# Capital and Revenue Expenditure

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**Why Distinguish?**

In dealing with the subject in question, the basic question that may well be raised is "Why distinguish between capital and revenue expenditure?" The distinction between the two may be justified on the following grounds:—

1. In order that financial statements show a true and fair view of the financial affairs it is necessary to clearly distinguish between capital expenditure and revenue expenditure. If this distinction is neglected the financial records will not only be incorrect but positively false.

2. Whereas revenue expenditures are to be shown in the Profit and loss Account, capital expenditures belong to Balancc-sheet. Thus, a careless treatment of the two will present a misleading statement.

**What are Capital and Revenue Items?**

The answer to this question is, however, not that simple. In fact, it is not possible to lay down any hard and fast rule for making distinction between capital and revenue expenditure. An expenditure may be of capital nature in one case and revenue in another. Thus, an item of expenditure cannot be properly allocated between capital and revenue until all the facts of the case are known.

Viscount Cave in Atherton vs. British Insulated and Halsby Cable Limited (10 T.C. 155 H.L.) said that on the facts of the case the payment should be treated as revenue item and not as a capital item if:

"It is a payment made in the course of business, dealing with a particular difficulty which arose in the course of the year, and was made not in order to secure an actual asset to the company but to enable them to continue, as they had in the past, to carry on the same type and high quality of business unfettered and unimperiled by the presence of one who, if the public had known about it, might have caused difficulty to their business and whom it was necessary to deal with and settle with at once."

"When an expenditure is made with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think 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."

Lawrence, J. in the well know case of Southern vs. Borax Consolidated Co. Ltd. (1940) 23 TC 597(1942) 10 ITR Supp 1, 5, (KB), observed "...question as to whether this is a payment properly attributable to capital or to revenue, in my opinion the principle which is to be deduced from the case is that where a sum of money is laid out for the acquisition or the imporvement of a fixed capital asset it is attributable to capital, but that if no alteration is made in the fixed captial asset by the payment, then it is properly attributable to revenue being in substance a matter of maintenance, the maintenance of the capital structure or the capital assets of the company."

The test laid down by Bowen L. J. (City of London Contract Corp. Ltd. vs. Styless (1887) 2 TC 239 (CA) is rather a simple one. He said that capital expenditure was a thing that was going to be spent once and for all, and revenue expenditure was a thing that was going to recur every year.

The same view was endorsed by Rowlatt J., in the case of Ounsworth Vs. Vickers Ltd (1915) 6 TC 671(KB). He said that the real test was between the expenditure which was made to meet a continuous demand for expenditure as opposed to an expenditure which was made once and for all.

Another test was also suggested by Rowlatt, J. and that was whether a particular expenditure could be against any particular work or whether it was to be regarded as an enduring expenditure to serve the business as a whole.

Yet another test which was applied by the Privy Council in the case of Tata Hydro Electric Agencies Ltd Vs, Commisioner of Income Tax (1937) 5 ITR 202(PC) was that the expenditure in the acquition of an income earning asset was a capital expenditure and the expenditure in the process of the earning of the profits was revenue expenditure.

In Jansatta Karyalaya Vs. Commisioner of Income Tax (1964) 54 ITR 792 (Guj) a division bench of Gujrat High Court considered the question of replacement and also considered the tests for determining whether an expenditure is of a capital or of a revenue nature and observed:

As has been often remarked in various decisions, the line of demarcation between capital expenditure and revenue expendiutre is a very thin one and, therefore, courts of law have refrained from attempting to define or lay down any precise definition and have been content to set out only broad tests. These broad tests are, however, only workable guides and ultimately the question always depends upon the facts and circumstances of each case".

Three broad principles were formulated by the full bench of Lahore High Court in re Banarsidas Jaganath (1947) 15 ITR 185 (Lahore). These principles are:—

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.

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.

These broad principles formulated by the Bench of the Lahore High Court were approved by the Supreme Court in the case of Assam Bengal Cement Co. Ltd Vs. Commisioner of Income Tax (1955) 27 TLR 34 SC. The observation of the Supreme Court may be noted hereunder:—

"If the expenditure is made for acquitting or bringing into existance an asset or advantage for the enduring benefit of the business it is properly attributable to capital and is of the nature of capital expenditure. If on the other hand, it is made not for the purpose of bringing into existence any such asset or advantage but for running the business or working it with a view to producing the profits, it is a revenue expenditure. If any such assest or advantage for the enduring benefit of the business is thus acquired or brought into existance it would be immaterial whether the source of the payment was the capital or the income or the concern or whether the payment was made once and for all or was made periodically."

"The aim and the object of the expenditure would determine the character of the expenditure whether it is a capital expenditure or a revenue expenditure. The source or the manner of the payment would then be of no consequence. It is only in those cases where this test is of no avail that one may go to the test of fixed and circulating capital and consider whether the exenditure incurred was part of the fixed capital of the business or part of the circulatory capital. If it was part of the fixed capital of the business, it would be of the nature of capital expenditure and if it was part of its circulating capital it would be of the nature of revenue expenditure."

Whether an expenditure shall be available as deduction under sec. 10 (2) (v) of the Income Tax Act on the grounds of being of revenue nature, Mysore High Cout, in Hanuman Motor Services Vs. Commissioner of Income Tax (1967) 66 ITR 88 (Mysore) held as follows :

In finding out whether a given case falls within the scope of section 10 (2) (v), the true test is whether as a result of the expenditure, which is claimed as expenditure for repairs, what is really being done is to preserve and maintain an already existing asset or whether the object of such expenditure was to bring a new asset into existence or to obtain a new or fresh advantage. If it is the former, then it is a repair, if it is the latter, it should be considered as a replacement or renewal.

Supreme Court (Commissioner of Income Tax Vs. Mahalakshmi Textile Mills Ltd., (1967) 60 ITR 710 (SC) : in this connection observed that if there is replacement of certain parts of the machinery, after replacement new parts would from part of the capital asset but since replacement is necessitated because of wear and tear, such expenditure for replacement of these parts can be deducted as revenue expenditure under section 10 (2) (v) of the Indian Income Tax Act.

Gujrat High Court in the case of H. Mohamad and Company Vs. Commissioner of Income Tax (1977) 107 ITR 639 (Guj) observed that if there is a substantial replacement of the existing capital assets of the assessee, the expenditure for such replacement will not be allowed as a deduction for repairs or replacements. If the replacement is of parts only, the expenditure of such replacement is deductible but if the replacement is of the whole machinery as such as distinguished from replacement of parts with a view to bring in a new asset into existenc the expenditure will not be deductible and will not be treated as revenue expenditure.

**Conclusion**

Having learnt the basic principles involved in settling as to whether an expenditure is of a capital nature or revenue nature, let it be noted that they should be very carefully applied. It is because an item by itself cannot always be classed as revenue or capital. The situation as a whole must be considered. For instance, legal expenses, stamp duty, brokerage, carriage, wages, etc., are normally the items of revenue expenditure, but when they are incurred in connection with the acquisition and development of fixed assets, they are treated as capital expenditure.

Similarly, ordinary repairs are treated as of revenue nature but if an old machinery has been purchased and an expenditure is incurred to bring it in proper working order, it will form part of the cost and will be capitalised as such.