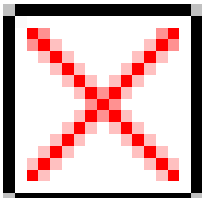


Taxability of Capital and Revenue Receipts - Dissection of a dichotomy

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most litigated issue in the law of income tax is whether particular receipts or accruals are of capital nature or are characterised as revenue receipts. Capital and revenue receipt play a vital role in accounting and taxation profit and they always influence the decision of the taxpayers. In common parlance, a capital receipt is one which adds to the corpus of an organization, while revenue receipts are the yields generated by the business operations. However, this is just a layman's view and the reality is not as simple to comprehend. The distinction between the two, however is vital for arriving at the taxability of the business as a whole. John Kennedy (Yablon, 2010) claimed,

"The tax on capital gains directly affects investment decisions, the mobility and flow of risk capital . . . the ease or difficulty experienced by new ventures in obtaining capital and thereby the strength and potential for growth in the economy". 1

Treatment of receipts under the Income Tax Act

Income tax is levied on total income earned by the Assessee in the previous year 2

. Thus, not all receipts form the basis of taxation under the Income Tax Act, 1961 (hereinafter referred to as 'the Act'). Receipts refer to amounts received by a business i.e., cash inflows. Receipts may be classified as Capital Receipts and Revenue Receipts. It is necessary to note this distinction clearly because only the revenue receipts are taken to the Profit and Loss Account and not the capital receipts. For ascertaining the total income, only the "revenue" expenses are deducted from the "revenue receipts" whereas amount spent on acquisition of "capital" assets is not considered. Capital expenditure is in relation to "capital" and it is not deductible from the gross income of business to determine the total income. It is a thumb rule that Capital receipts "are exempt from tax unless they are expressly taxable, whereas" revenue receipts "are taxable unless they are expressly exempt from tax."3

Thus, income tax being on 'income', 'capital' was not the subject of charge under the Act. Law Reports are full of cases where the legal battle raged over the issue:

whether a particular receipt is a return or realisation of capital, or it represents 'income/revenue' taxable under the Act

. The Legislature, in the name of plugging the loopholes has eroded and made ingress in this field with the result that what was not taxable as 'capital' became taxable by enacting express taxing provisions, "e.g.

, by way of capital gains under Section 45, or Compensation under section 17(3)(i) or 28(ii), or balancing charge (upto assessment year 1987-88) under sections 41 and 59, or annuity, etc.

From time to time courts comment about the difficulty of distinguishing between revenue and capital. In the case of ***Allied Mills Industries Pty Ltd v FC of T*** 4, the Federal Court has remarked that,

"The problem of distinguishing between a receipt of income and a receipt of capital frequently engages the attention of the courts, and, whilst the law reports are replete with cases involving this distinction, in the end each case has been found to turn on its own facts. No criteria of universal application emerge from the same; but the decided cases do provide useful guidance to decipher principles which may be helpful in considering the question."

Similarly in India, in the case of *CIT / CEPT v. South India Pictures Ltd* ⁵

, the Hon'ble Supreme Court while commenting on the difficulty of discerning a concrete test of distinction between the two types of receipts, laid down that,

"No infallible criterion or test can be, or has been, laid down and the decided cases are only helpful in that they indicate the kind of consideration which may relevantly be borne in mind in approaching the problem. The character of the payment received may vary according to the circumstances. Thus, the amount received as consideration for the sale of a plot of land may ordinarily be a capital receipt but if the business of the recipient is to buy and sell lands, it may well be his income/revenue."

The central theme and primary aim of this article is that, contrary to the suggestions in the cases stated hereinabove, to analyse certain fundamental principles as may be distilled from the numerous judicial decisions concerning the capital/revenue distinction in order to provide a coherent framework for distinguishing the two.

An Insight - Tests of Identification

The distinction between a capital receipt and revenue receipt though fine, is real. The dividing line may be thin, and often at first sight, imperceptible. The decision of the question is, however, not left to the application of any arbitrary standards. There are certain broad principles which guide the determination of the character of the receipt. ⁶

In this segment, a brief research is made to demonstrate the various methods of ascertaining the nature of receipts under the Act. It is pertinent to note that the Courts have enunciated certain tests for it; however, these tests, as discussed above, are not exhaustive in nature. The trends of judiciary in determination of chargeability of income-tax on receipts are highlighted hereinbelow.

1. Fruit-Tree Analogy - Income as a flow, Capital as a fund: In the case of CIT v. Shaw Wallace ⁷

pertaining to the determination of the taxability of compensation received on account of termination of an agency agreement, under the aegis of the Income tax Act 1922, it was laid down that,

"Income has been likened pictorially to the fruit of a tree or the crop of a field" In the US, this *para materia* famous analogy is that of Pitney J in *Eisner v Macomber*, ⁸ where his Honour said,

"The fundamental relation of 'capital' to 'income' has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop; the former depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time."

The tree signifies the source from which one gets fruits which symbolize the yield/income. The receipt arising from the sale of tree itself is, therefore, considered a capital receipt which is not income; but the receipts flowing from this source, i.e., fruits, are income. On application of this analogy, it can be said that while the receipt arising from the sale of a machine is not income but from the sale of produce brought out from the machine is income. In these cases, however, if a person deals in purchase and sale of machines, these assets do not remain a source and the profit derived from activities of purchase and sale become income.

2. Examine the character of the receipt in the hands of the receiver, payer's motive is immaterial

: In deciding whether a certain receipt is income or not, the test is its character in the hands of the recipient and not character in the hands of the payer, nor the fund out of which the money came. ⁹

A capital receipt in the hands of one may be income in the hands of another. ¹⁰

The source from which the payment is made has no bearing on the question. Where an amount is paid which, so far as the payer is concerned, is paid wholly or partly out of the capital, and the receiver receives it as income on his part, the entire receipt is taxable in the hands of the receiver. ¹¹

For example, in an instance of payment received on the redemption of debentures, if it is held as investment by the recipient then it is regarded as a capital receipt in the hands of the recipient, even if the company makes payment out of its trading profits, which is essentially a revenue receipt in nature.

3. Fixed capital v. Circulating capital

: It is well settled that a receipt is not taxable when it is a fixed capital. It is taxable as a revenue item when it is referable to circulating capital or stock-in-trade. ¹²

Fixed capital is what the owner turns to profit by keeping it in his own possession; circulating capital is what he makes profit by parting with it and letting it change masters: In other words, circulating capital is capital which is turned over, and in the process of being turned over yields profit or loss. ¹³

Whether an asset is a capital asset or a trading asset must be determined on the facts of each case. ¹⁴

4. Nomenclature used by the Parties is not conclusive

: The name which the parties may give to the transaction which is the source of the receipt and the characterization of the receipt by them are of little importance, and the true nature and character of the transaction have to be ascertained from the covenants of the contract in the light of the surrounding circumstances¹⁵.

Characterisation of the types of receipts - Recent Rulings:

1. Taxability of Proceeds realized from sale of Certified Emission Reduction Credit: Recently in the case of **CIT, Company Circle, Tirupur v. Prabhu Spinning Mills Pvt Ltd** ¹⁶, the Madras High Court laid down that the proceeds realized from sale of Certified Emission Reduction Credit, is capital receipt and are not taxable. In this case, the Assessee-company was involved in the business of manufacturing of yarn and is a member in the project called "Bundled Wind Power Project in Tamil Nadu, India, coordinated by Tamil Nadu Spinning Mills Association and received a sum of Rs. 4,07,53,169/- towards Clean Development Mechanism (CDM) receipts. In the total income statement, while computing total income of the Assessee, the CDM receipts were not included in the total income for the taxation by treating the CDM receipts as capital receipts. The Assessing officer, during the course of the assessment, did not accept any contention of the Assessee. The Assessing Officer treated the CDM receipts as revenue receipts and completed the assessment under Section 143(3). The Madras High Court decided the matter in favour of the Assessee by relying squarely on the *para materia* case of CIT -IV v. My Home Power Ltd ¹⁷, and quoted the Andhra Pradesh High Court by stating, **"Carbon Credit is not an offshoot of business but an offshoot of environmental concerns. No asset is generated in the course of business but it is generated due to environmental concerns. We agree with this factual analysis as the Assessee is carrying on the business of power generation. The Carbon Credit is not even directly linked with power generation. On the sale of excess Carbon Credits the income was received and hence as correctly held by the Tribunal it is capital receipt and it cannot be business receipt or income. In the circumstances, we do not find any element of law in this appeal."**

2. Taxability of Sum for relinquishing secretaryship of an educational society: The Supreme Court ¹⁸ in the 2019 laid down that where an Assessee had left the educational institution, after new members were elected as managing committee and it was not a case of life time appointment of Assessee. The sum received by Assessee for relinquishing secretaryship of an educational society could not be treated as a capital receipt since in forgoing secretaryship, there was no capital asset which had been transferred by Assessee.

3. Receipts under Collective investment scheme, a receipt under
a - Subscriptions received from public at large under collective investment schemes floated by Assessee which was an NBFC company constitute capital receipts, and hence not taxable as laid down by the Supreme Court in the case of **Peerless General Finance and Investment Co. Ltd. v. CIT**. ¹⁹.

4. Taxability of Subsidies: Subsidies are given for various purposes *inter alia*, such as promoting construction of new industries, expansion of existing industries or support for working capital requirements, etc Prior the Finance Act 2015, in cases such as Sahney Steelworks ²⁰, Ponni Sugars ²¹ and Chapalkar Bros ²², the Hon'ble Supreme devised a 'purpose test' to ascertain the nature of subsidies, whether the same is an investment subsidy or an operational subsidy. For instance, if the object of the subsidy scheme was to enable the Assessee to run the business more profitably or to meet day-to-day business expenditure then the receipt shall be treated as a revenue receipt, thus characterised as an operational subsidy. On the other hand, if the object of the assistance under the subsidy scheme was to enable the Assessee to set-up a new unit or to expand the existing unit, then the receipt shall be a capital receipt not chargeable to tax, and characterised as an investment subsidy. Thereafter, under the Finance Act 2015, an amendment was made to the definition of income u/s. 2(24) ²³ of the Act A new sub-clause (xviii) was inserted to the said section, which reads as, **"assistance in the form of subsidy or grant or cash incentive or duty drawback or waiver or concession or reimbursement (by whatever name called) by the Central Government or a State Government or any authority or body or agency in cash or kind to the Assessee other than subsidy or grant or reimbursement which is taken into account for determination of actual cost of the asset in accordance with the provision of Explanation 10 to clause (1) of section 43."**

Therefore, any subsidy, other than the one specifically excluded from the definition of income, shall be recognised as an income of the Assessee, irrespective of the fact that such subsidy is a capital receipt or a revenue receipt, thereby obliterating

the purpose test devised by the Apex Court.

Conclusion:

This Article has attempted to throw light on the fact that while there are no concrete guiding yardsticks or exhaustive mechanisms to ascertain the nature of income, the issue has been and shall be debated relentlessly before the judicial forum where new light could be thrown on certain hitherto ignored factors which may be a more conclusive test as to whether an income falls under the purview of revenue receipts or capital receipts. As no infallible criterion or test can be, or has been, laid down and the decided cases are only helpful in that they indicate the kind of consideration which may relevantly be borne in mind in approaching the problem of an income, which may be a revenue receipt in the hands of one Assessee but at the same time it can be a capital receipt by the way of its application and usage. It is in order of things that the legislature entails certain express parameters to decipher the character of the receipts, in order to mitigate the constant friction between taxpayer and the revenue officials and thus simplify the tax framework.

[The views expressed are strictly personal.]

¹Yablon, J. L. (Ed.). (2010). As certain as death: Quotation about taxes. U.S.A.: Tax Analysts

²Section 4, Charging Section, Income Tax Act, 1961

³**Maharajkumar Gopal Saran Narairi Singh v. CIT**, (1935) 3 ITR 237, 242 (PC)

⁴89 ATC 4365, 4369 (Bowen CJ, Lockhart and Foster JJ)

⁵[1956] 29 ITR 910 (SC) - [2002-TIOL-1009-SC-IT-LB](#)

⁶**National Cement Mines Industries v. CIT**, (1961) 42 ITR 69 [LNIND 1961 SC 21], 77 (SC) [2002-TIOL-969-SC-IT-LB](#); **CIT v. Krishna Industrial Corp. Ltd.**, (1973) 92 ITR 261, 265-6 (AP)

⁷AIR 1932 PC 138 = (1932) 2 Comp Cas 276 (PC)

⁸[\(1919\) 252 US 189.](#)

⁹**CIT v. Vazir Sultan & Sons** [1959] 36 ITR 175 - [2002-TIOL-1040-SC-IT](#)

¹⁰**CIT v. Presidency Co-operative Housing Society Ltd** - [2003-TIOL-432-HC-MUM-IT](#)

; **CIT v. Vithalnagar Co-operative Housing Society Ltd. : CIT v. Swastik Co-operative Housing Society Ltd. : Hatkesh Co-operative Housing Society Ltd. v. CIT**, (1995)216 ITR 321 [LNIND 1993 BOM 120], 325 (Bom)

¹¹**CIT v. Kamal Behari Lai Singha**, (1971) 82 ITR 460, 462 (SC) - [2002-TIOL-2110-SC-IT](#)

¹²**CIT v. Mahindra & Mahindra Ltd.**, (1973) 91 ITR 130 (Bom)

¹³**John Smith & Son v. Moore**, (1921) 12 TC 266, 282 (HL)

¹⁴**Addl. CIT v. Poddar Auto Dealers**, (1975) 101 ITR 14 (Pat).

¹⁵Supra Note vi

¹⁶ [2021-TIOL-1833-HC-MAD-IT](#)

¹⁷ (2014) 46 Taxmann.com 314 (Andhra Pradesh);- [2014-TIOL-978-HC-AP-IT](#)

¹⁸**CIT v. H.S. Ramchandra Rao** [2011] 330 ITR 322 (Kar.) - [2009-TIOL-472-HC-KAR-IT](#)

¹⁹[2019] 107 Taxmann.com 228 (SC) - [2019-TIOL-270-SC-IT](#)

²⁰**M/s. Sahney Steel & Press Works v. CIT**, 1985 AIR 1754 1985

²¹**CIT v. Ponni Sugars and Chemicals Ltd** . 306 ITR 392 (SC) - [2008-TIOL-174-SC-IT](#)

²²**CIT v. M/s. Chaphalkar Brothers Pune** (SC) Civil Appeal Nos. 6513-6514 of 2012 - [2017-TIOL-459-SC-MISC](#)

²³ Applicable w.e.f 1/4/2016

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