Revenue vs. Capital Expenditure

- Adv. Radha Halbe

!!!...INCOME TAX…!!!

"The Hardest Thing in the World to Understand is The Income Tax."

- Albert Einstein

"The only thing that hurts more than paying an income tax is not having to pay an income tax."

- Lord Thomas Dewar

!!!...INCOME TAX…!!!

- **Article 265** of the Constitution provides that no tax shall be levied or collected except by the '***authority of law.'***

- Central Government has the power to **levy tax on income**, other than agricultural income, as specified by Entry 82 of List 1 of Constitution of India.

- However, there is **no definition of the word 'income' in the Constitution**. The question thus arises, what is the meaning of the word 'income'?

!!!...INCOME TAX…!!!

- **Charge of Income Tax [Section 4]**

(1) Where any Central Act enacts that income-tax shall be charged for any assessment year at any rate or rates, income-tax at that rate or those rates shall be charged for that year in accordance with, and subject to the provisions (including provisions for the levy of additional income-tax) of, this Act in respect **of the total income of the previous year** of every person :

Provided that where by virtue of any provision of this Act income-tax is to be charged in respect of the income of a period other than the previous year, income-tax shall be charged accordingly.

(2) In respect of income chargeable under sub-section (1), income-tax shall be deducted at the source or paid in advance, where it is so deductible or payable under any provision of this Act.

Certain basic Concepts

- Concept of Previous year and Assessment Year
- Tax on ‘total income’
- Income tax is a trust based tax
- Heads of income
- Cash and mercantile system of accounting

WHAT IS INCOME?

SECTION 2 (24)

Section 2(24) : Income

- The first definition of income which was incorporated in the form of section 2(6C) of the 1922 Act, was an inclusive definition which had the avowed purpose to include four categories of receipts, viz. **dividend, profit in lieu of salary, balancing charge and profits of a mutual insurance company**, in the definition of income and to tax them as such.

- Judicial decisions have considerably enlarged the concept of income. It has been observed by Lord Wright in Raja Bhadur Kamakshya Narain Singh of Ramgarh v. CIT [1943] 11 ITR 513 (PC) that **the word 'income' is one of the broadest connotation.**

Section 2(24) : Income

- The definition of Income as per the Income Tax Act, 1961 **begins with the words "Income includes".** Therefore, it is an inclusive definition and not an exhaustive one.

- Does it mean that by simply amending clause (24) of Section 2, **any receipt can be included in the definition of income and thus made chargeable to Income Tax**?

  Larger question is – whether such an artificial expansion of the definition of income is permissible under Entry 82 of List I in Schedule VII to the Constitution.

- Since the definition of income in section 2(24) of the Income Tax Act is an inclusive one, its ambit should be the same as that of the word income occurring in Entry 82 of List I.

  -CIT v. G.R. Karthikeyan [1993 Supp (3) SCC 222]

Revenue v. Capital Income

- Tree can be compared to a source of income whereas fruit can be compared to a revenue income
- What if u sell the fruit?
- What if the tree is destroyed due to a natural calamity?

Suppose you have a gold mine. There are three ways of earning income from it.

- Selling the mine
- Leasing out the mine
- Mining and selling the gold

- What among this is a revenue income and a capital income?

FINANCIAL ASSISTANCE FORM A FRIEND WHO IS NOT A RELATIVE.

What if a person receives financial assistance from friends, well wishers etc. (non relatives) for some need like medical or educational needs and he spends the same for that purpose?

Case of money laundering?

Case of bogus capital building?

Addition to wealth of recipient?

If no, can there be any taxability?

BROAD PRINCIPLES CLARIFYING THE CONCEPT OF INCOME

- ***Regular & Definite Source :***

  The term 'income' connotes a periodical monetary return coming in with some sort of regularity or expected regularity from definite sources.

- ***Different Forms of Income :***

  Income may be received in cash or in kind. When income is received in kind, its valuation is to be made according to the rules prescribed in the Income Tax Rules. If, however, there is no prescribed rule, valuation thereof is made on the basis of market value.

BROAD PRINCIPLES CLARIFYING THE CONCEPT OF INCOME

- ***Receipt Vs. Accrual :***

  Income arises either on receipt basis or on accrual basis.

  Income may accrue to a tax payer without its actual receipt.

  Various charging sections – 15, 22, 28, 45 and 56 play an important role in deciding the trigger point of taxability.

  Also Section 145 is relevant.

  But certainly, income once charged to tax on either basis, can not be again taxed when the other trigger point is reached.

BROAD PRINCIPLES CLARIFYING THE CONCEPT OF INCOME

- ***Illegal Income :***

  The Income Tax law does not make any distinction between income accrued or arisen from a legal source and income tainted with illegality.

  Explanation 1 to Section 37(1) attacks expenditure tainted with illegality but not the illegal business itself. In fact loss tainted with illegality has been held by SC not to be affected by Explanation 1 to section 37(1).

  - Dr. T.A. Quereshi vs. CIT [2006] 287 ITR 547 (SC)

BROAD PRINCIPLES CLARIFYING THE CONCEPT OF INCOME

- ***Disputed Title (Principle of Protective Assessment) :***

  Income Tax assessment cannot be held up or postponed merely because of existence of a dispute regarding the title of income.

  This principle is well-settled by the Supreme Court decision in Lalji Haridas v. ITO [1961] 43 ITR 387.

  Where owing to litigations it is not possible to establish finally as to who is the proper assessee, if the income-tax authorities are precluded from making an alternative assessment, then, by the time the disputes are over, the real assessment would be time barred.

  Therefore, there is no reason why an alternative assessment, that is to say protective assessment, should be declared to be illegal.

BROAD PRINCIPLES CLARIFYING THE CONCEPT OF INCOME

- ***Relief or reimbursement of expenses not treated as income :***

  Mere relief or reimbursement of expenses is not treated as income. For example, reimbursement of actual travelling expenses to an employee is not an income.

- ***Surplus from mutual activity :***

  A person cannot make taxable profit out of a transaction with himself. Income must, therefore, come from outside. A surplus arising to a mutual concern cannot be regarded as income chargeable to tax.

- ***Temporary & Permanent Income :***

  For the purpose of Income Tax, there is **no distinction** between temporary & permanent income. **Even temporary income is taxable**.

BROAD PRINCIPLES CLARIFYING THE CONCEPT OF INCOME

- ***Lumpsum Receipt :***

  Income, whether received in lump sum or in installments, is liable to tax. For instance, arrears of bonus received in lumpsum is income and is taxable as salary.

- ***Personal Gifts :***

  Gift of a personal nature e.g. birthday gifts, marriage gifts, etc. is a capital receipt and therefore, generally the recipient of such a gift is not liable to Income Tax. This is, however, subject to the provisions of Section 56.

- ***Tax Free Income :***

  If a person receives tax-free income on which tax is paid by the person making payment on behalf of the recipient, it has to be grossed up for inclusion in his total income.

BROAD PRINCIPLES CLARIFYING THE CONCEPT OF INCOME

- ***Same income cannot be taxed twice :***

  It is a fundamental rule of the law of taxation that unless otherwise expressly provided, the same income cannot be taxed twice.

- ***Income should be real and not fictional :***

  Income means real income and not fictional income. A person cannot make a profit by trading with himself or out of transfer of funds/assets from one pocket to another pocket – **[Sir Kikabhai Premchand Vs. CIT [1953] 24 ITR 506 (SC)].**

  Similarly, income does not arise in a **transaction between Head Office and branch office** even if goods are invoiced at price higher than cost price.

BROAD PRINCIPLES CLARIFYING THE CONCEPT OF INCOME

- ***Source of income need not exist in the assessment year :***

  It is not necessary that a source of income should exist in the assessment year. If there is an income during the previous year, it is chargeable to tax for the following assessment year even if the source of income does not exist during the assessment year.

- ***Pin Money :***

  Pin money received by wife for her dress/personal expenses and small savings made by a woman out of money received from her husband for meeting household expenses is not treated as her income.

- ***Alimony :***

  Monthly alimony received from ex-husband as per court decree is chargeable to tax, whereas lumpsum alimony is not taxable – Princess Maheshwari Devi of Pratapgarh v. CIT (1983) 12 Taxman 220 (Bom.)

BURDEN OF PROOF

BURDEN OF PROOF

- Section 4 of the Act imposes a general liability to tax upon all income.
- But the Act does not provide that whatever is received by a person must be regarded as income liable to tax. In all cases in which a receipt is sought to be taxed as income, the **burden lies upon the Income tax Department** to prove that it is within the taxing provision.
- However, where a receipt is in the nature of income the **burden of proving that it is not taxable** because it falls within an exemption provided by the Act **lies upon the assessee.**

-Parimisetti Seetharamamma v. CIT [1965] 57 ITR 532 (SC)

Capital expenditure

- Refers to expenditure to **acquire, upgrade and maintain its fixed assets**.
- These expenses give a long term **enduring advantage**
- Capital expenditures are typically **one-time large purchases** of fixed assets that will be used for revenue generation over a longer period.
- Examples-
  - Immovable properties, Machinery and Equipment
  - Intellectual property rights

Revenue expenditure

- Revenue expenditures are **short-term expenses** used in the current period or typically within one year.
- They include the expenses required **to meet the ongoing operational costs** of running a business.
- This is a **recurring expenditure** wherein there are no future benefits beyond a defined period which is an year generally.
- Examples- Salaries, Repairs and maintenance, lease rentals etc.

Distinction

- Capital Expenditure
  - Capital expenditures usually take two forms:
  - Acquisition expenditures and Expansion expenditures.

- Revenue Expenditure
  - Classified into two sub-categories-
  - **Direct Expenses:** Cost of manufacturing raw material to finished goods
  - **Indirect Expenses:** Costs connected to only selling and distribution of goods apart from manufacturing.

Distinction

- **Capital Expenditure**

- Capital expenses are classified in the **Balance sheet as Assets**.
- Certain capital expenditures **depreciate** every year.

- **Revenue Expenditure**
- Revenue expenditures appear in the **Trading and Profit and Loss account**.
- The benefit is **consumed in the same accounting year.**

Distinction

- Capital Expenditure

- Challenges associated-
- **Measurement Problems**
- **Unpredictability**
- **Temporal Spread**

- Revenue Expenditure

- Challenges associated-
- **Yield benefits in the short-term**
- **Only determines current financial standing of the firm.**
- **It does not necessarily provide an accurate picture of a firm's overall financial standing.**

Business Income and Expenditure

- **Meaning of Business & Profession :**
- **Business -** The word 'Business' is defined in section 2(13) to include any trade, commerce or manufacture or any adventure or concern in the nature of trade, commerce or manufacture.

- **<u>What makes a transaction an adventure in the nature of trade?</u>**
- "In order to find whether a transaction of purchase and subsequent sale amounts to an adventure in the nature of trade, the initial intention is an important factor but not a conclusive one. The subsequent events and the assessee's conduct are also important factors and the facts to be considered are: first, **whether the transaction was in the line of the assessee's business** and, secondly, **whether it was an isolated transaction or there was a series of similar transactions**."[ITO v. Rani Ratnesh Kumari (1980)123 ITR 343 (All.)]

Isolated transaction when can constitute adventure in nature of trade

- It is not necessary that in order to constitute trade, there should be a series of transactions, both of purchase and of sale. **A single transaction of purchase and sale outside the assessee's line of business may constitute an adventure** in the nature of trade. Neither repetition nor continuity of similar transactions is necessary to constitute an adventure in the nature of trade.
- Even a **single and isolated transaction can be held to be capable of falling within the definition of "business"** if it bears clear indication of trade. However, a stray activity of a non-businessman would not be business. **[CIT v. Prabhu Dayal (1971) 82 ITR 804 (SC)].**

Expenditure for the purpose of the Act:

- Certain types of expenditure have been separately dealt with in sections 30 to 36. Wherever any such expenditure detailed in or covered by any of the **sections 30 to 36** is found to have been incurred, deduction or allowance there for is to be claimed-under that particular section.
- **Section 37(1) is the residuary section** so far as business expenditure is concerned. If any expenditure is not referable to any of the sections 30 to 36 and fulfils the conditions of this section, it may be claimed hereunder. Thus, if any particular expenditure falls within the ambit of any of the sections 30 to 36 and it is found not to be fulfilling the conditions for allowances laid down in that section, it cannot be claimed under the residuary section. [Laxman Sejram v CIT (1964) 54 ITR 763 (Guj)].

- The mere fact that a particular subject of deduction is expressly dealt with in one of sections covered by sections 30 to 36 does not imply that deduction in respect of that subject cannot be allowed on general principles or under the residuary section – unless the specific section is so worded as to prohibit expressly or implicitly any allowance apart from that section and except on the conditions prescribed by that section.
- E.g. Expenditure on replacement of old machines is in the nature of accumulated repairs and not current repairs. Therefore, the High Court allowed such deduction under section, 37 in place of section 31. [CIT v Gitanjali Mills Ltd. (2004) 136 Taxman 21 (Mad)].

Expenditure should not be of capital nature to be allowed

- One of the most vexed questions in the computation of business income is **whether a particular expenditure is revenue expenditure or capital expenditure**. For purposes of the income-tax, the question is important in as much as it determines whether or not a particular expenditure is allowable as a permissible deduction. If it is revenue expenditure, it is permissible as a deduction; if, on the other hand, it is capital expenditure, it is not so allowable.
- 2. The line of **demarcation has been found to be very thin** and each case has to be decided on the **facts and circumstances** of the case. In any event, in order to determine whether an expenditure is revenue or capital expenditure, **certain broad principles** have to be borne in mind. These principles have been **formulated over a period of many decades and have the support of a whole wealth of case-laws.**
- 3. The trend of the judicial decisions also indicates a progressive liberalisation of the concepts and tendency will be noticed to treat many items as revenue expenditure in regard to which, a few years back, a contrary conclusion would have unhesitatingly been reached.

- The Andhra Pradesh High Court in the case of **Hylam Ltd. v. CIT [1973] 87 ITR 310 and the Supreme Court in the case of Empire Jute Co. Ltd. v. CIT (1980) 124 ITR** laid down the following guiding principles for determining as to whether particular expenditure is capital or revenue expenditure :
- **If the expenditure is for initial outlay or for acquiring or bringing into existence an asset** or advantage of an enduring benefit to the business that is being carried on, or for extension of business that is going on or for substantial replacement of an existing business asset- it would be capital expenditure.
- If, on the other hand, the expenditure, although for the purpose of acquiring an asset or advantage, is **for the running of the business** or for working out that asset with a view to produce profit, it would be revenue expenditure.
- If the expenditure is so related to the carrying on or the conduct of the business that it may be **regarded as an integral part of the profit-earning process** or operations, and not for the acquisition of an asset of a permanent character, the possession of which is a condition precedent for the running of the business, **then it would be expenditure of revenue nature**. **Eg. Construction of a temple by a builder in the housing complex.**
- If it is **intrinsically a capital asset, it is immaterial whether the price for it is paid once and for all, or periodically**, or whether it is paid out of capital or income, or linked up with the net sales. The outgoing, in such a case, would be of the nature of capital expenditure.

- If the amount paid for the acquisition of an **asset of an enduring nature** is settled, the mere fact that the amount so settled is chalked out into various small amounts orperiodic instalments, the capital nature, of expenditure would not cease to be so or alter into the nature of revenue expenditure.
- If the expenditure is **recurring** and is incurred during the course of business or manufacture, it would be revenue expenditure.
- An asset or advantage of an enduring nature **does not mean that it should last for ever.** If the capital is, in its nature, a short-lived one, the expenditure incurred over it does not for that reason, cease to be a capital expenditure.

- 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 on revenue** account, even though the advantage may endure for an indefinite future. ` blindly and mechanically without regard to the particular facts and circumstances of a given case.

Judicial Decisions

- Acquisition of the **goodwill of a business is acquisition of a capital asset** irrespective of whether its purchase price is paid in lump sum at one time or in instalments distributed over a definite period. **Where, however, the transaction is not one for acquisition of the goodwill, but for the right to use the goodwill, the expenditure would be revenue expenditure.** [Devidas Vithaldas & Co. v CIT (1972) 84 ITR 277 (SC)]
- **Brokerage and stamp duty incurred for taking a five year lease of office premises is revenue expenditure.** [CIT v Hoechst Pharmaceuticals Ltd. (1978) 113 ITR 877 (Bom)] [CIT v Cinceita Pvt. Ltd. (1982) 137 ITR 652 (Bom)]

- Fees paid to a **legal adviser for obtaining advice in connection with purchase of land** for expansion of its manufacturing activities, **though land was not purchased is revenue expenditure.** [Hindustan Milk-food Manufacturers Ltd. v CIT (1989) 179 ITR 302 (Punj)
- Expenditure incurred **for the preservation of the entire business** as an entity and for defending against a claim of hostile title is **allowable under section 37(1)** [CIT v Malayalam Plantations Ltd. (1964) 53 ITR 140 (SC)]

- Damages paid by way of interest and storage charges for breach of contract for purchase of a capital asset, cannot be termed as revenue expenditure. [CIT v Ramakrishna Engineering Industries (Coimbatore) Ltd. (1995) 215 ITR 723 (Mad)].
- Ordinarily, money paid to keep out a potential competitor in business, where the benefit is of an enduring nature, is an expenditure in the nature of capital. [Behari Lal Beni Parshad v CIT (1959) 35 ITR 576 (Pun)]

Tests to determine whether software expenses are capital or revenue in nature Amway India Enterprises v. Dy. CIT (2007) 114 TTJ 476 (Del.) (SB)

- Three tests generally applied to decide whether an expenditure is capital or revenue in nature are:
- **Ownership test:** An assessee purchasing such software, or the licence to use such software, becomes owner thereof. (Decision of the Supreme Court in the case of Tata Consultancy Services v. State of Andhra Pradesh, 192 CTR 257
- **Test of enduring benefit:** Having regard to the fact that software becomes obsolete with technological innovation and advancement within a short span of time, it can be said that where the life of the software is short (say, less than two years), then it may be treated as revenue expenditure. Any software having its utility to the assessee for a period beyond two years can be considered as accrual of benefit of enduring nature.
- **Functional Test:** **<u>If the advantage consists merely in facilitating the assessee's trading operations or enabling the management and conduct of the business to be carried on more efficiently or more profitably while leaving the fixed capital untouched, then the expenditure would be on revenue account even though the advantage may endure for an indefinite future.</u>**

Distinction between shares held as stock-in-trade and shares held as investment - Tests for such a distinction

- It must be **shown that they were held as stock-in-trade** and that existence of the power to purchase and sell shares in the **memorandum of association** is not decisive of the nature of transaction;
- **The substantial nature of transactions, the manner of maintaining books of accounts, the magnitude of purchases and sales and the ratio between purchases and sales and the holding**
- ordinarily purchases and sales of shares with **the motive of realizing profit** would lead to inference of **trade/adventure** in the nature of trade; where the object of the investment in shares of companies is **to derive income by way of dividends** etc., the transactions of purchases and sales of shares would **yield capital gains** and not business profits.

- CBDT also wishes to emphasize that **it is possible for a tax payer to have two portfolios, i.e., an investment portfolio comprising of securities which are to be treated as capital assets and a trading portfolio comprising of stock-in-trade which are to be treated as trading assets**. Where an assessee has two portfolios, the assessee may have income under both heads i.e., capital gains as well as business income.

- **However, it should be noted that securities held by FII are always considered as capital assets and not as stock in trade. [Amendment to S. 2(14)]**

<u>Circular no. 6/2016, dated 29-2-2016</u>

- Where the **assessee itself**, irrespective of the period of holding the listed shares and securities, **opts to treat them as stock-in-trade**, the income arising from transfer of such shares/securities would be treated as its **business income**

- In respect of listed shares and securities **held for a period of more than 12 months** immediately preceding the date of its transfer, if the **assessee desires to treat the income arising from the transfer thereof as Capital Gain**, **the same shall not be put to dispute** by the Assessing Officer. However, this stand, **once taken by the assessee in a particular Assessment Year, shall remain applicable** in subsequent Assessment Years also and the taxpayers shall not be allowed to adopt a different/contrary stand in this regard in subsequent years;

- In all other cases, the nature of transaction (i.e. whether the same is in the nature of capital gain or business income) shall continue to be decided keeping in view the aforesaid Circulars issued by the CBDT

Other Judicial Precedents

- If the assessee acquires a right to receive the income, the income is said to have accrued to him, though, it may be received later on. The basic concept is that he must have acquired a right to receive the income. In other words, there must be a debt owed to him by somebody. Unless and until a debt is created in favour of the assessee by somebody, it cannot be said that the assessee has acquired a right to receive the income or the income has accrued to him.

  -E. D. Sassoon & Co. Ltd. vs. CIT [1954] 26 ITR 27 (SC)

- Where income cannot be said to have resulted at all, there is neither accrual nor receipt of income, even though an entry might have been made in the books of account .

  -CIT vs. Shoorji Vallabhdas & Co. 46 ITR 144 (SC).

Other Judicial Precedents

- It is well settled that the way in which entries are made by the assessee in his books of account is not determinative of the question whether the assessee has earned any profit or suffered any loss.

  -State Bank of India v. CIT [1986) 157 ITR 67 (SC)].

- A mere book keeping entry cannot be income unless income has actually resulted.

  -CIT v. Shoorii Vallabhdas & Co. [1962] 46 ITR 144 (SC)].

- A receipt which in law cannot be regarded as income cannot become so merely because the assessee erroneously credited it to the profit and loss account.

  -CIT v. India Discount Co. Ltd. [1970] 75 ITR 191 (SC)].

Treatment of Interest on Sticky Loans

- *The Supreme Court in UCO Bank v. CIT (1999) 237 ITR 889*, laid down following prepositions:

  (1) The mercantile system of accounting does not require credit of interest on doubtful debts to profit and loss account.

  (2) The system of accounting regularly followed cannot be rejected as contrary to section 145 of the Income-tax Act.

- The Supreme Court in the context of the assessee crediting the interest on sticky loans to interest suspense account **and not to profit & loss account** treated it as a mixed system consistently followed &, therefore, **not impermissible under section 145.**

- Though hybrid or mixed system, i.e. of both cash & mercantile system is not permissible from 01/04/1997, the system of crediting such interest on sticky loans is not a mixture of cash with mercantile system, hence it need not be taken as barred from 1.4.1997. If the system followed is not crediting interest on such sticky loan because of its uncertainity, even such a system cannot be treated as prohibited under section 145 as substituted.

DIVERSION OF INCOME BY OVERRIDING TITLE

VS.

APPLICATION OF INCOME

Diversion of Income by Overriding Title

- Income is received by a person other than the person who is actually entitled to it.
- The recipient later on diverts the income under a pre-existing title to the person who is actually entitled to it.
- Though the assessee was legally entitled to receive the income, it was not his income at the very outset.
- Income is not taxable in the hands of the person who first receives it.
- Tax is payable by the person to whom income is diverted by overriding title.

Application of Income

- Income is **received by the person who is actually entitled to it**. He is chargeable to tax.

How to find out whether it is diversion or application ?

- In order to decide whether a particular payment is a diversion of income or application of income, **it has to be determined whether amount sought to be diverted reaches the assessee as his own income or not.**

- To put it differently, it has to be seen whether the disbursement of income made by the assessee:

  (a) is a result of fulfillment of an obligation on him

  or

  (b) whether income has been applied to discharge an obligation after it reaches the assessee.

Instances of diversion of income by overriding title

Instances of diversion of income by overriding title :

- Income received from property charged under a court's decree with maintenance allowance to a dependent and spent on maintenance

  -Raia Beioy Singh Dudhuria v. CIT [1933] 1ITR 135 (PC).

- Income from trust property which under the trust deed is to be spent on the maintenance of the assessee & his wife

  -**CIT v. ManilalDhanji [1962] 44 ITR 876 (SC).**

- When an amount is diverted by virtue of a partnership/sub-partnership agreement, it is equivalent to diversion by overriding title

  -CITv. Raja Ram Jaiswal [1991] 57 Taxman 225 (All.)

Instances of application of income

Instances of application of income

- Salary retained by employer for being credited to a compulsory deposit fund is "application of income"

  -Bell v. Gribble [1903] 4 TC 522.

- Similarly, the sum credited by employer to employee's account of Provident Fund Scheme is application of income -Smyth v. Stretton [1904] 5 TC 36.

- Income from dividend on shares purchased by an assessee through a loan taken from a creditor and handed over to it with an obligation to adjust it towards the payment of interest on loan and part of the principal loaned

  -IRC v. Paterson (1924] 9 TC 163 (CA).

Taxation of Interest on Client's funds held by CAs

- Under the Chartered Accountants Act, 1949 and Chartered Accountants Regulations, **monies belonging to clients have to he kept in a separate bank account**. The Chartered Accountant holds these monies in a fiduciary capacity. The beneficial interest in these monies is that of clients under the Indian Trusts Act.

- The Chartered Accountant being a trustee **cannot use or deal with the monies for his own benefit.** The corpus being that of the client, the **interest derived from such corpus is also subject to the fiduciary relationship.**

- It is also possible to take a view that the client has got a clear title to the monies & any interest arising thereon should properly belong to him & not to the chartered accountant. This is based on the principle of overriding title.

REVENUE

VS.

CAPITAL

Revenue vs. Capital

- Revenue receipt is t**axable as income, unless it is expressly exempt** under the Act.

  On the other hand, a **capital receipt is generally exempt from tax, unless it is expressly taxable**

  -Cadell Wvg. Mill Co. (P.) Ltd v. CIT [2001] 249 ITR 265 (Bom.)

- In order to determine whether a receipt is capital or revenue in nature, **one has to go by its nature in the hands of the recipient.** The source from which the payment is made has no bearing on the question.

  -CIT v. Kamal Behari Lal Singha [1971] 82 460 (SC)

- The **motive of payer is not relevant** while deciding whether a particular receipt is revenue or capital in nature.

  -P.H. Divecha v. CIT [1963] 48 ITR 222 (SC)

Revenue vs. Capital

- **A receipt in lieu of source of income is a capital receipt.**

  A receipt in lieu of income is revenue receipt.

  For instance, compensation for loss of employment is a capital receipt, as it is in lieu of source of income.

  Likewise, sale proceeds of trees removed from land together with their roots, leaving behind no prospect of regeneration, is a capital receipt as the receipt is in lieu of source of income

  -A.K.T.K.M. Vishnudatta Antharjanarn v. CAIT [1970] 78 ITR 58 (SC)

Revenue vs. Capital

- In order to determine whether a receipt is capital or revenue in nature **the fact that it is a lump sum payment, large payment or periodic payment, is not relevant.**

  It is not necessary that a revenue receipt should be recurring or a capital receipt should be a single receipt.

  -CIT v. Vardhini & Co. 165 ITR 342 (Kar)

- **Treatment of a receipt under the company law or general law is not relevant** while deciding whether a receipt is capital/revenue in nature under the tax law. Moreover, a particular treatment of a receipt in accounts of the assessee is not conclusive against or in favour of the assessee.

  -Punjab Distilling Industries Ltd. v. CIT [1965] 57 ITR 1 (SC).

  -Hoshiarpur Electric Supply Co. v. CIT [1961] 41 ITR 608 (SC).

Revenue vs. Capital

- The mere fact that compensation is measured by estimated annual profits cannot make the receipt a revenue receipt. There is no relation between the measure that is used for the purpose of calculating a particular result and the quality of the figure that is arrived at by means of the application of that test. It is the quality of payment that is decisive of the character of the payment (rather than the method of the payment or its measure) and makes it fall within capital or revenue.

  *-**Senairam Doongarrmall v. CIT [1961] 42 ITR 392 (SC)***

- If interest is received under a contract or a statute, it is a revenue receipt & hence taxable. But if interest is awarded by the court for loss suffered on account of deprivation of property, it amounts to compensation & hence not taxable.

  -CIT v. Chiranjilal Multanimal Rai Bahadur (P) Ltd. (179 ITR 157) (P & H)

Revenue vs. Capital: Profit prior to incorporation

- A company becomes a legal entity in the eyes of law only when it is incorporated. Under section 27 of the Specific Relief Act, it is no doubt open to a company to adopt and ratify a contract entered into by a promoter and enforce the same.

- The question as to who is liable to pay tax on such income cannot depend upon whether or not the company after incorporation so decides. It is he who carried on the business and received the income when it accrued who is liable to bear the burden of tax thereon.

- Therefore, the pre-incorporation profits could not be included in the assessment of the assessee-company. It should be noted that however difficult the quantification or the apportionment of income may be, the income-tax authorities must find out how much of the income or profits could be attributed to the company after the date of its incorporation and make it assessable only in respect thereof.

  -CIT v. City Mills Distributors (P) Ltd. (1996) 219 ITR 1(SC)

CONCEPT OF MUTUALITY

JUDICIAL PRECEDENTS

- The receipts for the various facilities extended **by the clubs to the members** as part of the usual privileges, advantages and conveniences, attached to the membership of the club, could not be said to be a trading activity. The **surplus being excess of receipts over the expenditure as a result of mutual arrangement could not- be, said to be income chargeable to tax.**

  - CIT vs. Bankipur Club Ltd. (1997) 226 ITR 97(SC)

- In the case of a mutual concern if the **income is derived both from mutual activity as well as from non-mutual activity**, the **exemption applies** only to the income from mutual activity. The income attributable to the **non-mutual activity will be liable to tax.**

  -Sports Club of Gujarat Ltd., vs. CIT (1987) 171 ITR 504 (Guj. HC)

Depreciation

- Concept of block of assets
- Specific specified percentages of depreciation
- Half rate of depreciation where the asset is put to use for less than 180 days
- WDV Method

Conditions for claiming depreciation

- The assets **must be owned, wholly or partly**, by the assessee.
- The assets **must be in use for the business** or profession of the taxpayer. If the assets are **not used exclusively** for the business, but for other purposes as well, depreciation allowable would be **proportionate** to the use of business purpose. The Income Tax Officer also has the right to determine the proportionate part of the depreciation under Section 38 of the Act.
- **Co-owners can claim depreciation** to the extent of the value of the assets owned by each co-owner.
- You cannot claim depreciation on **Goodwill and cost of land**.
- Depreciation is mandatory from A.Y. 2002-03 and shall be **allowed or deemed to have been allowed as a deduction irrespective of a claim made by a taxpayer** in the profit & loss account. That is, the taxpayer can carry forward the WDV after reducing the depreciation amount.
- If opted for **presumptive taxation scheme,** the **deemed profit is said to have considered** the effect of depreciation.
- Depreciation under the Companies Act, 1956 is different from that of Income Tax Act. Therefore, depreciation rates prescribed under the Income Tax Act are only allowed irrespective of the depreciationrates charged in the books of accounts.

Section 50

Capital gain can arise in two situations on sale of a depreciable asset:

- When all the assets in a block are sold
- Where the sale consideration exceeds the value of the block

Situation I

1. When net sale consideration on such asset's sale is reduced from the written down value (opening WDV + cost of assets acquired if any) of the block of the assets.
2. And the **written down value of the block of the asset becomes Nil** (Note: The written down value can be Nil but not negative).
3. Then the income from such transfer of capital asset shall be considered to be a **short-term capital gain**.

Situation II

1. When net sale consideration on such asset's sale is reduced from the written down value (opening WDV + cost of assets acquired if any) of the block of the assets.
2. And the **written down value of the block of asset is not Nil**.
3. There is no capital gain on transfer of assets.
4. Hence, normal depreciation will be allowed

Situation III

1. If the **whole of the block of asset is sold** and the **sale consideration is less than the written down value** (opening WDV + cost of assets acquired if any) of the block of assets.

2. Then there is short-term capital loss on sale of block of asset.

3. And no depreciation shall be allowed from such block of assets.

Situation IV

1. If **whole of the block of assets is sold** and the **sale consideration is more than the written down value** (opening WDV + cost of assets acquired if any) of the block of assets.
2. Then income from such sale of block of asset is short-term capital gain.

Depreciation not allowable when:

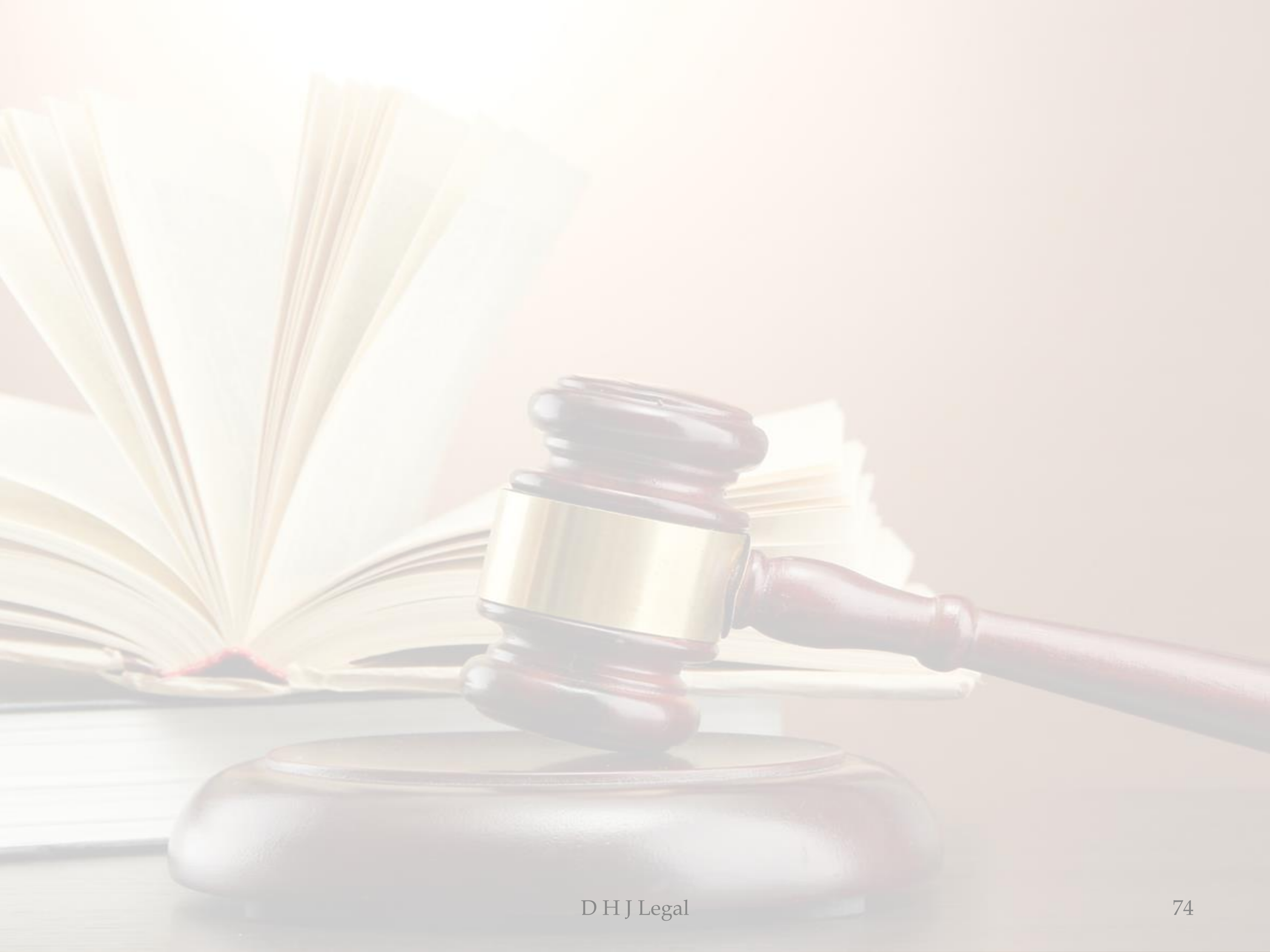
- No depreciation on land and money
- Building does not include land
- Payment for asset made in cash for more than Rs. 10,000
- GST credit claimed on the asset
- Depreciation to be split among succession companies

Judicial Decisions

- **Expenditure on test run of machinery** - Expenses incurred for test runs of plant and machinery before the same are ready to commence commercial production, are part of actual cost of plant and machinery [CIT v. Food Specialties Ltd. [1982] 136 ITR 203 (Delhi)]
- **Compensation for delayed delivery of machinery** - In Shree Digvijay Cement Co. Ltd v. CIT [1982] 138 ITR 45 (Guj.) the seller had to pay compensation to the purchaser for delay in delivery of the machinery but the Court held that such compensation received by the purchaser could not go to reduce the cost of machinery as it had nothing to do with the cost of machinery but was paid to set off the loss occasioned by the said delay.

Practicalities of Revenue v. Capital

- Principles of consistency
- Judicial precedents
- Sale of business – period of inactivity does not conclusively state that the business is discontinued.
- Mere realisation of business asset does not mean the business is carried on




Thank you