

## HC rules cost of Enterprises Resources Planning (ERP) software is revenue expenditure

### Executive Summary

This Tax Alert summarizes the recent Bombay High Court (HC) ruling pronounced on 4 July, 2011 in the case of **Raychem RPG Ltd<sup>1</sup>** (Taxpayer).

The Taxpayer engaged in the business of manufacturing of telecommunication and power cable accessories and trading in oil retracing system, incurred expenditure of INR 23.62 lacs on ERP software which was claimed as deductible revenue expenditure in its return of income. While the tax authorities denied deduction holding it to be non-revenue expenditure, the Income Tax Appellate Tribunal (ITAT) ruled in favour of the Taxpayer. Dismissing Revenue's appeal against the ITAT ruling, HC upheld the ITAT's reasoning that ERP software, in the facts of the case of the

Taxpayer, facilitated conduct of its trading operations more efficiently but the software is not in the nature of a profit making apparatus, hence, the expenditure be allowed as deduction to the Taxpayer.

### Background

Under the Income Tax Act (ITA), an expenditure which is of revenue nature is allowed as deduction in computation of income of a Taxpayer subject to applicable conditions, if any. It has been often a matter of litigation as to whether a particular expenditure is capital in nature or a revenue expenditure. With technological advancement, business processes are largely driven by information technology, of which, computer softwares are the backbone. Judicial views are divided as to whether expenditure on

softwares which have enduring benefits is deductible as revenue expenditure in the computation of income.

The HC ruling discussed in this alert would be helpful to the Taxpayers, especially those under Bombay HC jurisdiction, to advance their case for claiming deduction for software expenses which are used for day-to-day business operations.

### Facts of the case

The Taxpayer is engaged in the business of manufacturing of telecommunication and power cable accessories and trading in oil retracing system. During the financial year under consideration, it incurred expenditure of INR 23.62 lacs on ERP software and claimed deduction for the same as revenue expenditure in the computation of income. The Tax Authority

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<sup>1</sup> ITA No. 4176 of 2009

did not allow the deduction. Hence, the Taxpayer preferred an appeal before the ITAT who ruled in favor of the Taxpayer<sup>2</sup>. The Revenue preferred an appeal before HC against the above ITAT ruling.

### Taxpayer's contentions

- The Taxpayer contended that it is engaged in the business of manufacture of telecommunication and power cable accessories etc. and the ERP software facilitates conduct of the business more efficiently or more profitably
- The expenditure does not form part of the profit making apparatus that it can be considered as capital in nature
- The case is supported by the ITAT Special Bench ruling in the case of Amway India Enterprise<sup>3</sup>

### Revenue's contentions

- The expenditure on ERP software is a capital expenditure

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<sup>2</sup> The ruling does not state the view of the first appellate authority

<sup>3</sup> 111 ITD 112

- It is not eligible for deduction as revenue expenditure as claimed by the Taxpayer

### HC ruling

- Having regard to the nature of business of the Taxpayer, it is clear that the software is for facilitating conduct of the Taxpayer's business more efficiently or more profitably
- On application of the functional test suggested by the Special Bench of ITAT in the case of Amway India Enterprise (supra), it cannot be said that the ERP software forms part of the profit making apparatus of the Taxpayer
- The expenditure is fully deductible as revenue expenditure in the year of incurrence

### Our comments

- In a brief ruling, the HC endorsed the principles of functional test enunciated by the Special Bench of ITAT in the case of Amway India Enterprise (supra) viz. expenditure

on softwares would be revenue in nature if the purpose of the expenditure is to carry on the running business smoothly, efficiently and more profitably

- When the above functional test is satisfied, the characterisation of the expenditure is not changed merely for the reason that the expenditure may result into benefit of enduring nature
- The HC has not discussed the facts of the case. Also, no detailed discussion is found in terms of legal principles and judicial precedents except the endorsement of ITAT ruling in the case of the Taxpayer. Since the said ITAT ruling is not in public domain, currently, evaluation of this ruling as a binding judicial precedent appears to be difficult. Application of this ruling in a particular case would require a close examination of nature of business, purpose of expenditure and other surrounding facts.

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