

Subsidy received from holding company, to recoup losses of subsidiary, is not a trading receipt and hence not taxable under the Act

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Background

Recently, the Delhi High Court (High Court) in the case of Handicraft and Handlooms Export Corpn of India Ltd¹ (the taxpayer) held that subsidy received from parent company, to recoup losses of subsidiary, is not in the nature of revenue receipt. Since the parent company did not contribute trading income to the taxpayer, it is not taxable under the Income-tax Act, 1961 (the Act).

The High Court observed that the ruling pronounced in the taxpayer's earlier case has not been overruled by the decisions of the Supreme Court². The Supreme Court applied the purpose test and held that if the object of subsidy scheme was to enable the taxpayer to run the business more profitably, then the receipt would be on revenue account and taxable under the Act.

Facts of the case

- The taxpayer is a Government company and operates as channelising agency for sale of handicrafts and handlooms abroad. The taxpayer is a wholly owned subsidiary of State Trading Corporation (STC).
- The taxpayer approached STC for a grant in order to meet its liabilities consequent to loss suffered in export business.
- During the year under consideration the taxpayer received INR 2.5 million as grant from STC. This grant was given to recoup losses incurred by the taxpayer and was in the nature of capital contribution. The taxpayer claimed that grant received was not taxable since it is a capital receipt.

¹ CIT v. Handicraft and Handlooms Export Corpn of India Ltd (ITA No 3/2001) – Taxsutra.com

² Decision of the Supreme Court in the case of Sahney Steel and Press Works Ltd v. CIT [1997] 7 SCC 764 (SC) and CIT v. Ponni Sugars and Chemicals [2008] 9 SCC 337 (SC)

- The Assessing Officer (AO) held that the payment received by the taxpayer was a trading receipt and consequently brought the same to tax. However, the Income-tax Appellate Tribunal (the Tribunal) has decided the issue in favour of the taxpayer following the taxpayer's earlier decision³ of the High Court.

Issue before the High Court

- Whether grant received by the taxpayer from its holding company to recoup losses is a revenue receipt?

Tax department's contention

- The present decision is overruled by the Supreme Court in the case of Sahney Steel and Press Works Ltd.

High Court's ruling

- The High Court referred to the decision of the Kerala High Court in the case of Ruby Rubber Works Ltd.⁴ where it has been held that where subsidy is received for acquisition of an asset by replanting rubber plants of high yield varieties, it would be of capital in nature. Similarly, subsidy received for producing new original films was held to be capital receipt as they were for creating or acquiring of a new asset.
- The High Court referred to the decision of the Supreme Court in the case of Ponni Sugars and Chemicals which has explained the performance test and observed that it is the object for which the subsidy/assistance is given which determines the nature of the incentive subsidy. The form of the mechanism through which the subsidy is given is irrelevant.
- The High Court referred to the decision of the Supreme Court in the case of Sahney Steel and Press Works Ltd. where it has been observed that the source from which the amount is paid to the taxpayer is not determinative whether the subsidy payments are of revenue or capital nature. If the payment was made to the taxpayer to assist him in carrying on his trade or business, it was considered as revenue receipt. However, if the funds are given to the taxpayer to acquire new machinery for further expansion of manufacturing capacity, it was held to be capital receipt in the hands of the taxpayer.

- The Delhi High Court in taxpayer's earlier decision has held that the grant received from holding company was of capital in nature and not revenue or contributing to the trading income of the taxpayer.
- In the present case, the amount was not paid by a third party or by a public authority but by the holding company. It was not on account of any trade or a commercial transaction between the subsidiary and holding company. The holding company was a shareholder and the shares were in the nature of capital. Share subscription money received in the hands of the taxpayer was a capital receipt.
- The intention and purpose behind the said payment was to secure and protect the capital investment made by STC in the taxpayer. The payment of grant by STC and receipt thereof by the taxpayer was not during the course of trade or performance of trade, therefore, it can be classified as a gift or a capital grant and did not partake character of trading receipts.
- It cannot be said that the earlier decision of the Delhi High Court has been overturned by the Supreme Court in the two decisions⁵. Therefore, the grant received from holding company for recouping losses of its subsidiary is not taxable as revenue receipt under the Act.

Our comments

Taxability of grant received from holding company to recoup losses of its subsidiary is a contentious issue before the judiciary from a long time. Various Courts have held that payment received from holding company for recouping losses of its subsidiary is a capital receipt. However, the purpose for which the amount is received determines whether the transaction is capital or revenue in nature and the resultant taxability of such receipts.

Though such receipts are not taxable because it is capital in nature, a company may need to evaluate the impact under the provisions of Minimum Alternate Tax if such receipts have been considered while computing book profits.

³ Handicrafts & Handlooms Exports Corporation of India Ltd. v. CIT [1983] 140 ITR 532 (Del)

⁴ CIT v. Ruby Rubber Works Ltd [1989] 178 ITR 181 (Ker)

⁵ Sahney Steel & Press Works Ltd. and Ponni Sugars and Chemicals (SC)

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