

THE FOOD CORPORATION OF INDIA
HEAD QUARTERS : NEW DELHI

No. Accts/14(1)/93-94

DT : 6.6.1994

CIRCULAR NO. 658/ACCTS

Sub.: Capital or Revenue loss / expenditure-clarification thereof – Reg.

The field units suffer from Confusion in regard to treatment of capital or Revenue Losses / expenditure. Statutory Auditors / Govt. Auditors also raising observations for accountal of some items, the allocation of which between capital and revenue becomes disputed. The field officers are also not following uniform procedure in this regard as already pointed out in Headquarters Circular No. 649/Accts. issued under reference No. Accts/14(1)/92-93 dt. 9.2.94. In this regard some of the legal decisions taken by the Hon'ble Supreme Court and High Courts on the subject, published in the Journal of Institute of Chartered Accountants of India for the month of May, 1994, are enclosed for guidance and correct treatment to account for expenditure / loss.

Sd/-
(A.K. CHAKRABORTY)
JT. MANAGER (ACCTS.)

1. CIT vs Mihir Textiles Ltd (1994) 206 ITR 112 (Guj.)

Business expenditure – Capital or revenue

Decision : The Court made the following points :

- 1. The sum to be paid for default in fulfilling the export obligation may be described as penalty. However, in the ultimate analysis, it is the substance of the transaction between the parties which had to be considered for the purpose of determining as to what is the true nature and import of the scheme. From the facts of the case, it is clear that the amount which was required to be paid to the Textile Commissioner, for non-fulfilment of the assessee's export obligations, was a business expenditure incurred wholly and exclusively for the purpose of the assessee's business.**
- 2. Where the assessee makes a payment which represents the acquiring of tenancy rights, the assessee in fact acquires a right to possession which is of an enduring nature and therefore, such expenditure incurred for the acquisition of such a right is capital in nature.**
- 3. The increase of the paid-up capital by issue of bonus shares will increase the credit worthiness of the issuing company. Hence expenditure incurred in connection with the issue of bonus shares are incurred by the company for its permanent structure. They are directly connected with the acquisition of capital and it has an advantage of an enduring nature. Hence, they cannot be treated as revenue expenditure.**

2. Kirloskar oil Engines Limited vs CIT (1994) 206 ITR 13 (Bom)

Capital or revenue expenditure tests.

Facts/Issues : under an agreement between the assessee company and a non-resident company, it was agreed that the assessee company shall pay a sum of DM 220.000 to the non-resident for the purchase of export rights. The non-resident company also sold the exclusive right of manufacture in India of single-cylinder, four-stroke diesel engines, designed and developed by the non-resident company. The engines were built with a special type of ball bearings and roller bearings which were not being manufactured in India and were not available to the assessee company. The designs, drawings and specifications were to be given to the assessee company and under the agreement. The assessee company was entitled to manufacture the above mentioned engines in India and to sell the same in India and also in any part of the world with assessee's own trademark. The drawings and the information received by the assessee company, under the terms and conditions of the agreement became entirely the property of the assessee. The assessee was required to pay a certain sum for purchase of manufacturing rights and drawings designs and specifications as stated above. This payment was to be made within 30 days from the receipt there of by the assessee. The monay payable for the purchase of export rights was to be paid in five yearly instalments. A question arose whether the instalment payment for the purchase of export rights was deductible as business expenditure.

Decision : While examining whether the expenditure is of the capital or revenue nature of the authorities should always examine the controversy from the point of view of a practical and prudent businessman, rather than from the view point of a tax-gatherer, upon strict juristic classification of the legal right secured in the process. From a careful reading of the agreement, it is clear that the assessee had purchased were the manufacturing rights drawings, designs, specifications and export rights. For all other items except the export right, the payment was to be made in

one instalment within 30 days of the receipt of the relevant material. The Supreme Court has clearly held in *Devidas Vithaldas and Company vs CIT (1972) 84 ITR 277*, that once there is an acquisition of a capital asset, the payment there of will be a capital expenditure and it would not make any difference as to whether it is paid in a lump-sum at one time or instalments disbursed over a definite period. In the light of the clear decision of the Supreme Court, the expenditure on acquisition of export, right is capital expenditure.

3. **Godfrey Philips India Ltd. vs CIT (1994) 206 ITR 23 (Bom)**

Legal expenses – amalgamation – whether capital or revenue.

Facts/Issues : The controversy relates to two assessment years during which the assessee company incurred certain legal expenses in connection with the amalgamation of its distribution company. The assessing officer claimed it as revenue expenditure. The claim was based on the fact that the distributing company was amalgamated with the assessee so that the distribution marketing and selling of the assessee's products, which had so far been carried on by the amalgamating company, could be carried out by the assessee himself. It was contended that the amalgamation was done keeping in mind the fact that by the amalgamation, services of the experienced staff and existing distribution organization of the company amalgamated would become available to the assessee company which would ultimately result in increased profitability.

Decision : Legal expenses per se can neither be revenue nor capital. It will depend upon the facts of each case. The purpose for which the expenses have been incurred in the course of running the business or for protecting business, it will be a revenue expenditure. But if it is in connection with the acquisition of a business of an enduring nature or an asset of permanent character, then the legal expenditure would partake of the character of capital expenditure. This proposition is well brought out in the decision of

the Supreme Court in **Dalmia Jain and Company Limited Vs CIT (1971)81 ITR 754.**

In order to hold a particular expenditure to be revenue expenditure, the nexus between the expenditure and the profitability should be direct and proximate. In the instant case, there is no such direct nexus. The object and purpose of the amalgamation is to acquire the distribution network of the other company which is a capital asset and an advantage of an enduring nature. The expenditure in question resulted in the addition to, or expansion of, the profit making apparatus of the assessee. Hence it is capital expenditure.

4. CIT Vs. V.S. Dempo & Co. Pvt. Ltd. (1991)206 ITR 291 (Bom)

Capital or revenue loss-foreign exchange-loan taken in foreign currency devaluation of Indian rupee-how the loss should be treated ?

FACTS/Issues : The relevant assessment year is 1967-68. During the years 1957-58 and 1958-59, the assessee company borrowed a sum of 7,00,000 dollars equivalent to Rs. 33,42,783 from a company in Japan who were selling agents of the assessee company for iron ore. There was another limited company namely. M/s Dempo & Souza Ltd in which the assessee company held 50 per cent of the shares. This company used to extract iron ore from the mines and supply the same exclusively to the assessee. As the method of extracting iron ore from its mines by the said company had become outdated, it was felt by the company as well as the assessee company that the mines of the former company should be mechanized, in order to reduce the cost of production as well as to increase production. The necessary machinery for mechanization was to be imported from Germany and other countries. The assessee Company agreed to provide the necessary foreign exchange required for the import of machinery. Accordingly, the assessee company advanced the sum of 7,00,000 dollars which it had obtained as loan from the Japanese Company to the said company for the import of mining machinery. The loan given by the

assessee was thus utilized by the other company for the import of mining machinery. The amount so advanced was agreed to be adjusted against the price of iron ore supplied by the said company to the assessee. On June 6, 1966, there was a devaluation of the Indian rupee. On account of the devaluation, the assessee's liability in respect of the above loan from the Japanese company was increased by a sum of Rs. 19,07,217 which the assessee claimed as a deduction in computing its income for the relevant previous year. The assessing officer disallowed the claim on the ground that the whole of the amount of loan was utilized for purchase of machinery for the use of another company namely M/s Dempo & Souza Ltd., which was the capital equipment of the company. The nature of the loan according to the assessing officer, was therefore, capital and the increased liability consequent to devaluation also according to the assessing officer, was therefore, capital and the increased liability consequent to devaluation also remained the same in nature. He, therefore, disallowed the claim of the assessee. The Appellate Assistant Commissioner upheld it. The reason was that the transaction of providing finance to the other company was of an investment nature and the asset, namely the debt due to the assessee by M/s Dempo & Souza Ltd., was an asset of capital nature and hence the loss on account of devaluation was a loss due to depreciation of the value of capital asset. The tribunal found the contention of the assessee to the effect that any loss incurred by it on account of enhancement of the liability due to the devaluation was a business loss since the money borrowed had been utilized by it for the purpose of its business, was valid.

It further found that even though the loan of Seven Lakh dollars taken by the assessee company from the Japanese company was initially utilized for the purchase of machinery imported for the mechanization of mines of M/s Dempo & Souza Ltd., it was ultimately realized from them in accordance with the terms and conditions of the loan by adjustment against the price of supplies of iron ore. It was further observed that as M/s Dempo & Souza Ltd., were supplying the iron ore extracted by them from

their mines exclusively to the assessee company, the assessee company was benefited by advancing loan to them. It also found that the entire loan had been repaid by the said company to the assessee company before the date of devaluation by the adjustment against price of iron ore supplied to the assessee. The Tribunal therefore, held that the loss incurred by the assessee on account of devaluation was a revenue loss.

Decision : The Bombay High Court laid down the following principles in determining whether a loss is allowable as a business loss :

1. A loss arising in the process of conversion of foreign currency which is part of the trading asset of the assessee is a trading loss as any other loss ;
2. The cause which occasions the loss is immaterial; what is material is whether the loss has occurred in the course of carrying on the business or is incidental to it ;
3. If there is a loss in a trading asset, it would be a trading loss, whatever be its cause, because it would be a loss in the course of carrying on the business ;
4. Loss in respect of circulating capital is revenue loss whereas loss in respect of fixed capital is not ;
5. Loss resulting from depreciation of foreign currency which is utilized or intended to be utilized in business and is part of the circulating capital, would be a trading loss ; the depreciation of fixed capital on account of alteration in exchange rates would be a capital loss;
6. For determining whether devaluation loss is a revenue loss or capital loss, what is relevant is the utilization of the amount at the time of devaluation and not the object for which the loan had been obtained, even if the foreign currency was intended or had originally been utilized for acquisition of fixed asset, if at the time of devaluation, it had changed its character and had assumed the new character of

stock-in-trade or circulating capital, the loss that occurred on account of devaluation shall be revenue loss and not a capital loss.

7. The way in which the entries are made by an assessee in the books of account is not determinative of the question whether the assessee has earned any profit or suffered any loss. What is necessary to be considered in the true nature of the transaction and whether in fact it has resulted in profit or loss to the assessee.

In the instant case, the entire amount of loan which had been advanced to M/s Dempo Souza Ltd. for the purchase of machinery had been repaid to the assessee by way of adjustment against the price of iron ore supplied to it which was its stock-in-trade. Hence whatever might have been the original object of the loan at the time of devaluation, the amount of loan was utilized by the assessee as circulating capital. Hence the loss which occurred due to devaluation of the Indian rupee was clearly a revenue loss and allowable as deduction in computation of the income of the assessee for the assessment year 1967-68.

5. CIT vs New India Sugar Mills Ltd. (1994) 206 (TR 212 (Cal)

Capital or revenue expenditure

Facts/ Issues : The assessee is a limited company. The Assessment year involved in 1980-81. The business of the assessee company is manufacture and sale of sugar. During the relevant accounting year, the assessee company made certain reserve under the head “Molasses Storage Reserve fund” and claimed the same as revenue expenditure. The Assessing Officer did not agree.

Decision : The Tribunal has not found that the assessee had gained any advantage of an enduring nature or acquired any capital asset as a result of the contribution made under compulsion of law. There cannot be any dispute that the expenditure was incurred wholly and exclusively for the purpose of business. The expenditure is not a capital nature in any way. The contribution made by the assessee and the other sugar millowners may be used for creating storage facilities. But the result of the expenditure will be augment or improve the capital structure of the assessee company in any way. Hence it is revenue expenditure.

