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Supreme Court upholds constitutional validity of deduction of leave encashment on payment basis

The Hon'ble Supreme Court has upheld constitutional validity for the allowability of deduction for leave encashment under Section 43B(f) of the Income Tax Act, 1961, on payment basis

Facts of the case:

- Exide Industries Limited (taxpayer)¹ is an Indian company engaged in the business of manufacturing of storage batteries.
- Section 43B of the Income Tax Act, 1961 (ITA) lists down certain expenditure (e.g. tax, duty, fee, cess, etc.), deduction for which is available only on payment basis. Clause (f) to Section 43B of the ITA was introduced with effect from Financial Year (FY) 2001-02 corresponding to Assessment Year (AY) 2002-03 to restrict deduction for leave encashment only on payment basis.
- The taxpayer had filed an appeal before the Hon'ble Calcutta High Court (HC), by way of a writ petition, challenging the constitutional validity of introduction of clause (f) to Section 43B of the ITA. The contentions of the taxpayer were as follows:
 - Section 43B of the ITA is an exception to the general rule of accrual where deduction is allowed on actual payment;
 - The due date for encashment of leave does not arise in the year of creation of provision and hence, deduction cannot be subject to payment being made;
 - Section 43B of the ITA comes into operation only in limited set of cases covering statutory liability (cess, duty, tax, etc.) and liabilities created for welfare of employees. Clause (f) to Section 43B of the ITA is of a different nature and hence, cannot be included in the main section without clearly specifying the objects and reasons;
 - The case of Bharat Earth Movers² holds the field of law that leave encashment is a present liability and not contingent. The introduction of clause (f) to Section 43B of the ITA was to subjugate the principle laid down in the case of the Bharat Earth Movers².
- The Hon'ble Calcutta HC vide order dated 27 June 2007 held that clause (f) to Section 43B of the ITA is arbitrary and violates Article 14 of the Constitution of India (Constitution) on the following basis:
 - Inclusion of clause (f) to Section 43B of the ITA could be done only after disclosure of reasons which are consistent with the original enactment. The Hon'ble HC observed that there were no reasons mentioned at the time of inclusion of clause (f) to Section 43B of the ITA.
 - Leave encashment is neither a statutory liability nor a contingent liability. It is a trading liability and does not have any nexus with the original enactment of Section 43B of the ITA.

¹ 116 Taxmann.com 378 (SC)

² Bharat Earth Movers v. Commissioner of Income Tax, Karnataka [2000] 6 SCC 645

Further, clause (f) to Section 43B of the ITA was inconsistent with the original Section 43B of the ITA (introduced to plug evasion of statutory liability).

- Clause (f) to Section 43B of the ITA was inserted to nullify the case of Bharat Earth Movers².
- Aggrieved by the decision of the Hon'ble Calcutta HC, the Revenue filed an appeal before the Hon'ble Supreme Court (SC).

Decision of the Hon'ble SC:

- The Hon'ble SC relied on the case of Rakesh Kohli³ for the two-step principle to determine the constitutional validity of clause (f) to Section 43B of the ITA:
 - The appropriate legislature has the power to make / enact the law; and
 - The enacted provision does not take away / abridge any fundamental right enumerated in Part III of the Constitution.
- The Hon'ble SC noted that legislative power of the Parliament to enact clause (f) to Section 43B of the ITA was not doubted. Thus, the first principle was satisfied.
- With respect to the second principle, the Hon'ble SC held that clause (f) to Section 43B of the ITA does not contravene any right enumerated in Part III of the Constitution. The same was on the following basis:
 - Section 43B of the ITA neither stops a taxpayer from adopting a particular method of accounting nor deprives a taxpayer from any lawful deduction. It merely operates as an additional condition for the availment of a deduction.
 - Section 43B starts with a non-obstante clause that has an overriding character against any other provision of general application and thus, provisions under Section 43B of the ITA could be different from mercantile system of accounting.
 - The thrust of the provisions is not to control the timing of payment to the employee, but to control the timing of claiming the deduction.
 - Initially, Section 43B of the ITA included deductions in respect of tax, duty, contribution to provident fund and superannuation fund. Subsequently, various other deductions such as cess, bonus, interest on loan payable to financial institution or bank, etc. were included. Thus, there was no merit that the section only provides for deductions concerning statutory liabilities.
 - An employer could claim the deduction from tax liability in advance, in lieu of leave encashment, without making any actual payment to the employee when due to him. Clause (f) to Section 43B of the ITA was enacted to remedy this particular mischief and the concerns of public good, employees' welfare and prevention of fraud on Revenue and hence, should receive a liberal construction in government's favour.
- Further, the Hon'ble SC examined the following three points based on which the Hon'ble Calcutta HC in the case under consideration, had held that the introduction of clause (f) to Section 43B of the ITA was not constitutionally valid:
 1. Non-disclosure of objects and reasons for its introduction;

³ State of Madhya Pradesh v. Rakesh Kohli & Anr. [2012] 6 SCC 312

2. Inconsistency and absence of nexus with Section 43B of the ITA
3. Enactment was to nullify the dictum in Bharat Earth Movers⁴ case

Non-disclosure of objects and reasons:

- The Hon'ble SC observed that when the Court examines validity of a provision, it first tests the literal interpretation. When the text is ambiguous and can have multiple meanings, the Court examines real meaning of the provision.
- The objects and reasons may be useful for limited purpose to understand the surrounding circumstances at the time of enactment and for appreciating the true intent / object of the legislature for the enactment of the provision. The Court is not bound by such external elements in interpreting a provision.
- Based on the above, the Hon'ble SC held that non-disclosure of objects and reasons would not render a provision unconstitutional unless, the provision is ambiguous and the possible interpretation leads to constitutional infirmity. Considering that no such infirmity was observed by the Hon'ble Calcutta HC in the case under consideration, the Hon'ble SC held that disclosure of objects and reasons was not required while enacting Clause (f) to Section 43B of the ITA.

Inconsistency and absence of nexus with Section 43B of the ITA

- The Hon'ble SC observed that Section 43B of the ITA has evolved from its original enactment in 1983, covering diverse nature of deductions, ranging from tax, duty, bonus, commission, railway fee, interest on loans and general provisions for welfare of employees. Thus, the Hon'ble SC held that there is no restriction under Section 43B of the ITA to include only a particular type of deduction.
- Further, the Hon'ble SC held that the broad objective of Section 43B of the ITA was to protect larger public interest primarily of Revenue (including welfare of the employees). Thus, clause (f) to Section 43B of the ITA fit into the scheme and shared sufficient nexus with the broad objective.

Enactment was to nullify the dictum in Bharat Earth Movers⁵ case

- The Hon'ble SC in Bharat Earth mover's case had held that deduction for leave encashment could be claimed on accrual basis (even if the payment for the same was pending) as leave encashment is present and definite liability and not a contingent liability.
- The Hon'ble SC held that merely because a liability was held to be a present liability by the Hon'ble SC in Bharat Earth Movers⁴ case, it did not restrict the legislature to correct the mischief by enacting a new provision.
- Further, amendment by way of clause (f) to Section 43B of the ITA neither reversed the nature of liability nor took away the deduction from taxpayers. Leave encashment continued to be a present liability as per the mercantile system of accounting even after the amendment. The amendment only deferred the timing of deduction to be availed by taxpayers i.e. on actual payment.
- Thus, the Hon'ble SC held that the sole purpose for insertion of clause (f) to Section 43B of the ITA was not to defeat the dictum in Bharat Earth Movers⁵ case.

⁴ Bharat Earth Movers v. Commissioner of Income Tax, Karnataka [2000] 6 SCC 645

⁵ Bharat Earth Movers v. Commissioner of Income Tax, Karnataka [2000] 6 SCC 645

Based on the above, the Hon'ble SC upheld the constitutional validity of inclusion of clause (f) to Section 43B of the ITA pertaining to availability of deduction of leave encashment on payment basis.

Observations:

- This ruling reiterates the following two key principles which are relevant for determining the constitutional validity of a provision:
 - The appropriate legislature should have the power to make / enact the law; and
 - The enacted provision should not take away / abridge any fundamental right enumerated in Part III of the Constitution.
- This ruling lays also down the following key principles which may be relevant for taxpayers:
 - Objects and reasons may be useful for limited purpose to understand the surrounding circumstances at the time of enactment and for appreciating the true intent / object of the legislature for the enactment of the provision. The Court while passing a judgement is not bound by such external elements.
 - The legislature can curb mischief with a prospective amendment.



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