$~R-71

* **IN THE HIGH COURT OF DELHI AT NEW DELHI**

Date of decision: September 18, 2014

\+ **ITA 142/2002**

COMMISSIONER OF INCOME TAX ..... Appellant

Through: Mr.Balbir Singh,
Sr.Standing Counsel with
Mr.Abhishek Singh Baghel,
Mr.Arjun Harkauli, Advs.

versus

M/S. TRIVENI OIL FIELD SERVICES LTD ...... Respondent

Through:

CORAM:
HON'BLE MR. JUSTICE SANJIV KHANNA
HON'BLE MR. JUSTICE V. KAMESWAR RAO

SANJIV KHANNA, J (ORAL)

1. This appeal under Section 260A of the Income Tax Act, 1961 (Act, in short) by the revenue relates to the Assessment Year 1991-92 and vide order dated 21st October, 2002 stands admitted for hearing on the following substantial question of law:

> *"Whether on the facts and in the circumstances of the case the Tribunal was correct in law in holding that*

the expenses of Rs. 38,91,369/- incurred by the assessee on payment of salaries were revenue in nature?

2. The respondent assessee during the period relevant to the Assessment Year in question was engaged in the business of oil drilling operations and drilling oil wells. The respondent assessee owned oil rigs were given to different clients like ONGC, Oil India Ltd. etc.

3. The respondent assessee filed their return of income on 31.12.1991 declaring loss of Rs. 3,17,55,920/-, which was revised to Rs. 3,65,06,041/- on 9.11.1992. The revision was on account of depreciation claimed.

4. The Assessing Officer, on the issue in question, in the Assessment Order dated 10.02.1994 has observed that for the previous year ending 31.03.1991, an amount of Rs. 3.89 Crores had been capitalized or kept apart for allocation towards three deep drilling rigs. Out of the said three rigs, one was commissioned in February, 1991 and the remaining two were commissioned in the subsequent year. The Assessing Officer held that the respondent assessee had capitalized the cost of acquisition and deployment of the three additional rigs in the books of account but had claimed the

aforesaid expenditure as revenue in nature on the plea that the expenses incurred were for extension of existing business and not for setting up of a new business. The Assessing Officer disallowed the claim and treated the aforesaid amount of Rs. 3.89 Crores as capital expenditure as it pertained to acquisition of plant and machinery namely the three rigs. The aforesaid amount included the expenditure incurred on salaries paid to the employees which was treated as capital expenditure on the ground that if the respondent assessee had employed engineers/workers from an external agency the amount paid would have been capitalized. The Assessing Officer observed that it would not make any difference if the assessee had procured the raw material first and then converted them into plant and machinery after incurring some expenditure or to reduce his headache the assessee had brought/purchased a ready to use plant and machinery from the market. In either case the principle for computing the cost of plant and machinery would remain the same. He further held that in the latter case, it was not material whether the assessee was assembling the plant and machinery in his own premises. No part of such expenditure should be debited to profit and loss account and allowed as a revenue expenditure.

5. Aggrieved, the respondent assessee preferred an appeal and the Commissioner of Income Tax (Appeals) (CIT(A), in short) called for details of expenditure incurred and perused the same. He noticed that the major expenditure was related to consumption of stores and spares (Rs. 55,17,748.90) , sub-contract charges (Rs. 18,06,300/-) , salaries (Rs.38,91,263.52), travelling and conveyance (Rs.32,90,757.35) , loans (Rs.1,66,94,413/-) and other financing charges (Rs.26,13,851/-). The last two amounts were incurred for the acquisition of the rigs. He observed that it was not disputed that out of the three rigs, one had become operational in the previous year, whereas the other two became operational in the subsequent year. CIT(A) allowed the interest expenditure of 1,66,94,413/- and financial charges of Rs. 26,13,851/- as revenue expenditure as they had been incurred for acquisition of the rigs but the other expenses i.e. on consumption of stores and spares, sub-contract charges, salaries, travelling and conveyance were disallowed.

6. The Income Tax Appellate Tribunal (Tribunal, in short) has accepted the findings of the CIT (A) relating to consumption of stores and spares, sub-contract charges etc. as these were direct cost for the rigs. However, with regard to the salaries, the Tribunal noted

that the salaries could not be treated as direct cost for acquisition of the rigs and should be treated as a revenue expenses. It was noted that the salaries computed and attributed at Rs. 38,91,369/- , were the proportionate amount and not the actual amount which had been reflected in the books for setting up whole or part of the rigs. The Tribunal observed that the entries in the book of accounts would not be definitive on the issue whether the amount should be capitalized or treated as revenue expenditure.

7. The findings recorded by the Tribunal make it apparent that the new rigs purchased by the assessee were financed. The financing cost was allowed as revenue expenditure. The new oil rigs were a new capital asset. Thereafter, the rigs had to be installed for the purpose of making them operational. The assessee had deployed their workers and technicians to whom salaries were paid to make the rigs operational. The business of the respondent assessee was continuous and ongoing. The business required constant deployment, installation and re-installation of the rigs, which upon purchase or on shifting from an location to the other had to be made functional. The rigs, no doubt, constitute capital asset, but, we do not think, the expenditure incurred on the salary paid to the employees can be

treated as capital expenditure.

8. The business undertaken by the assessee, as already noticed, was oil drilling operations, drilling oil wells and giving on hire oil rigs to clients. Making the oil rigs operational was the very business of the assessee. It was this business activity, which yielded income in the form of earning or even hire charges. The respondent-assessee had employed salaried workers or technicians for the purpose of its business, i.e., drilling of oil wells with the help of rigs and carry out drilling operations and thereafter to give the said oil rigs on hire.

9. The line between capital or revenue expenditure in-spite the settled principles is beset with difficulties and an onerous task. In ***M.K. Brothers Private Limited versus Commissioner of Income Tax***, (1973) 3 SCC 30, the Supreme Court held that the answer does not depend upon the fact whether the amount spent is large or small, paid in lumpsum or in instalment, but upon the purpose for which the payment was made and the expenditure incurred. The nature and quality of payment was determinative and decisive. The test, whether the payment was made to acquire a capital asset or for running of business and working with a view

to produce profits is helpful. The principal or the main test normally applied is that of enduring benefit but the Supreme Court in ***Empire Jute Company Limited versus Commissioner of Income Tax***, (1980) 124 ITR 1 (SC) cautioned that in spite of palpable advantages, the test may break down and what is material to be considered is the nature of the advantage in the commercial sense. If the advantage consists of merely facilitating assets in trading operations or enabling the management to conduct of business more efficiently, it would amount to 'revenue expenditure', even though the advantage may be of indefinite future. Earlier in ***Assam Bengal Cement Company Limited versus CIT***, ***West Bengal***, (1955) 27 ITR 34 (SC) it was observed that if the expenditure is not for the purpose of bringing into existence any asset or advantage, but for running of business or working with it to produce profits, it would be 'revenue expenditure'. Reference in the said decision was made to Dixon, J. opinion in ***Sun Newspapers Limited and Associated Newspapers Limited versus Federal Commissioner of Taxation,*** (1938) 61 CLR 337 wherein distinction between 'revenue' and 'capital' was made by drawing distinction between business entity, structure or organisation set up or established for earning of profits on one hand and the process by which an organisation operates to obtain regular returns on the other, but with a warning that business structure or entity may assume almost infinite variety of shapes and, therefore, it may be difficult to comprehend.

10. The Delhi High Court in ***CIT versus J.K. Synthetics Limited***, (2009) 309 ITR 371 (Delhi) after referring to the case law on the subject had set out the test or principles, which read as under:-

> "An overall view of the judgments of the Supreme Court, as well as of the High Courts would show that the following broad principles have been forged over the years which require to be applied to the facts of each case :
> (i) the expenditure incurred towards initial outlay of business would be in the nature of capital expenditure, however, if the expenditure is incurred while the business is on going, it would have to be ascertained if the expenditure is made for acquiring or bringing into existence an asset or an advantage of an enduring benefit for the business, if that be so, it will be in the nature of capital expenditure. If the expenditure, on the other hand, is for running the business or working it with a view to produce profits it would be in the

nature of revenue expenditure ;
(ii) it is the aim and object of expenditure, which would determine its character and not the source and manner of its payment ;
(iii) the test of ―once and for all‖ payment, i.e., a lump sum payment made, in respect of, a transaction is an inconclusive test. The character of payment can be determined by looking at what is the true nature of the asset which is acquired and not by the fact whether it is a payment in ―lump sum‖ or in an instalment. In applying the test of an advantage of an enduring nature, it would not be proper to look at the advantage obtained, as lasting forever. The distinction which is required to be drawn is, whether the expense has been incurred to do away with, what is a recurring expense for running a business as against an expense undertaken for the benefit of the business as a whole ;
(iv) an expense incurred for acquisition of a source of profit or income would in the absence of any contrary circumstance, be in the nature of capital expenditure. As against this, an expenditure which enables the profit-making structure to work more efficiently leaving the source or the profit making structure untouched would be in the nature of revenue expenditure. In other words, expenditure incurred to fine tune trading operations to enable the management to run the business effectively, effi-ciently and profitably leaving the fixed assets untouched would be an expenditure of a revenue nature even though the advantage obtained may last for an indefinite period. To that extent, the test of enduring benefit or advantage could be

considered as having broken down ;
(v) expenditure incurred for grant of licence which accords "access" to technical knowledge, as against, "absolute" transfer of technical knowledge and information would ordinarily be treated as revenue expenditure. In order to sift, in a manner of speaking, the grain from the chaff, one would have to closely look at the attendant circumstances, such as :

(a) the tenure of the licence.
(b) the right, if any, in the licensee to create further rights in favour of third parties,
(c) the prohibition, if any, in parting with a confidential information received under the licence to third parties without the consent of the licen-sor,
(d) whether the licence transfers the "fruits of research" of the licen-sor, —once for all",
(e) whether on expiry of the licence the licensee is required to return back the plans and designs obtained under the licence to the licensor even though the licensee may continue to manufacture the product, in respect of which "access" to knowledge was obtained during the subsistence of the licence.
(f) whether any secret or process of manufacture was sold by the licensor to the licensee. Expenditure on obtaining access to such secret process would ordinarily be construed as capital in nature ;

> (vi) the fact that the assessee could use the technical knowledge obtained during the tenure of the licence for the purposes of its business after the agreement has expired, and in that sense, resulting in an enduring advantage, has been categorically rejected by the courts. The courts have held that this by itself cannot be decisive because knowledge by itself may last for a long period even though due to rapid change of technology and huge strides made in the field of science, the knowledge may with passage of time become obsolete ;
> (vii) while determining the nature of expenditure, given the diversity of human affairs and complicated nature of business ; the test enunciated by courts have to be applied from a business point of view and on a fair appreciation of the whole fact situation before concluding whether the expenditure is in the nature of capital or revenue."

11. In ***Oracle India Private Limited versus Commissioner of Income Tax***, (2014) 264 CTR 144 (Del) reference was made to the concept of income, which refers to income generated during two particular points of time by a person without impoverishing oneself. It was observed that accounting and reporting standards are based upon conventions or standards designed to achieve what are perceived to be the desired objectives of financial accounting and reporting. Word 'expense' it was elucidated

would include depreciation in form of outflow caused due to depletion of assets. Referring to the Framework for the Presentation and Preparation of Financial Statements published by the International Accounting Standards Board, the word ‘expense’ would mean decreases in economic benefits during the accounting period in the form of outflows and depletions of assets or incurrence of liabilities. Thus, the word ‘expense’ will take into account decreases in future economic benefits relating to an asset. Referring to Section 37 of the Act, it was held that emphasis is placed on business and commercial considerations rather than pure legal and technical aspects. Thus, primacy is to be given to practical and business point of view and not on juristic classification. The expression ‘capital’ or ‘revenue expenditure’ must be construed in a business sense and by applying sound accountancy principles unless there is a statutory mandate to the contrary.

12. Similarly in ***Commissioner of Income Tax versus Bharti Hexacom Limited***, (2014) 265 CTR 130 (Del) it was held:-

> “16. ......The nature of advantage has to be considered in commercial sense and only when the advantage was in capital field, the

expenditure could be disallowed by applying the enduring benefit test. If the advantage consisted merely facilitating trading operations or enabling the management or conduct of business more efficiently or profitably, while leaving the fixed capital ntouched, the said expenditure would be on revenue account, though the advantage may endure for an indefinite period. Enduring benefit test, therefore, was not conclusive and cannot be mechanically applied without considering the commercial aspect.

17. The second test which can be applied was fixed and circulating capital test. Fixed capital being what the owner turns to profit by keeping it in his ossession; circulating capital is what the assessee makes profit by parting or letting the product/asset change masters/hands. This test could be applied when the acquisition of asset clearly falls within one of the two categories but the test would breakdown where the expenditure does not fall easily within the specified category. The demarcation line between assets out of which profits were earned and the profit made upon assets or with assets, was thin and difficult to draw in several cases. It was observed that purchase of loom hours was not like circulating capital (labour, raw material, power etc.), but "loom hours" were also not a part of fixed capital. Revenue's contention that purchase of loom hours was for acquisition of source of profit or income and, therefore, capital expenditure, was rejected on the ground that source of profit or income was the profit making apparatus which had remained untouched. There was no enlargement of

> permanent structure or capital assets. Primarily and essentially the expenditure was relating to operation or working of looms, which constituted profit earning apparatus. The Supreme Court, however, added a word of caution that in the field of taxation, analogies could be deceptive and misleading but nevertheless they referred to an example of an assessee acquiring raw material regulated under a quota system to increase his production. Money spent to acquire the quota right, it was observed would entitle the assessee to acquire more raw material to increase profitability of the profit making apparatus and would undoubtedly be revenue expenditure as it was a part of the operating cost. However, the said example relates to already existing or ongoing industry. Outgoing whether it was revenue or capital, it was highlighted, should depend upon practical and business point of view, rather than juristic classification of legal rights. The question should be judged in the context of business necessity or expediency; was the expenditure a part of assessee‘s working expenditure or a part of process of profit earning; whether the expenditure was necessary to acquire a right of permanent character, the possession of which was a condition for carrying on trade etc?”

13. In the facts of the present case, we notice that the expenditure was incurred on labour, i.e., wages. Normally, it would be a ‘revenue expenditure’ unless there are special or specific reasons why it should be treated as capital in nature, the

expenditure being akin to raw material. We have already noticed the factual matrix of the present case that after the oil rigs were acquired by the assessee as a capital asset, they had to be made operational and functional. This was the very business or the activity, which was undertaken by the respondent-assessee. The said activity required expenditure in the form of salary to workers. It was in the nature of running expenses. Drilling operations being the very business of the assessee, expenditure incurred to make the rig operational would be covered and should be treated as 'revenue expenditure', whereas the cost of the rig would fall and should be treated as a 'capital expenditure'.

14. Thus, we do not think, the order of the Tribunal requires any interference. The question of law is accordingly answered against the appellant-revenue and in favour of the respondent-assessee.

The appeal is disposed of. No costs.

SANJIV KHANNA, J

V. KAMESWAR RAO, J

SEPTEMBER 18, 2014/akb