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## Operational subsidies are eligible for tax holiday if there is a direct link between the subsidies and manufacturing activities

### In brief

In a recent ruling, the Gauhati High Court (HC) in the case of Meghalaya Steels Ltd.<sup>1</sup> and Pride Coke Pvt. Ltd., held that the subsidies received by the assessee, which were operational in nature, were eligible for deduction under section 80-IB/80-IC of the Income-tax Act, 1961 (the Act). The HC held that subsidies which are inter-linked, inter-laced and directly linked with manufacturing activities are eligible for deduction under section 80-IB/80-IC of the Act.

### Facts

- Meghalaya Steel Ltd. is an industrial undertaking engaged in the manufacture of Steel and Ferro Silicon. Pride Coke Pvt. Ltd. is engaged in the manufacture of coke products. The assessee received subsidies for setting up units in backward areas, as per the central and state industrial policy, and claimed deductions under section 80-IB/80-IC of the act.

<sup>1</sup> CIT v. Meghalaya Steels Ltd. [TS-241-HC-2013(Gauh)]

Assessment Year under consideration	Name of the Assessee	Nature of subsidy	Section in consideration
2004-05	Meghalaya Steels Ltd.	Transport, Interest and Power subsidy	80-IB
2006-07	Pride Coke Pvt. Ltd.	Transport, Insurance, Interest and Power subsidy	80-IC

- The assessing officer (AO) in the case of Meghalaya Steels Ltd. disallowed the claim on the ground that the subsidies were *revenue receipt* and did not qualify for deduction. Furthermore, the AO treated them as income from other sources.
- The Commissioner of Income-tax (Appeals) (CIT(A)) upheld the AO's order and noted that subsidies could not be classed as profits and gains *derived from* manufacturing and accordingly, the assessee was not eligible for the deduction. However, CIT(A) held that as the subsidy had some commercial connection with the business, it should be assessed as business income.
- In the case of Pride Coke Pvt. Ltd, the assessing officer disallowed the claim with an observation that the subsidies received had no direct link with the industrial undertaking and hence were to be treated as other business income, which was ineligible for deduction.
- The CIT(A) allowed the assessee's appeal and took the view that subsidies received by the assessee would reduce the expenditure incurred on transport, insurance etc. As such, the subsidy received was judged eligible for deduction.

- On appeal before the Income-tax Appellate Tribunal (the Tribunal) in both cases, the Tribunal, relying on the decision in the case of Meghalaya Steels Ltd., held that subsidies are eligible for deduction under section 80-IB/80-IC of the Act.
- The Revenue challenged the decision of the Tribunal before the HC.

### Issues before the Tribunal

Whether subsidies are eligible for deduction under section 80-IB/80-IC of the Act?

### Revenue's contentions

- The object of subsidy was to encourage the setting up of new industries in backward regions, and subsidies were made available only after the production was commenced, hence they were revenues.
- There was no distinction between the phrases '*derived from*' and '*derived by*' used in section 80-IB/80-IC of the Act.
- A direct link between the subsidy and manufacturing activity could not be established, as the source of subsidy was Government schemes and so it could not be termed as profit and gains derived from/by industrial undertaking (known as '*first degree*' rule). In this regard, reliance was placed on the decision of Liberty India<sup>2</sup>, wherein it had been held that incentives originating from a Government scheme fell beyond first degree rule and hence were not entitled to deduction under Chapter VI-A.

### Assessee's contentions

- '*Derived from*' and '*derived by*' were two separate expressions and could not be used interchangeably; '*derived from*' means a direct source of the profits

<sup>2</sup> Liberty India v. CIT [2009] 9 SCC 328

and gains, and 'derived by' means the undertaking business is the recipient of the profits and gains.

- The ratio of the decision in the case of Liberty India (above) could not be applied, as the Duty Entitlement Passbook Scheme (DEPB) and Duty Drawback Scheme were schemes providing export incentives to augment exports. As such, the schemes were not related to the manufacturing or production activities.
- For various types of subsidies, the assessee relied on the industrial policy to contend that the objective was to subsidise the expenditure incurred.
- Assessee relied on the decision of Mepco Industries<sup>3</sup> wherein the court has pointed out that the nature of a subsidy is a fact specific exercise and has to be examined in each case independently.
- Furthermore, the assessee relied upon various decisions to support its contention, out of which the key decisions were:
  - **Transport subsidy**<sup>4</sup> –The object of the transport subsidy was to improve trade and commerce between the backward regions and other parts of the country.
  - **Power subsidy**<sup>5</sup> –This subsidy was aimed at neutralising the expenses incurred for power, and thus reinforced the eventual income of the business<sup>6</sup>.

## High Court Ruling

- The important question to be decided in these appeals was whether there was a direct link between the subsidies on the one hand, and the profits and gains of the undertaking on the other.
- The HC evaluated the provisions of the relevant industrial policy / scheme which allowed the assessee to claim subsidies and noted:
  - **Transport subsidy** – A transport subsidy was promised by the Government to eligible undertakings to reduce the cost of transportation of raw material, as well as finished goods, which would help the entities in reducing the cost of manufacturing. Thus there was a direct link between the subsidy and profits earned by the undertaking.
  - **Power subsidy** – A power subsidy was made available to the eligible undertaking in the form of a reimbursement of fully paid power bills, reducing the cost of production augmenting thereby the undertaking's income.
  - **Interest subsidy** – An interest subsidy was available to the extent of 3% on the working capital advanced to undertakings by scheduled banks or central/state financial institutions, for a period of 10 years, and this reduced the interest expense for undertaking. Thus, there was a direct link with the cost of manufacturing activity.
  - **Insurance subsidy** – An insurance subsidy was extended by way of a reimbursement of insurance premiums paid on business assets and stock, thereby reducing the undertaking's running costs.
- The HC discussed in detail the decision in the case of Liberty India (above) and held that the ratio of the decision was inapplicable to the current case. In Liberty India's (above) case, the Supreme Court dealt with DEPB and Duty

<sup>3</sup> Mepco Industries Ltd v. CIT 319 ITR 208 (SC)

<sup>4</sup> Jai Bhagwan Oil & Flour Mills v. UOI [2009] 14 SCC 63, Merinoply and Chemicals Ltd v. CIT 209 ITR 508 (Cal), Sarda Plywood Industries Ltd. v. CIT 238 ITR 354 (Cal)

<sup>5</sup> Sahney Steel and Press Works Ltd & others v. CIT 228 ITR 253 (SC)

<sup>6</sup> Panchratna Cement Pvt. Ltd. v. UOI 317 ITR 259 (Gau)

Drawback, which are export incentives and so not linked with manufacturing or production activities.

- In view of the above, the HC held that subsidies which are inter-linked, inter-laced and directly linked with manufacturing were eligible for deduction under section 80-IB/80-IC of the Act.

## **Conclusion**

The tax treatment of any operational subsidy received would depend upon the purpose for which it is granted, relevant provisions of the scheme and the tax benefits available to the undertaking.

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