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Direct Tax Alert

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Supreme Court rules on the tax implications arising on waiver of loans

In the recent past, the issue whether waiver of loan should trigger a tax liability under the Income-Tax Act, 1961 ('Act') has been controversial[1]. Notably, the Bombay High Court in *Mahindra and Mahindra Ltd.* v. *Commissioner of Income-Tax*[2] had decided in favour of the taxpayer (i.e. that the waiver of loan should not constitute income of the taxpayer) as the borrowing was accounted for as a capital receipt and not used towards trading transactions or to earn business income. This view was recently upheld by the Supreme Court[3].

Background

Mahindra and Mahindra Ltd. ('Company') had entered into a purchase agreement with Kaiser Jeep Corporation ('KJC') for import of welding equipment, tools, die models, etc. at an agreed value. For the procurement, KJC agreed to provide a loan to the Company. Subsequently, upon the takeover of KJC by American Motor Corporation, the principal amount of the loan taken by the Company was waived.

The tax authorities sought to tax the amount of waiver as business income under section 28(iv) of the Act by asserting that the waiver resulted in the Company effectively purchasing equipment without any payment. They also contended that there was a remission of the Company's liability, which was taxable under section 41(1) of the Act.

Key conclusions of the Supreme Court

The Supreme Court rejected both the arguments of the tax authorities. The findings of the Court are briefly summarised below:

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[1]**See** *Commissioner of Income-Tax* v. *Tosha International Limited* [176 Taxman 187 (Delhi)]; *Commissioner of Income-Tax* v. *T.V. Sundaram Iyengar and Sons Ltd*. [(1966) 222 ITR 344]; *Solid Containers Limited* v. *Deputy Commissioner of Income-Tax* [(2009) 308 ITR 417 (Bom)]

[2] (2003) 261 ITR 501 (Bom)

[3] Civil Appeal No. 6949-6950 of 2004 (Supreme Court, 24 April 2018)

On the applicability of section 28(iv)

Under section 28(iv), the value of any benefit or perquisite, whether convertible into money or not, arising from business is chargeable to income-tax under the head 'Profits and Gains of Business or Profession". The Court held that this clause applied only to benefits and perquisites which were not in the form of money. The Court noted that the Company received cash due to the waiver of the loan, and therefore concluded that section 28(iv) would not be attracted in this case.

On the applicability of section 41(1)

Under section 41(1), if an allowance or a deduction has been availed by a taxpayer in respect of any loss, expenditure or trading liability, and thereafter the taxpayer receives any sum in respect of such loss or expenditure or any benefit by way of remission / cessation of the trading liability, such sum / remission becomes taxable in its hands.

The Court held that the provisions of section 41(1) were not applicable to the present case as-

- The Company had not claimed any deduction under section 36 in respect of the interest paid on the loan. The Court noted that the depreciation claimed by the Company on the machinery purchased from KJC could not be considered as any allowance or deduction in respect of the loan taken by it. Consequently, the provisions of section 41(1) could not be invoked in this case.

- The Court also noted that section 41(1) applied only in respect of remissions made towards trading liabilities of the taxpayer. In this case, capital assets purchased by the Company had not been debited to the trading account or the profit and loss account in any of the assessment years. Since the waiver of loan did not amount to the cessation of a trading liability, section 41(1) could not be applied to bring the amount of waiver to tax.

Dhruva Comments

This decision will help bring about clarity on the tax implications arising from the waiver of loans. Although the judgment was rendered in a very specific fact pattern, it will have implications in several other cases, including in the context of matters that are being taken up under the Insolvency and Bankruptcy Code.

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