HR & Tax Alert

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India - Tribunal rules tax paid by an employer qualifies as a non-monetary benefit.

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Executive summary

A Special Bench of the Income Tax Appellate Tribunal (ITAT) has recently ruled in the case of RBF Rig and interveners that "tax paid by the employer" qualifies as a "benefit in kind not provided for by way of a monetary payment". Any tax due on such remuneration does not create a liability for the employee under the provisions the Income Tax Act, 1961 ("The Act"). The Special Bench came to this conclusion on the basis that the payment was not made directly to the employee, but paid on his behalf to a third party.

The favorable ruling from the Special Bench overrules two earlier decisions of the Delhi ITAT which held that "tax paid by the employer" is a "monetary payment" and does not qualify for this exemption.

Further to the Special Bench ruling, the ITAT has also held in related appeals that:

(i) the employer cannot be liable for a failure to withhold taxes on this income.

(ii) "tax paid by the employer" being a "benefit in kind" cannot form part of "Salary" for computing the benefit in kind value of rent-free accommodation provided to the taxpayer.

Our analysis

The Indian tax laws state that income tax paid by an employer on behalf of an employee in respect of a non-monetary benefit in kind is not taxable subject to certain conditions. However, there was some ambiguity in the law as to what could be regarded as a "non-monetary benefit in kind". Income tax borne by the employer was one such benefit.

Facts of the case

RBF Rig and several intervener companies paid salaries to certain employees net of tax as the employer had borne the taxes. In the tax returns filed by the employees, tax borne by the employer on the salary paid was considered as a non-monetary benefit in kind and as such, the exemption from tax had been claimed.

The tax officer did not allow the claim of the taxpayers and held that this payment was a monetary benefit in kind and was therefore not eligible for this exemption. The taxpayers appealed to the Commissioner of Income Tax (Appeals) (CIT (A)). The CIT (A) agreed with the view of the tax officer. Subsequently, the taxpayers appealed before the ITAT and a Special Bench was constituted to decide the matter.

Decision of the special bench

The Special Bench looked at various decisions including the earlier decision of the Supreme Court in the case of *Mafatlal Gangabhai & Co [219 ITR 643 SC]*. The Supreme Court in that case noted the difference between a payment made by the employer to the employee and a payment made by an employer to a third party. The payment to a third party in respect of any obligation which, but for such payment, would have been payable by the employee would only be a benefit in kind for the employee.

Based on the above decisions, the Special Bench concluded that "tax paid by an employer" on behalf of an employee at the option of the employer is not money paid to an employee but is a discharge of his obligation. As this payment is made to a third party, this should not be treated as a monetary payment made to the employee but as a non-monetary benefit in kind. As such, the exemption applied and there was only a single stage gross-up required as the exemption was applied.

Based on the Special Bench ruling, the Delhi ITAT has also pronounced its ruling on two other appeals. One of the appeals related to a shortfall in withholding by the employer which had claimed this exemption. Since the Special Bench upheld the exemption claim, the ITAT has concluded that there is not a lack of withholding by the employer.

The other appeal was regarding the inclusion of tax paid by the employer in "Salary" for the purpose of computing the benefit in kind value of rent free accommodation. Under the Income Tax law in India, the value of an accommodation benefit in kind is calculated as a percentage of employees' salary. 'Salary' for this purpose has been defined and specifically excludes benefits in kind. Further to the Special Bench ruling which states that "tax paid by the employer" is a benefit in kind, the ITAT concluded that the same cannot be included as part of 'Salary' for computing the accommodation benefit.

Impact

The Special Bench decision lays down the principle that payments made to a third party on behalf of the employee are to be considered as a non-monetary benefit in kind and are therefore eligible for the exemption.

Where tax is paid by the employer, as is the case in most tax equalised arrangements, the tax is considered as income and taxed again leading to multiple gross-up. With ITAT confirming that tax paid by the employer is a non-monetary benefit in kind and eligible for the exemption, only a single stage gross-up will be required. This could generate savings for the employer with respect to overall tax costs in situations where this exemption could be applied.

The Special Bench decision is a binding precedent for tax tribunals in the various jurisdictions of the country. However, a challenge of this ruling by the revenue authorities before the High Court cannot be ruled out.

Next steps

Employers should take note of this ruling and apply the principles laid down and consider whether the exemption applies.

For further information please contact your local Ernst & Young Human Capital professional, or in India:

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