Taxation of Subsidy – Pre and Post Finance Act, 2015

Taxability of subsidy/assistance provided by the Central/State Government, under the Income Tax Act, 1961 ("ITA") has been a vexed issue. Prior to the Finance Act 2015, there was no specific provision dealing with the taxability of subsidy. The judicial precedents on this issue have held that the nature of a subsidy (i.e. capital receipt or trading receipt) is to be determined with reference to the purpose for which such subsidy is given, i.e. 'purpose test.' In case the subsidy is qualified as 'capital receipt,' the same would not be chargeable to tax. However, the amendment made by the Finance Act, 2015 seeks to overturn the said judicial precedents. In this article, the relevant provisions of the ITA, judicial precedents on taxability of subsidy, amendments to the ITA till date and the amendments recently made by the Finance Act, 2015 along with their impacts have been examined. Read on…

CA. Sahil Gupta

(The author is a member of the Institute and may be reached at sahilgupta93@gmail.com.)

Section 2(24) of the Income-tax Act, 1961 ('ITA') defines the term 'income' in an inclusive manner. In this regard, it is pertinent to mention that the Courts[1] on several occasions have held that the term 'income' should not be interpreted to include receipts of 'capital nature,' unless such receipts are deemed to be 'income' because of a specific provision in the ITA. A capital receipt, therefore, can be brought to tax under the inclusive definition of term 'income' as defined in Section 2(24) of the ITA, only if it is expressly covered within the scope of the said definition. The definition of 'income' has been amended from time to time, to specifically provide for taxation of certain capital receipts. Some of the instances where capital receipts have been specifically held liable to income tax are:

[1] *Padmaraje R. Kadambande vs. Commissioner of Income Tax [1992] 195 ITR 877 (SC), Cadell Weaving Mills Company Ltd vs. CIT [2001] 249 ITR 265 (Bom)*

- Non-compete fee (with effect from 1st April, 2003),
- Money received in excess of fair value on issue of share (with effect from 1st April, 2013),
- Receipt of immovable property without consideration (with effect from 1st October, 2009),
- Receipt of shares without consideration or for a value less than their fair market value (with effect from 1st June, 2010), *etc.*

Prior to such specific inclusion of these capital receipts in the definition of *income* under Section 2(24) of the ITA, no tax could have been charged on such receipts. In view of the above, the subsidy received by a taxpayer would not be liable to tax if the following conditions are satisfied cumulatively:

(a) Such subsidy is regarded as 'capital receipt'; and
(b) There is no specific provision under the ITA deeming such subsidy as 'income'.

Nature of Subsidy – Capital or Revenue

Pre Finance Act 2015, there was no specific provision dealing with the taxability of subsidy. However, the Courts have had the occasions to deal with the issue of taxability of subsidy. In such judicial precedents, the Courts perused the governing scheme (under which the relevant subsidy was given to the assessee) in detail to determine the nature of the subsidy, i.e. 'capital receipt' vs. 'revenue receipt'. In this regard, it would be useful to note the following judicial precedents:

- ***Sahney Steel and Press Works Ltd vs. CIT [1997] 228 ITR 253 (SC):*** The Supreme Court ("SC"), in this case, examined the taxability of subsidy received by the assessee company from State Government. The subsidy was received by way of refund of sales tax paid on purchase of machinery, raw material, *etc.*, only after the commencement of production.
  Referring to the decisions pronounced in the past by the foreign courts and the Indian courts, the SC held that the nature of a subsidy, whether capital or revenue, depends on the purpose for which such subsidy is given. *In case purpose of the subsidy is to support the assessee to set up its business, to complete a project, or to acquire a capital asset, the subsidy would be regarded as capital receipt.* However, if the subsidy is given to the assessee for assisting him in carrying out the trade/business operations only after commencement of production, such subsidy would be regarded as a revenue receipt. Based on the analysis of facts of the case, the SC held that as subsidies were not granted for production of any new asset and were granted year after year only after setting up of the new industry and commencement of production, such subsidy would be regarded as assistance given for the purpose of carrying on of the business of the assessee and thus, would be taxable in the hands of the assessee company.
- ***CIT vs. Ponni Sugars and Chemicals Ltd. [2008] 306 ITR 392 (SC):*** In this batch of appeals, the SC examined taxability of subsidy received by sugar factories from the Government under identical schemes for different years. The SC referred to its earlier decision in the case of *Sahney Steel and Press Works Ltd. (supra)* and held that nature of the subsidy is to be determined with reference to the purpose for which such subsidy is given (i.e. the 'purpose test'). Factors such as the source/form of the subsidy, time of payment of the subsidy are not relevant. Based on analysis of facts of the case, the SC held that as subsidy must be utilised for repayment of loans taken by sugar factories for setting up of new units or for substantial expansion of existing units, such subsidy would be of capital nature and thus, not includible in total income of the sugar factories.
- ***Shree Balaji Alloys vs. CIT [2011] 198 Taxman 122 (J&K):*** In this case, the Jammu and Kashmir High Court ("HC") examined the taxability of subsidy received by the assessee company under new industrial policy and other concessions announced by the Government of India for Jammu and Kashmir. The HC applied the ratio affirmed by SC in case of *Sahney Steel and Press Works Ltd. (supra)* and *Ponni Sugars and Chemicals Ltd. (supra)* and held that as the intent of the new industrial policy was to generate employment through acceleration of industrial development of the State, the subsidy received by assessee company was capital in nature and thus, not liable to tax under provisions of the ITA. Further, the Jammu and Kashmir HC also held that merely because the subsidy was available to the eligible industrial units from the date of commencement of the commercial production, and that it was not required for creation of new assets, cannot be viewed in isolation to treat the subsidy as a revenue receipt.

- ***DCIT vs. Inox Leisure Ltd. [2013] 351 ITR 314 (Guj):*** In this case, the Gujarat HC examined the nature of subsidy received by a company engaged in the business of multiplexes/theaters from respective State Governments. The subsidy was given by the State Governments by way of exempting the assessee company from levy of entertainment tax; in one of the schemes, the amount of subsidy was linked with the capital investment. Based on the analysis of facts of the case, the HC held that objective of the schemes was to give incentive to the multiplex units which were highly capital intensive and therefore, the subsidy received by the assessee company was capital in nature i.e., not liable to tax under provisions of the ITA.

The principles enunciated in the aforementioned decisions have been applied/referred by Courts in the following cases –

- *CIT vs. Tiruttani Co-op Sugar Mills Ltd. [2009] 322 ITR 59 (Mad)*
- *CIT vs. Chaphalkar Brothers [2011] 351 ITR 309 (Bom)*
- *CIT vs. Rasoi Ltd [2011] 335 ITR 438 (Calcutta)*

Based on a reading of the aforementioned judicial precedents, the following key principles can be culled out in relation to characterisation of subsidy as a capital receipt or a revenue receipt:

- Nature of a subsidy (i.e. capital receipt or trading receipt) is to be determined with reference to the purpose for which such subsidy is given, i.e. 'purpose test'.
- In case objective of the subsidy scheme is to enable the assessee to carry on the business in a profitable manner, the subsidy would be regarded as a revenue receipt. However, if objective of the scheme is to support the assessee to set up its business, to complete a project, or to acquire a capital asset, the subsidy would be regarded as capital receipt.
- Factors such as the source/form of the subsidy, time of payment of the subsidy, *etc.* are not relevant for determining nature of the subsidy.
- The obligation/(s), if any, attached to the permissible end-use of the subsidy (such as, repayment of loan taken for acquisition of fixed assets) should be considered while determining whether the subsidy is a capital receipt or a trading receipt.

The SC referred to its earlier decision in the case of *Sahney Steel and Press Works Ltd.* (*supra*) and held that nature of the subsidy is to be determined with reference to the purpose for which such subsidy is given (i.e. the 'purpose test'). Factors such as the source/form of the subsidy, time of payment of the subsidy are not relevant.

Amendment Made by the Finance Act, 2015

The Finance Act, 2015 seeks to include the following in the definition of 'income':

> *"assistance in the form of a subsidy or grant or cash incentive or duty drawback or waiver or concession or reimbursement (by whatever name called) by the Central Government or a State Government or any authority or body or agency in cash or kind to the assessee other than the subsidy or grant or reimbursement which is taken into account for determination of the actual cost of the asset in accordance with the provisions of Explanation 10 to clause (1) of Section 43"*

The amendment seeks to clarify that any subsidy or reimbursement, *etc.* which is not reduced from the actual cost of the asset under Explanation 10 to Section 43(1) shall be chargeable to income under the head 'profits and gains of business and profession'. The intention of the Government is to align the provisions of the ITA, with the corresponding treatment provided by 'Income Computation and Disclosure Standards' ("ICDS")[2]. The ICDS VII relating to Government Grants prescribes the following treatment for computation of taxable income:

Nature of Government Grant	Treatment Prescribed by ICDS VII
Government grant pertains to a depreciable fixed asset or assets	The grant shall be deducted from the actual cost of the asset or assets concerned or from the written down value of block of assets to which concerned asset or assets belonged.
Government grant pertains to a non-depreciable asset or assets of a person requiring fulfillment of certain obligations	The grant shall be recognised as income over the same period over which the cost of meeting such obligations is charged to income.

[2] *Notified by the Central Board of Direct Taxes ("CBDT") under Section 145(2) of the ITA vide Notification dated 31st March, 2015*

In both the cases above, where the Government grant is of such a nature that it cannot be directly relatable to the asset acquired, so much of the amount which bears to the total Government Grant, the same proportion as such asset bears to all the assets in respect of or with reference to which the Government Grant is so received, shall be deducted from the actual cost of the asset or shall be reduced from the written down value of block of assets to which the asset or assets belonged.	
Government Grant that is receivable as compensation for expenses or losses incurred in a previous financial year or for the purpose of giving immediate financial support to the person with no further related costs	Shall be recognised as income of the period in which it is receivable.
Other Government Grants	Shall be recognised as income over the periods necessary to match them with the related costs which they are intended to compensate.
Government Grants in the form of non-monetary assets, given at a concessional rate, shall be accounted for on the basis of their acquisition cost.	

Further, the Government has also clarified that the proposed amendment will not be applicable to individuals not having any income chargeable under the head 'profits and gains of business or profession' and receiving LPG subsidy or any other subsidy which is for the welfare of the individual[3].

Reduction of Subsidy from the Cost of Fixed Assets

As per the provisions of ITA, depreciation allowance computed at prescribed rates on the Written Down Value ("WDV")[4] of respective block of assets is allowed as a deduction to the assessee. For the purpose of computing WDV for a particular year, *inter alia*, the opening WDV[5] is increased by the 'actual cost' of the asset acquired during the year.

In this regard, it is pertinent to examine the

The obligation/(s), if any, attached to the permissible end-use of the subsidy (such as, repayment of loan taken for acquisition of fixed assets) should be considered while determining whether the subsidy is a capital receipt or a trading receipt.

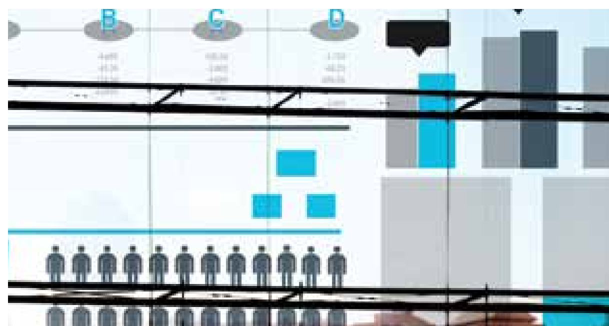
definition of the term 'actual cost' provided in Section 43(1) of the ITA; relevant text of the Section has been reproduced below –

"…….

(1) *"actual cost" means the actual cost of the assets to the assessee, reduced by that portion of the cost thereof, if any, as has been met directly or indirectly by any other person or authority……"*

[Emphasis supplied]

- In addition to the above, Section 43(1) also contains a number of Explanations prescribing the rules for determination of 'actual cost' for depreciable assets in specified situations. In this regard, note that Explanation 10 to Section 43(1) of the ITA inserted with effect from 1st April, 1999, deals with determination of 'actual cost' for depreciable assets in case where a subsidy is received by the assessee; text of the said Explanation is reproduced below:
  "Explanation 10.—Where a portion of the cost of an asset acquired by the assessee has been met directly or indirectly by the Central Government or a State Government or any authority established under any law or by any other person, in the form of a subsidy or grant or reimbursement (by whatever name called), then, so much of the cost as is relatable to such subsidy or grant or reimbursement shall not be included in the actual cost of the asset to the assessee:



[3] Press Release dated 5th May, 2015
[4] The value as on 31st March of the relevant financial year
[5] The value as on 1st April of the relevant financial year

The amendment seeks to clarify that any subsidy or reimbursement, *etc.* which is not reduced from the actual cost of the asset under Explanation 10 to Section 43(1) shall be chargeable to income under the head *'profits and gains of business and profession'*. The intention of the Government is to align the provisions of the ITA, with the corresponding treatment provided by 'Income Computation and Disclosure Standards' ("ICDS").

Provided that where such subsidy or grant or reimbursement is of such nature that it cannot be directly relatable to the asset acquired, so much of the amount which bears to the total subsidy or reimbursement or grant the same proportion as such asset bears to all the assets in respect of or with reference to which the subsidy or grant or reimbursement is so received, shall not be included in the actual cost of the asset to the assessee."

[Emphasis supplied]

- For the purpose of interpretation of the main clause of Section 43(1), it would be useful to note the decision of SC in the case *CIT vs. PJ Chemicals [(1994) 210 ITR 830 (SC)]*, wherein the SC dealt with treatment of subsidy received by assessee to establish industries in backward areas under the provisions of Section 43(1) of the ITA. Whilst the SC acknowledged the conflicting rulings pronounced on the issue by different High Courts, the SC affirmed the views expressed by High Courts in pro-assessee rulings. The SC held that Government subsidy quantified with reference to cost of assets but not given for the specific purpose of meeting the cost of the asset would not be regarded as payment intended directly or indirectly to meet cost of assets.

  The aforementioned decision of SC was subsequently followed by the Bombay High Court in the case of *CIT vs. KCA Ltd [283 ITR 65 (Bom)]*. Further, the Allahabad High Court in case of *CIT vs. Paliwal Glass Works [326 ITR 407 (All)]* held that subsidy given specifically for purchase of an asset would be reduced from actual cost the asset.
- It is pertinent to note that the aforementioned ruling of the SC was rendered prior to insertion of Explanation 10 in Section 43(1) of the ITA. Accordingly, it would be relevant to understand the scope of Explanation 10 and its impact on the SC decision in case of *PJ Chemicals (supra).*
- The Central Board of Direct Taxes has explained the aforementioned amendment in Circular No. 772 dated December 23, 1998. The relevant text of the Circular is reproduced below –

  "Certain receipts not to be included for computing the actual cost of an asset

  22.1 In order to rationalise the definition of the term "actual cost", Section 43 is amended by inserting Explanations 9 and 10 to sub-Section (1) in this Section. ......

  22.2 Explanation 10 provides that where a portion of the cost of an asset acquired by the assessee has been met directly or indirectly by the Central Government or a State Government or any authority established under any law or by any other person, in the form of a subsidy or grant or reimbursement (by whatever name called), then, so much of the cost as is relatable to such subsidy or grant or reimbursement shall not be included in the actual cost of the asset to the assessee. Cost incurred/payable by the assessee alone could be the basis for any tax allowance. This Explanation further provides that where such subsidy or grant or reimbursement is of such nature that it cannot be directly relatable to the asset acquired, so much of the amount which bears to the total subsidy or reimbursement or grant the same proportion as such asset bears to all the assets in respect of or with reference to which the subsidy or grant or reimbursement is so received, shall not be included in the actual cost of the asset to the assessee........."

[Emphasis supplied]

- Further, for the purpose of interpretation of Explanation 10 to Section 43(1), it would be useful to note following judicial precedents –
  - ***Sasisri Extractions Ltd vs. ACIT[307 ITR 127 (Vishakhapatnam Tribunal)]***: In this case, the Vishakhapatnam Bench of the Tribunal examined the treatment of subsidy given to the assessee under a scheme for promotion of State's industrial development; for the purpose of determining the amount of subsidy cost of eligible investment was

The Tribunal held that even after insertion of Explanation 10, ratio enunciated by the SC in *PJ Chemicals (supra)* continues to be valid. The Tribunal held that as the subsidy was given for promotion of industrial development and not specifically for subsidising cost of the capital, the subsidy cannot be considered as a payment made for directly/indirectly meeting the actual cost of assets under Explanation 10.

taken as a base. The Tribunal held that even after insertion of Explanation 10, ratio enunciated by the SC in *PJ Chemicals (supra)* continues to be valid. The Tribunal held that as the subsidy was given for promotion of industrial development and not specifically for subsidising cost of the capital, the subsidy cannot be considered as a payment made for directly/indirectly meeting the actual cost of assets under Explanation 10.

– ***M/s. PVR Ltd vs. Addl. CIT [ITA No. 1897/ Del/2010 (Del)]:*** In this case, the Delhi Bench of the Tribunal examined the treatment of entertainment subsidy given for promotion of cinema/multiplex industry. The Tribunal took note of the fact that whilst the maximum amount of subsidy available was limited to capital cost of assets, the payment of subsidy was made after completion of the multiplex based on its running for a period of 3 years and therefore, the subsidy was not relatable to any specific asset. The Tribunal relied on ratio of ruling pronounced in *PJ Chemicals (supra)* and *Sasisri Extractions Ltd (supra)* and held that as subsidy received by the assessee was not related to any asset or capital outlay, the same is not required to be reduced from actual cost of the asset under Explanation 10.

- Whilst the aforementioned decisions of the Tribunal support the view that even after insertion of Explanation 10 in Section 43(1), the ratio enunciated by the SC in *PJ Chemicals (supra)* continues to be valid and thus, amount of subsidy should be adjusted from actual cost of the asset only when the subsidy is given specifically for subsidising the cost of asset, a contrary view is also possible. In this connection, it is relevant to note the decision of Delhi Bench of Tribunal in the case of *DCIT vs. Dalmia Cement Bharat Ltd (307 ITR 36) (Del)*. In this case, the Tribunal held that incentive received by a sugar mill (by way of higher free sale quota of sugar) was capital in nature, as such, incentive was to be utilised for payment of loan taken by the sugar mill in respect of fixed assets. Further, considering the manner of utilisation of the incentive (or subsidy), the Tribunal held that such incentive would be reduced from actual cost of the assets under the Explanation 10/main clause of Section 43(1).

Conclusion and the Way Forward

While the Government's intention is to align the provisions of the ITA regarding taxability of subsidy with the treatment suggested by ICDS, effectively it will mean that the taxpayers would have to shell out around 1/3rd of the subsidy received as taxes. Going forward, the taxpayers might want to reduce the subsidy from the cost of the asset rather than offering the entire subsidy to tax under Section 28, to defer the tax payment. On the other hand, a taxpayer with accumulated business losses would want to offer the entire subsidy in the first year itself – to utilise the business losses which might otherwise lapse. Thus, it could trigger a fresh round of litigation, even after the proposed amendment. Further, while the Government has sought to clarify/align the provisions of the ITA regarding taxability of subsidy with the corresponding provisions of ICDS, there are a lot of differences between the ICDS and the provisions of ITA which are yet to be clarified and could lead to a lot of disputes between the revenue authorities and the taxpayers.

Lastly, the proposed amendment is in line with the announcement made in Budget Speech by the Finance Minister, wherein it was proposed to reduce the corporate tax rate to 25 % in a phased manner coupled with the reductions in exemptions in a phased manner. Let us hope that the tax officers do not interpret the proposed amendment as 'clarificatory' in nature and start taxing subsidies retrospectively. ■