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DIRECT TAX ALERT

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Bombay High Court upheld the constitutional validity of amendment made in definition of term "income" relating to taxability of subsidies

BACKGROUND

- Prior to introduction of Income Computation and Disclosure Standards (ICDS) and amendment made by Finance Act' 2015, there was no provision in the Income Tax Act, 1961 ("The Act") which explicitly dealt with the taxability of Subsidies. However, through catena of judgements addressing the taxability of Subsidy, a principle was drawn that taxability of subsidy shall depend on whether the subsidy is a capital receipt or revenue receipt in the hands of the assessee.

- For ascertaining the character of Subsidies as capital or revenue in nature, the Hon'ble Supreme Court in the landmark cases of **Sahney Steel**[1] & **Ponni Sugars and Chemicals Ltd**[2] has laid down the broad principle that whether a subsidy is capital or revenue receipt is to be judged from view point of the purpose for which it is given. It is the object for which the subsidy is given that needs to be examined while determining the nature of the subsidy.

- Hon'ble Apex Court while reiterating the significance of 'purpose test' has held that the point of time at which the subsidy is paid is not relevant, the source of the subsidy is immaterial; the form of subsidy is equally immaterial. Further, it was held that if the subsidy is granted for setting up or expansion of the existing unit, it would be regarded as capital receipt. On the other hand, if the purpose of granting subsidy is to help the assessee to run the business more profitably or meet daily business expenses, it is to be considered a revenue receipt and thus taxable.

- Thereafter, in exercise of the powers conferred by Sec. 145(2), CBDT vide **Notification**[3] notified Income Computation Disclosure Standards (ICDS) which was made applicable for the purpose of computation of Profit & Gains from Business or Profession and Income from Other Sources. As per ICDS –VII – "Government Grant", Government grant shall be either deducted from the actual cost or WDV of block of asset or recognized as income over the same period over which the cost of meeting such

[1] Sahney Steel & Press Works Ltd. -vs.- CIT (1997) 228 ITR 253 (SC)
[2] CIT –vs.- Ponni Sugars & Chemicals Ltd. (2008) 306 ITR 392 (SC)

[3] Notification No. 32/2015 dated 31-03-2015

obligations is charged to income. Thus, there was no provision in the ICDS to exclude any Government Grant from income tax on the contention that same is a capital receipt.

- Hence, ICDS was in conflict with the judicial decisions which have laid down the purpose test while analyzing the nature of subsidy. Further, preamble to ICDS provided that in case of conflict between ICDS and IT Act, the provisions of IT Act shall prevail. Thus, subsidy could not be taxed in absence of amendment to definition of "income".

- In light of the aforesaid, the Accounting Standard Committee, which drafted the ICDS, suggested that the definition of income under clause (24) of Section 2 of the Act be amended to tax subsidy so as to avoid any future controversy in this matter.

- Vide Finance Act, 2015, amendment[4] was made in the definition of "income" under Sec. 2(24) with effect from A.Y. 2016-17 by inserting a new sub-clause (xviii) which provided that subsidies, grants, cash incentives, duty drawback, waivers, concessions or reimbursements provided by the Central or State Governments etc. either in cash or kind, will be included within the meaning of term "income" and consequently, will be taxable under the Act.

- Subsequent, to the amendment, any subsidy or incentives given in whichever form by the Government and with whatever purpose or objective are to be treated as income and assessable to tax irrespective of the fact as to whether or not the same is in the nature of capital assistance and or revenue assistance.

- After the amendment made vide Finance Act, 2015, Hon'ble Apex Court judgements laying down the "purpose test" to classify the subsidy or incentive as capital or revenue receipt, shall not be applicable if subsidy or incentive is received on or after 01-04-2015.

BRIEF FACTS

- In the present case, assessee[5] is a bio-technology company and engaged in the manufacturing of drugs and vaccines and has expanded its business unit in Maharashtra. The Government of Maharashtra had issued several Industrial Policies and Schemes to promote industries in less developed areas of the State of Maharashtra which includes Package Scheme of Incentives, 2013' w.e.f. 01-04-2013. In pursuance of it, assessee made capital investment of more than Rs. 1,500 Crs and made application on 27-03-2018 for being eligible under the scheme. The same was approved by State of Maharashtra on 12-10-2018 whereby assessee was entitled to incentive to the extent of 75% of eligible investment in the form of exemption of electricity duty, 50% stamp duty on land acquisition, VAT/CST/SGST etc.

- The concerned incentive received is for encouraging capital investments which will indirectly create jobs and nurture the economy. Though the true nature of such subsidy is to support or supplement the capital invested by the assessee, therefore, a capital receipt, however the same shall be treated as "Income" u/s 2(24)(xviii) by virtue of amendment made in said definition of term 'income' vide Finance Act, 2015.

- In this regard, the assessee challenged the constitutional validity of the above amendment, by filing the writ before Hon'ble Bombay High Court, raising following points:-

  - The amendment has unintended retrospective application since at the time of introduction of the Scheme by the State Government, the impugned sub- clause was not there in the Act.

  - The amended Sec. 2(24) seeks to tax a capital receipt which obliterates the fundamental distinction between "income" and "capital receipts" disregarding the constitutional scheme that tax can be imposed only on

[4] The said amendment was introduced by amending the Finance Bill, 2015 and was not part of Finance Bill, 2015.

[5] Serum Institute of India Private Limited –vs.- UOI & Ors (2023) 157 taxmann.com 107 (Bom. HC.)

"income" and hence is constitutionally impermissible.

- The amendment does not create any distinction between taxability of a capital subsidy or revenue subsidy and is contrary to the principles of "real income" theory which is one of the foundations for levy of income tax, and hence liable to be struck down as being unconstitutional and violates fundamental rights. The legislature has not provided any legal or rationale basis for the amendment.

- The expression "income" defined u/s 2(24) read with Sec. 4 of the Act denotes that income is any monetary return coming in. In case of capital subsidy, there is no monetary return coming in. Only "real income" is taxable. Further, the Hon'ble Apex Court has repeatedly held that a capital receipt is not a taxable receipt, and consequently not an income and to amend the Sec. 2(24) in the teeth of the Supreme Court's decision without any rationale or any reason is ultra vires the Constitution of India.

- The impugned sub-clause seeks to expand the scope of "income" beyond the meaning which could be capable of being ascribed under Entry 82 of List 1 to Schedule VII of Constitution.

- The State Government which provides incentives from its funds to promote industries and employment, hence levy of tax by the Central Government on these incentives will be an indirect mechanism to tax the revenue of the State which is impermissible under the Constitution and violates the Article 289 of the Constitution.

- The sub-clause (xviii) of Sec. 2(24) is in violation of Articles 12, 14, 19(1)(g), 246, 265 and 289 of the Constitution of India and is contrary to the provisions of Sec. 4 and 5 of the Income Tax Act, 1961.

- In absence of any specific head, the income is to fall under the residuary head "income from other sources". This classification, however, may not be correct as these subsidies, if assumed to be subsidies, will be treated as business income. Therefore, in absence of any corresponding amendment to Section 28 of the Act, subsidies received on capital account remains outside the scope of Section 28 and thereby not taxable under the Act.

- The impugned amendment to include capital subsidies amounts to legislative overruling of several Supreme Court decisions which is impermissible. It was mandatory for Parliament to have removed the basis of the Supreme Court rulings on subsidies by a suitable explanation which has not been done.

- Alternatively, it was contended that the impugned sub-clause should be read down to the extent it purports to cover subsidies/grants/assistance received in "capital account" within the taxation ambit.

ISSUE BEFORE THE HON'BLE HIGH COURT

- Whether, the writ petition filed by the assessee challenging the constitutional validity of the insertion of sub clause (xviii) of Sec. 2(24) of the Act vide Finance Act, 2015 whereby all incentives given in whichever form by the Government and with whatever purpose of objective are to be treated as income, irrespective of the fact as to whether or not the same is in the nature of capital assistance and or revenue assistance, is sustainable?

RULING OF THE HON'BLE BOMBAY HIGH COURT

- Hon'ble Bombay High Court while rendering the judgement observed that there is a very limited scope in challenging the constitutional validity since the fulcrum of the constitutional challenge is the question of legislative competence. Every legislation is an experiment in achieving certain desired ends and trial and error method is inherent in every such experiment. The legislature should be allowed some play in the joints because it has to deal with

complex problems which do not admit of solution through any doctrine or straight jacket formula which is more particularly evident in case of legislation dealing with economic matters.

- Reliance was placed in the ruling of Hon'ble Apex Court in the case of **R. K. Garg**[6], where it was held that every legislation particularly in economic matters is essentially empiric and it is based on experimentation. There may be crudities, inequities and even possibilities of abuse but on that account alone it cannot be struck down as invalid. Moreover, there is always a presumption in favour of the constitutionality of a statute and the burden is upon him who attacks it to show that there has been a clear transgression of the constitutional principles.

- Further, reliance was placed on the judgement of Hon'ble Apex Court in **Federation of Hotel and Restaurant**[7], wherein it has been held that there has to be flexibility in the modes of effectuating a tax in view of inherent complexities in fiscal adjustment of diverse economic factors.

- Taxing laws are not outside the scope of Article 14 of the Constitution of India, however, having regard to the wide variety of diverse economic criteria that go into the formulation of a fiscal policy, legislature enjoys a wide latitude in the matter of taxation. Legislative assumption cannot be condemned as irrational and constitutionality shall be presumed even if it bring some hardship in some individual cases which is, inevitable since "every cause, it is said, has its martyrs".

- Mere excessiveness of a tax or even the circumstance that its imposition might tend towards the diminution of the earnings or profits of the persons of incidence does not constitute violation under Article 19(1)(g).

- Hon'ble High Court rejecting the petitioner's stance observed that there was nothing arbitrary in amendment made in Finance Act, 2015 and it did not suffer from the vice of discrimination since all have been treated with equality and uniformity and there is no discrimination against any particular persons or classes.

- In the present case, the legislative power of the Parliament to enact sub-clause in the light of Article 245 of the Constitution is not doubted at all.

- The imposition of tax on the subsidies under the amended provision does not constitute "taking away" of a benefit but rather represents a recalibration of fiscal advantages in line with broader economic and policy considerations. It is the duty of the legislature to ensure that taxation policy reflects a balance between incentivizing economic activity and ensuring the equitable distribution of fiscal resources. Sec. 2(24)(xviii) of the Act is an example of this balancing act, and its imposition is a reflection of a subsidy's life cycle coming to its fiscal fruition.

- When petitioner applied for the subsidy, the amendment u/s 2(24)(xviii) had been in effect for more than two years and the petitioner who is engaged in business activities is presumed to have conducted due diligence and engaged in careful planning, which would undoubtedly include an assessment of tax implications on all fiscal benefits, including subsidies. By choosing to partake in the subsidy scheme, petitioner implicitly acknowledged and consented to the accompanying tax obligations as legislated by the amendment. The amendment was in public knowledge and the implications of the inclusion of subsidies within the ambit of taxable income were clear and unambiguous and it is a well settled principle that ignorance of the law is no excuse.

- It is permissible for a competent Legislature to overcome the effect of a decision of a Court setting aside imposition of tax by passing a suitable legislation, by amending the relevant provisions of the statute concerned with retrospective effect. Thus, it should be left to the wisdom of the Legislature to decide whether there should be an amendment or explanation.

[6] R. K. Garg -vs.- UOI and Ors. (1981) 4 SCC 675 (SC)
[7] Federation of Hotel and Restaurant -vs.- UOI (1989) 3 SCC 634

- A retrospective annulment of this provision would cause a state of chaotic disarray as the individuals and entities that have complied with the tax obligations thereof stand to face an untenable situation. Dismantling this retrospectively would be to penalize compliance and create an environment of uncertainty and unpredictability in tax matters. Moreover, such a judicial step would likely instigate a flood of claims and litigations for refund of taxes paid under the provision, straining the administrative machinery and judicial resources. This would not only disrupt the revenue stream but also place an undue burden on the exchequer.

- In **Bhagwan Dass Jain -vs.- Union of India and Ors[8],** the argument made by the assessee was that as assessee is not deriving any monetary benefit by residing in his own house, no tax can be levied on him on the ground that he is deriving income from that house. Repelling this contention, Apex Court held that the word "income" in Entry 82 is capable of a wider meaning than what was given to it in the Indian Income Tax Act, 1922 or the English Act of 1918 and includes all items which were taxable under the contemporaneous law.

- Matters of economic policy should be best left to the wisdom of the legislature. In the context of a changed economic scenario, the expertise of the people dealing with the subject should not be lightly interfered with. While dealing with economic legislation, the Court would interfere only in those cases where the view reflected in the legislation is not possible to be taken at all. Further, the mere fact that the institution of tax by virtue of the insertion of sub clause (xviii) in Sec. 2(24) falls more heavily on the assessee cannot result in its invalidity.

- The amendment to Sec. 2(24) of the Act by the insertion of sub-cause (xviii) vide Finance Act, 2015, was a perfect example of a legislative endeavour to align the definition of "income" with the evolving economic landscapes and judicial precedent of it being an inclusive and elastic term. The amendment indicates the well-established jurisprudential path ensuring that the income tax laws remain in line with the economic realities and continue to serve as a vital cog in the nation's fiscal machinery and ensuring the equitable distribution of fiscal resources.

- In view of the above, Hon'ble Bombay High Court dismissed the assessee's writ petition.

KEY TAKEAWAYS

- The decision of Hon'ble High Court reinforces the principle that there is a very limited scope in challenging the constitutional validity and unless a fiscal statute is manifestly arbitrary or discriminatory in its provisions or its operation, it cannot be struck down.

- In taxing statutes, legislature holds the power to frame laws to plug in specific leakages. Merely because tax falls more heavily on the assessee due to any amendment, that cannot result in its invalidity.

- The petitioner, among others, has challenged under which head of income subsidy shall be taxable since corresponding amendment were not made either in charging Sec. 28 (business income) or Sec. 56 (Income from other sources). In the absence of amendment, the same shall be not taxable. However, the High Court has not rendered any finding on the said issue since the core issue for consideration before the Hon'ble High court was on the constitutional validity of sub clause (xviii) of Sec. 2(24) of the Act. Hence the said issue still remains open for adjudication.

- It may so happen that SLP could be filed before the Hon'ble Supreme Court against the aforesaid High Court decision. Thus, till the matter is finally decided by the Hon'ble Supreme Court, assessee's may be in a precarious position regarding the stand to be taken with respect to treatment of the subsidy in the return of income.

[8] (1981) 2 SCC 135

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