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Overview of Revenue and Capital Expenditure

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In actual practice there is a good deal of difference of opinion as to whether a particular payment is capital or revenue expenditure. Sometimes, the distinction between capital and revenue creates a considerable litigation. In many cases borderline between the two is very thin. However it is essential to distinguish revenue expenditure and capital expenditure to prepare correct financial statements so that they present true and fair value of the business. For instance, the alteration of accounting entry of the capital expenditure if recorded in the revenue by mistake or intention, it shrink the amount of revenue and profit, while revenue expense if capitalised appreciates the profits, which misrepresent the actual position of the business. The distinction of transaction into revenue and capital is done for the purpose of placing them in profit and loss account or in the Balance Sheet.

Thus, for the purpose of accounting and taxation, the distinction between the two is very important, According to general principle what can be recognized as revenue expenditure is stated in **Section 37(1)** which reads as under:-

"Any expenditure (not being expenditure of the nature described in sections 30 to 36 and not being in the nature of capital expenditure or personal expenses of the assessee), laid out or expended wholly and exclusively for the purposes of business or profession shall be allowed in computing the income chargeable under the head "**Profits and gains of business or profession**."

However it is very surprising that in spite of being such a debated issue in the Income tax proceedings i.e. to place the expenditure properly in the financial statements as per their nature i.e. revenue or capital, the Income tax act does not define the terms revenue expenditure and capital expenditure, so one has to depend on their natural meaning and as well as on decided cases to interpret their meaning as per facts in consideration.

General Meaning

Capital Expenditure

Capital Expenditure is that expenditure which is incurred

- For acquiring or bringing into existence an asset or advantage of an enduring benefit as land, buildings, plant and machinery, furniture and fixtures, office equipment, copyright, etc. Capital expenditure includes not only the purchase price of the fixed asset but also various other expenses incurred in connection with their acquisition. So brokerage or commission paid in connection with the acquisition of an asset, freight and cartage paid for transportation, installation expenses , and registration charges incurred in connection with purchase of land and buildings are also treated as capital expenditure.
- For extending or improving a fixed asset or
- For substantial replacement of an existing fixed asset. The benefit on such expenditure is going to accrue for more than one year.

The examples of capital expenditure include cost of land and building, plant and machinery, furniture and fixtures, etc. Such expenditure normally yields benefits which extends beyond current accounting period

Revenue Expenditure

When the benefit of expenditure is not likely to be available for more than one year, it is treated as revenue expenditure. It is incurred to run the business. It does not increase the capacity of the business. Usually, the benefit is consumed in the period in which it is incurred except in the case of deferred revenue expense. It is taken to the Trading or Profit & Loss account of the concern. Examples: cost of goods purchased, administrative expenses (rent, salary.etc.), manufacturing (oil, fuel, etc,) selling and distribution expenses (discount, advertising, etc.), Depreciation, interest on loan, loss on sale of assets, etc

However, there **is *no firm rule* or *clear line of demarcation*** that can be drawn for making distinction between capital expenditure and revenue expenses.

Myths about the differentiation between Capital Expenditure and Revenue Expenditure

1. Quantum of payment is relevant for determining whether an expenditure is Revenue or Capital: Lump-sum payment can represent revenue expenditure, if it is incurred for acquiring circulating capital though payment is made in one go and similarly payment made in instalments can in fact be for acquiring a capital asset, price of which is paid for over a period of time. Thus the character of payment can be determined by looking at what is the true nature of the asset which has been acquired and not by the fact whether its payment is made in lump sum or by instalments. e.g. the expenditure incurred for the purchase of truck for business purpose, to reduce the overall transportation cost of business is of capital nature irrespective of the fact that whether the same can be purchased on lump sum payments or instalment payments.

2. Universal application of the concept of enduring benefit: The nature of advantage has to be considered in commercial sense and only when the advantage is in capital field, the expenditure could be disallowed by applying the enduring benefit test. If the advantage consisted merely facilitating trading operations or enabling the management or conduct of business more efficiently or profitably, while leaving the fixed capital untouched, the said expenditure would be on revenue account, though the advantage may endure for an indefinite period. Enduring benefit test, therefore, was not conclusive and cannot be blindly and mechanically applied without regard to the fact and circumstances of a given case. e.g. In the case of CIT vs. Coal Shipment Pvt. Ltd the Hon'ble Supreme Court held that "Although payments made to eliminate competition in business, to a rival dealer would constitute capital expenditure if the object of making that payment is to derive an advantage by eliminating the competition over some length of time, the same result would not follow if there is no certainty of the duration of the advantage and the same can be put to an end at any time. A benefit need not be of an everlasting character, but it should not, be so short lived that it can be terminated at any time at the will of any of the parties. Also in case of Lakshmi ji Sugar Mills 1971, it was decided that wherein expenditure incurred on construction and development of roads between sugarcane producing centres and sugar factories was held to be revenue in the nature as it was incurred for the purposes of facilitating running of the assessee motor vehicles etc.

3. Fixed and circulating Capital test: Fixed capital being what the owner turns to profit by keeping it in his possession; circulating capital(labour, raw material, power etc.) is what the assessee makes profit by parting or letting the product/asset change masters/hands. This test could be applied when the acquisition of asset clearly falls within one of the two categories but the test would breakdown where the expenditure does not fall easily within the specified category. The demarcation line between assets out of which profits were earned and the profit made upon assets or with assets, was thin and difficult to draw in several cases. e.g. In the case of Empire Jute Company (supra), the assessee company was carrying on the business of manufacture of jute and was a member of Indian Jute Mills Association.. A working time agreement was entered into between the members of association restricting the number of working hours per week for which the mills were entitled to work their looms. Accordingly, no signatory could work for more than 45 hours per week but signatories were entitled to transfer, their allotted hours of work per week to any one or more of the other signatories. Under that clause the assessee purchased "loom hours" from four other mills for an aggregate amount of Rs.2,03,255/- and claimed those expenditure as revenue expenditure. Loom Hours means Right to use that machine for a particular time. It was observed that purchase of loom hours is not like circulating capital (i.e. labour, power, raw material). Also, loom hours can also not be treated as part of fixed capital as there is no addition in capital structure of the business. However Hon‟ble Supreme held that "the expenditure incurred by the assessee was for the purpose of removing a restriction on the number of working hours for which it could operate its looms with a view to increase its profits and, thus, was revenue in nature. The purchase of loom hours does not result in creation of any new asset and thus there was no addition to or expansion of the profit making apparatus of the assessee".

Decisive tests of demarcations between Capital Expenditure and Revenue expenditure as indicated by various courts

The judgements of the Supreme Court as well as of the High Courts from time to time have evolved various tests for distinguishing between capital and revenue expenditure but no test is paramount or conclusive. Every case has to be decided on its own facts keeping in mind the broad picture of the whole operation in respect of which the expenditure has been incurred. The below tests are thus mutually exclusive and have to be applied to the facts of each particular case in a rational manner

1. If the ***expenditure is made for acquiring or bringing in to existence*** an asset or an advantage of an enduring benefit for the business, it will be in the nature of capital expenditure, however if the expenditure is for running the business or working it with a view to produce profits it would be in the nature of revenue expenditure; e.g. In case of Commissioner of Income Tax v. Madras Auto Services (P) Ltd. (1998) 233 ITR 468 (SC), the assessee had incurred expenditure on demolishing the existing building and constructing a new building at their own expense. The new building belonged to the lessor and the assessee remained a lessee but at a low rent. Term for lease was 39 years but the Supreme Court held that the expenditure was revenue in nature as the newly constructed property from the beginning was owned by the lessor.

2. It is the ***aim and object of expenditure***, which would determine its character and not the source and manner of its payment; In case of **Mascon Technical Services Ltd.** v. CIT (2013) 358 ITR 545 (Mad), the assessee-company incurred share issue expenses of 35.39 lakh for its proposed public issue, which could not ultimately materialize due to non-clearance by the SEBI. It claimed such expenses as revenue in nature, on the ground that the same was incurred for augmenting its working capital.

The claim of the assessee was, however, rejected by the Assessing Officer. High Court‟s Decision: The High Court noted that the assessee-company had taken steps to go in for a public issue and incurred share issue expenses for the same. However, it could not go in for the public issue by reason of the orders issued by the SEBI just before the proposed issue. Though the efforts were aborted, the fact remains that the expenditure incurred was only for the purpose of expansion of the capital base. The capital nature of the expenditure would not be lost on account of the abortive efforts. The expenditure, therefore, constitutes a capital expenditure.

3. In applying the test of ***an advantage of an enduring nature, it would not be proper to look at the advantage obtained, as lasting forever***. The distinction which is required to be drawn is, whether the expense has been incurred to do away with, what is a recurring expense for running a business as against an expense undertaken for the benefit of the business as a whole. e.g. In case of Mohan Meakin Breweries Ltd. v. Commissioner of Income Tax, (1997), the High Court has held that payment made to the State towards license fee or permit under the provisions of Punjab Excise Act and Punjab Distilleries Rules applicable to the State of Himachal Pradesh, was capital expenditure. However the expenditure incurred for operating or running of distillery would not be capital expenditure as it relates to and is a part of the operational expenses.

4. An expense incurred for acquisition of a source of profit or income would in the absence of any contrary circumstance, be in the nature of capital expenditure. As against this, an expenditure which enables the ***profit-making structure to work more efficiently leaving the source or the profit making structure untouched would be in the nature of revenue expenditure.*** In other words, expenditure incurred to fine tune trading operations to enable the management to run the business effectively, efficiently and profitably leaving the fixed assets untouched would be an expenditure of a revenue nature even though the advantage obtained may last for an indefinite period..

5. Expenditure incurred for grant of licence which accord ‟access‟ to technical knowledge, as against, ‟absolute‟ transfer of technical knowledge and information would ordinarily be treated as revenue expenditure. In order to sift (examine thoroughly), in a manner of speaking, the ***grain from the chaff*** (sort the valuable thing from the worthless), one would have to closely look at the attendant circumstances such as

a) The tenure of license

b) The right, if any, in the licensee to create further rights in favour of third parties,

c) The prohibition, if any, in parting with a confidential information received under the license to third parties without the consent of the licensor,

d) Whether on expiry of the license the licensee is required to return back the plans and design obtained under the license to the licensor even though the licensee may continue to manufacture the product, in respect of which ‟access‟ to knowledge was obtained during the subsistence of the license,

e) Expenditure on obtaining access to such secret process would ordinarily be construed as capital in nature

6. While determining the nature of expenditure given the diversity of human affairs and complicated nature of business ; the test enunciated by courts have to be applied from a business point of view and on a fair appreciation of the whole fact situation before concluding whether the expenditure is in the nature of capital or revenue.

To summarise ‘whether a particular expenditure is ‟revenue or capital’ must be determined on a consideration of all the facts and circumstances, and by the application of principles as laid down by various decided cases. The question must be viewed in the larger context of business necessity or expediency. If the expenditure is for the initial outlay or for acquiring or bringing into existence an asset or advantage of an enduring benefit in the capital field to the business that is being carried on, or for extension of the business that is going on, or for a substantial replacement of existing business assets, it would be capital expenditure. However if, on the other hand, the expenditure, although for the purpose of acquiring an advantage of enduring nature, is for running of the business with a view to produce profit, or increase efficiency, or increase profitability, it would be revenue expenditure. In other words, an expenditure which brings into existence an advantage of enduring benefit may still be revenue expenditure if the advantage, so obtained, is in the revenue field. The most important distinguishing feature in the deciding whether expenditure is capital or revenue is the purpose and intended object of incurring such expenditure.

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