



Higher rentals received from third party sub-lessees taxable in the hands of the first lessor where the lease is shown to be sham

Background

Section 4 of the Income-tax Act, 1961 (the Act) provides for a charge of income tax on every person. Recently, the Supreme Court of India in the case of Maneklal Agarwal¹ (the taxpayer) held that it is the prerogative of the revenue to take a decision on who would be the 'right person' for such charge of tax.

Facts of the case

- The taxpayer had leased out his property to his own family members for a nominal rent, who in turn had sub-leased it to third parties on much higher rental values.
- The tax authorities, at both assessment and first appellate levels, held that such sub-letting income was subject to tax in the hands of the taxpayer only.
- Upon further appeal, the order of the Commissioner of Income-tax (Appeals) was upheld by the Income-tax Appellate Tribunal (the Tribunal) with a directive to consider municipal valuation as basis of income so charged to tax.
- The tax department challenged the order passed by the Tribunal before the Andhra Pradesh & Telangana High Court (High Court).
- The High Court allowed the revenue's appeal and dismissed the taxpayer appeals on the ground that the nature of lease executed by the taxpayer was proved to be bogus as a fact by the Tribunal, leading to a conclusion that the net rental value would be chargeable to tax in the hands of the taxpayer.

- Aggrieved by the High Court's order, the taxpayer filed an appeal with the Supreme Court.

Supreme Court's decision

- The Supreme Court observed that the taxpayer had devised a structure to show lesser income in his hands by entering into a lease agreement with his wife, son, and daughter-in-law at very nominal rates and allowing such family members to sub-let the property at a much higher rental value.
- The Supreme Court relied on its own decision² where it had held that the Assessing Authority has the right to tax the 'right person'. In the instant case, given the finding of fact that the first lease transaction was bogus, the taxpayer was found to be the 'right person', making it permissible for the revenue to tax the said rental income in the hands of the taxpayer.
- To avoid dual taxation of the same income, the Supreme Court further held that the taxpayer's relatives could separately seek redressal.

Our comments

This decision gives impetus to the revenue to pierce the veil in respect of sham transactions made with the express intent of tax avoidance and to assess the 'right person' on whom the charge of tax needs to be made under Section 4 of the Act.

¹ Maneklal Agarwal v. Deputy Commissioner of Income-tax [2017] 84 taxmann.com 116 (SC)

² ITO v. Ch. Atchiah (1996) AIR 993, 1996 SCC (1) 417

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