

Tax alert: Gratuity payments to employees for services rendered to former employer allowable as a deduction: Delhi ITAT

Issued on: 26 June 2019



Summary

The Delhi bench of Income Tax Appellate Tribunal (ITAT), in a recent decision¹ in the case of a joint venture (JV), has allowed tax deduction of gratuity payment to employees transferred from the JV partners to the JV under section 37 of the Income-tax Act, 1961 (the Act).

The ITAT observed that the taxpayer was required to pay gratuity as per the terms and conditions of appointment for such employees. Accordingly, it held that the payments constituted a contractual obligation of the taxpayer, and hence should be treated as being incurred wholly and exclusively for business purposes.

Facts of the case

- The taxpayer is a JV with other telecom companies (JV partners), and renders telecom support services to several telecom operators.
- At the time of incorporation, certain employees of the JV partners were transferred to the JV. The taxpayer agreed to consider the past period of service while computing gratuity/ex-gratia payable on retirement/resignation from employment with taxpayer.
- During the year under consideration, the taxpayer paid gratuity/ex-gratia to employees transferred from JV members.
- The tax officer contended that part of the gratuity expenditure is in respect of services of the employees which were rendered to earlier employers (i.e. JV partners), and not to the taxpayer.
- Further, the tax officer also observed that the duration of service of employees with the

taxpayer is less as compared to the duration of service with the earlier employer.

- Hence, the tax officer disallowed the gratuity expenditure on the ground that it is not incurred wholly and exclusively for business purposes.
- The first appellate authority² did not support the reasoning of the tax officer, and held that gratuity payments were contractual obligations and hence allowable as deduction³.
- Subsequently, an appeal was filed before the ITAT.

Arguments by the tax department

- It was argued that the expenditure has not been incurred wholly and exclusively for business purposes.
- The tax authorities stated that such gratuity payments were capital and non-recurring in nature and related to earlier period, and hence not allowed as deduction.

¹ DCIT vs. Indus Towers Ltd [TS-324-ITAT-2019 (DEL)]

² Commission of Income tax (Appeals)

³ Under Section 37(1) of the Act

- The tax authorities also contended that there is a bar on the allowability of deduction⁴ of gratuity payments under general provisions since there is already a specific deduction⁵ allowed under other provisions of the Act.

Arguments by the taxpayer

- The taxpayer stated that payments for gratuity were as per the terms and conditions of employment, and hence constituted a contractual obligation.
- The taxpayer also relied on an apex court decision⁶ wherein it is held that payment for contractual obligation would be a business expenditure.
- The taxpayer also submitted that payment of ex-gratia to their employees is a general practice and based on the principles of commercial expediency.

ITAT observation and ruling

- The ITAT placed reliance on the judicial precedent⁷ highlighted by the taxpayer wherein it was held that if the entire amount of gratuity is not allowable under Section 36(1)(v) of the Act, the balance amount would

necessarily have to be allowed as business expenditure under general provisions⁸.

- Further, in view of the fact that gratuity was actually paid, the provisions of Section 40A (7) would not apply.
- Thus, the ITAT held that the gratuity payment, being contractual in nature, is allowed as a business expenditure.

Our comments

The ruling would be relevant in cases where the obligations of entities undergoing corporate restructuring are contractually discharged by the newly formed/acquiring entities.

It may be noted here that while contribution made to an approved gratuity fund is covered by section 36(1)(v), the payment of gratuity directly to employees is not covered therein. Thus, classifying such payments under section 37 (being a general tax deduction provision) of the Act by the ITAT is consistent to that extent. The ratio of the case also asserts the expansive application of section 37 of the Act.

⁴ Under section 37(1) of the Act

⁵ Under section 36(1)(v) of the Act

⁶ Kerala Road Lines vs CIT (2008) 168 Taxman 308(SC)

⁷ CIT vs Premier Cotton Spg. Mills Ltd (2003) 131 Taxman 79 (Mad.)

⁸ Under section 37(1) of the Act

Contact us

To know more, please visit www.grantthornton.in or contact any of our offices as mentioned below:

NEW DELHI National Office Outer Circle L 41 Connaught Circus, New Delhi 110001 T +91 11 4278 7070	NEW DELHI 6th floor, Worldmark 2, Aerocity, New Delhi – 110037 T +91 11 4952 7400	AHMEDABAD 7th Floor, Heritage Chambers, Nr. Azad Society, Nehru Nagar, Ahmedabad - 380015	BENGALURU 5th Floor, 65/2, Block A, Bagmane Tridib, Bagmane Tech Park, C V Raman Nagar, Bengaluru – 560093 T+91 80 4243 0700	CHANDIGARH B-406A, 4th Floor, L&T Elante office Industrial area, Phase-I, Chandigarh 160002 T +91 172 4338 000
CHENNAI 7th Floor, Prestige Polygon 471, Anna Salai, Teynampet Chennai - 600 018 T +91 44 4294 0000	DEHRADUN Suite 2211, Michigan Avenue, Doon Express Business Park, Saharanpur Road, Dehradun – 248002 T +91 135 264 6500	GURGAON 21st Floor DLF Square, Jacaranda Marg, DLF Phase II, Gurgaon 122002 T +91 124 462 8000	HYDERABAD 7th Floor, Block III White House, Kundan Bagh, Begumpet Hyderabad 500016 T +91 40 6630 8200	KOCHI 7th Floor, Modayil Centre Point, Warriam road junction, M.G. Road, Kochi 682016 T +91 484 406 4541
KOLKATA 10C Hungerford Street, 5th Floor, Kolkata 700017 T +91 33 4050 8000	MUMBAI 16th Floor, Tower III, Indiabulls Finance Centre, SB Marg, Elphinstone (W) Mumbai 400013 T +91 22 6626 2600	MUMBAI 9th Floor, Classic Pentagon, Nr Bisleri, Western Express Highway, Andheri (E) Mumbai 400099 T +91 22 6176 7800	NOIDA Plot No. 19A, 7th Floor Sector – 16A, Noida 201301 T +91 120 4855 901	PUNE 3rd Floor, Unit No 309 to 312, West Wing, Nyati Unitree Nagar Road, Yerwada Pune- 411006 T +91 20 6744 8800

For more information or for any queries, write to us at contact@in.gt.com



Follow us @GrantThorntonIN



Grant Thornton

An instinct for growth™

© 2019 Grant Thornton India LLP. All rights reserved.

“Grant Thornton in India” means Grant Thornton India LLP, a member firm within Grant Thornton International Ltd, and those legal entities which are its related parties as defined by the Companies Act, 2013.

Grant Thornton India LLP is registered with limited liability with identity number AAA-7677 and has its registered office at L-41 Connaught Circus, New Delhi, 110001.

References to Grant Thornton are to Grant Thornton International Ltd (Grant Thornton International) or its member firms. Grant Thornton International and the member firms are not a worldwide partnership. Services are delivered independently by the member firms.