28(ii)(e) and 56(2)(xi) of the ITA would not be applicable on compensation received by taxpayer (in course of its 'profession') on account non-renewal of contract.

Taxpayers with similar facts may want to evaluate the impact of this ruling to the specific facts of their cases.

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