Retention money is not taxable as 'income', under both normal provisions and MAT regime

March 14, 2017

In brief

The Kolkata Bench of the Income-tax Appellate Tribunal (Tribunal) in the case[1] of a company engaged in executing turnkey contracts held that

- retention money was not income under the normal provisions of the Income-tax Act, 1961 (the Act)
- retention money, though credited to the profit and loss account, was to be excluded while computing book profits under minimum alternate tax (MAT) regime as stipulated under section 115JB of the Act.

In detail

Facts

- The taxpayer was a company engaged in the business of manufacture and sale of metallurgical machinery, materials handling and conveying plant/ machinery/ spares and coal washing plant on a turnkey contract basis.
- Under the terms of turnkey contracts, a certain percentage of the value of contract was retained by the taxpayer's customers till the successful trial run and final acceptance by the customer.
- The taxpayer credited the said retention money to its profit and loss account, as per the mercantile system of accounting followed by the taxpayer.
- During the year under consideration, the taxpayer was liable to tax under the MAT regime.
- The taxpayer claimed that its right over the retention money was contingent until acceptance by the customer. Therefore, this amount could not be considered as income under the normal provisions of the Act. Furthermore, the same should be excluded while computing the book profit under MAT regime.
- The Commissioner of Income-tax (Appeals) [CIT(A)] accepted the taxpayer's contentions, stating that the retention money had not accrued to it and could not be regarded as income. The CIT(A) further held that the MAT could not be levied on notional income which had not accrued to the taxpayer.
- Aggrieved by the CIT(A)'s order, the Revenue preferred an appeal before the Tribunal.

Issues before the Tribunal

- Was the retention money income taxable under the under the normal provisions of the Act?
- Was the retention money credited to the profit and loss account to be reduced for computing book profits under the MAT regime?[2]

[1] ITA No. 100/Kol/2011

[2] There were few more issues discussed in the ruling, which have not been covered in the instant news alert.

Taxpayer's contentions

- Right to receive the retention money was contingent till the time trial run was successfully concluded and final settlement was obtained.
- Therefore, until and unless all obligations under the contract were fulfilled, the retention money could not be regarded as income. In this regard, the taxpayer placed reliance on a decision of the Calcutta High Court.[3]
- The taxpayer contended that if a receipt was not in nature of income, it could not be considered for the purposes of computing book profits under the MAT regime, even though it was credited to the profit and loss account. In this regard, the taxpayer placed reliance on various Tribunal decisions.[4]

Revenue's contention

- The taxpayer was following mercantile system of accounting and had to account for all receipts on accrual basis. Accordingly, retention money could not be excluded from the taxpayer's income.
- Section 115JB of the Act clearly laid down the sums that had to be excluded from, and included in, the profits as per the profit and loss account prepared in accordance with the Companies Act, 1956. Accordingly, only those items were to be reduced from the net profits which have been stated in section 115JB of the Act, and retention money was not one of them.

Tribunal ruling

- With respect to computation under normal provisions, the taxpayer's reliance on the Calcutta High Court's decision[5] was appropriate. The retention money could not be regarded as the taxpayer's income, as it would become legally due to the taxpayer only on successful completion of the contract.
- With respect to MAT, the Tribunal held that levying MAT on receipts which were not in the nature of income would defeat two fundamental principles, *viz.*, it would levy tax on a receipt which was not in nature of income at all, and secondly, it would not result in arriving at real working results of the company. This principle was also upheld by a co-ordinate bench in another case[6].
- Amounts taxable as income, but exempt under a specific provision of the Act, were to be included while computing book profits, as held by the Special Bench of the Tribunal.[7] However, where a receipt was not in the nature of income at all, it could not be included while computing book profits under the MAT regime.
- Therefore, the retention money could not be regarded as income even for the purpose of computing book profits under MAT regime, though it was credited to the profit and loss account.

The takeaways

- This ruling is welcome since it supports the position that notional income should not be subjected to tax under MAT regime irrespective of the fact that the same is credited to the profit and loss account.
- Furthermore, this ruling reaffirms the principle that unless the taxpayer has a right to receive it, the amount cannot be taxed as income. The right to receive retention money arises on satisfaction of the obligations under the contract. Therefore, retention money does not partake the character of income.
- It is important to note that Income Computation Disclosure Standard (ICDS) – III on construction contracts, applicable from financial year 2016-17, provide that retention money is to be considered as income. To this extent, the applicability of the above-discussed principles in ICDS regime will need to be evaluated.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor.

[3] 179 ITR 8
[4] 7 SOT 51, 90 ITD 654, 4 SOT 376 and ITA No. 144/Kol/2013
[5] 179 ITR 8
[6] ITA No. 144/Kol/2013
[7] 131 TTJ 514

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