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

\+ **INCOME TAX APPEAL NOS. 25/2012, 287/2008, 417/2009, 447/2009, 461/2009, 683/2009**

Reserved on: 2nd September, 2013
Date of decision: 25th November, 2013

ORACLE INDIA PRIVATE LIMITED

..... Appellant

Through Mr. M.S. Syali, Sr. Advocate with Ms. Husnal Syali Nagi, Mr. Mayank Nagi and Mr. Harkunal Anand, Advocates.

versus

COMMISSIONER OF INCOME TAX

..... Respondent

Through Mr. Sanjeev Sabharwal, Sr. Standing Counsel & Mr. Puneet Gupta, Advocate.

INCOME TAX APPEAL NOS. 797/2006, 951/2006, 961/2006, 390/2007

ORACLE SOFTWARE INDIA LIMITED

..... Appellant

Through Mr. M.S. Syali, Sr. Advocate with Ms. Husnal Syali Nagi, Mr. Mayank Nagi and Mr. Harkunal Anand, Advocates.

versus

COMMISSIONER OF INCOME TAX

..... Respondent

Through Mr. Sanjeev Sabharwal, Sr. Standing Counsel & Mr. Puneet Gupta,

Advocate.

CORAM:
HON'BLE MR. JUSTICE SANJIV KHANNA
HON'BLE MR. JUSTICE SANJEEV SACHDEVA

SANJIV KHANNA, J.:

These 10 appeals by the assessees-Oracle India Private Limited and Oracle Software India Limited relating to Assessment Years 1994-95 to 2004-2005 raise a common substantial question of law and are, therefore, being disposed of by this decision. The substantial question of law as admitted for hearing reads:-

> "Whether on the facts and in the circumstances of the case, the Income Tax Appellate Tribunal was justified in holding that media cost paid for the import of a master copy of Oracle Software used for duplication and licensing is an expenditure of a capital nature and as such is not an allowable deduction?"

2. For the purpose of clarity and to notice facts, ITA No. 797/2006, which relates to Assessment Year 1995-96, was treated as a lead case but as noticed below, wherever necessary and required we have referred to facts of assessment year 1994-95.

3. The appellant-assessee incorporated on 18th January, 1993, is a subsidiary of Oracle Corporation, USA. The appellant entered into licence agreement dated 28th May, 1993 with its parent/holding company under which the appellant was granted non-exclusive non-

assignable right and authority to duplicate on appropriate carrier media software products mentioned in schedule 'A' thereto or other products which may be added to the said list, and sub-licence the same to third parties in India. The appellant could enter into enforceable sub-licensing and services agreement in the prescribed form with third parties users. The holding company retained ownership of the copyright in the software and all associated and applicable intellectual property rights in the products mentioned in schedule 'A' or to be added to the said schedule. It was specifically stipulated that nothing contained in the agreement shall confer or deem to confer on the appellant any of the aforesaid rights. The holding company also retained rights to continue to manufacture or distribution activities in the field of software and software products, including the products mentioned in schedule 'A' or to be added to the said schedule with full rights to produce, reproduce, duplicate and distribute the said products in India or into India. The agreement stipulated that the appellant shall duplicate and reproduce the software in India and sub-licence the same as per the terms of the sub-licence deed stipulated and with the holding company retaining entire data/intellectual property rights in the software. The appellant was entitled to use the trademark and trade name of the holding company with approval as to the manner of use from the holding company and no royalty or remuneration was to be

paid for the said use.

4. The appellant was to pay royalty to the holding company @ 30% of the list price of the licenced products as prescribed in the Indian Published Price, fixed in consultation with the licensor at the time of the sub- licence or such lesser amount agreed to. Royalty was to be also paid on software products put to internal use. The royalty was payable on quarterly fiscal basis and was subject to deduction of tax at source. The licence agreement was for a period of five years but it appears it was extended for further period relevant to the assessment years in question.

5. In addition to the aforesaid royalty, the appellant had also paid the following amounts to the parent company reflected as expenditure on import of software master copy:-

S No.	ITA	Assessment Year	Expenditure on import of software master copy
1	951/06	1994- 95	94,49,041
2	797/ 06	1995-96	1,02,34,099
3	961/06	1996-97	82,39,876
4	390/07	1997-98	49,87,045
5	287/08	1998-99	72,49,066
6	461/09	1999-2000	45,52,944
7	417/09	2000- 01	20,05,860
8	447/09	2001- 02	17,37,557
9	683/09	2002- 03	4,11,177
10.	25/ 12	2004- 05	14,40,342

6. The aforesaid payments were not made in lumpsum, but on distinct and separate dates in each assessment year on import of the

master media from the holding company. To avoid prolixity, we are not reproducing details of import in each assessment year but for the purpose of clarity, we are reproducing details of the said import in the Assessment Year 1994-95:-

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Invoice No.	Invoice Date	Invoice Value (in IEP)	Bill of Entry No.	Bill of Entry Date	No. of Copies
13896	20/10/93	158.88	264270	18/11/93	2
13962	26/10/93	599.60	264271	18/11/93	25
13910	21/10/93	807.10	264860	19/11/93	24
13307	16/9/93	411.00	264800	11-10-93	20
14619	12-1-93	113.26	274179	27/12/93	2
14942	17/12/93	716.83	274191	27/12/93	10
14698	12-6-93	168.84	274540	28/12/93	15
14745	12-8-93	150.47	275522	31/12/93	3
15045	23/12/93	194.93	275525	31/12/93	4
15044	23/12/93	209.25	275518	31/12/93	2
14821	13/12/93	143.84	275733	31/12/93	4
15287	14/1/94	7381.85	204690	24/1/94	351
15165	1-7-94	2028.38	204703	24/1/94	150
15228	1-11-94	274.59	204705	24/1/94	5
15156	1-7-94	6702.20	205951	29/1/94	700
15191	1-10-94	808.91	204701	24/1/94	110
15336	17/1/94	241.29	206483	31/1/94	10
15385	19/1/94	1282.47	207246	2-2-94	129
15425	21/1/94	740.73	207259	2-3-94	15
15541	26/1/94	324.17	209405	2-11-94	15
15578	27/1/94	234.83	209403	2-11-94	5
15501	25/1/94	327.70	209429	2-11-94	15
15604	28/1/94	401.69	209399	2-11-94	20
15656	31/1/94	192.19	209401	2-11-94	3
15569	27/1/94	344.46	209397	2-11-94	5
16395	3-11-94	326.87	220380	28/3/94	5
14206	11-11-93	208.70	266143	24/11/93	5
14186	11-10-93	535.55	266135	24/11/93	10
Total IEP		**26,030.58**		**Total**	**1664**

”

7. The Assessing Officer held that the aforesaid payments of Rs.94,49,041/- for the Assessment Year 1994-95 and similar payments for the other years described as software master copy and documentation was capital expenditure and not revenue in nature. He referred to the agreement dated 28th May, 1993, which was for a term of five years and observed on interpreting the terms that the appellant had acquired copyright and all other associated and applicable Intellectual Property Rights. He invoked Section 35A and held that on this amount, the appellant was entitled to deduction equal to 1/14th of the expenditure as it was incurred on acquisition of copyright. He held that there was transfer of copyright, in addition to other associated and applicable Intellectual Property Rights by Oracle Corporation, USA to the appellant company and the appellant had acquired the said rights for the purpose of business.

8. For the Assessment Years 1994-95 to 2004-2005, Commissioner of Income Tax (Appeals) reversed the finding of the Assessing Officer to this extent. For the Assessment Year 1994-95, Commissioner (Appeals) observed that the obsolescence rate in software industry was extremely high and updated version of softwares were developed frequently. Some softwares had a commercial life of only 1 - 2 months and had to be substituted by an upgraded version thereby making the

earlier version redundant or useless. Referring to the agreement, he observed that the intellectual property rights in the software were not transferred to the appellant by Oracle Corporation, USA. Royalty was payable to Oracle Corporation, USA based upon the number of copies duplicated from each original master copy sold or sub-licensed to third parties. Large number of master copies were imported every 2-3 weeks. As far as royalty payment was concerned, there was no dispute that it was revenue in nature. Similarly, the cost of procuring the master copy was of recurring nature, which was established and proved beyond doubt from shipment of numerous master copies and the fact that there was no single lumpsum payment. He observed that firstly, master copy updated software had to be procured, which was a recurring expenditure. Secondly, there was no enduring benefit as there were corrections; strides and frequent upgradation of software. Thirdly, the expenditure incurred in question was for conduct of business as an integral part of profit earning process and not for acquisition of assets or right of permanent character. Fourthly, the expenditure in question was in nature of procurement of raw material for the purpose of business and not to procure capital and, therefore, was a part of working capital of the company.

9. After noticing these facts, the Commissioner (Appeals) deemed it appropriate to ask for remand report. The Assessing Officer

submitted a report and also appeared in person. Before the first appellate authority, the assessing officer somewhat changed his stance and submitted that the expenditure was in the nature of technical services and know-how but, tax at source had not been deducted. It was accordingly pleaded that if the expenditure was to be allowed as revenue, it cannot be allowed as a deduction as per Section 40(a)(i) of the Income Tax Act, 1961 (herein after referred to as the "Act"). Commissioner (Appeals) did not agree with the Assessing Officer and observed that the expenditure incurred was neither for extension of business nor for substantial replacement of equipment, which related to carrying on or conduct of business and an integral part of profit making process. It was nothing but for procurement of raw material. He overturned the finding of the Assessing Officer that the appellant had acquired right of enduring nature by importing master copies and also rejected the finding that Section 35A was applicable. The price paid for the master copy or royalty payment did not involve transfer of intellectual property rights and no such rights were acquired by the appellant. The price at which the product was sold did not include the cost of intellectual property right. He noticed that the Assessing Officer in the appellate proceedings for the first time had relied upon Section 40(a)(i) and observed that the cost of the master copy does not constitute technical know-how or royalty under Section 9 of the Act.

The transaction in question, i.e., import of master copy was separate and could not be inter-linked with payment of royalty. It was held that the payments made for acquisition of the master copy should be allowed as business expenditure under Section 37 of the Act. Commissioner (Appeals) for the Assessment Year 1994-95 gave a categorical finding that there was no transfer of intellectual property rights and the copyright continued to vest and remain with Oracle Corporation, USA. The master copies were not of enduring nature/benefit as they had to be updated frequently in view of high degree of obsolescence. Price paid for the master copy did not include cost involved in transfer of rights in the software. Royalty was paid towards intellectual property rights of the Oracle Corporation, USA and the cost of the master copy did not include the said price.

10. Tribunal by their order dated 28th October, 2005, which was a common order, relating to Assessment Years 1994-95, 1995-96, 1996-97 reversed the order of the Commissioner (Appeals) and restored the view taken by the Assessing Officer. We would like to reproduce two paragraphs from the said impugned order as the same reflect the core of the findings recorded by the tribunal:-

> "3.4 We have perused the records and considered the rival contentions carefully. The assessee is a 100% subsidiary of Oracle Corporation, USA and is authorised as per the agreement signed to sub-lease the software

> products developed by the foreign company. For this purpose, the assessee has imported the Master Copy of the softwares as goods under the open general licence scheme of the Export Import Trade Policy. The assesse is making duplicate copies from the Master Copy and selling it to local clients. For importing the Master copy it has paid a lumpsum consideration and is also paying royalty @ 30% of the listed price of duplicate softwares sold locally. The Assessing Officer treated the lumpsum consideration paid for import of the Master Copy as capital expenditure holding that it was an asset of enduring benefits to the assessee.
>
> 3.5 The import of Master Copy with the righty of duplication is definitely an asset of enduring benefit. But whether the expenditure on the acquisition of the same can be considered as capital expenditure or a revenue expenditure has to be examined in the light of judicial pronouncements on the subject. The payment of lumpsum consideration or enduring benefits are not conclusive tests in deciding whether an expenditure is a revenue expenditure or capital expenditure as held by the Supreme court in the case of M/s Empire Jute company (124 ITR 1) and subsequently reiterated in the case of M/s Alembic Chemical Works (177 ITR 377). It would be pertinent to elaborate these cases which will be useful in understanding the true nature of the expenditure in the instant case."

11. Thereafter, reference was made to the facts and the ratio in the case of ***Empire Jute Company*** (1980) 124 ITR 1 (SC) *and* ***Alembic Chemical Works*** (1989) 177 ITR 377 (SC) and it was observed that imported master copy was used for duplicating copies of software and,

therefore, a part of the profit earning apparatus. It was not a case where the appellant had imported some know-how device or device by which copying of software was done more efficiently. Once master copies were held to be a part of profit earning apparatus or source of income, it was immaterial whether the appellant had ownership rights or only right to duplication. Decisions of the tribunal in the cases of sound tracks of film songs and the film music were distinguished as they related to payment of yearly royalty, based on sales of cassettes obtained from master plates. In the said cases, the expenditure was relating to trading operation and no lumpsum payment was made. In the present case also, on royalty there was no dispute but the dispute related to lumpsum payments. Another case was distinguished on the ground that lumpsum payment made for procurement of master plates for producing audio cassette could be treated as revenue expenditure as the sound tracks got duplicated in the process and were used as raw material. The master copies of softwares, it was observed had unlimited life and capable of giving unlimited number of copies. The master copies were not raw material but only a tool to get duplicate copies of software. Further, the mater copies were not procured from third parties but from in-house establishment.

12. Before we dwell upon the questions raised, we would like to point out certain undisputed facts. The Assessing Officer had also

denied benefit to the appellant under Section 80-IA on the ground that duplication of software did not amount to manufacture. Section 40(a)(i) was also invoked in respect of royalty payments. The tribunal decided the two issues against the revenue. Revenue preferred appeals before the High Court, but the appeals were dismissed on the two issues vide judgment ***CIT v. Oracle Software India Ltd.*** (2007) 293 ITR 353 (Delhi) observing that no substantial question of law arose for consideration and Section 40(a)(i) was not applicable.

13. Not satisfied, Revenue preferred further appeals on issue of deduction under Section 80-IA but did not succeed vide detailed decision in ***CIT v. Oracle Software India Ltd.*** reported as (2010) 320 ITR 546 (SC). The Supreme Court in the said decision has noted that the appellant had imported master media of software from Oracle Corporation, USA for duplicating on blank disc, which were packed and sold in the market along with the relevant brochure. The appellant had paid lumpsum amount to Oracle software for import of master media. The Supreme Court has further observed that the software in question was application software and not operating software or system software. The software could be categorised as product line application, application solutions and interim applications. The master media was subjected to validation and checking process by software engineers by installing and rechecking the integrity of the master

media with the help of the software installed in the fully operational computer. Thereafter the same was inserted in a machine CD blaster and virtual image of the software was created on the internal storage device. This virtual image was replicated to produce or duplicate the software. The virtual image was too large to be shown on screen. The Supreme Court has further observed that softwares were goods as held in ***Tata Consultancy Services versus State of Andhra Pradesh***, (2004) 271 ITR 401 (SC). The software copyright might remain with the originator of the programme but the moment copies were made and sold, they would be termed as goods. There was no difference between sale of software programme on CD and sale of music on cassettes/CDs. The intellectual copyrights had got incorporated on the media for the purpose of transfer and, therefore, media cannot be split up. Reference was made to the decision in ***Gramophone Company of India Limited versus Collector of Customs***, (1999) 114 ELT 770 (SC) and it was observed that duplication or recording of audio cassettes amounts to manufacture as goods were produced.

14. Before proceeding further, we would like to reproduce the exact reply given by the appellant as recorded in the assessment order for Assessment Year 1994-95 on the issue in question. The same reads as under:-

> "1. Imports master copy of Oracle products

> under the OGL Classification 85.24 after the full payment of custom duty. These are further replicated in India using the appropriate carrier media by virtue of an agreement OSIPL has with Oracle Corporation.
>
> 2. The master copies are versions of Oracle's new product offerings which have a very accelerated obsolence. At any point of time it is not capable of determining whether the version will be current for one day or one month. In the life cycle of product if a version is released and improvement is developed the next day the earlier version is obsolete. The master copy/documentation write off policy which Oracle has adopted recognizes the accelerated obsolence and the non-enduring use of master copy/documentation."
>
> (Emphasis supplied)

15. After recording/ reproducing the said reply, the Assessing Officer in the assessment order has not disputed or factually controverted the contents or the assertion made by the appellant. The Assessing Officer accepted and did not contradict the said factual assertion as incorrect, but addition was made by the Assessing Officer on the grounds, namely, (i) in spite of the factual position the expenditure was capital (ii) Section 35A of the Act was applicable and, therefore, the cost paid on master copy was to be amortised/allowed in 14 instalments for the Assessment Year 1994-95. Even if the expenditure was revenue in nature, the same has to be disallowed.

16. We have quoted the finding recorded by the tribunal in

paragraphs 3.4 and 3.5 of the order for the Assessment Years 1994-95, 1995-96 and 1996-97. It has been observed that lumpsum payment was made for the master copy and as the appellant also had right of duplication it lead to creation or acquisition of an asset of enduring benefit. It became part of the profit making apparatus and source of income. The Tribunal without disturbing or contradicting the stand of the appellant, on legal principles has held that the expenditure was capital in nature.

17. We have given thoughtful consideration to the said findings, but find that the final conclusion cannot be sustained and should be reversed. Tribunal in the impugned order and the reasoning given therein has not disturbed the finding of the Commissioner (Appeals) or the assertion of the appellant before the Assessing Officer that the master copies were versions of software developed by Oracle Corporation, USA, a new product offerings, which had high accelerated obsolescence and even at the point of time of import it was difficult whether the version would be replaced by a new or updated version after one day or a month. The life cycle of the version released was limited and improvements and further developments were constant and intermittent. The earlier version had a high degree of obsolescence and the master copy, documentation and policy adopted by the appellant recognised that the master copy did not have enduring or

long- term benefit.

18. The Right to duplication and import of master copy though connected, cannot and does not show that the expenditure in question was capital in nature. The import of master copy was for the purpose of creating virtual image for the purpose of duplication. The right to duplication was given to the appellant under the agreement dated 28th May, 1993 and was subject to payment of royalty. The payments in question were not for acquiring the right to duplication. This is not the case of the Revenue or the finding of the Assessing Officer or the Tribunal. We have also quoted above the sample data for Assessment Year 1994-95, which shows that there were as many as 28 imports on different dates after October, 1993 indicating the number of master copies imported. The average price per copy was minimal. We have also noted the findings recorded by the Supreme Court as to the nature and character of the software of which virtual image was created from the master copies. This is not a case where the master copies contained operating or system software, which normally do not require frequent upgradation or changes for consideration or price. Neither are we dealing with a case of an assessee who is the end user of software. We are dealing with the appellant who was required to repeatedly pay for the master copy media in view of frequent newer or updated versions of the application software from time to time. Once newer or

better version of application softwares was available, the earlier application softwares were not saleable and did not have any market value for the seller i.e. the appellant. The earlier versions became obsolete and had limited shelf life, as long as the newer version was not available. No one would like to pay or obtain an older version of the same software, when the new or updated version was available.

19. Courts have grappled with the problem of classification of income and expenditure as capital and revenue. The distinction between capital and revenue nature though basic and fundamental to preparation of accounts and income tax, appears to be a never ending concoct and resultant cause of litigation. Even the principles applicable, oscillate and the difficulty also arises on selecting the right principle applicable to facts of the given case. There is divergence and conflict as to the principle which should be applied. Thus, it is not a case of application of principles to facts alone, which is a cause of debate and confusion. The terms "capital" or "revenue expenditure" have not been specifically defined in the Act. They are closely connected with accounting practices, though elucidated and expounded in judicial pronouncements. Most income tax enactments, including the present Act, require and mandate determination of income earned by the appellant during two particular points of time i.e., the assessment year. The income is determined on the basis of principles

of accountancy or accounting practices as moderated and subject to mandate/ amendments by the Act. The expression "income" has historically received somewhat derisory and derisive interpretation but as a theoretical as well as practical concept means the income generated during two particular points of time by a person without impoverishment of oneself. (see J.R. Hicks "Value and Capital- An inquiry into some fundamental principles of economic theory, Oxford University Press, London, Second Edition 1946). Alexander making reference to the term income in corporate context has stated: income is "the amount which [a] company can distribute to the shareholders and be as well off at the end of the year as it was at the beginning". It was observed:-

> "The net income of an entity for any period is the maximum amount that can be distributed to its owners during the period and still allow the entity to have the same net worth at the end of the period as at the beginning, after adjusting for the owner's contributions. In other words, capital must be maintained before an entity can earn income."

20. The aforesaid definitions are improvements on the conceptualization of the term "income" as assigned by the German economist Georg Von Schanz in 1896, who held that income means the economic power accrued to a given person over a period of time, i.e., the disposing power of a given person during the period in

question, without impairing his capital or incurring personal debts. The aforesaid definitions have become subject matter of new thought/ thinking to categorise revenue and capital expenditure based upon market place criteria [see Working Paper "The Classification of capital and revenue in accounting and the definition of income in the market place (Centre for Accounting, Governance and Taxation Research, School of Accounting and Commercial Law, Wellington, New Zealand" at the works referred to therein.) The aforesaid article refers to the notion of capital maintenance or net accretion. The said note also refers to the report on Wheat Committee, 1972 (a special committee of the American Institute of Certified Public Accounts charged with studying how accounting principles should be determined) wherein it has been observed that financial accounting standards and reporting are not grounded in natural laws as are the physical sciences, but must rest on a set of conventions or standards designed to achieve what are perceived to be the desired objectives of financial accounting and reporting.]

21. While interpreting the meaning of "accounting income", the Financial Accounting Standards Board, United States of America formally embodied capital maintenance, or net accretion, notion in its statements of Financial Accounting Concepts (Financial Accounting Standards Board). It has been elucidated as:-

> " An enterprise receives a return only after its capital has been maintained or recovered. The concept of capital maintenance, therefore, is critical in distinguishing an enterprise's return on investment from return of its investment. Both investors and the enterprises in which they acquire an interest invest financial resources with the expectation that the investment will generate more financial resources than they invested."

22. In the Framework for the Presentation and Preparation of Financial Statements published by International Accounting Standards Board, an asset has been defined as "a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity" in subsequent accounting periods. The assets are recognised in the balance sheet, when "it is probable that future economic benefits will flow to the entity and the asset had a cost or value that can be measured reliably." The words "income" and "expenditure" have been defined in the said framework as under:-

> "Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants"

23. The word "expense" in the said Framework has been defined as decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities

other than those relating to distribution to equity participants. The Framework recognised the principle of matching of costs with the revenues in preparation of financial statements and has stipulated:-

> "Expenses are recognised in the income statement on the basis of a direct association between the costs incurred and the earning of specific items of income. This process is commonly referred to as the matching of costs with revenues.....
>
> When economic benefits are expected to arise over several accounting periods and the association with income can be only broadly or indirectly determined, expenses are recognised in the income statement on the basis of systematic and rational allocation procedures.....These allocation procedures are intended to recognise expenses in the accounting periods in which the economic benefits associated with these items are consumed or expire.
>
> An expense is recognised immediately in the income statement when an expenditure produces no future economic benefits or when, and to the extent that, future economic benefits do not qualify, or cease to qualify, for recognition in the balance sheet as an asset."

24. Compendium of Accounting Standards by Institute of Chartered Accountants of India defines "income" as encompassing both revenue and gains including unrealized gains. The term "expenses" encompasses the expenditures that arise in the ordinary course of an enterprise as well as losses. Expenses will include depreciation as it is in the form of outflow caused due to depletion of assets. The term

"depreciation" and its significance in accounting as elucidated in the Compendium of Accounting Standards are set out below. Adjustment towards capital accounts is when the expenditure includes a future economic benefit associated with the article/ goods which will flow to or from the enterprise. This may be, inspite of the degree of uncertainty regarding future economic benefits and this degree of uncertainty is ascertained on the basis of evidence available when the financial statements are prepared. But, an asset is not recognised in the balance sheet, when expenditure has been incurred in respect of an item, on which it is improbable that economic benefit will flow beyond the current accounting period. Such transactions merit recognition as an expense in the statement of profit and loss. Thus the term 'expenses' as recognized in the profit and loss account will take into account decrease in future economic benefits relating to an asset. Concept of expenses includes decrease in the value of asset. An expense is recognized immediately in the statement of profit and loss account, if expenditure produces no future economic benefit (see paragraphs 73 to 97 of the Compendium of Accounting Standards issued by the Institute of Chartered Accountants of India).

25. Matching of cost with revenues takes into consideration direct association between cost incurred and earning of specific items of income and also includes various components of expenses making up

the cost of goods. The term 'depreciation' has been defined in the Accounting Standard VI, as a measure of wearing out, consumption or loss of value arising from use of any type, efflux of time, of obsolescence through technology and market changes. But depreciable items are those which are used for more than accounting period and its useful life is over a period during which a depreciable item is expected to be used by the enterprise or number of production of similar units expected to be obtained from use of the asset by the enterprise. Assessment of depreciation is done based upon the three criterions: (1) historical cost or other amounts substituted when the asset has been revalued; (2) expected useful life of the depreciable asset; and (3) estimated residual value. Useful life of depreciable asset may be shorter than its physical life and is determined by several factors including obsolescence due to technological changes, improvements, change in market demand or service output etc. Useful life of depreciable asset is a matter of estimation and is mainly based upon experience with similar type of assets. Determination of residual value, it is stated, is a difficult matter but when insignificant, it should be taken as nil. One of the basis for determining residual value would be realizable value of similar assets.

26. The Act does not define the term 'asset' in generality though the term 'block of assets' is defined but the said definition is not relevant.

Explanation 3 to section 32 states the term asset for the said provision means tangible and intangible assets being know-how, copyrights etc. The Act, however, more appropriately and pertinently defines the term 'capital asset' in Section 2(14) as property of any kind, but does not include stock in trade, consumable stores or raw materials held for the purposes of his business or profession. Personal effects and agricultural land etc. are also excluded. The term/expression 'expenditure' finds elucidation in Section 37 of the Act and it excludes any expenditure of capital nature or personal expenses. There is substantial authority for the proposition that determination of whether an expenditure is capital or revenue in nature must and should be decided keeping in view the nature of the business, commercial reasons for incurring the said expenses in business and the object for which the expense is incurred. Emphasis being placed on business and commercial considerations, rather than pure legal and technical aspects. Thus, primacy is given to practical and business point of view and not on juristic classification. The expression 'capital or revenue expenditure' must be construed in business sense and by applying sound accountancy principles unless there is statutory mandate to the contrary. (see Section 145 of the Act and observations of the Delhi High Court in CIT v. Virtual Soft Systems Ltd. (2012) 341 ITR 593).

27. This aforesaid principle of matching, as we shall elucidate

below, is of immense importance and significance. When we determine whether an expenditure is capital or revenue in nature, it exposes and brings to forefront the practice and commercial approach from the true and correct perspective and objective; "income" earned should be taxed. This has to be kept in mind as the guiding principle, subject to the statutory mandate which will override. A statement of accounts prepared on the basis of the aforesaid matching principle will generally reflect the true and correct income earned during the specified period. The said determination would be fair, just and equitable both to the appellant and the revenue. An asset is not normally created when a liability is incurred and it does not give benefit or advantage in future accounting periods or beyond a short/ small length of time, in view of the past practice and practical/ commercial reality. The expenses will be revenue in nature if its usefulness will come to an end within the financial year itself or is for limited time and would not have any residual value thereafter. Therefore, while determining whether expenditure is capital or revenue in nature, we must also dwell into the question whether the expenditure, would create an asset which is of value in further assessment periods and should be amortised (i.e. depreciated) as long as it has value. (The last portion is obviously subject to the statutory mandate of an enactment, which may prescribe amortisation

or depreciation rates. These being fixed by law will override the accounting principles). Thus, when an expenditure incurred does lead to creation of an asset but of a limited or short life, it has to be treated as a liability and not as a fixed asset. The said expenditure cannot be valued for price for future financial years.

28. A word of caution and a caveat for the aforesaid test, is one of importance as was elucidated by the Supreme Court in ***Empire Jute Company Limited versus Commissioner of Income Tax,*** (1980) 124 ITR 1 (SC). The said decision highlights advantage of enduring benefit test but nonetheless it was cautioned that the said test may break down and what is material to be considered is the nature of advantage in commercial sense. If the advantage consists of merely facilitating assets in trading operation or enabling the management and conduct of business more efficiently, it would be expenditure on revenue account even though the advantage may be of indefinite future. Thus, in ***Alembic Chemical Works Company Limited versus Commissioner of Income Tax***, (1989) 177 ITR 377 (SC) and ***Jonas Woodhead and Sons (India) Limited versus CIT***, (1997) 224 ITR 342 (SC), the Supreme Court observed that though the technology had been received but it related to a product already under production and to ensure betterment or of the improvement, it was part and parcel of the existing business and, therefore, the benefits were composite partly revenue and

partly capital. However, in the present case we need not apply the caveat. The caveats and caution elucidated would apply as exceptions of the enduring benefit tests. When the enduring benefit test itself justifies the conclusion that the expense is revenue, it would not be proper and appropriate to apply the caveats or exceptions. These secondary tests apply when in spite of the primary test of enduring benefit being in negative, i.e. against the assessee a different conclusion against the revenue is justified. Thus the dictum and in the words of Viscount Cave LC in ***Atherton v. British Insulated & Helsby Cables Ltd.*** 10 TC 155:-

> "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, 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 said enunciation has been approved by the Supreme Court in ***CIT vs. Finlay Mills Ltd.*** 20 ITR 475 (SC) and ***Empire Jute (Supra)*** and other cases. The term enduring we clarify does not mean permanent, perpetual or everlasting but it refers and indicates that the right acquired must have enough durability to justify it being treated as a capital asset.

29. The view we have taken find support and is in consonance with the view taken by the Delhi High Court in ***Commissioner of Income Tax versus Ashahi India Safety Glass Limited***, (2012) 346 ITR 329 (Del) wherein appellant had procured software which was amortised in the books as deferred revenue expenditure but was claimed as a deduction in the income tax income statement. It was observed that the said expenditure along with other expenditures neither created a new asset nor brought forth a new source of income. The expenditure incurred was to upgrade or to run the existing set up. It was to remove deficiencies in the software installed in the earlier years, to modify, customise or upgrade the software. Similarly, in ***Commissioner of Income Tax versus G.E. Capital Services Limited***, (2008) 300 ITR 420 (Del) it was observed that the software procured by the assessee in question was not customised software and the software in question required regular upgradation and, therefore, was not of enduring benefit.

30. The Punjab and Haryana High Court in ***Chief Commissioner of Income Tax versus O.K. Play India Private Limited,*** (2012) 346 ITR 57 has again observed that computer software does not enjoy a degree of permanence and it could be unrealistic to ignore the stand and repeated upgradation and newer versions which have to be adopted and applied on the payment. In ***Alembic Chemicals Works Company***

Limited (supra), lumpsum consideration paid for technical know-how to achieve higher level of production by better technology was held to be of revenue account. This was in spite of the fact that there was enduring benefit, but the Supreme court deemed it appropriate to apply a more liberal test on the consideration that in this age of rapidly advancing technology the contention of the Revenue that the expenditure brought into existing capital asset, should be rejected. The need of the age, the environment and the business consideration mattered and were given due recognition and acceptance. The said view has been followed by the Courts in India. As noticed above, in the present case the appellant is duplicating software and sells the same to generate income. It requires master copies, which have to be updated and upgraded to be able to sell the said software. In case the appellant had imported the said software and sold the same, it would be stock in trade and deductible. However, when the master copies were used for duplication and the software replicated and transferred on the media as a result of the said activities was then sold, the master copy itself might not be stock in trade as such in strict sense, but it did not have a long life and its value and life span was small since it perished and diminished when the upgraded version or a better software in form of the next master copy was imported, for the purpose of duplication. When we accept the said position, the requirement of enduring benefit

fails and it cannot be said that any capital asset was acquired or purchased. In these circumstances, we need not apply and go into the other test or caveats. The flaw and the error committed by the tribunal is that they applied other tests or caveats without first ascertaining and determining whether enduring benefit test is satisfied or not. The enduring test may not be the sole, exclusive or universal test but is considered to be the primary test.

31. The Supreme Court in ***CIT versus IAEC Pumps limited*** (1998) 232 ITR 316 upheld the decision of the tribunal that payment towards royalty was revenue expenditure and was allowable after observing that the licence for use of patents and designs was for a duration of 10 years with the parties having option to renew or extend the licence. The assessee had been only allowed use and there was no transfer of rights. The rights acquired by the assessee were not exclusive and were for a limited period which could be determined earlier also. Payment was dependent upon quantum of items manufactured.

32. Decision in the case of ***Commissioner of Income Tax versus Denso India Limited***, (2009) 318 ITR 140 (Del) and submission relying upon Section 35A of the Act is misconceived. The said provision comes into play only when the expenditure incurred is of capital nature and is on the acquisition of patent rights and copyrights.

Merely because expenditure has been incurred for material for duplication without acquisition of proprietary and when the expenditure is not of capital nature, the said Section would not be applicable. In any case, the said provision is not applicable with effect from the 1st day of April, 1998. The view we have taken finds affirmation and support from the decision of the Delhi High Court in ***Denso India Limited*** (supra). It supports the case of the appellant as it has been held that depreciation claim in respect of intangible assets would arise only when it is first determined that the expenditure was capital in nature. Reference was made to ***CIT v. J.K. Synthetics Ltd.*** (2009) 309 ITR 371 (Del) where broad principles have been culled out and some of the principles have been set out in seritum. Decision in ***CIT v. Sharda Motors Industrial Ltd.*** (2009) 319 ITR 109 (Del) was also referred too.

33. The question of law mentioned above is accordingly answered in favour of the appellant-assessee and against the Revenue.

34. In the assessment year 1997- 98, in ITA No. 390/2007 titled ***Orcale India Softwares Ltd vs. CIT Delhi***, two additional questions have been raised, which read as under:-

> "(2) Whether the Assessing Officer could have charged interest on the taxable income of the Assessee under the provisions of Section 234B of the Income Tax Act, 1961 without any specific order to this effect and in spite of the existence of ITNS 50?

(3) If the answer to the question No. (1) is in the affirmative, whether the interest under Section 234B of the Income Tax Act, 1961 has to be charged on the assessed income or the returned income of the Assessee?"

35. Interest under Section 234B is mandatory in nature and has to be paid when the statutory conditions are satisfied. Further, the interest has to be paid on the assessed income [see decision of the Supreme Court in ***Commissioner of Income Tax, Mumbai versus Anjum M.H. Ghaswala and Others***, (2001) 252 ITR 1 (SC)]. Tribunal in the impugned order has already directed that interest under section 234B of the Act shall be determined only after ascertaining the taxability. The question Nos. 2 and 3 are accordingly answered in favour of the Revenue and against the appellant.

36. The appeals are accordingly disposed of with no orders as to costs.

(SANJIV KHANNA)
JUDGE

(SANJEEV SACHDEVA)
JUDGE

NOVEMBER 25th, 2013
VKR