

Direct Tax Alert

April 13, 2023

Supreme Court denies deduction under section 80-IB with respect to receipts under Duty Drawback Scheme and on transfer of DEPB

Supreme Court in recent ruling¹ has denied deduction under section 80-IB with respect to receipts under the Duty Drawback Scheme and in respect of profit from transfer of Duty Entitlement Pass Book ('DEPB'), holding that these receipts are not 'derived from' industrial undertaking and fail the test of 'first degree of nexus' with the profits and gains of the industrial undertaking.

Background

- Taxpayer, a partnership firm, was engaged in the business of exports of wooden handicrafts. During the AY 2008-09, taxpayer claimed deduction under section 80-IB of the Income-tax Act, 1961 ('Act') *inter alia* of Rs. 70,197/- on account of DEPB and of Rs. 76,27,636/- on account of receipts under the Duty Drawback Scheme.
- The Assessing Officer ('AO') disallowed the deduction in respect of DEPB and Duty Drawback and this action was upheld by CIT(Appeals). Tribunal however, allowed the deduction to the taxpayer, observing that the decision of Supreme Court in case of *Liberty India*² had not considered the newly inserted clause (iiid) to section 28 of the Act and was therefore *per incuriam*.

¹ *M/s. Saraf Exports v. CIT* [Civil Appeal No. 4822 of 2022]

² *Liberty India v. CIT* [2009] 317 ITR 218 (SC)



- On appeal the High Court decided the matter against the taxpayer relying upon the decisions in case of *Liberty India* (supra) and *Sterling Foods*³. Aggrieved by the decision of High Court the taxpayer filed an appeal before the Hon'ble Supreme Court.
- The question before the Supreme Court was whether on profit from DEPB and Duty Drawback Schemes, the taxpayer is entitled to deduction under section 80-IB of the Act, and whether such an income can be said to be an income 'derived from' industrial undertaking.

Contention of the Taxpayer

- Taxpayer mainly contended that the receipts from Duty Drawback and DEPB were derived from industrial undertaking as they had direct nexus with the cost of the imports made by an exporter for manufacturing the export products⁴.
- Taxpayer heavily relied on ruling of Supreme Court in *Meghalaya Steels*⁵ where the Supreme Court allowed deduction under section 80-IB with respect to transport, interest, and power subsidies on the ground that these subsidies went on to reduce the cost of manufacturing.
- The taxpayer submitted that Supreme Court in *Meghalaya Steels* (supra) did not accept reliance on *Liberty India* (supra) put forth by Revenue to buttress their contention that receipts from government did not have first degree nexus with the

industrial undertaking and are not derived from industrial undertaking.

- Further, taxpayer also brought to fore the ruling of Delhi High Court in case of *Dharam Pal Prem Chand Ltd.*⁶ approved in *Meghalaya Steels* where the excise duty refund was held to be eligible for deduction under section 80-IB of the Act as the same went on to reduce the cost of manufacturing.
- Also, it was contended that these receipts were taxable under section 28 as profits and gains of business and profession and that therefore had to be also regarded as profit and gains of the industrial undertaking for section 80-IB.

Contention of the Revenue

- Revenue strongly argued that the issue was squarely covered against taxpayer by the rulings of Supreme Court in case of *Liberty India* (supra) and *Sterling Foods* (supra).
- Revenue submitted that Duty Drawback and DEPB benefits would constitute independent source of income and cannot be credited against the cost of manufacture. The Revenue therefore submitted that these receipts were beyond the first-degree nexus between profits of the industrial undertaking.
- It was submitted by Revenue that in *Meghalaya Steels* (supra) the subsidies had direct connection with the industrial activity of manufacturing, unlike Duty Drawback and DEPB which were related

³ (1999) 4 SCC 98

⁴ *Topman Exports v. CIT* [2012] 342 ITR 49 (SC)

⁵ [2016] 383 ITR 217(SC)

⁶ [2009] 317 ITR 353 (Delhi HC)



to stage of export; and to this effect they relied on *Meghalaya Steels* (supra).

- It was submitted that the object behind Duty Drawback and DEPB is to neutralise the incidence of customs duty payment on the import content of the export product. In such a scenario, it cannot be said the receipts on account such duty exemption scheme, were derived from the industrial undertaking.
- Further, Revenue put strong emphasis on the provisions of section 80-IB which used the word 'derived from' and not 'attributable to', wherein the former phrase has a narrower connotation and coverage as compared to the latter.
- Revenue also put forth the contention that the provisions of section 28 and section 80-IB are on different footing, where the former treated the receipts as profit and gains of business whereas in section 80-IB deduction was qua the profits from the industrial undertaking.

Ruling of the Supreme Court

- Hon'ble Supreme Court concurred with the Revenue and observed that issue is fully covered by *Liberty India* (supra) and *Sterling Foods* (supra).
- It noted that DEPB and Duty Drawback Schemes are incentives which flow from the schemes framed by the Central Government or from Section 75 of the Customs Act, 1962 and, hence, these are not profits derived from the industrial undertaking.
- While observing the ruling in case of *Sterling Foods* (supra), Hon'ble Supreme Court noted that for the application of the

words 'derived from', there must be, a direct nexus between the profits and gains and the industrial undertaking, whereas in case of import entitlements, the nexus is not direct but only incidental.

- The Supreme Court concurred with the contention of the Revenue that section 28(iiiia) to (iiie) regard these receipts as profits and gains of business, however for section 80-IB it must be profits and gains derived from industrial undertakings.
- Lastly, the Supreme Court distinguished *Meghalaya Steels* (supra) noting that export incentives in form of Duty Drawback and DEPB were very far from reimbursement of cost.
- Hon'ble Supreme Court held that receipts under Duty Drawback and DEPB do not form part of the profits of industrial undertaking and are not eligible for deduction under section 80-IB of the Act.
- The Supreme Court has specifically stated that any contrary decisions of any High Courts shall not be good law.

Dhruva Comments

- Another ruling after *Liberty India* (supra) on section 80-IB holding that the DEPB and Duty Drawback receipts are not to be reckoned as profits and gains derived from the industrial undertaking.
- Interestingly, in this case it was not argued before the Supreme Court that provisions of section 80-IB(1) which provide for deduction refer to profits and gains derived from any 'business' whereas the provisions of section 80-IB (3) and (4) quantifying the deduction, refer to the profits and gains derived from



such '*industrial undertaking*'. Since the base provision which provides for the deduction refers to profits from the business and provisions of section 80-IB(3) or (4) are computation provisions, the former should prevail over the later. Although, the Supreme Court has now ruled that export incentives are not derived from '*industrial undertaking*' but, whether it can be argued that such incentives are derived from '*business*', has possibly not been put pointedly before the Supreme Court and has therefore been still left unanswered. 'Profits from the business' could be wider in amplitude than profits from the industrial undertaking.⁷

- It would further be fascinating to unravel whether this ruling would hold good where the provisions use the term '*derived from business*' as used in section 80-IBA, 80-IAC, etc.

Impact on other incentives

- This ruling should arguably not have an impact on other receipts such as transport subsidy, power subsidy, interest subsidy, excise duty refund, etc., which are received as reimbursement of manufacturing cost incurred in the industrial activity. The deduction under 80-IB in respect of such receipts should continue to be allowed to taxpayer basis *Meghalaya Steels* (supra) and other applicable rulings.

Impact on concluded assessments

- As the Supreme Court has specifically stated that any High Court rulings to the contrary would be bad in law, interesting issues would arise on whether the Revenue shall be entitled to reopen the assessments of the past years which have already stood concluded or initiate proceedings for rectification.

Impact on ongoing assessments and positions to be taken in tax return

- The taxpayers may face disallowances in respect of proceedings which may be presently pending at any level. However, the taxpayer should be able to defend any potential penalty implications if the claim is bona fide⁸ and made basis the favorable rulings. The taxpayer could face interest exposure on such claims.
- Furthermore, the taxpayers would also need to assess their advance tax liability of the current year such that any interest exposure is minimized to the extent possible.
- Taxpayers should also consider whether there is any need to revise/update the tax returns of the earlier years.

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Hope you will find this alert useful. For any queries in relation to this tax alert, you can reach out to Dhruva Advisors LLP.

⁷ *ACIT v. Maxcare Laboratories Ltd.* [2005] 92 ITD 11 (Cuttack), *ACIT v. Kunal Printers Ltd.* [2005] 2 SOT 414 (Ahd.)

⁸ *CIT v. Haryana Warehousing Corporation* [2009] 314 ITR 215 (Punjab & Haryana)



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