APPARENT CONTRADICTIONS IN THREE JUDGEMENTS OF THE SUPREME COURT ON CAPITAL & REVENUE EXPENDITURE AND THEIR RECONCILIATION

By Subash Agarwal, Advocate

1. INTRODUCTION

Sec. 37(1) of the Income Tax Act 1961, which is the residuary section as for as the allowability of expenses under the "Business head " is concerned, provides that the expenditure has to be incurred wholly and exclusively for the purposes of business and it should not be in the nature of capital expenditure. Thus capital expenditure is not an allowable expenditure even if incurred for earning profits unless expressly provided in the "Act". Similar provision as in sec. 37(1) was embodied in the Indian Income tax , 1922 in the form of sec. 10(2) (xv)

2. CONTROVERSY OVER CAPITAL AND REVENUE EXPENDITURE

The term "capital expenditure" having not been defined either in 1961 Act or 1922 Act, controversy over capital and revenue expenditure has been raging for decades. So thin becomes the dividing line between the two sometimes that the appellate authorities and the judiciary faces a tough balancing task and the assessee and the revenue authorities are ultimately found locked in the see saw game on the issue . It is not uncommon to find instances where while the assessing officer refuses to treat an item of expenditure to be of revenue nature, the first appellate authority refuses to toe his line on appeal by the assessee.. Then on the departmental appeal, the Tribunal restores the order of the A.O. which is negatived by the hon'ble High Court to be finally reversed by the hon'ble Supreme Court on the departmental appeal.

3.THE TROUBLESOME TRIO

The hon'ble Supreme Court has in recent years rendered three important judgements on the issue of determination of capital and revenue expenditure and the year(s) of allowability of the expenditure held to be of revenue nature but the benefit in respect of which accrues over several years.
Some authors hold the view that the three decisions are contrary , extremely difficult to reconcile and one would have to wait for another SC judgement for the reconciliation of these three decisions.
Is it so?
The author feels that the three judgements, on contrary, are either landmark judgements inasmuch as they have given finality to the confused picture by reconciling the diverse precedents obtaining in a particular field or have reiterated the already decided position in their respective field and do not leave any question mark on the issues tackled.

4.BRIEF FACTS AND THE DECISIONS:

The three judgements in question are –

a)Madras Auto Services (P) Ltd. (1998) 233 ITR 468 (SC)

b)Madras Industrial Investment Corporation Ltd. v. CIT (1997) 225 ITR 802(SC)

c)Aditya Minerals (P) Ltd. v. CIT [1999] 106 Taxman 337(SC)

Brief facts of the judgements are:

A)Madras Auto Services (P) Ltd. (1998) 233 ITR 468 (SC)

In this case, the assessee company invested a sum of Rs. 1,62,835/- and Rs. 50,937/- during the previous year relevant to the assessment year 1968-69 and 1969-70 respectively in constructing a new building on a land acquired on lease for 39 years. As per the terms of lease, the new building was to belong to the lessor and not to the assessee from inception. Before the ITO, the assessee claimed the said expenditure as capital loss. In the alternative, the assessee claimed depreciation on capital investment; in the alternative, it claimed deduction of the payments as business expenditure. Ultimately, the Tribunal held the expenditure to be revenue expenditure and allowed the same as deduction. The contention of the revenue that the expenditure was capital expenditure was negatived by the Tribunal. On reference, the High Court upheld the view of the Tribunal and held that the two amounts constitute revenue expenditure. On further appeal by the department, the hon'ble Supreme Court , relying upon the finding of the Tribunal that the rent as stipulated in the lease was extremely low, observed-

"What advantage did the assessee get by constructing a building which belonged to somebody else and spending money for such construction? The assessee got a long lease of a newly constructed building suitable to its own business at a very concessional rent……

The saving in expenditure was a saving in revenue expenditure in the form of rent. Whatever substitutes for revenue expenditure should normally be considered as revenue expenditure. Moreover, the assessee in the present case did not get any capital asset by spending the said amounts. The assessee, therefore, could not have claimed any depreciation. Looking to the nature of the advantage which the assessee obtained in a commercial sense, the expenditure appears to be revenue expenditure."

B)Madras Industrial Investment Corporation Ltd. v. CIT (1997) 225 ITR 802(SC)

In this case, the assessee- company wrote off Rs. 22,500/- as discount allowed on issue of debentures on a proportionate basis over the tenure of debentures-Rs. 12,500/- pertained to the proportionate portion of the total discount of Rs. 3,00,000/- on debenture issued during the relevant previous year and Rs. 10,000/- related to the amount written off as discount on the previous issue. ITO disallowed the claim of the whole of Rs. 22,500/- on the ground that discount on bonds and debentures was not allowable as an expenditure. On appeal, the AAC held that the discount allowed at the time of the issue of the debentures was to be treated as a part of expenditure for such issue and allowed the claim for Rs. 12,500/- but rejected the claim as regards Rs. 10,000/- on the ground that it related to discount on debentures issued in earlier year. Emboldened by the decision of the AAC, the assessee contended before the Tribunal, inter alia, that the AAC having held that discount allowed at the time of issue of debentures was to be treated as part of the expenditure incurred on such issue, should have further allowed a sum of Rs. 2,87,500/- being the balance of the total discount of Rs. 3,00,000/-. The Tribunal held that the expenditure of Rs. 3,00,000/- was incurred during the relevant previous year and was allowable as expenditure incurred for the purpose of business. In the game of see-saw with the revenue, the balance tilted against the assessee when on a reference by the department, the Madras High Court held that the discount of Rs. 3,00,000/-did not represent any payment made to any one so as to constitute expenditure.

On appeal by the assessee -company against the decision of the High Court, the hon'ble Supreme Court reversed the said decision and held that the discount allowed on issue of debentures is a revenue expenditure. On the question, whether whole or part of such expenditure was allowable in the year in question, it held that the appellant is entitled to deduct a sum of Rs. 12,500/- out of the discount of Rs. 3,00,000/- in the relevant asst. year. The balance expenditure of Rs. 2,87,500/- cannot be deducted in the asst. year in question.

c)Aditya Minerals (P) Ltd. v. CIT [1999] 106 Taxman 337(SC)

In this case, the assessee company obtained a lease of and for 15 years for excavation purposes. According to the agreement, the assessee was required to pay Rs.35/- per acre by way of rent per month. The annual rent worked out to Rs.10,752/-. The assessee deposited with the lessor, the rent for the entire period of 15 years aggregating to Rs.1,61,280/- by way of a guarantee for due performance of lease for 15 years. However, the deposit was adjustable against the rent of each month and it carried no interest.
For the assessment years in question the assessee claimed as business expenditure the annual rental of Rs.10,752/- paid to the lessor. The ITO held that the lease amount claimed by way of deduction could not be allowed as revenue expenditure. On first appeal, the AAC confirmed the disallowance. The second appeal before the Tribunal was also unsuccessful. Appeal by the assessee before the hon'ble Andhra Pradesh High Court also failed, which after considering several Supreme Court judgements came to the conclusion that the expenditure was incurred for acquiring an asset or advantage of enduring character and must, therefore, be held capital in nature. The hon'ble Supreme Court, in a brief judgement, affirmed the judgement of the High Court.

Before proceding to reconcile the apparently three contrary decisions cited above, it is pertinent to discuss various tests courts have evolved for determining capital and revenue expenditure-

5.TESTS FOR DETERMINING CAPITAL AND REVENUE

One of the important test applied usually by the courts was laid down by Lord Cave L.C. in **British Insulated and Helsby Cables Ltd. v. Atherton (1925) 10 TC 155 (HL***)* at pg. 192, where the learned Lord stated-
"When an expenditure is made, not only once and for all but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think that there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital".
The above test specifies the two basic elements of a capital expenditure-

i) The expenditure is incurred once and for all and
ii) It creates an asset or brings advantage for the enduring benefit.

But the test specified above is not of universal application. The parenthetical clause itself provides that the test will break down if there are special circumstances pointing to the contrary.
The hon'ble Supreme Court in **Assam Bengal Cement Co. Ltd. v. CIT (1955) 27ITR34** has laid down the following tests-

1) Outlay is deemed to be capital when it is made for the initiation of a business, for extension of a business, or for a substantial replacement of equipment.
2) Expenditure may be treated as properly attributable to capital when it is made not only once and for all but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade. If what is got rid of by a lump sum payment is an annual business expense chargeable against revenue, the lump sum payment should equally be regarded as a business expense, but if the lump sum payment brings in a capital asset, then that puts the business on another footing altogether.
3) Whether for the purpose of the expenditure any capital was withdrawn, or in other words, whether the object of incurring the expenditure was to employ what was taken in as capital of the business. Again, it is to be seen whether the expenditure incurred was part of the fixed capital of the business or part of its circulating capital.

6.APPARENT CONTRADICTIONS IN THE THREE JUDGEMENTS

Following apparent contradictions are visible-

a) While on the one hand in Madras Auto's case, the court holds the view that the cost of construction of a new building on a land acquired on lease for 39 years is a revenue expenditure, on the other hand in the Aditya mineral's case it held that the annual rent of Rs. 10,752/- for obtaining a lease of land for 15 years for excavation purposes is an expenditure for acquiring an asset or advantage of enduring character and therefore capital in nature.

b) In the Madras Auto's case, the court holds the view that whatever substitutes for revenue expenditure should normally be considered as revenue expenditure and therefore did not ask for the proportionate allocation of the total expenditure over the period of lease. On the other hand, in the Madras Industrial Investment Corp.'s case it held that the total amount of discount on debentures is to be written off over the tenure of debentures.

7.RECONCILING THE APPARENT CONTRADICTIONS

(a) Both the cases operate in different fields. Madras Auto service's case belong to the class of cases where assessee creates an asset of an enduring nature but the asset so created do not belong to the assessee. Test of enduring benefit as discussed earlier is not of universal application. Lord Radcliffe had emphasised about the non-universality of this test in **Commissioner of Taxes v. Nchanga Consolidated Copper Mines Ltd. (1965)58 ITR241(PC***)* in the highly felicitous language by stating that it would be misleading to suppose that in all cases securing a benefit for the business would be, prima facie, capital expenditure "so long as the benefit is not so transitory as to have no endurance at all." The Supreme Court had observed in Assam Bengal Cement Co.'s case (supra) that what is got rid of by a lump sum payment is an annual business expense chargeable against revenue, the lump sum payment should equally be regarded as a business expense. The Court, therefore, in the Madras Auto Service's case observed-

"Right from inception, the building was of the ownership of the lessor. Therefore, by spending this money, the assessee did not acquire any capital asset. The only advantage which the assessee derived by spending the money was that it got the lease of a new building at a low rent. From the business point of view, therefore, the assessee got the benefit of reduced rent. The High Court has, therefore, rightly considered this as obtaining a business advantage. The expenditure is, therefore, to be treated as revenue expenditure."

The Court relied upon the following cases (all Supreme Court decisions) which related to the same field, in coming to the stated conclusion-

----Lakshmi Sugar Mills Co. (P) Ltd. v. CIT (1971) 82I TR 376
----L.H. Sugar Factory And Oil Mills (P) Ltd. v. CIT (1980) 125 ITR 293
----CIT v. Associated cement Companies Ltd. (1988) 172 ITR 257
----CIT v. Bombay Dyeing And Manufacturing Co. Ltd.(1996)219 ITR 521

Aditya Mineral's case, on the other hand, fall altogether in a different field where different set of tests and precedents are applicable. Emphasizing upon the "method of arguing by analogy" in such difficult situations, Justice P. N. Bhagwati in L. H. Sugar factory's case (supra) observed-

"It was pointed out by Lord Radcliffe in **Commissioner of Taxes v. Nchanga Consolidated copper Mines Ltd.(1965)58 ITR 241(PC**) that "in considering allocations of expenditure between capital and income accounts it is almost unavoidable to argue from analogy." There are always cases falling indisputably on one or the other side of the line and it is a familiar argument in tax courts that the case under review bears close analogy to a case falling on the right side of the line and must therefore be decided in the same manner."

Undisputably, Aditya Minerals case fell on the other side of the line. It related to mining lease and therefore, hon'ble Andhra Pradesh High Court in its judgement as reported in *167ITR774* refused to take cognizance **of Empire Jute Co. Ltd. v. CIT(1980)124 ITR1** which was cited by the counsel for the assessee. It may be

noted that the Supreme Court on further appeal by the assessee in this case gave a very short verdict as the five judge bench agreed fully with the A.P. High Court verdict.
The decision in Aditya Mineral's case is reaffirmation of well settled principle in the case of mining leases that expenditure for acquiring right over land to win minerals is of capital nature whereas the expenditure incurred for obtaining the right to acquire the raw material is of revenue character for being laid out for the acquisition of stock in trade. The Constitution Bench of the Supreme Court in this case, in fact, resolved the apparent conflict between the judgements of its two benches in Pingle Industries ltd. v. CIT (1960) 40 ITR 67 and Gotan Lime Syndicate v. CIT (1966)59 ITR718 on the basis of this principle.
The Court likened the case in hand , on facts, to Pingle Industries Ltd.'s case (supra) and held that the sum of Rs.10,752/-p.a. at the rate of Rs. 35/- per acre per month as indicated by the lease deed was rent for the land that was leased. At para 4 pg. 338, it made following important observations-" It is true that if a capital sum is arrived at and payment is made every year by chalking out the capital amount in various instalments, the payment does not lose its character as a capital payment if the sum determined was capital in nature."

(b) The question of charging the expenditure, which has been held to be of revenue nature but the benefit in respect of which is likely to accrue over several years, in the year in which it is incurred or to spread it proportionately over the period the benefit is derived, has been another bone of contention between the revenue and the tax payer.
Normally, excepting certain specific provisions relating to amortisation of initial expenses, the revenue expenses are allowed only in year in which the expenses are incurred. In fact, there is no provision in the Act for allowing revenue expenses in a phased or spread - out manner.
The Allahabad High Court in **Hindustan Commercial bank Ltd. (1952) 21 ITR 353** had occasion to examine a case where the assessee-bank had incurred certain expenditure in opening 46 new branches and sub branches. Rs. 24,675/- was in relation to advertisement etc. and Rs. 89,870/- represented salary, postage, telephone expenses etc. The Tribunal held Rs. 89,870/- as deferred revenue expenditure, spread it over 20 years and allowed deduction of $1/20^{th}$ of the amount in the relevant asst. year. On reference, the Court held that there was no legal justification for spreading out the sum over a period of 20 years and the whole amount would be deductible in the year in which it was incurred.
More recently, the Bangalore Tribunal in **Bangalore Tool Works (P) Ltd. v. ITO (1993) 47 ITD 604** held, in a case where the assessee claimed deduction of expenditure incurred in the past, in subsequent assessment years as deferred revenue expenditure, it was not entitled to deduction having failed to claim such expenditure in the year in which such expenses were incurred.
Whether in Madras Industrial Investment Corporation Ltd.'s case (supra) the Supreme Court has deviated from this normal rule. Yes, it has, but at the same time it has given a new direction towards real income taxation wherever situation so permits. In this sense, this is a landmark judgement.
Does it follow that the normal rule is no more valid? This is also not true. Deviation is allowed where the facts so warrant. In fact, the Supreme Court in this case itself observes-
"Ordinarily, revenue expenditure which is incurred wholly and exclusively for the purpose of business must be allowed in its entirely 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. However, the facts may justify an assessee who has incurred expenditure in a particular year to spread and claim it over a period of ensuing years. In fact, allowing the entire expenditure in one year might give a very distorted picture of the profits of a particular year."
Supreme Court in this case, referred and supported the Calcutta High Court judgement in **Hindustan Aluminium Corporation Ltd. v. CIT (1983) 144ITR474** and Madhya Pradesh High Court judgement in **M.P.Financial Corporation v. CIT (1987)165 ITR765.**
In the former case, Calcutta High Court upheld the claim of the assessee to spread out a lump sum payment to secure technical assistance and training over a period of 20 years and allowed a proportionate deduction in the accounting year in question. In the later case, the Madhya pradesh High Court held that where the issue

of bonds is at a discount, the assessee is entitled to proportionate deduction spread over the period for which the bonds remain outstanding.

From the above discussion, it is clear that the Supreme Court by virtue of its judgement in Madras Industrial Investment Corporation's case has laid new rule of spreading the deferred revenue expenditure over the period of benefit derived, where ever such period can be ascertained with certainty.

However, the Apex Court did not give any ruling for spreading over the cost of construction over the lease period of 39 years in the case of Madras Auto Service's case because the fight between the assesee company and the revenue from the inception was over the treatment of expenditure between capital and revenue and the question of spread over was never raised.

8.CONCLUSION

It is now clear that the hon'ble Supreme Court has been following a set pattern evolved over the decades as far as the capital and revenue expenditure is concerned. The incongruities between the different judgements is felt because of our inadequate appreciation of the facts and the rules to be applied thereon.