FBT – A CASE FOR CLARIFICATION/AMENDMENT

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Ever since the introduction of Fringe Benefit Tax controversies and issues have not abated. Confusion and uncertainty prevails in the minds of taxpayers about the possible scope and application of the provisions. For instance, FBT on Motor Car expenses, relevant clause (H) is so widely worded that it is an all compassing clause, that would attract tax on all expenses on Motor Car, whether or not, actual or beneficial use of the Motor Car lies with employer, thus potentially would cause genuine hardship to various taxpayers falling under various trades.

A. Statutory provisions of FBT pertaining to tax on expenses on Motor Car

The provisions for levy of tax on car benefits enjoyed by employees can be summarized into as under :

(i) Section 115WA : Levy a tax at the rate of 30% on value of fringe benefit provided or deemed to be provided.

(ii) Section 115WB(2): Provides defines deemed fringe benefits as

"Fringe benefit shall be deemed to have been provided by the employer to his employees, if the employer has, in the course of his business or profession (including any activity whether or not such activity is carried on with the object of deriving income, profit or gains) incurred any ***expense on*** *, or made any payment for ,* ***the following purposes,*** *namely;*

> *"(H) repair, running (including fuel), maintenance of motors cars and the amount of depreciation thereon;*

Section 115WB(2) provides for deemed fringe benefit on 17 types of expenses listed under clause (A) to (Q). Further Section 115 WC Subsection (1) clause (c) provides that value of fringe benefit shall be 20% of expenses referred to in clause (A) to (Q) which includes the relevant clause (H). An over rider is provided in subsection 115WC (2) clause (e) to the effect the value of fringe benefit shall be 5% in case of employer engaged in the business of carriage of passengers or goods by Motor Car.

B. FBT – the Legislative intent

(i) Speech of Finance Minister ("FM") (relevant portion to this context) :

"I have looked into the present system of taxing perquisites and I have found that many perquisites are disguised as fringe benefits, and escape tax. At present, where benefits are fully attributable to the employee they are taxed in the hands of the employee: that position will continue. In addition, I propose that where the benefits are usually enjoyed collectively by the employees and cannot be attributed to individual employees, they shall be taxed in the hands of employer"

(ii) **Memorandum Explaining the provisions**

" ……..enjoyment of such benefits amd attributing the same directly to the employee. This is so specially where the expenditure incurred by the employer is ostensibly for purpose of business but includes, in partial measure, a benefit of personal nature. Moreover, in Cases where the employer directly reimburses the employee for expenses incurred , it becomes difficult to effectively capture the true extent of the perquisite provided because of the problem of cash flow in the hands of the employer"

(iii) **What the FM said in Lok Sabha** [1](for legislative intent speech made by mover of Bill can be referred to[2] *):*

"……Therefore by presumptive tax method what we are trying to do is to tax that part which is clearly a perquisite, clearly a benefit but which is going untaxed both in hands of employer and the employee."

C. **The Presumptive Method of Charge**

The charge on Fringe benefits, as is evident from the speech of FM in Lok Sabha(supra) is on presumptive basis. Excepting only two items as under:

(i) is regarding free & concession in travel for private journey's, and;
(ii) contribution to superannuation fund.

Balance all, as given above, have been brought to tax on deemed basis. Section 115WB(2) specifies that once an expenditure is incurred for **identified purpose**, Fringe benefit is deemed to be provided. The purpose is a that which legislature as identified as containing the benefits that were going untaxed.

The concept of presumptive taxation has been succinctly brought out in the Report of Tax Reforms Committee,1991. The report of the at para 6.120 (a) refers "*The presumptive method as an instrument of taxing the hard to tax groups*". The report at para 6.121 further points out "*Faced with the problem of determining*

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[1] [Monday , May 2 , Vaisakha 12, 1927 (saka)]

[2] K.P Varghese Vs ITO[1981] 131 ITR 597(SC)

*"actual income" many countries practicing income taxation have found it expedient to apply what is called the "presumptive" method, **whereby the tax is levied on income determined or estimated on the basis of certain indicators**. In essence , presumptive taxation envisages the application of simple methods for assessing the tax base, or in some cases, the tax itself instead of going though complicated legal and accounting processes. **Under this method, only the income which taxpayer could be reasonably presumed to earn in a given situation** as reflected by his investment or assets or scale of business is sought to be taxed. ……"*

Also at para 6.126 the report further says *" presumptive taxation can in principle be based on **"potential" income** whereby potential is estimated with reference to the investments, the rated capacity of the plant or equipment installed in business, ………………..**therefore one has to look for ways of determining income presumptively which could be said reasonably approximate "actual incomes"**. The tax would be levied on income ex post but determined presumptively and not on income ex ante so to say."*

Presumptive methods be rebuttable or irrebuttable[3]. Under Rebuttable method a taxpayer can elect to not to be taxed under the presumptive method but under normal provisions of the IT Act whereas in case of Irrebuttable method not such option exist. Irrebuttable methods are of two types : **Minimum tax**, where the tax liability as per the presumptive rules is the compulsory minimum that the taxpayer has to pay, and **exclusive** where the tax liability is determined under presumption alone. The FBT provisions falls under exclusive sub-category within the irrebuttable category. Concept of presumptive tax is not new in India. It has been prevalent since long in areas of Tax on Agriculture Income, Minimum Alternate Tax on Companies, Alternate Tax Scheme on Small traders etc.

Identified purposes: As per FAQ No 1[4] what are given under clauses (A) to (K) are purpose of expenses. Apex court in case of R and B Falcon (A) Pty. Limited (Supra) have referred to them as "identified purpose". Thus the potential income has been identified with these purpose, and any expenditure incurred for identified purpose is deemed to be a fringe benefit provided. The purpose as appearing under clause (A) to (Q) of 115WB(2) are those which defines the presumptive base of tax. Presumption has arisen from past experience of the Revenue authorities that certain business activities contain at least in partial measure employee benefits. This is clear from the object and intent of the legislation. Thus there is a potential income in those "Identified purpose" This is

[3] Tax Law Design and Drafting (volume 1: International Monetary Fund: 1996; Victor Thuronyi, ed.) Chapter 12: Presumptive Taxation

[4] Circular No 8/2005 dated 29/8/2005

the **fact/experience** which has primarily determined the presumptive base. There is a reasonable basis of such presumption where the income potential is identified by such experience. Once the Expense is such that which is spent for the "identified purpose" the presumption is made and any expenditure on such purpose, whether actually containing at income or not, or containing income partly or wholly or in what measure are not relevant. The "purpose" is identified with the potential income and not actual income.

D. FBT on expenses on Motor Car : potential benefit not in all cases

The Clause is worded as "*(H) repair, running (including fuel), maintenance of motors cars and the amount of depreciation thereon;* Plain wording of the clause suggests that any expenditure incurred for the purpose of repair, running (including fuel), maintenance of motor car would be fringe benefit provided. Now there are certain expenses in nature specified in clause (H) by Employers engaged in a variety of Trade as under:

- The **Service Stations** engaged in the business of Repairs and Maintenance of Motor Cars.
- **A dealer** engaged in the business of dealing in Second hand car may buy old cars, repair them, and resell at a profit. The dealer would also incur expenses on repair , maintenance etc.
- A **Car dealer** would incur expenditure on Demo Car on repair, running and maintenance.
- A **Car manufacturer** would incur expenditure on repair, running, maintenance of test cars.
- Motor Car owner giving it on **dry lease** (comes under definition of sale of goods); can incur expenses on driver, interest on finance, depreciation etc.
- Motor Car owner giving it on **wet lease**, where possession and control is not parted (recently covered under supply of tangible goods under Service tax.) ; could incur expense on finance charges, driver, running (including fuel), maintenance
- By owner or Lessee/ hirer of such car for **motor training** school ; could incur expense on finance charges, driver, running (including fuel), maintenance etc..
- By owner of lessee / hirer of Car for use in **business of providing services of carriage of passenger or goods**; could incur expense on expense on finance charges, driver, running (including fuel), maintenance.

The plain reading of clause (H) seems to suggest that expenditure once incurred on the Motor Car would be deemed to be fringe benefit provided and would subject all the above cases to FBT. One can say expenses on motor car shall be deemed to be Fringe Benefit provided irrespective of the trade in which it is incurred at the clause does not contain any stipulation regarding trade. Above cases certainly do not even potentially contain a personal benefit. These expenses relate directly to production of services/goods, and the customer pays for such service provided/goods sold. The potential absurdity in the clause can be better understood with the following example. Say employer "A" wet leases a Motor Car to another employer "B" which is engaged in business of Carriage of Passengers, who in turn is servicing the conveyance needs of Executive of a large manufacturing company "C" which is an employer. The beneficial enjoyment and use of such Motor Car lies with the Executive of company "C". In context of FBT only the Employer "C" should be taxed on the expenses on purchase of services from "B", yet going by the plain language of clause (H) all of the employers "A", "B" and "C" bears FBT!! This is a clear anamoly. Add to that, FBT is payable even on the service tax component of expenses. From case to case this would differ as some employers would be eligible for cenvat and some would not.

E. "Purpose of expenditure"

(a) "Identified Purposes"

As is evident above the purposes as defined in clause (H) is so widely worded that any expenses on Motor Car would attract FBT. It would be useful to refer to he report of Tax Reforms Committee (supra)

The Tax Reforms Committee at para 6.121 reports that " *Under this method, only the income which a taxpayer* ***could be reasonably presumed*** *to earn in a given situation as reflected by his investment or assets or scale of business is sought to be taxed*." At para 6.126 the committee observes " *….. **therefore one has to look for ways of determining income presumptively which could be said to reasonably approximate "actual incomes"***". Study[5] on Presumptive Taxation suggest that presumptive assessments should be defined precisely because they are legally binding. Further, it says, presumptive Methods can have quite different incentive effects, revenue effects, distributional consequence, levels of complexity, and legal and administrative implications. This makes it dangerous to generalize about presumptive taxation.

Thus it is clear that the definitive base of presumption should be so defined so as to reasonably approximate the "actual incomes" As the plain reading of the Clause (H) suggests there is a clear anomaly, there a element of doubt whether

[5] Tax Law Design and Drafting (supra)

the identified purpose are one which contain a potential income or not. Where the income potential is absent, the presumption would lack a valid basis.

(b) Defined "Purpose" also includes those expenditure where there is no potential income

Pure business Expenses do not contain potential Income/Benefit. Referring to what the Finance Minister himself said in Lok Sabha[6] "…….*They have examined everything. I have received a report from my officers who consulted them extensively over several days and we have now modified the proposals.* ***We have exempted some of the benefits which we thought were fringe benefits, but which they thought were legitimate business expenditure****………*" which clearly brings out the legislative intent to not to bring the business expenditure within the ambit of FBT.

Certain expenses are purely business expenses with no potential income.

- Expenditure on Use of Assets in business which are not in nature of Consumer Durables i.e those which are not meant to be used by Human beings e.g a Cement Manufacturing machinery. Expenditure on consumption of goods or services which are not in nature of consumer non durables/perishables i.e those which are not meant for consumption or use by Human Beings like Industrial chemicals or services of repairs to Industrial Machinery.
- Expenditure on use of Asset in Business which are in nature of Consumer durables like Motor Car, Mobile Telephone etc. which are used in provisions of services to customer and Employee has no occasion to use such assets. Like Motor Car used(employed) in business of "Carriage of Passenger" or a "time charter". The use of such Motor Car for which it is designed lie with the customer. The employee has no occasion to use the Motor Car. Distinction should be drawn between "use by Employee" and "Motor Vehicle use (employed) for business" where the Employee is only driving the Car. In case of latter employee is merely employed along with the Asset i.e Motor Car in the Business to produce a output services. In contrast there can be situation where a Motor Car is provided to the exclusive use of a Executive for his commuting needs. In such case the Motor Car is employed for Use of Executive (Human Capital employed in business)

- Expenditure on consumption of goods or services which are in nature of consumer non durables/perishables of which Human Capital Employed has no occasion to consume or use. For e.g food served in a restaurant to a customer, dry-cleaning services to a customer in a hotel. The employees

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[6] (Fourteenth Series, Vol. IX Fourth Session, 2005/1927 (Saka) No. 29, Monday, May 2, 2005 /Vaisakha 12, 1927 (Saka)

merely act as catalyst in providing those services to the Customers. In contrast expenditure incurred for a sales manager entertaining a prospective customer by a lavish dinner at a Hotel could contain potential income in the hands of employee.

The determinative factor of "potential income" in a purpose can be traced only to the potential as to the beneficial use, enjoyment or consumption in the hands of Employees, contained in that purpose. The above can also be viewed from another angle. As per the Accountancy principles expenditure on Manufacturing, Production or trading function are a separate class – Direct expenses namely Manufacturing/production/Trading expenses. While there are other expenses are Indirect namely Administrative and other expenses. Accounting principles distinguish between Direct Expenses which are a direct cost of output services or goods and according to settled principles of accountancy[7] only the elements that have actually gone into the manufacture/production of these intermediates i.e. sum total of the direct labor cost, direct material cost, direct cost of manufacture and the factory overheads of the factory producing such intermediate products are included in the cost of production. Direct Expenses are purely business expenditure. Accounting principles also to classify expenditure incurred for a purpose according to function. For e.g expenditure on raw-materials consumables used in preparation of fooding provided by a customer at a Hotel would be classified in production expenses . Whereas the expenditure in incurred by a manufacturing company for fooding in a hotel for a vendors conference would be booked under entertainment expenses.

Courts while determining the nature of expenses under the disallowance route, as existed in past, drew distinction between those expenditure which was a direct function of production of goods of services with those which are not. In case of CIT Vs Sarabhai Management Corporation [8] , where the assessee was engaged in business of running a Guest House, the Gujarat High Court held that expenditure on rent of premises used as guest house is a trading expenditure and is not to be treated as "Guest House Expenses" for the purpose of section 37(4)(i) for disallowance.

Commentaries on taxation of benefits have sought to clearly distinguish between purely business expenditure and expenditure that potentially contains an element of employee benefit for the purpose of taxing employee benefits[9].

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[7] *Wheldon's Cost Accounting and Costing Methods, Cost Accounting methods* by B.K. Bhar, *Principles of Cost Accounting* by N. K. Prasad, and *Glossary of Management Accounting Terms* by ICWAI

[8] C.I.T Vs Sarabhai Management Corporation Limited {1991} 196 ITR 436 (Guj.)

[9] Delimiting the Concept of Income: The Taxation of in-kind Benefits – K.R Brooks at Hhttp://journal.law.mcgill.ca/abs/vol49/2brook.pdf

The purpose defined under clauses (A) to (K) does not recognize the functional classification or any other mechanism to weed out the pure business expenses from FBT net. In absence thereof the purpose as defined under the clauses on a plain reading looks to be all compassing entries. And even pure expenses looks to be covered like in case of Expenses on Motor Car all expense on motor car. No distinction is made on Expenses which are incurred for providing a service to customer and those which are not.

(c) Present definition of "purpose" as contained in Clause (H), plain reading suggests that it lacks sound legal basis:

The question, if travels to the courts, would face intense litigation and several issues are expected for consideration such as :

- Definition of "purposes" of expenditure as mentioned in clauses should contain a rational and intelligent connection with the Potential employee benefits. The present definition lacks clarity and clearly legitimate expenses are also attracted to FBT. There has to be proper mechanism to clearly distinguish purely business expenses from FBT net. In this connection the Supreme Court has said [10] :

  "*In order to pass the test, two conditions must be fulfilled, namely (i) Classification must be founded on an intelligible differentia which distinguishes those that are grouped together from others and (2) that differentia must have a rational relation to the object sought to be achieved by the Act.*"

  As opined by the experts , the tax is merely a tax on expenditure and thus travel beyond the legislative power.

- Though the charge is by way of deeming fiction, yet the deeming fiction cannot be interpreted beyond a point. In this connection, it would be relevant to refer the observation of the Apex Court in Case of Imagic Creative (P.) Ltd [11] have observed as under:

  "26. *We have noticed hereinbefore that a legal fiction is created by the reason of the said provision. Such legal fiction, as is well known, should be applied only to the extent for which it was enacted. It, although must be given full*

[10] State of West Bengal V Anwar Ali Sarkar (supra)

[11] [(2008) 12 STT 392 (SC)]

effect but the same would not mean that it should be applied beyond a point which is not contemplated by the legislature or which lead to an anomaly or absurdity."

Potential benefit of an employee whether in partial or whole measure is a pre-requisite for an activity to fall under the FBT provision. Expenses on running of motor Car in a business of carriage of passenger are pure business expenses falling under section 28, the use of motor car for which it is designed does not lie in the business of Employer but with customer who pays for such use. Without the beneficial enjoyment or use no benefit could ever arise to an employee or any individual in the Business of Employer.

- **Treating unequals as equals**

  In context of FBT, Use of motor car in a business of running in carriage of passenger or goods is different from the use in business for self/employee/constituents commuting needs. Both class of use are distinct and distinguishable. Clause (H) seeks to treat the expenditure on both the class of use as fringe benefit provided thus treating unequals as equals.

  While it may argued that the value of benefit (income computation or machinery) provisions have distinguished the two type of employers with a concessional 5% value as against 20% normal value of Fringe Benefits. It seems that there are many presumptions within this presumption.

  Normal Value is 20% thus 5% value would stand good only when the proportion of expenditure that is purely in business of carriage to that of expenditure that relates to actual use of car within the Business is 75:25 thus a value of 20% on 25 would equal to 5% as provided. From employer to employer this ratio could differ depending on the specific requirement and efficiencies. An efficient employer with a ratio of 90:10 actually would end up paying more. Unequals when treated equally would result in distorted and absurd results. The incidence of FBT on some employers could be as high as the profit itself.

  Another instance is where there could be combination of a two or more business segments say carriage of passenger and tourist operator. The expenses of running of Motor Car would be under the three distinct segments – Business of Carriage of Passenger, Business of Tourism, and use of Motor Car within the business itself. What would be the value of benefit for each of the category, or how does that average out or from employer to employer; category to category; depending on the business mix the value in percentage terms would vary widely thus distorting beyond any reasonable comprehension, the value of a fringe benefit embedded in the expenditure.

- **Treating equals unequally**

As per 115WC (2) clause (e) value of fringe benefit in case of employer engaged in the business of carriage of passengers or goods by Motor Car shall be 5% instead of normal 20%. There are certain class of employers who fall in the same category like employers engaged in leasing (dry, wet leases); motor training schools; Motor car dealers who use the Motor car for Demo purposes; the beneficial use and enjoyment of Motor Car in their respective businesses do no lie within the business but to a Customer. The legislature has singled out business of carriage of passengers whereas, contextually the other employers also fall in the same class. For the same class the provisions call for a differential tax treatment.

- **Double taxation**

In the above referred example, out of the three employers A (*wet leasing Motor Car*) employer "B" (*running the same in Business of Carriage of passenger*) and Employer "C" (*using the same for commuting needs of its executives*), the Use of Motor Car for which its designed lie with only Employer "C". However concurrently each of the employer "A", "B" & "C" are liable to pay Fringe benefit on the use of the Motor Car. It is a fact that expenses incurred by "A" *plus* margin are charged to "B" and those incurred by "B" *plus* the markup is charged to "C" the actual consumer. Thus the same expenses *plus* markup gets charged and transferred to each successive Employer of which each one pays FBT thus resulting in double taxation of Motor Car benefit. Unless double taxation is by express intention, the inference that follows is otherwise[12].

- May cause prejudice to a class of person carrying a particular trade or vocation say wet leases of Motor Cars. The charge of FBT in case of small business likes of taxi hire/leases could be so high that it may erode the profit base itself. For e.g the running, repair, maintenance etc expenses is 85% and sundry overheads being 5%, the balance profits

[12] **Jain Brothers vs. Union of India , 77 ITR 107, 112 (SC)**

itself could get eroded with a Income tax of 33.66% = 3.36% and FBT on 85% * 20% * 33.66% = 5.72% thus on a total of 10% profits the Income tax + FBT itself would be 9.08 % thus leaving the person with a less than 1% margin. The incidence of tax on such trade is absurdly high and to the extent the trade or vocation itself is impaired.

- The forgoing clearly demonstrates that provisions attracts unintended expenditure to tax and thus likely to produce absurd results. Court observed that the rule of literal interpretation cannot be adhered to if it leads to manifest absurdity[13]. On the same lines the provision lacks a rational or intelligent connection with the subject matter of tax which is not permissible[14]. Further it can be contended that it fails the classification test. Classification must be founded on an intelligible differentia that has a rational relation to the object sought to be achieved[15]. Such selection and or differentiation must not be arbitrary and should rest upon rational basis, having regard to the object which legislature has in view[16].

While placing interpretation several approaches are possible like purposive construction, reading down etc. From taxpayer's perspective, the scope of differing interpretation itself points out to the litigation in waiting and as the provisions are by way of a legal fiction there is clear apprehension that liability of FBT may arise even in a situation where there is none. Thus from the taxpayer's perspective the above is a clear anomaly.

G. Need for clarification/amendment

Legitimate Business expenses should be specifically excluded: As pointed out by Gujarat High Court in case of Sarabhai Management Corporation (supra) expenses which are pure trading expenses which are deductible u/s 28 itself. These expenses do not contain any potential income and should be taken out of the ambit of FBT provisions. A general exclusion as applicable to all clauses (A) to (Q) to this effect should be provided to weed out undesirables.

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[13] **CIT vs. Kishoresinh Kalyansinh Solanki** (1960) 39 ITR 522 (Bom)

[14] Rajasthan Chemists Association Vs State of Rajasthan and Ors (supra)

[15] State of West Bengal V Anwar Ali Sarkar, 1952 S.C 75(93); AIR 39(E)

[16] Ram Prasad Sahi V State of Bihar, 1958 SC 215,219 (AIR V 40) (F)

Overall Cap is Desirable: FBT provisions have existed for more than three years now and issues and ambiguities still persists. Presumptive taxations calls for precise definition approximate the "actual income". The dispute in individual clauses have been too many and still continuing as a precise definition for individual clauses still eludes legislators and undue hardships is faced by specific trades.

It may be worthwhile to consider alternative remedial approaches instead up taking up onerous task of precisely defining the individual clauses. One of such approach could be placing a overall maximum cap of value of FBT as a function of total taxable salary paid by Employer. The value cap can be decided either as an average of fringe value of benefits as a Percentage of the Taxable salary paid by a sample of employers representing a cross section of Employers in the last three years. Alternatively it could be fixed by some empirical basis say a 10%/15%/20% of the taxable salaries paid by Employer. Value cap as a function of Taxable Salary of Employees establish a discernable and proximate connection with Employee income. Business expenditure as a measure of income have a inherent difficulty to approximate to the Employee income, and some individual clauses could result in a varied tax liability from employer to employer based on the nature of businesses as the experience has shown in the past three years. Value cap would not only sort out the individual industries hardships but on the other hand would help in securing the tax base of FBT.

H. Conclusion

The forgoing clearly suggest that there is an urgent need for a suitable amendment/clarification on the nature and scope of the individual clauses. Lawmakers would surely pay heed to the genuine hardships faced by the taxpayers and it is expected that the executive action would not wait for the wake-up call from the Courts. This would go a long way in affirming the taxpayer's faith in the Administration.