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DIRECT TAX ALERT

October 21, 2026

Supreme Court holds Power
Subsidy as Revenue Receipt

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The Hon'ble Supreme Court¹ holds that the power subsidy received under the Power Subsidy Scheme of the Government of Pondicherry, constitutes a revenue receipt taxable under the Income-tax Act, 1961 ("the Act"). Reaffirming the 'purpose test', the Court observes that the immediate and operative purpose of the financial assistance determines character of Subsidy in the hands of the assessee. Since the subsidy was calculated with reference to the electricity charges incurred in the manufacturing operations and was not linked to the acquisition of any capital asset or expansion of its industrial undertaking, the same was held to be revenue in nature.

Background

- M/s Mepco Industries Ltd. ("the taxpayer") was engaged in the business of manufacturing potassium chlorate. It received power subsidy from the Government of Pondicherry during Assessment Year ("AY") 1997-98 pursuant to Power Subsidy Scheme ('the Scheme') launched to foster the growth of industries in the Union Territory of Pondicherry.
- Under the Scheme, eligible industrial units were entitled to a subsidy on power charges for five years from commencement of production. The subsidy was calculated at 33⅓% of actual power charges for the first three years, 20% for the fourth year and 10% for the fifth year, subject to the applicable ceiling.
- The Assessing Officer ("AO") treated the subsidy as a revenue receipt and levied tax on the same. The Commissioner of Income-tax (Appeals) ["CIT(A)"] and the Income Tax Appellate Tribunal ("ITAT") upheld the AO's order.
- The Madras High Court, relying on the decision in the case of Karaikal Chlorates Ltd.², dismissed the taxpayer's appeal and upheld the treatment of the subsidy as a revenue receipt.

- Aggrieved by the decision of the High Court, the taxpayer preferred an appeal before the Hon'ble Supreme Court.

Issue under consideration

- Whether the electricity subsidy received by the taxpayer under the Power Subsidy Scheme constitutes a capital receipt or a revenue receipt under the Act?

Taxpayer's contentions

- The taxpayer emphasised the stated purpose of the scheme, contending that the incentive was intended to encourage industrial activity rather than merely reimburse an expense incurred in the ordinary course of business.
- The scheme was framed with the broader objective of fostering industrial growth in the Union Territory of Pondicherry and encouraging the establishment of industries in backward areas. Accordingly, the subsidy should be treated as 'capital receipt' by reference to the objective sought to be achieved by the scheme.

¹ MEPCO Industries Ltd. (Civil Appeal No. 8694 of 2012)

² 2011 SCC OnLine Mad 2604

Revenue's contentions

- The Revenue's position, as reflected in the assessment and the findings of the lower authorities, was that the subsidy represented assistance towards the cost of electricity consumed in the course of taxpayer's business operations and hence, should be treated as 'revenue receipt'.
- Since the subsidy was computed as a specified percentage of actual power charges, its immediate effect was to reduce the expenditure incurred in carrying on the taxpayer's existing business. The subsidy was therefore regarded as operational assistance rather than assistance towards the establishment of the industrial undertaking.
- Placing reliance on the decision in *Sahney Steel & Press Works Ltd.*³, the Revenue contended that the subsidy was provided as an assistance in carrying on the business rather than as a contribution towards the capital outlay of the industrial undertaking. The Subsidy was also not earmarked for any capital purpose such as acquisition of plant and machinery.
- Consequently, the power subsidy, being assistance received after commencement of production and operating to reduce the cost of electricity consumed by the appellant, should be treated as revenue in character.

Ruling of the Supreme Court

- The Supreme Court referring to its earlier decisions in the case of *Sahney Steel & Press Works Ltd.* (supra) and *Ponni Sugars and Chemicals Ltd.*⁴, reaffirmed 'the Purpose Test' that the character of a subsidy must be determined with reference to the 'Purpose' for which it is granted. The purpose of the subsidy has to be ascertained from the scheme as a whole and not merely from a general statement of policy or from the nomenclature employed by the Government.
- The "purpose test" cannot be applied by isolating one general object clause while disregarding the operative provisions of the scheme. The scheme must be read as a whole, and when so read, the general object of industrial development is

implemented through a specific subsidy on power charges, calculated with reference to actual energy charges and available only for a defined period after production commences. It is this immediate and operative purpose of the financial assistance that determines its character in the hands of the assessee.

- The fact that a scheme of subsidy is intended to encourage industrial growth, employment or development of a backward area cannot, by itself, conclude the character of the receipt. It is also important to examine the manner in which the incentive actually operates and the benefit which it is designed to confer upon the recipient.
- The broader object of the Scheme cannot be viewed in isolation since an industrial incentive may undoubtedly have the broad economic objective of encouraging industrialisation, employment or development of a backward region, while the particular financial assistance granted under the scheme may nevertheless be intended to meet an operational cost of an industry which has already commenced production. Therefore, the relevant inquiry is not whether the scheme, viewed at a high level, seeks to promote industry, but what the subsidy is intended to achieve in the hands of the recipient.
- Supreme Court reiterated the principles that the point of time at which the subsidy is paid, its source and its form are not decisive, but the decisiveness is on the object sought to be achieved by the scheme. Where the object is to enable the assessee to run its business more profitably, the receipt is held to be on revenue account, and where the object is to enable the assessee to set up a new unit or substantially expand an existing unit, the receipt is on capital account.
- The subsidy was not an independent grant calculated with reference to the capital invested in the industrial undertaking, rather its quantum moved directly with the electricity charges incurred in the course of production. The power subsidy granted to the assessee was tied to power charges, and the scheme itself contemplated that the

³ (1997) 7 SCC 764

⁴ (2008) 9 SCC 337

consumer would pay the electricity charges and claim subsidy with reference to the electricity consumed for the manufacturing process.

- The fact that the subsidy was released only after commencement of production cannot be regarded as the sole reason for treating it as revenue.
- The Supreme Court distinguished its earlier decision in the case of Chaphalkar Brothers⁵, where the subsidy was held to be capital in nature because the scheme was designed to encourage the construction of highly capital-intensive multiplex complexes. In the present case, by contrast, the subsidy reduced electricity expenditure incurred after production commenced. The different outcomes reflected the application of the purpose test to the specific terms and objectives of the respective schemes.
- Given the direct linkage of the subsidy to actual electricity charges, its effect of reducing operating expenditure and the absence of any demonstrated nexus with capital investment, the Court held the Power Subsidy as revenue receipt.

⁵ (2018) 13 SCC 358

The Supreme Court's decision reaffirms the importance of the Purpose Test in determining whether a government subsidy constitutes a capital or revenue receipt. However, the taxpayer should take into consideration the Subsidy Scheme in totality (including operative mechanics) while determining the Purpose of the Scheme.

For taxpayers receiving government incentives, the decision highlights the importance of examining the scheme's operative provisions, eligibility conditions, computation methodology and any restrictions on the utilisation of the assistance. The distinction between a subsidy intended to support capital investment and one that reduces expenditure incurred in the ordinary course of business remains central to the analysis. The tax treatment should therefore follow the substance and operation of the particular scheme, rather than its stated policy objective alone.

The decision also clarifies the relationship between the Purpose Test and receipt of such subsidy. The fact that the subsidy was available only after commencement of production was not treated as conclusive in itself.

The Supreme Court decision would be relevant for the ongoing pending appellate proceedings for the Assessment Year 2015-16 or earlier regarding the taxability of subsidy receipts.

Subsidy taxation has undergone changes from Assessment Year 2016-17 onwards. With introduction of Section 2(24)(xviii) of the Income-tax Act, 1961, any subsidy directly / indirectly relatable to depreciable assets, shall be adjusted from the 'Actual Cost' of such depreciable assets. However, if such Subsidy is not relatable to depreciable asset, such subsidy would be treated as an 'income' under section 2(24) of the Act [corresponding to section 2(40) of the 2025 Act], except in the case of corpus subsidy receivable by trust or institutions established by the Government. Post Assessment Year 2016-17, the ratio laid down by the Supreme Court decision regarding 'Purpose Test' would be helpful to determine the relationship between the depreciable asset and the Subsidy receipt.

Contributors

[Rushi Shah \(Senior Manager\)](#)

[Jay Kosarekar \(Senior Associate\)](#)

For any queries in relation to this tax alert, please feel free to reach out.



ADDRESSES

Mumbai

Dhruva Advisors India Pvt. Ltd.
1101, One World Center,
11th Floor, Tower 2B,
841, Senapati Bapat Marg,
Elphinstone Road (West),
Mumbai – 400 013
Tel: +91 22 6108 1000 / 1900

Ahmedabad

Dhruva Advisors India Pvt. Ltd.
402, 4th Floor, Venus Atlantis,
100 Feet Road, Prahlad Nagar,
Ahmedabad – 380 015
Tel: +91 79 6134 3434

Bengaluru

Dhruva Advisors India Pvt. Ltd.
SKAV 909, 8th Floor,
Ashok Nagar, Lavelle Road,
Bengaluru - 560001
Tel: +91 90510 48715

Delhi / NCR

Dhruva Advisors India Pvt. Ltd.
305-307, Emaar Capital Tower-1,
MG Road, Sector 26, Gurugram
Haryana – 122 002
Tel: +91 124 668 7000

GIFT City

Dhruva Advisor IFSC LLP
510, 5th Floor, Pragya II,
Zone-1, GIFT SEZ, GIFT City,
Gandhinagar – 382050, Gujarat.
Tel: +91 79 6512 3604

New Delhi

Dhruva Advisors India Pvt. Ltd.
1007-1008, 10th Floor, Kailash
Building, KG Marg, Connaught
Place, New Delhi – 110001
Tel: 011 4471 9513

Pune

Dhruva Advisors India Pvt. Ltd.
406, 4th Floor, Godrej Millennium,
Koregaon Park,
Pune - 411001,
Tel: +91 20 6730 1000

Kolkata

Dhruva Advisors India Pvt. Ltd.
4th Floor, Unit No 403 & 404B, Camac
Square, 24 Camac Street, Kolkata –
700016, West Bengal
Tel: +91 33 66371000

Singapore

Dhruva Advisors Pte. Ltd.
#16-04, 20 Collyer Quay,
Singapore – 049319
Tel: +65 9144 6415

Abu Dhabi

Ryan Tax Services L.L.C.
1905 Addax Tower,
City of Lights, Al Reem Island,
Abu Dhabi, UAE
Tel: +971 26780054

Dubai

Ryan Tax Services L.L.C.
Emaar Square Building 4, 2nd Floor,
Office 207, Downtown,
Dubai, UAE
Tel: +971 4 240 8477

Saudi Arabia

Ryan Tax Consulting Services Company
308, 7775 King Fahd Rd,
Al Olaya, 2970, Riyadh 12212,
Saudi Arabia

KEY CONTACTS

Dinesh Kanabar

Chairman & CEO
dinesh.kanabar@dhruvaadvisors.com

Punit Shah (Mumbai)

Partner
punit.shah@dhruvaadvisors.com

Mehul Bheda (Mumbai/ Ahmedabad/ GIFT City)

Partner
mehul.bheda@dhruvaadvisors.com

Aditya Hans (Bengaluru/ Kolkata)

Partner
aditya.hans@dhruvaadvisors.com

Vaibhav Gupta (Delhi/ NCR)

Partner
vaibhav.gupta@dhruvaadvisors.com

Sandeep Bhalla (Pune)

Partner
sandeep.bhalla@dhruvaadvisors.com

Nimish Goel (Middle East)

Leader, Middle East
nimish.goel@dhruvaadvisors.com

Dilpreet Singh Obhan (Singapore)

Partner
dilpreet.singh@dhruvaadvisors.com

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