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DIRECT TAX ALERT

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Mumbai ITAT upholds deductibility of expenditure based on legal nature; overrides accounting treatment

Mumbai ITAT upholds deductibility of expenditure based on legal nature; overrides accounting treatment

In a recent ruling of Hon'ble Mumbai ITAT[1], the Tribunal has addressed important aspects around allowability of expenditure and its dependency of the accounting treatment followed in the books of accounts vis a vis legal character of the expense under the provisions of the Income Tax Act, 1961 ('the Act'). The Tribunal has weighed character of the expenditure over the accounting treatment and deleted a disallowance of expenditure claimed as deduction in the Income Tax Return ('ITR').

Background

- Reliance Jio Infocomm Limited ('the Assessee' or 'the Company') is a public limited company engaged in the business of providing digital and telecommunication services through its pan-India telecom network. It has established a wide telecom infrastructure comprising towers, fibre, telecom equipment, electronics and allied network facilities. Its commercial operations for providing digital services had commenced in FY 2016-17.
- During the previous year relevant to assessment year ('AY') 2019-20, the Company had already commenced commercial operation on a substantial scale with strong subscriber base.
- During the year under consideration, the Company incurred capital expenditure towards acquisition and construction of tangible telecom network assets. Such expenditure was treated as 'capital expenditure' for the purpose of Income-tax Act as well as books of accounts.
- Additionally, company incurred additional indirect and operational expenditure such as employee cost, professional fees, call-centre expenses, power and fuel, repairs, interest, selling and distribution expenditure etc. Such expenditure was added to CWIP[2] as per the accounting policy followed for determining when network assets attained the level of functionality intended by the management. However, in the return of income, the Company claimed deduction of such expenditure with a description 'expenses capitalized in books of accounts – allowable as revenue for tax purposes'.

Assessee's contention

- The Assessee's contention for allowability was that these expenses represented routine operating costs incurred in connection with an already established telecom business and did not, in themselves, bring into existence any new capital asset or enlarge the installed profit-making apparatus.
- This expenditure was treated as CWIP in the books of accounts owing to accounting policy followed by the management which has prescribed Quality of Service ('QoS') Parameters. The said parameters intended to measure the quality and efficiency of its operating network in its continuing telecom operations rather than creation of a new business or a new source of income.

[1] ITA no. 3540 of 2026 dated 21 August 2026
[2] Capital work-in-progress

- Once the network infrastructure had achieved the QoS parameters, the corresponding expenditure was transferred from CWIP and was charged to Profit and Loss Account.
- It was argued that the accounting treatment itself was not conclusive of the legal character of an expense for its allowability under the provisions of the Act. Merely because of the accounting policy of the management, an expenditure which is otherwise revenue in nature cannot be treated as capital in nature.

Revenue's contentions

- The Assessing Officer on the other hand referred to the accounting policy followed by the Assessee and observed that the underlying expenditures were incurred as a part of ongoing assets addition and for improvement of existing network infrastructure.
- He also harped upon the fact that the Assessee had consciously classified the disputed expenditure as CWIP, while it has separately offered expenditure of similar nature to profit and loss account treating such other similar expenditure as revenue in nature. The expenditure cannot assume two different characters merely because one treatment was adopted for preparation of financial statements and another for computation of taxable income.
- The fact that the assessee itself had capitalized the expenses reflects their true nature of the expenditure.
- Accordingly, the Assessee was now disputing its own stand in reference to the accounting treatment which has resulted into apparent dichotomy.
- Considering the above facts, it was held that the disputed expenditure was incurred for improvement of network infrastructure and considered as capital in books, and hence, falls outside the ambit of section 37(1) of the Act. Therefore, in the assessment order the entire claim of deduction was disallowed, and the Assessing Officer granted depreciation under section 32 of the Act for such expenditure.

CIT(A) proceedings

- Before the First Appellate Proceedings, the Assessee challenged the assessment order on the ground that the Assessing Officer has failed to demonstrate generation of any capital asset or benefit of enduring nature out of disputed expenditure.
- The Assessee further contended that the expenditure was part of already operational profit apparatus which was functional from FY 2016-17 and has reported substantial revenue during the year in question from its activities. The mere fact that the network was simultaneously being stabilized, strengthened or expanded to cater increasing demand did not convert every expenditure into capital outlay.
- The First Appellate Authority concurred with the averments of the Assessee and observed that the underlying expenditure was in the nature of regular operational expenditure incurred in course of existing business of the Assessee.
- More particularly, the CIT(A) did not accept the Assessing Officer's inference to classify an expense as capital expenditure merely because the same was incurred to upgrade and improve existing network or towards attainment of operational standards.
- The CIT(A) supported its observations with ruling passed by the ITAT-Mumbai[3] on similar issue in Assessee's own case for AY 2018-19, wherein the Hon'ble ITAT had upheld allowability of operational expenditure despite of its capitalization in the books of accounts.
- Reference was also drawn from the decisions passed by the ITAT – Mumbai[4] in the case of group entities of the Appellant which were subsequently upheld by the Hon'ble Bombay High Court[5]. In these decisions, it was held that the accounting treatment is not a determinative factor for character of an expenditure for

[3] ITA no. 2843 of 2022 dated 01 May 2023
[4] Reliance Footprints Ltd. v. ACIT [2014] 41 Taxmann.com 553 and Reliance Fresh Ltd. v. ACIT [2016] 72 Taxmann.com 170
[5] CIT v. Reliance Footprints Ltd., ITA no. 948 of 2014 and PCIT v. Reliance Fresh Ltd. ITA 985 of 2017

taxation purpose and expenditure incurred to expand an already operational business was treated as revenue in nature when no capital asset was generated out of the same.

- Basis the observations, the CIT(A) ordered to delete the disallowance made in the assessment order.

Issue under Consideration

- Whether the accounting treatment accorded to the expenditure as a part of CWIP is determinative of its character under the Act, or whether its allowability has to be adjudged independently having regard to the nature and purpose of the expenditure and the business circumstances in which it was incurred?

ITAT Observations:

Importance of Accounting treatment, nomenclature of expenditure vis a vis underlying business of the Appellant

- The ITAT observed that while the accounting treatment of an expense is a relevant circumstance, the same cannot become a substitute for examining the real nature of the expenditure. Due weightage must be given to commercial framework of the Assessee's business to understand need for incurrence of expenditure.
- The accounting rationale cannot automatically be transposed into the statutory test for determining whether the underlying operating expenditure is capital or revenue.
- Similarly, nomenclature of an expense itself is not sufficient to categorize an expense as revenue or capital. Expenditure such as professional fees, salaries, indirect charges etc. may be treated as capital if a clear nexus can be established between its incurrence in creation of a capital asset. In the present case, there was absence of such exercise undertaken by the Assessing Officer. Such a broad characterization adopted by the Assessing Officer does not adequately address the true nature of the individual expenditure comprising the disallowance.
- Lastly, the magnitude of expenditure cannot influence the juridical character of an expense. The outlay must be considered in the context of nationwide telecom outreach of the Assessee.

Salient aspects to identify true nature of expense

- A distinctive feature to identify nature of an expense is whether the same results into creation of profitmaking apparatus for the Company or it merely increases operational efficiency of an apparatus already in existence.
- Treating an expense as capital or revenue basis the treatment in the books of accounts is not an absolute proposition and deduction of an expense must be granted basis the provisions of the Act. The ITAT referred to catena of rulings of Hon'ble Apex Court[6], wherein it is duly held that capitalization in books of accounts is important, however accounting treatment cannot override statutory provisions to determine its permissibility under relevant provisions of the Act such as section 37(1).
- Even where the expenditure provides enduring benefit for some period, unless there is an enhancement in profit making structure of a business, such expense would still be considered as revenue in nature.[7]

Due Consideration must be given to the nature of underlying business and operational requirements

- Affirming the fact about operationality and scale of the Assessee's telecom business, the ITAT observed that substantial outlay was required for optimization and maintenance of telecom network to keep up the quality of service.

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[6] Kedarnath Jute Mfg. Co. Ltd. v. CIT [1971] 82 ITR 363 (SC), Taparia Tools Ltd. v. JCIT [2015] 372 ITR 605 (SC), Tuticorin Alkali Chemicals and Fertilizers Ltd. v. CIT [1997] 227 ITR 172 (SC)

[7] Empire Jute Co. Ltd. v. CIT [1980] 124 ITR 1 (SC)

- Referring to the jurisdictional high court ruling[8], it was held that where fixed capital structure is made more efficient without adding further endurance to it, the correct categorization of such expenditure should be revenue.

Relevance of past rulings on the similar issue in the Assessee's own case and in the case of group entities

- The ITAT concurred to the fact that on similar issue in the Assessee's own case for AY 2018-19, the co-ordinate bench has given favorable ruling and favorable rulings are also available in the case of group entities Reliance Fresh Limited (supra) and Reliance Footprint Ltd. (supra) which were upheld by the Hon'ble Jurisdictional High court as well.

[8] CIT v. Salgaocar Mining Industries (P.) Ltd. [2019] 108 taxmann.com 116 (Bom.)

This is a welcome ruling from the Mumbai ITAT reinforcing importance of legal character of an expense over accounting treatment in the books of accounts for the purpose of claiming deduction under the Income Tax laws. The above principals affirmed by the ITAT shall continue to apply under the Income-tax Act, 2025.

This ruling assumes significance in the era of Ind AS, which prescribes different treatment of the transaction in the books of accounts compared to Indian Generally Accepted Accounting Policies ('GAAP'). The Income-tax Law gives more weightage to the legal characteristic of the transaction, rather than merely accounting treatment.

An important aspect that seems to have convinced the ITAT in coming to this decision that this was an existing and operational telecom business. The expenditure for upgrading the existing network was undertaken with a view to meet the increasing demand and pressure on the network. It did not give rise to any new profit-making apparatus. These observations are important to analyse in the given factual matrix before taking a tax position.

The ratio of the ruling is particularly important for capital intensive and highly regulated businesses such as data center, pharmaceuticals, or manufacturing industries which require significant capital outlay to upgrade the operational efficiency of existing units or incurring expenditure to standardize its plants as per the requirements of statutory authorities.

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