Expenditure incurred on development of software platform, which is subsequently abandoned, is revenue in nature – Bangalore ITAT

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Summary

The Bangalore bench of the Income Tax Appellate Tribunal (ITAT), in a recent case, held that the expenditure incurred on development of a software platform, which was abandoned before being fully developed and put to use, should be allowed as a revenue expenditure and not be treated as a capital expenditure.

Facts of the case

- The taxpayer[1] a private limited company, is engaged in the business of rendering customised internet advertising services for advertisers such as news, financial services and entertainment.
- During the Assessment Years (AY) 2015-16 and 2016-17, the taxpayer had incurred expenditure for development of software platform. The platform was to cater to a less sophisticated client base, which could not afford to spend on specialised ad operations.
- The taxpayer paid salaries to employees who were involved in developing the software platform, and incurred marketing expenditure for creating brand value for the taxpayer in the North American market in the segment.
- However, due to rapid changes in technology and shifting of advertisement from desktop to mobile platform, the software being developed by the taxpayer was abandoned in AY 2016-17 and was never used.
- The tax officer held that salaries paid for developing the platform and marketing expenditure incurred by the taxpayer, should be capitalised, since the software platform would have given an enduring benefit to the taxpayer.
- Further, the tax officer held that since the taxpayer is the owner of the platform, the expenses incurred on technical personnel and in marketing

[1] Adadyn Technologies Private Limited

and sale of the software indicated that it is likely to become central tool of business of the taxpayer. Hence, the expenses incurred should be capitalised.

- Accordingly, the tax officer disallowed salary and marketing expenditures amounting to INR 60 million in the assessment order. The Commissioner (Appeals) upheld the tax officer's order.
- Aggrieved by this order, the taxpayer preferred an appeal before the ITAT.

Taxpayer's contentions

- Development of the software platform was at its feasibility stage during AY 2015-16 and subsequently abandoned during AY 2016-17, due to rapid changes in technology. Therefore, expenses incurred on the platform which was never fully developed and put to use, should not be capitalised.
- Reliance was placed on the jurisdictional High Court ruling[2] wherein it was held that expenditure incurred on investigation, research and feasibility studies laid out by the taxpayer was revenue in nature and thus, an allowable deduction.
- Reliance was placed on Accounting Standard (AS) 26 relating to Intangible Assets, to argue that in the research phase of a project, an enterprise cannot demonstrate that an intangible asset existed from which future economic benefits are probable. Further as per AS-26, expenditure on research should be recognized as expenditure, when it is incurred.
- The marketing expenditure was incurred for development of business in general for the company and not for the promotion of the software platform, hence the marketing expenditure should not be capitalised.

ITAT's observations and order

- The ITAT noted that the taxpayer was developing a new software platform. However, due to rapid changes in the technology and shift in customer preferences, such new platform was abandoned during the next year.

[2] Karnataka State Industrial and Investment Development Corporation (163 ITR 657)

- The ITAT held that the product was in the development stage during the year and was the same has never been put to use and finally abandoned, then it cannot be termed that an independent product came into existence, thereby giving enduring benefit to the taxpayer. Thus, it held that the expenditure incurred for the development of the software platform, should not be capitalised.
- In arriving at the conclusion, the ITA relied on the decision of the jurisdictional High Court in the case of Karnataka State Industrial and Investment Development Corporation (supra). In the said case, the High Court categorically held that expenditure incurred on investigation, research and feasibility studies was revenue expenditure and thus was an allowable deduction.
- The ITAT also perused AS-26 which if expenditure on research should be recognised as an expenditure when it is incurred. Further, during the research phase of the project, an enterprise cannot demonstrate that an intangible asset exists from which future economic benefits are probable.
- On the issue of marketing expenditure, the ITAT held that there is no direct nexus between the marketing expenses incurred and the new software platform under development.
- Based on the above, the ITAT ruled in favour of the taxpayer and held that expenditure incurred towards development of software platform and marketing expenses should be allowed as revenue expenditure.

Our comments

The issue of classification of expenditure when a project is abandoned has been a subject matter of considerable litigation before various courts. While certain judicial precedents have held that expenditure incurred on abandoned projects should be allowed as revenue expenditure, the tax department is generally of the view that the expenditure should be classified based on the intention of the taxpayer during incurrence of such expenditure.

In the present ruling, the ITAT has considered the facts and held that expenditure incurred to develop an intangible asset, which never came into existence and was never put to use, cannot be capitalised and accordingly, be allowed as revenue expenditure. Further, the ITAT has provided the guidance that only that expenditure could be capitalised that has a nexus with the capital asset, which is under development.

This is a welcome ruling and may be referred by taxpayers facing similar issues.

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