IN THE HIGH COURT OF JUDICATURE AT MADRAS

DATED:25.01.2019

CORAM

THE HON'BLE DR.JUSTICE VINEET KOTHARI

AND

THE HON'BLE DR.JUSTICE ANITA SUMANTH

Tax Case (Appeal) No.535 of 2009

M/s.Chemplast Sanmar Ltd.,
9, Cathedral Road,
Chennai - 600 086 .... Appellant

Vs

The Asst. Commissioner of Income Tax
Company Circle - I (3)
Chennai .... Respondent

APPEAL filed under Section 260A of the Income Tax Act, 1961 against the order dated 04.11.2008 made in I.T.A.No.2225/(Mds)/06 on the file of the Income Tax Appellate Tribunal "C" Bench, Chennai, against the order of the Commissioner of Income Tax Appeals(XI) dated 07/08/06 against the order of the Assistant Commissoner of Income Tax Company Circle-I(3), Chennai dated 18/03/2005.

For Appellant : Mr.Vikram Vijayaraghavan
For M/s.Subbaraya Aiyar Padmanabhan

For Respondent: Mr.T.Ravikumar
Sr.Standing Counsel

J U D G M E N T
(Judgment of the Court was delivered by Dr.ANITA SUMANTH,J.)

This Tax Case (Appeal) is filed by the assessee challenging an order of the Income Tax Appellate Tribunal (in short 'Tribunal') dated 04.11.2008 for A Y 2002-03.

2. An interesting, though not new, issue arises in this appeal as seen in the following substantial question of law framed and admitted for our consideration:

> 'Whether on the facts and in the circumstances of the case, the Tribunal was right in holding that the expenditure incurred towards SAP R3 license fees, ERP implementation expenses and lotus note software is capital in nature?'

3. We have heard Mr.Vikram Vijayaraghavan, learned counsel appearing for the appellant/assessee and Mr.T.Ravikumar, learned Sr. Standing Counsel appearing for the respondent/revenue.

4. The appellant is a company engaged in a variety of business interests including the manufacture and sale of PVC resins, Caustic soda, Choloromethane, Refrigerant gases and operation of ships amongst others. In the financial year relevant to Assessment Year 2002-03, the company had spent a sum of Rs.1,61,17,951/- as expenses towards the procurement of Enterprise Resource Planning (ERP) licences, implementation of the ERP software and lotus notes.

5. The Assessing Authority called upon the assessee to show cause as to why the acquisition cost was not capital in nature, liable to be disallowed. According to the assessee, the purpose of the software was to facilitate smooth business operations and to effect savings in time and costs. The ERP system eased production, planning, dispatches, materials procurement, inventory control, accounting and management information systems. Since technology in software undergoes frequent changes, it becomes necessary to update the licences on annual basis in order to ensure that the software was up to date.

6. The Assessing Authority, on the other hand, was of the view that the very fact that the software had been used in the assessees' business operations consistantly for several years indicated that the benefit was enduring and the expenditure was thus clearly capital in nature. He also noted that depreciation for software had been provided for only from 01.04.2004 and thus, though acquisition of software was in the capital field, the benefit of depreciation was not available till such time software was included in the depreciation schedule with effect from Assessment Year 2004-05. He thus categorised the software under the head 'plant and machinery' and granted depreciation at the rate of 25%.

7. The Commissioner of Income Tax (Appeals) (in short 'CIT (A)) confirmed the assessment vide order dated 07.08.2006. The appellant reiterated its submissions that the acquisition was in the revenue field stressing upon the demands of fast changing technologies. The CIT(A) did not accept the argument, being of the view that ERP, by its very nature, had all pervasive effects

on the business and its conduct. He relied on the test laid down by the Privy Council in the case of Atherton V.British Insulated and Heisby cables Ltd (10 TC 155 : 27 ITR 40) quoting the following observation:

> 'When an expenditure is made, not only once but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think that 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'.

8. According to him, the expenditure towards ERP licences had resulted in the assessee obtaining an enduring benefit as the implementation of such procurement encompasses all aspects of the conduct of the business itself. Applying the judgment of the Supreme Court in the case of Scientific Engineering House Ltd. V. CIT (157 ITR 86), where the Supreme Court had held that expenditure incurred by the assessee therein by way of purchase price of drawings, designs, charts, plans, processing data and other documentation was capital in nature, he confirmed the assessment of expenditure in regard to procurement of ERP licences as capital, and the categorisation of the licences as falling within the definition of 'plant', entitled to depreciation at the rate of 20%.

9. The assessee was also unsuccessful in second appeal before the Tribunal. The assessee stressed that since the software had been brought into the depreciation schedule only with effect from assessment year 2004-05, the logical conclusion of the same would be that prior thereto it was to be classified as a revenue asset. The Tribunal, however, concurred with the lower authorities holding that ERP software platform impacted the entire business and the assessee thus gained an asset of enduring nature, relying upon the judgment of the Supreme Court in the case of Alembic Chemical Works Co. Ltd. V. CIT (172 ITR 257).

10. The specific submission of the assessee to the effect that ERP platform comprises of several modules or components and that each component performs different functions that had to be examined separately to determine the benefit provided, was negated by the Tribunal stating that the expenditure was to be taken as composite. It is as against the aforesaid order of the Tribunal dated 04.11.2008 that the assessee is in appeal before us having lost concurrently before all three lower authorities.

11. The Supreme Court in the case of Commissioner of Income Tax V. Mastek Limited ((2010) 229 CTR 313) was concerned with the allowability of expenditure incurred as Royalty. The Bench noted the categorisation of different kinds of software, such as customised software, packaged software and agency products and that the processes involved in the creation of the software and

the application of the same would vary substantially from one software package to another. The matter was thus remanded to the High Court to enable it to carry out an in-depth exercise to understand the actual role that the software plays in the business of the assessee. Bearing this judgment in mind, we undertake an analysis of the use of the ERP platform in the business of the assessee.

12. The payments made by the assessee are of three types: licence fee, payment for ERP implementation and software expenses on lotus notes, the last, though not part of ERP implementation, was grouped along with the same for convenience. The object of the package offered by the ERP platform is to facilitate operations that are multi-locational and involving a variety of products. The software admittedly facilitates processes in the areas of financial accounting, inventory valuation, material management, sales and distribution, budgetary management, fixed asset management and funds management.

13. There are several benefits that are associated with ERP itself; that the platform permits integration of business processes across Departments and thus increases efficiency; there is a consequent reduction in operation cost, since inventory production and help desk support is streamlined optimally and that the software facilitates accurate and quick accounting and record keeping. In summary, it is a software package/platform that facilitates day-to-day management and better access to data. The above features and benefits offered by ERP are not in question and, in fact, all three orders of the lower authorities reiterate that the ERP platform provides very valuable features in the area of day-to-day management, administratively, logistically and financially.

14. The annual licence fee is necessitated on account of frequent updations in technology, calling for regular optimisation of the software. No optimisation can result from obsolete software, which will be of little value in running the business operations. The characterisation of ERP licence as 'operational software' is thus clear and admitted by both sides.

15. We now discuss the citations relied on by the Bar.

16. The assessee relies on the decision of this Court in the case of Commissioner of Income Tax V. Southern Roadways Ltd. ((2007) 288 ITR 15, wherein the Division Bench of this Court considered whether the expenditure incurred on upgradation of software was revenue in nature. At paragraph 6, the Bench observes that expenditure incurred for improving the efficiency of the existing system with a view to keep it in line with improvements in technology would have to be treated as revenue expenditures.

17. Reliance is also placed by the assessee on the decisions of the Delhi High Court in the case of Commissioner of

Income Tax V. Asahi India Safety Glass Ltd. ((2012) 346 ITR 329) and Commissioner of Income Tax V. Amway India Enterprises ((2012) 346 ITR 341). In the case of Asahi India Safety Glass Ltd. (supra), at paragraph 12, the Bench states that ERP software is 'application software' enabling the assessee to execute tasks in the field of accounting, purchases and inventory management. The mere fact that the software requires updation based on the requirements of the assessee and in the context of advancement of its business and/or its diversification, if any, would not change the characterisation of the software itself. The expenditure incurred in that connection was held to be allowable.

18. The Bombay High Court in the case of Commissioner of Income Tax V. Raychem RPG Ltd. ((2012) 346 ITR 138), while considering the categorisation of ERP package held that it only optimises trading operations of the assessee enabling it to conduct its business more efficiently or profitably. The Bench thus concluded that the expenditure incurred would be revenue in nature.

19. Per contra, the Revenue cites the judgment of the Jaipur Bench of the Rajasthan High Court in the case of Commissioner of Income Tax V. Arawali Constructions Co. (P) Ltd. ((2003) 259 ITR 30) where the Bench holds that expenditure on classification of computer software used in data analysis for mining operations was capital in nature.

20. Likewise, the Bench of Delhi High Court in the case of Bharti Televentures Ltd. V. Additional Joint Commissioner of Income Tax ((2013) 81 DRT 225) considered the classification of expenditure on software provided under a licence agreement entered into between the assessee and the supplier. The Bench noted as a fact, that the software was required in the context of updating and accounting of cellular phone calls and caters to the hardware itself. On the basis of this factual position, the Bench concluded that the software was intrinsic to the operation of the hardware and acquired solely for that purpose and hence, fell within the capital field. Though a factual dispute was raised by the assessee subsequently to the effect that the software was not, in fact, an integral part of the lease for purchase of hardware, the Bench proceeded on the factual matrix as revealed in the order of the Tribunal impugned before it. Perhaps, if the facts have been different and the assessee had been able to establish that the software was, in fact, one which did not impact upon or advance the profit making apparatus of the assessee, the decision of the Bench may have been different. However, its conclusion was based on the fact that the software was intrinsically connected to and was catering to the hardware itself.

21. We have heard learned counsel in detail and perused all materials before us. The test set out by the Supreme Court in the case of Alembic Chemical Works Co. Ltd. (Supra) is instructive in determining whether expenditure incurred on softwear is capital or revenue in nature. The Bench, after referring to the decision in the case of B.P.Australia Ltd. V. Commr. of Taxation of the Commonwealth of Australia ((1966) AC 224) (PC) lays down the following test to determine whether expenditure is capital or revenue:

> 'What is capital expenditure and what is revenue are not eternal verities but must need be flexible so as to respond to the changing economic realities of business. The expression 'asset or advantage of an enduring nature' was evolved to emphasise the element of a sufficient degree of durability appropriate to the context'.

22. It is thus essentially, the 'function' of the software in the business of the assessee that is relevant to determine its nature or character. The functionality test has been used in the context of interpreting the term 'plant', while deciding the utility of an asset and in determining whether it would be a 'plant' or an 'amenity'. Lord Guest in IRC V. Barclay, Curle & Co. Ltd. (76 ITR 62) (House of Lords) outlined the functionality test in these words:

> 'In order to decide whether a particular subject is an 'apparatus' it seems obvious that an inquiry has to be made as to what operation it performs. The functional test is, therefore, essential at any rate as a preliminary.'

23. We are of the view that this test is equally applicable in the present case. Though software has been categorised as a capital asset with effect from assessment year 2004-05, it is the purpose for which the software is acquired and the functions that it performs in the working of a business that would essentially determine its nature. Upon application of the functionality test, one would see that the software in the present case is operational in nature, no doubt of substantial value when it comes to assisting the day-to-day operations of the company, but admittedly, not impacting the profit making apparatus or core business fucntions of the company itself. We are thus of the view that the expenditure incurred on ERP licence, its installation and lotus notes do not fall within the capital domain.

24. In view of the above, the concurrent orders of the lower authorities stand reversed. The substantial question of law is answered in favour of the assessee and against the revenue.

25. This Tax Case (Appeal) is allowed. No costs.

Sd/-

Assistant Registrar(CS III)

//True Copy//

Sub Assistant Registrar

TO:

1.The Registrar,

Income Tax Appellate Tribunal,

Madras "C" Bench, Chennai.

2.The Commissioner of Income Tax(Appeals) XI,

Chennai-600 034

3.The Assistant Commissioner of Income Tax,

Company Circle I(3), Chennai.

Tax Case (Appeal) No.535 of 2009

ppa(co)

nr 25/02/2019