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Capital or Revenue Expenditure

(by N Vimala Devi)

It has been expressed many times, particularly by many learned judges on the difficulty in determining whether an item of expenditure qualifies as capital or revenue expenditure. Only the latter qualifies for tax deduction so that is available for set off against income subject to tax.

SINGAPORE LAW

Section 14(1) of the Singapore Income Tax Act ("the Act") provides:

> "For the purposes of ascertaining the income of any period from any source chargeable with under this Act, there shall be **deducted all outgoings and expenses wholly and exclusively incurred** during the period by that person **in the production of income**, ..."

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On the other hand section 15(1) of the Act provides:

> "Notwithstanding the provisions of this Act, for the purpose of ascertaining the income of any person, **no deduction** shall be allowed in respect of –
>
> (b) any disbursements or expenses **not being money wholly and exclusively** laid out or expended **for the purpose of acquiring income**;
>
> (c) any **capital withdrawn** or any **sum employed or intended to be employed as capital**..."

On the question of whether it is an item of revenue or capital expenditure, there is no definition in the Act. Tax case laws have played a major role in coming out with the tests and guidelines of what constitutes revenue or capital expenditure.

TAX CASE LAW PRINCIPLES

Lord Dunedin in ***Vallambrosa Rubber Co Ltd v Farmer (1910) 5 TC 529*** said:

> "that in a rough way it was not a bad criterion of what is capital expenditure as against what is income expenditure, to say that **capital expenditure** is a thing that is going to be **spent once and for all**, and **income expenditure is a thing to recur every year**"

However, it was further expounded in ***British Insulated and Helsby Cables Ltd v Atherton (1926) A.C. 205***, where Judge Viscount Cave said:

> "... when an expenditure is made not only once and for all, but with a view to **bringing into existence an asset or an advantage of enduring benefit** of a trade..."

Then, unless there are special circumstances in leading to an opposite conclusion, such an expenditure is properly attributable not to revenue but to capital.

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Probably one of the valuable guides can be derived from the judgement in the Australian tax case of ***Sun Newspapers Ltd v Federal Commissioner of Taxation (6) CLR 337,359***:

"There are 3 matters to be considered,
(a) the character of the advantage sought,
(b) the manner in which it is to be used, relied upon or enjoyed, and in this and under the former head, recurrence may play its part, and
(c) the means adopted to obtain it, that is, by providing a periodical reward or outlay to cover its use or enjoyment for periods commensurate with the payment or by making a final provision or payment so as to secure future use or enjoyment."

Based on the above there is no conclusion to be drawn or there is no single test to distinguish between capital and revenue expenses. One has to look into the facts of each case and the purpose of the expense in order to ascertain whether the expense is of a capital or revenue nature. Hence, the true nature of the expenditure is a matter of fact and the purpose of the expenditure is an important factor. If it is incurred for the purpose of acquiring a capital asset for the business, it is capital expenditure regardless even if it is paid in annual installments. On the other hand, if the facts can prove that it is part of the cost incidental to perform the income producing operations, distinct from the plant and machinery, then it is revenue expenditure even if it is paid in a lump sum.

In light of the above, we examine below a Singapore Income Tax Board of Review case decided in 2005.

KD V COMPTROLLER OF INCOME TAX (2005) SGITBR 3

Background

- Appellant manufactured Diagnostic Kits for sale.
- Appellant infringed on patent belonging to B
- Appellant eventually settled with B, a total compensation of $5.2m which was calculated based on royalties which an unrelated party would have paid to B for granting a limited non-exclusive sub-licence at US$2.2 per Diagnostic Kit sold.
- Appellant also incurred legal fees of $1.5m on the settlement of the above matters.

Contention

Whether or not the above settlement of $5.2m to B and the legal fees of $1.5m incurred by the Appellant are tax deductible expenditure under section 14(1) of the Act?

Appellant's arguments

- Settlement sum was not made for the purpose of acquiring an asset or an enduring benefit
- Patent infringement lawsuit arose out of the Appellant's day to day business activities and did not imperil either its business or capital assets.
- Payment of the settlement sum and legal expenses also did not result in the Appellant acquiring any capital asset of an enduring nature, or for that matter, any assets at all.

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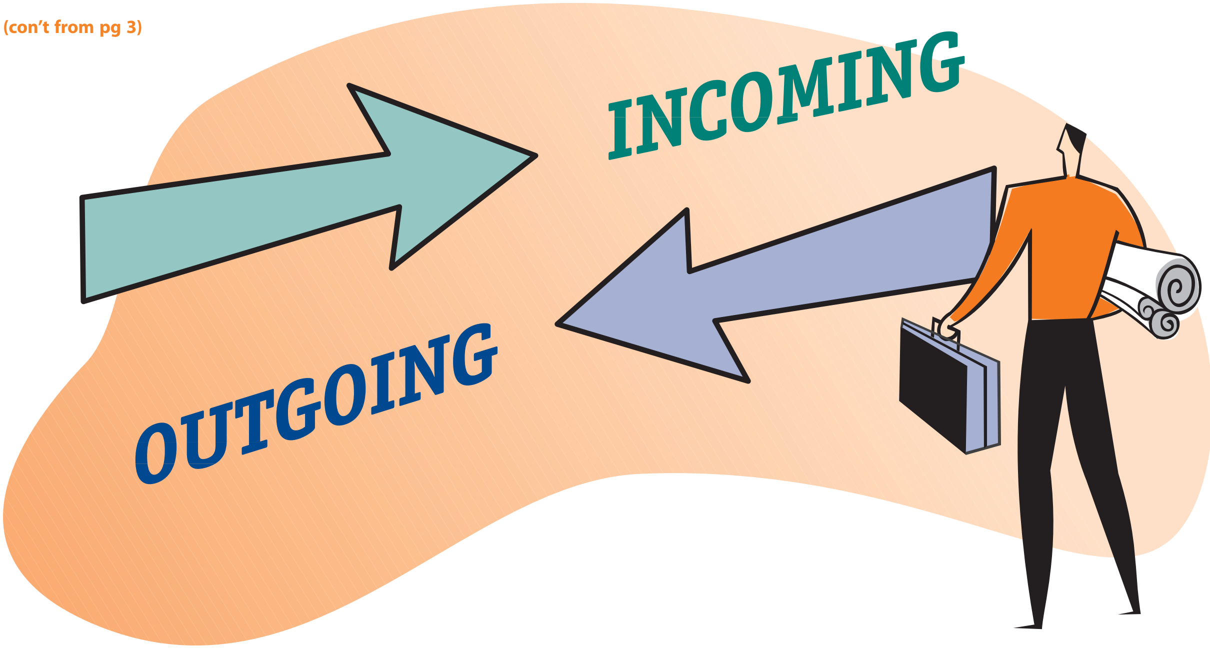

Respondent's argument

- An expenditure incurred to protect or preserve a business or a manner of carrying on the business is capital in nature.

Conclusion

The Board concluded in favor of the Appellant that the expenditures incurred are revenue nature for the following reasons:

- No assets or any enduring advantage was acquired by Appellant.
- The appellant was not seeking to defend its capital asset or eliminate competition, as the patent did not belong to it; and
- The expenditure in this case did not go to the character and organization of the profit earning business. The Appellant's operation before and after the expenditure did not change in any manner.

In the instant case, the Board stated that:

"No expenditure, strictly speaking, in itself actually gains or produces income. It is an outgoing, not an incoming. Its character can be determined only in relation to the object which the person making the expenditure has in view. If actual object is to conduct the business on profitable basis, then the expenditure is an expenditure incurred in producing income."

In conclusion, on the question of revenue versus capital expenditure, one has to look at the circumstances surrounding the incurrence of the expense to determine the true nature of it. If the expense is for the purpose to bring into existence an asset of enduring benefit or to preserve or protect the profit earning business structure, this would be treated as capital expenditure. On the other hand, if the expense is incurred as part of business outlay in operating a business and it is part of that process of profit earning operations, then one should be able to argue that it should qualify for tax deduction as a revenue expense. BSL

Writer's Caveat
These articles have merely attempted to provide a broad overview on the subject matters. It is not in any way intended to be comprehensive and no specific action should be taken on the basis of the above without consulting your professional advisors.

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BSL Corporate Services Pte Ltd (Company Reg. No. 199705883C)
220 Orchard Road #05-01 Midpoint Orchard
Singapore 238852
Tel: 65 6235 3388 Fax: 65 6235 3178
Email: main@bslcs.com.sg URL: http://www.bslcs.com.sg

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