

Financial Service Update

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CONTINGENT DEPOSITS TAXABLE HOLDS SC

The Supreme Court ("SC") in its recent decision in the case of M/s. Sundaram Finance Ltd. v. Assistant Commissioner of Income Tax, Chennai¹ held contingent deposits received by the assessee, being a non-banking finance company ("NBFC"), from leasing/hire purchase customers with a view to protect itself from potential sales tax liability as "income" and assessable to income-tax on the grounds that deposits were not kept in a separate interest bearing account, rather they formed part of the business turnover. The SC based its decision on a well-established legal principle that legal character of transaction is the key to determine the source of the receipt.

FACTS

M/s Sundaram Finance Ltd. ("Assessee") a non-banking finance company engaged in the business of hire purchase financing, equipment leasing and allied activities collected amount of Rs. 36,47,585/- ("Amount") as 'contingent deposit' from the leasing/ hire purchase customers in anticipation of potential sales tax liability. The Amount was collected on ad-hoc basis and was not offered to tax on the ground that the Amount was collected as contingent deposits and was refundable depending on outcome of the pending appeal before the High Court. The appeal was against the orders passed by the sales tax authorities for assessment years 1997-98 to 2000-01.

The question before the SC arose to decide whether the Amount collected by the Assessee as contingent deposit is income of the Assessee under section 28 of the Income-tax Act, 1961 for the assessment year 1998-99.

ARGUMENTS ADVANCED

On behalf of the Assessee:

The Assessee argued that in order to safeguard itself against, inter-alia, the said sales tax liabilities, the Assessee received the Amount as contingent deposits from its customers, which were refundable, if the Assessee was to succeed in its challenge to the levy of the said sales tax. The Amount therefore, was an imprest with a liability to refund and bore the characteristics of deposits and hence was not taxable in the year of receipt but was taxable only in the year in which the liability to refund the sales tax ceased (in case the Assessee failed in the pending sales tax appeals).

HELD

The SC observed that it is well settled that in determining whether a receipt is liable to be taxed, the taxing authorities could not ignore the legal character of the transaction, which is the source of receipt. The taxing authorities are bound to determine the true legal character of the transaction.

In the current case, the Amount was not kept in a separate interest bearing bank account but it formed part of the business turnover. Rejecting the contention raised by the Assessee the SC applied the 'substance over form' test to declare the Amount as income assessable to tax.

The SC distinguished this decision from the principle laid down in the case of CIT v. Bazpur Co-operative Sugar Factory Limited² which dealt with equalization fund created by co-operative society and in such a case principle of mutuality applies. Such principle does not apply to the present case.

ANALYSIS

In the instant case, the SC analyzed the intention of the concerned parties and held that the contingent deposits were collected from the customers towards sales tax liability but instead of keeping such deposits in a separate bank account, it formed part of the business turnover. Thus, it can be said that the SC has correctly categorized such deposits to form part of income assessable to tax giving due credit to the intention behind collecting such deposits. This decision re-iterates the principle of 'substance over form' and clearly shows the importance of intent behind such transactions.

NBFCs while holding contingent deposits towards tax liability or otherwise will need to pay heed to this judgment and create separate interest bearing accounts so that these deposits are not characterised as "income" in the hands of NBFCs.

— Shashank Singh, Ankita Srivastava & Pratibha Jain
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¹Civil Appeal no. 5895 of 2008
² (1988) 3 SCC 533

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