DEFERRED REVENUE EXPENDITURE AND THE INCOME-TAX ACT, 1961[1]

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The question of classification of any item of expenditure as Capital or Revenue is integral to the determination of the allowability thereof, under the Income-tax law. However, in recent times the question of allowability of Deferred Revenue Expenditure has also garnered attention and come into sharp focus.

To begin with it needs to be understood that the concept of "Deferred Revenue Expenditure" is alien to the Income –tax Act, which recognises only "Capital" or "Revenue" expenditures. Deferred Revenue Expenditure is essentially an accounting concept denoting expenditure, for which a payment has been made or a liability incurred, which is essentially revenue in nature but which for various reasons (quantum, period of expected future benefit, considerations of impact on the bottom line etc) and also on the "presumption" that the same will result in benefits over a subsequent period or periods is spread out and written-off over a period of time.

Deferred Revenue Expenditure can comprise diverse components of expenditure and manifest itself in the accounts in a wide variety of ways. For instance in recent years, the rising demand consequent upon the increased purchasing power in the hands of the consumers has led, the business and industrial world to incur major expenditures *inter-alia* on advertisement, sales promotion etc with a view to enhance the visibility of their products and thereby increase their top-line. Such expenditure invariably represents either outlays on a major advertising campaign undertaken in different media with a view to enhance the visibility or modify the image of a product; holding of contests to expand the reach and promote sales, celebrity endorsements, one-time sponsorship of mega events, dealership incentives and other such significant sales promotion initiatives which go to increase and expand the brand recall of the products of a particular company. Such expenditure may also comprise of expenditure on civil works on leased/rented assets without resulting in the creation of any corresponding Capital Asset or on Research and Development, especially in the case of industries, which are prone to rapid technological advancements and where the risk of obsolescence is high.

Although the nature of such expenditure is entirely revenue, keeping in view the fact that the benefits arising there from are expected to be derived over a period of time, stretching sometimes over several accounting periods, the business world has been prone to treat such expenditure as a "Deferred Revenue Expenditure" and consequently has been amortising the same over the expected time period over which the benefits are likely to accrue there from. Accordingly only a proportion of the same is amortised in the Profit and Loss Account but an appropriate adjustment is made in the Computation of Income whereby the entire expenditure is claimed as allowable revenue expenditure. This treatment is based on the premise that since the nature of such expenditure is essentially revenue, the same is claimable as revenue expenditure and consequently allowable

Editorial Note

[1] On Accounting Standard (AS) 26, Intangible Assets, becoming mandatory, an enterprise can not recognise any expenditure as 'deferred revenue expenditure'. Thus, presently, for the purpose of preparation and presentation of the financial statements, an expenditure will be recognised as an asset if it meets the criteria in this regard laid down in relevant standard, e.g. AS 10, AS 26, AS 13 etc.; otherwise it has to be expensed. In other words, for accounting purposes, the concept of 'deferred revenue expenditure' has ceased to exist unless otherwise specified in a standard, e.g. voluntary retirement expenditure as a transitional measure in the revised AS 15, 'Employee Benefits'. This article deals with the aspect of deferred revenue expenditure from the tax point of view and not from the accounting point of view.

in the income computed pursuant to the Income-tax Act, 1961. The Income-tax Department has however been loathe to allow the same as an allowable deduction leading thereby to a, perhaps avoidable, controversy and legal dispute which is the subject matter of this Article. The whole issue when dealt with a fair, factual and legal perspective can perhaps lead to a resolution of the controversy arising therefrom to the satisfaction of all parties connected thereto.

To begin with it needs to be understood that Section 37(1) of the Income-tax Act, as per which - governs the question of allowability of any expenditure, which is otherwise not covered by any specific provision of the Income-tax Act, 1961 -

(i) Any expenditure;
(ii) Not being expenditure of the nature described in sections 30 to 36;
(iii) Not being in the nature of capital expenditure; or
(iv) Personal expenses of the assessee; and
(v) Laid out or expended;
(vi) Wholly and exclusively for the purposes of the business or profession.

shall be allowed in computing the income chargeable under the head "Profits and Gains of Business or Profession."

To put it differently to be an allowable expenditure within the meaning of Section 37 (1), the money paid out or expended must be:

(a) Paid out wholly and exclusively for the purpose of the business or profession and further
(b) Must not be--
  (i) capital expenditure;
  (ii) personal expense; or
  (iii) an allowance of the character described in Sections 30 to 36

In the given context in order to determine the allowability or otherwise of the various items of expenditure illustrated and discussed hereinbefore the question as to whether the said expenditure is capital or revenue in nature acquires critical importance and significance. However, the vexatious question of classification of any item as capital or revenue is such that no precise or concise parameters can be laid down. The expression "Capital Expenditure" is not defined in the Act and the words "in the nature of capital expenditure" occurring in Section 37 (1) make the meaning of the expression more elastic in its application to the facts of each case. Nevertheless the same should be viewed in the context of accounting parlance, judicial interpretation and commonly held perceptions, the crux of which is summarised below:-

- The expression must be construed in a business sense save in so far as there may be rules of construction applicable to it *[Mohanlal Hargovind v. CIT (1949) 17 ITR 473 (PC)]*.
- For determining whether expenditure is of a capital or revenue nature, it is immaterial whether the expenditure is made out of moneys withdrawn from the capital or out of the profits. One should consider the nature of the concern, the ordinary course of business usually adopted in that concern, and the object with which an expense is incurred. *[Taj Mahal Hotel v. CIT, (1967) 66 ITR 303 (AP)]*.
- The word "capital" connotes permanency and capital expenditure is, therefore, closely akin to the concept of securing something, tangible or intangible property, or corporeal or incorporeal right, so that they could be of a lasting or enduring benefit to the enterprise in issue. Revenue expenditure, on the other hand, is operational in its perspective and solely intended for the furtherance of the enterprise. This distinction, though candid and well accepted, yet is susceptible to modification under peculiar and distinct circumstances *[CIT v. Ashok Leyland Ltd., (1972) 86 ITR 549 (SC)]*.
- To put it differently, ordinarily, 'capital' means an asset which has an element of permanency about it and which is capable of being a source of income and "capital expenditure" must, therefore, generally mean an acquisition of an asset and the asset must be intended to be of lasting value; while income or revenue expens-

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es are generally running expenses incurred in earning profit or expenses incurred with the primary object of an immediate return or acquisition of assets which are not of lasting value and are likely to get exhausted or consumed in the process of the return or a very limited number of returns *[Jagat Bus Service v. CIT, (1950) 18 ITR 13 (All); Radha Kishan Kapoor (R.S.) v. CIT (1963) 47 ITR 938 (All)].*

The commonly held perception is that an expenditure made with a view to bring into existence an asset or "an advantage for the enduring benefit of a trade, in the absence of special circumstances leading to an opposite conclusion should be a sufficient ground for treating such an expenditure as properly attributable not to revenue, but to capital". However, it has also been held by the Supreme Court in the case of *Punjab State Industrial Development Corp. Ltd. vs. CIT [225 ITR 792, (SC)]* that the same is not a straight-jacket formula and the test laid down can at best be a guide for determining whether a particular item is capital or revenue. It has also been held by various other authoritative judicial pronouncements that the test of enduring benefit is not a certain or conclusive test and cannot be applied blindly or mechanically. There may be cases where expenditure, even if incurred for obtaining advantage of enduring benefit, may nevertheless, be on revenue account and the test of enduring benefit may break down. What is material to consider is the nature of the advantage in a commercial sense and it is only where the advantage is in the capital field that the expenditure would be disallowable on an application of the above test. If the advantage consists merely in facilitating the assessee's trading operations or enabling the management and conduct of the assessee's business to be carried on more efficiently or more profitably while leaving the fixed capital untouched, the expenditure would be in revenue account, even though the advantage may endure for an indefinite future. Judicial support to the above proposition and conclusion can be derived from the following judicial pronouncements:-

- *Empire Jute Ltd. v. CIT [(1980) 124 ITR 1 (SC)];*
- *CIT v. Associated Cement Companies Ltd. [(1988) 172 ITR 257 (SC)];*
- *Saraswati Industrial Syndicate Ltd. v. CIT [(1982) 137 ITR 886 (Punj)];*
- *CIT v. Cominco Binani Zinc Ltd [(1993) 204 ITR 56 (Cal)]*

Even if the test of enduring benefit were to be followed in respect of the above mentioned expenditure it is clear that no enduring benefit has been derived or capital asset has come into existence as a result of the said expenditure. The expenditure which is treated as "Deferred Revenue" in the books almost in all cases comprises of items, the benefits derived where from are ephemeral and transitory in nature in as much as they are a part of a continuous process and need to be expended in order to generate and increase the brand recall and sustain it in the minds of customer. The Supreme Court in the case of *Alembic Chemical Works Co. Ltd. vs. CIT (1989) 177 ITR 377* has itself observed that the idea of 'once for all' payment and 'enduring benefit' are not to be treated as something akin to statutory conditions; nor are the notions of 'Capital' or 'Revenue' a judicial fetish. What is capital expenditure and what is revenue are not eternal verities but must need to be flexible so as to respond to the changing economic realities of business. The expression 'asset or advantage of an enduring nature' was evolved to emphasise the element of a sufficient degree of durability appropriate to the context.

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Thus while, for the purpose of the issue under consideration, the test of the enduring benefit fails at the initial stage itself, and even if the said test were to be explicitly applied it cannot be said that the said expenditure is of a capital nature. Further, no capital assets come into being as a result of the same and consequently the same cannot be classified as a capital expenditure.

The expenditure is essentially revenue in nature and the decision to treat the same as deferred revenue only represents a management decision taken in view of the magnitude of the expenditure involved. For the purpose of allowability of any expenditure under the Income-tax Act 1961, what is material is the classification between the capital and revenue and the same does not recognise of any concept of deferred revenue expenditure. There have been a slew of recent judgments of various Benches of the Income-tax Appellate Tribunal wherein the above issue has been addressed directly and almost universally the decision has been in favour of the assessees. More particularly reference may be made in this context to the following judgments:-

- *Amar Raja Batteries Ltd. v. ACIT [(2004) 91 ITD 280 (Hyd)]*
- *JCIT v. Modi Olivetti Ltd. [(2005)4 SOT 859 (Delhi)]*
- *ACIT vs. Medicamen Biotech Ltd. [(2005) 1 SOT 347 (Delhi)]*
- *Hero Honda Motors Ltd. v. Joint Commissioner of Income Tax [(2005) 3 SOT 572 (Delhi)]*
- *Charak Pharmaceuticals v. JCIT [(2005) 4SOT 393 (Mumbai)]*

The argument universally recognised and affirmed among all the above judgments is that "where any expenditure is treated as a "Deferred Revenue Expenditure", it presupposes that the concerned expenditure, creating benefit is in the Revenue field and is a revenue expenditure, but considering its enduring benefits as well as the fact that it does not result in the creation of any new asset or advantage of enduring nature in the Capital field, the same is required to be treated distinctly from Capital Expenditure". By following the above line of argument the various Benches of the Tribunal have unanimously upheld the allowability of such Deferred Revenue Expenditure as Revenue Expenditure. However, the said observations needs to be tempered with the fact that where any identifiable capital asset, tangible or intangible comes into existence as a result of the amount expended, the same will have to be treated as a Capital Expenditure and depreciation allowable thereon as per the prescribed rules and procedures under the Income-tax Act.

However, in a recent trend, it has been observed that the Income-tax Department is increasingly reluctant to allow such expenditure as "Revenue Expenditure". The Department, in this case is by and large placing reliance on the Supreme Court judgment in the case of *Madras Industrial Investment Corporation Ltd. vs. CIT ((1997) 225, ITR 802)* wherein it has been held that discount on the issue of debentures is allowable on proportionate basis during the period over which they are outstanding. While putting forth such an interpretation, the Department seems to be ignoring one crucial fact in as much as the Supreme Court dealt with the question of issue of debentures which can be clearly and succinctly identified with and is relatable to a defined time-frame i.e. the period in which the Debentures are outstanding and as such can be specifically allocated over defined periods. On the contrary, the nature of expenditure, which is normally treated as "Deferred Revenue" is such that, although the benefit arising therefrom may extend over several accounting periods, the same cannot be clearly and definitively assigned over time since the same is intangible in nature. Moreover such expenditure has also not lead to the creation of any Capital Asset, tangible or intangible, and the question of treating the same as Capital Expenditure should normally not arise. Infact the Supreme Court has itself while discussing the issue, in the said case, and distinguishing between various situations has observed that "ordinarily, revenue expenditure which is incurred wholly and exclusively for the purpose of business must be allowed in its entirety in the year in which it is incurred. It cannot be spread over a number of years even if the assessee has written it off in his books over a period of years".

The Supreme Court has observed that "whether the Assessee is entitled to a particular deduction or not will depend on the provision of law relating thereto and nor on the view which the Assessee might take of his rights not can the existence or absence of entries in the books of account be decisive or conclusive in the matter".

Another sore point, in such cases for the Income-tax Department has been the variation and dichotomy between the accounting treatment of such expenditure in the books of account and its claim under the Income-tax Act. The accounting entries in the books of accounts are occasioned by a diverse set of considerations and issues such as compliance with statutory laws and mandatory accounting standards / principles and of course management decisions as to the treatment of a particular item which can be guided by considerations of reported profitability earning per share, impact on share prices etc. Of course, the merits, intentions and motives of the management behind such a decision are not the subject matter of this article. However, it should also be understood that accounting entries and treatment in the account books can at best serve as a guide to their tax treatment but cannot in the very least lead to a definitive conclusion as to the tax treatment thereof. The tax treatment of a particular item of income or expenditure recorded in the books has to be determined with reference to corresponding provisions of the Income-tax law as interpreted by the canons of judicial interpretation and guided by the principles laid down by Courts from time to time in their judicial pronouncements. As such for the issue under discussion what is material is to determine the nature of the underlying expenditure which has to be interpreted in the light of the provisions of the Act and judicial pronouncements and mere divergence between the accounting entries and tax treatment cannot lead to any definitive conclusion. The Supreme Court in the case of *Kedarnath Jute Manufacturing Co. Ltd. vs. CIT ((1971) 82 ITR 363) (SC)* also affirmed the above view by observing that "whether the Assessee is entitled to a particular deduction or not will depend on the provision of law relating thereto and not on the view which the Assessee might take of his rights nor can the existence or absence of entries in the books of account be decisive or conclusive in the matter". Subsequently the said court itself has also re-affirmed the said view in the case of *Sutlej Cotton Mills Ltd. vs. CIT 1979 (116 ITR 1) (SC)* by remarking that "the way in which entries are made by an Assessee in his books of account is not determinative of the question whether the Assessee has earned any profit or suffered any loss. The Assessee may be making entries which are not in conformity with the proper principles of accounting, conceal profit as show loss and the entries made by him cannot, therefore, be regarded as conclusion one way or the other. What is necessary to be considered is the true nature of the transaction and whether infact it has resulted in profit or loss to the Assessee". As such the mere divergence between accounting records and tax treatment cannot lead to any conclusion as to the treatment thereof as has been emphatically judicially affirmed in the cited cases.

To conclude the position arising out of the above discussion can be summed up as follows:-

- The nature of the expenditure which has been treated as a "Deferred Revenue Expenditure" in the books needs to be properly analysed before taking a decision as to the allowability or otherwise of the same in the Income-tax Act, 1961;
- Where such expenditure results in the creation of an identifiable Capital Asset (tangible or intangible) a case can be made out to treat the same as a Capital Expenditure with corresponding allowability of Depreciation at the prescribed rates;
- In cases where the nature of the expenditure is such that the same can be clearly and unambiguously identified over specified future time periods (e.g. discount on issue of debentures) akin to Prepaid Expenses the same would be allowable over the period to which they relate proportionately applying the Matching Principle. It should be noted here that the expenditure in question in such cases is not treated as Capital Expenditure but is a Revenue Expenditure which is clearly allocable over defined time periods which is the reason for its allocating over different accounting periods;
- In other cases where the same does not result in the creation of any identifiable capital asset or where the same is not allocable over defined future time periods there can be no case for amortising the same under the Income-tax Act, 1961 over the expected period over which the benefit is likely to arise there from since in such cases the expenditure is essentially revenue in nature but is amortised in the books only on account of some other considerations. ❐