



Subsidies for reimbursement of cost relating to manufacture or sale of products of an industrial undertaking are eligible for deduction under Section 80-IB and 80-IC of the Income-tax Act

Background

Recently, the Supreme Court of the India (the Supreme Court) in the case of Meghalaya Steels Ltd.¹, held that the transport, interest, insurance and power subsidies are revenue receipts, which are reimbursed to the taxpayer for elements of cost relating to manufacture or sale of their products, and there is a direct nexus between profits and gains of the industrial undertaking and the reimbursement of such subsidies. Therefore, such subsidies are to be included in the profits eligible for deduction under Sections 80-IB and 80-IC of the Income-tax Act, 1961 (the Act).

It was also held that such subsidies amounted to reimbursement of costs, and have to be included under the head 'profits and gains of business or profession', and not under the head 'income from other sources'.

Facts of the case

- The taxpayer is engaged in the business of manufacture of steel and ferro silicon. The taxpayer filed its return of income for the year 2004-05 disclosing an income after claiming deduction under Section 80-IB of the Act on the profits and gains of business of its industrial undertaking. The taxpayer had received the transport, interest and power subsidies during the year.
- The Assessing Officer (AO) held that the amounts received by the taxpayer as subsidies were revenue receipts and did not qualify for deduction under Section 80-IB(4) of the Act. Accordingly, the taxpayer's claim for deduction on account of subsidies was disallowed.
- The Commissioner of Income-tax (Appeals) [CIT(A)] dismissed the appeal of the taxpayer. The taxpayer preferred an appeal before the Income-tax Appellate Tribunal (Tribunal) where the Tribunal held in favour of the taxpayer. The tax department filed an appeal before the High Court, which also went in favour of the taxpayer. Accordingly, the matter reached Supreme Court.

¹ CIT v. Meghalaya Steels Ltd. [CIVIL APPEAL No.7622 of 2014] – Taxsutra.com

The Supreme Court's ruling

- The tax department contended that there is a difference between the expression profits and gains 'derived from' any business, and profits 'attributable to' any business, and that since the section in the question speaks of profits and gains 'derived from' any business, such profits and gains must have a close and direct nexus with the business of the taxpayer. Subsidies that are allowed to the taxpayer have no close and direct nexus with the business of the taxpayer but have a close and direct nexus with grants from the government.
- In the case of Pandian Chemicals Limited², the question before the Supreme Court was as to whether interest earned on a deposit made with the electricity board for the supply of electricity to the appellant's industrial undertaking should be treated as income derived from the industrial undertaking under Section 80HH of the Act. It was held that although electricity may be required for the purposes of the industrial undertaking, the deposit required for its supply is a step removed from the business of the industrial undertaking. The derivation of profits on the deposit made with the electricity board could not be said to flow directly from the industrial undertaking itself.
- The Supreme Court in the case of Liberty India³, dealt with the question whether DEPB credit or duty drawback receipt could be said to be in respect of profits and gains derived from an eligible business. The Supreme Court made the distinction between 'attributable to' and 'derived from' stating that the latter expression is narrower in connotation as compared to the former. By using the expression 'derived from', the Parliament intended to cover sources, not beyond the first degree.
- In the case of Cambay Electric Supply Industrial Company Limited⁴, it was held that since an expression of wider import had been used, namely 'attributable to' instead of 'derived from', the legislature intended to cover receipts from sources other than the actual conduct of the business of generation and distribution of electricity. In short, a step removed from the business of the industrial undertaking would also be subsumed within the meaning of the expression 'attributable to'. This decision is relevant only insofar as it makes a distinction between the expression 'derived from', as being something directly from, as opposed to 'attributable to', which can be said to include something which is indirect as well.
- In the case of Sterling Foods⁵, the Supreme Court referred to the decision in the case of Cambay Electric Supply and emphasised the difference between the wider expressions 'attributable to' as contrasted with 'derived from'. The industrial undertaking itself had to be the source of the profit. The business of the industrial undertaking had directly to yield that profit. Further, there should be a direct nexus between such profits and gains, and the industrial undertaking or business. Such nexus cannot be only incidental. By reason of an export promotion scheme, the taxpayer was entitled to import entitlements which it could thereafter sell. The sale consideration therefrom could not be said to be directly from profits and gains by the industrial undertaking but only attributable to such industrial undertaking inasmuch as such import entitlements did not relate to manufacture or sale of the products of the undertaking, but related only to an event which was post manufacture namely, export.

⁴ Cambay Electric Supply Industrial Company Limited v. CIT [(1978) 2 SCC 644]

⁵ CIT v. Sterling Foods [(1999) 4 SCC 98]

² Pandian Chemicals Limited v CIT [2003] 262 ITR 278 (SC)

³ Liberty India v. CIT [2009] 9 SCC 328 (SC)

- On an application of the aforesaid test to the facts of the present case, as all the subsidies in the present case are revenue receipts which are reimbursed to the taxpayer for elements of cost relating to manufacture or sale of their products, there can certainly be said to be a direct nexus between profits and gains of the industrial undertaking or business, and reimbursement of such subsidies.
- What is to be seen for the applicability of Sections 80-IB and 80-IC of the Act is whether the profits and gains are derived from the business. So long as profits and gains emanate directly from the business itself, the fact that the immediate source of the subsidies is the government would make no difference as it cannot be disputed that the said subsidies are only in order to reimburse, wholly or partially, costs actually incurred by the taxpayer in the manufacturing and selling of its products.
- The 'profits and gains' under Sections 80-IB and 80-IC have reference to net profit. And net profit can only be calculated by deducting from the sale price of an article all elements of cost which go into manufacturing or selling it. Thus, the profits and gains are derived from the business of the taxpayer means profits arrived at after deducting manufacturing cost and selling costs reimbursed to the taxpayer by the government.
- The decision of the Supreme Court in the case of Pandian Chemicals Limited is distinguishable, as interest on a deposit made for the supply of electricity is not an element of cost at all. The derivation of profits on such a deposit made with the electricity board could not, therefore, be said to flow directly from the industrial undertaking itself. Unlike in the present case, all the subsidies went towards reimbursement of actual costs of manufacture and sale of the products of the business of the taxpayer.
- The case of Liberty India also does not help the tax department, where the Supreme Court was concerned with an export incentive, which is very far from reimbursement of an element of cost. A DEPB drawback scheme is not related to the business of an industrial undertaking for manufacturing or selling its products. DEPB entitlement arises only when the undertaking goes on to export the said product that is after it manufactures or produces the same. Therefore, it cannot be said that such duty exemption scheme is derived from profits and gains made by the industrial undertaking or business itself.
- The Calcutta High Court in the case of Merino Ply & Chemicals Ltd.⁶ held that transport subsidies were inseparably connected with the business carried on by the taxpayer. However, in the case of Andaman Timber Industries Ltd.⁷, the same High Court arrived at an opposite conclusion in considering whether a deduction was allowable under Section 80HH of the Act in respect of transport subsidy without noticing the earlier decision of the same court.
- The Calcutta High Court in the case of Cement Manufacturing Company Limited distinguished the decision in the case of Andaman Timber Industries Ltd. and followed the decision in the case of the Gauhati High Court, in the present case.
- In the decisions in the case of Merino Ply & Chemicals Ltd. and Cement Manufacturing Company Limited, the Calcutta High Court have correctly appreciated the legal position.
- The Supreme Court decision in the case of Sahney Steel and Press Works Ltd.⁸, dealt with subsidy received from the state government in the form of a refund of sales tax paid on raw

⁶ Merino Ply & Chemicals Ltd. v. CIT [1994] 209 ITR 508 (Cal)

⁷ CIT v. Andaman Timber Industries Ltd. [2000] 242 ITR 204 (Cal)

⁸ Sahney Steel and Press Works Ltd. v. CIT [(1997) 7 SCC 764]

materials, machinery, and finished goods; subsidy on power consumed by the industry and exemption from water rate. It was held that such subsidies were treated as assistance given for carrying on the business of the taxpayer.

- A Delhi High Court decision in the case of Dharampal Premchand Ltd.⁹ held that refund of excise duty should not be excluded in arriving at the profit derived from business for the purpose of claiming deduction under Section 80-IB of the Act.
- Section 28(iii)(b) specifically provides that income from cash assistance, by whatever name called, received or receivable by any person against exports under any scheme of the Government of India, will be income chargeable to income-tax under the head 'profits and gains of business or profession'. If cash assistance received or receivable against exports schemes are included as being income under the head 'profits and gains of business or profession', the subsidies which go to reimbursement of cost in the production of goods of a particular business would also have to be included under the head 'profits and gains of business or profession', and not under the head 'income from other sources'.

Our comments

There have been contrary decisions rendered by different High Courts in relation to including the operational subsidies in the profit eligible for deduction under Section 80-IB and 80-IC of the Act. Some of the High Courts have held that certain operational subsidies can be included in profits and gains of an industrial undertaking, whereas the others have held that such subsidies cannot be included. The Supreme Court of India has put this controversy at rest and held that

transport, interest, insurance and power subsidies given by the government for reimbursing the costs relating to manufacture/sale of the products are eligible for deduction under Section 80-IB and 80-IC of the Act.

The Supreme Court also held that the subsidies which go to reimburse the cost of the production of goods of a particular business would have to be included under the head 'profits and gains of business or profession', and not under the head 'income from other sources'. The 'profits and gains' mentioned in Sections 80-IB and 80-IC have reference to net profit, which can only be calculated by deducting from the sale price of an article, all elements of cost which go into manufacturing or selling it. Accordingly, the profits are to be arrived at after deducting manufacturing cost and selling costs reimbursed by the government.

The Finance Act 2015 has amended the definition of income under section 2(24) of the Act to provide that the income shall include assistance in the form of a subsidy, grant, cash incentive, duty drawback, waiver, concession or reimbursement (by whatever name called), by the central government, state government, etc., in cash or kind to the taxpayer, other than the subsidy, grant or reimbursement which is taken into account for determination of the actual cost of the asset¹⁰.

⁹ CIT v. Dharampal Premchand Ltd. [2009] 317 ITR 353 (Del)

¹⁰ In accordance with the provisions of Explanation 10 to section 43(1) of the Act

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