* **IN THE HIGH COURT OF DELHI AT NEW D**

ITA No. 677 of 2009

Reserved on: 06th October, 2009.
% Pronounced on : 06th, November, 2009.

Commissioner of Income Tax . . . Appellant
through : Ms. Suruchi Aggarwal with Mr. Anish Kumar, Advocates.

VERSUS

M/s. Control & Switchgear Contactors Ltd. . . . Respondent
through: Mr. Ajay Vohra with Ms. Kavita Jha and Ms. Akansha Aggarwal, Advocates.

CORAM :-
THE HON'BLE MR. JUSTICE A.K. SIKRI
THE HON'BLE MR. JUSTICE SIDDHARTH MRIDUL

1. Whether Reporters of Local newspapers may be allowed to see the Judgment?
2. To be referred to the Reporter or not?
3. Whether the Judgment should be reported in the Digest?

A.K. SIKRI, J.

1. The assessee company is engaged in the business of manufacturing of the Electrical products, control panel, switchgear, Air circuit breakers etc. In its return filed for the Assessment Year 2003-04, the assessee company declared loss of Rs.3,12,57,184/-. This return was processed under Section 143(1) of the Income Tax Act (hereinafter referred to as 'the Act'), as the MAT income of Rs.3,22,23,192 under Section 115JB of the Act. Subsequently, notice under Section 143(2) was issued pursuant to which assessment order was passed on 30.03.2006

assessment year, the assessee had paid Rs.2,06,00,010/- Simelectro France and treated it as royalty. The AO after examining the relevant clauses of agreement relating to payments of royalty/technical know-how fee held that the assessee was deriving enduring benefit from the technology/information received. Accordingly, the AO capitalized the same and made addition under this head after allowing 25% depreciation to the assessee. The AO relied on the judgment in the cases of ***Commissioner of Income Tax*** Vs. ***Jacobs (P) Ltd.***, (1979) 120 ITR 197, Division Bench of Kerala High Court, ***Commissioner of Income Tax*** Vs. ***Polyformation (P) Ltd.*** (1986) 161 ITR 36 (Ker.), ***Commissioner of Income Tax*** Vs. ***Coal Shipments P. Ltd.***, (1971) 82 ITR 902 (SC) and held that the expenses incurred by way of royalty/technical fee were capital in nature and assessee was not entitled to deduction of the same as an item of revenue expenditure. Hence, capitalizing this expenditure, he allowed deduction of 25% of the amount, treating the same as technical know-how fee as defined in Section 32 of the Act.

2. The assessee preferred appeal against this order of the AO. In the appeal, the CIT(A) noted that the royalty/technical know-how fee was paid two parties, which required to be decided in

(i) In respect of royalty paid to M/s. Sir France as technical know-how fee for Rs.20,60,010/-, the CIT(A) found that the assessee was deriving enduring benefits from such party. Hence, in the light of case laws as relied upon by the AO, the CIT(A) upheld the AO's action trading treating this expenditure as capital in nature. Thus, the AO was held to be justified in allowing the depreciation @ 25%.

(ii) In respect of payment of Rs.17,45,198/- in favour of M/s. SPG Holding GMPH, the CIT(A) found that neither the technical know-how was provided by the said party nor the amount was refunded. Thus, the payment made to this party was still in dispute. Hence the payment of Rs.17,45,198/- in favour of M/s. AVK SPG Holding was receivable amount and the same was a matter of balance sheet. It was neither a capital expenditure nor the revenue expenditure nor the capital loss. In this situation, the disallowance of Rs.17,45,198/- was upheld, and the deprecation already allowed @ 25% against such capitalization of Rs.17,45,198/-, was held to be not justified. Accordingly, the AO

was directed to withdraw the deprecation against the capitalized amount of Rs.17,45,198/-.

Aggrieved by the order of the CIT(A), the assessee filed an appeal before the Income Tax Appellate Tribunal (hereinafter referred to as 'the Tribunal') being ITA No.5007/DEL/2007. The Tribunal vide its impugned order dated 12.12.2008 has partly allowed the appeal of the assessee and directed the AO to capitalize 25% of royalty payment of Rs.20,60,010/- to M/s. Simelectro France instead of 100% capitalization by the AO. The Tribunal held that the facts correspond to the facts of the case of ***Southern Switch Gear Ltd.*** (supra), a decision which was later on approved by the Hon'ble Supreme Court. Following this decision, it was held that 25% of the expenditure was of capital nature and balance 75% was revenue in nature and the AO was directed to allow the expenditure and depreciation accordingly.

3. The Revenue is in appeal against the aforesaid order. The grievance is that the Tribunal wrongly equated the present case with that of ***Southern Switch Gear Ltd.*** (supra) and gave the benefit of capitalizing the amount paid to M/s. Simelectro France. It is the submission that entire amount paid to the said company should have been capitalized and not only 25%. It is

between the assessee and M/s. Simelectro France was to in force for a long period of ten years. The agreement further provided that the assessee could file, with prior consent of the said company, an application with the Indian Patent Agency with respect to any new invention, patent and design without any financial obligation on the part of the assessee. Even after the expiry of the agreement, after the lapse of ten years, the assessee was still permitted to use technical information, improvements and patents, etc. free of charge for a period of ten years. It was clear that residuary benefit was available to the assessee for use of the technical know-how, patents, etc. free of charge and therefore, the entire royalty paid was in the nature of capital expenditure and the Tribunal could not have held that only 25% of this amount is to be capitalized and 75% is to be treated as revenue expenditure.

4. The learned counsel for the respondent, on the other hand, supported the reasoning given in the order of the Tribunal and referred to plethora of case law, on the basis of which he went to the extent of submitting that even entire expenditure could have been treated as revenue expenditure. Therefore, the order of the Tribunal should not be interfered with and no question of law arises.

5. We may point out that the Tribunal has referred to the various

therefrom as well. On the basis of this agreement, the T came to the conclusion that the assessee had obtained assistance in pre-order phase as well as post-order phase from M/s. Simelectro France. The consideration was fixed on the basis of the contract value of the order received. The Tribunal also specifically noted the features of the agreement as pointed out by the learned counsel for the Revenue as well. After considering the same, it opined that the facts of the case are same as in ***Southern Swith Gear Ltd.*** (supra) and therefore, accorded the same treatment as was done in the said case by Madras High Court and approved by the Supreme Court.

6. ***Commissioner of Income Tax*** Vs. ***Southern Switch Gear Ltd.,*** 148 ITR 272 (Mad.), that is also a case where an exclusive license to manufacture, use and sell during the continuance of this agreement was granted to the assessee for all drawings, specifications and other data were also furnished to the assessee, which was to be the property of the assessee on the condition that it agreed to hold such property of the assessee on the continued fulfillment of all obligations contained in certain clauses of the said agreement. Agreement was for a period of ten years and right to use the technical know-how was provided for another ten years after the expiry of the agreement period.

"23. Upon the termination of the agreement:

(a) any licences, permissions, authorities granted by BRUSH in favour of S S. in respect of any patent or similar rights shall determine and S.S. shall forthwith return to BRUSH all copies of drawings specifications, information and other data in the possession or under the control of S.S. and relating in whole or in part to the designs or inventions which are the subject of patent or similar rights owned or controlled by BRUSH in India.

(b) S.S. hereby agrees to continue to observe the obligations contained in clauses 6(e) and 6(d) and 25 of this agreement throughout the period of ten years commencing upon the termination of this agreement but in all other respect, S.S. shall have the right to use and to continue to use all information, methods, process and formulae acquired in pursuance of this agreement so far as the same shall not relate to patents or similar rights owned or controlled by BRUSH in India. Provided always that this right shall not apply in the event of this Agreement being terminated by BRUSH pursuant to either clause 22 or clause 24 hereof."

7. The clauses of agreement were thus almost similar. After taking note of the aforesaid agreement, the Madras High Court found that the benefit secured by the assessee was of an enduring nature and therefore, the entire technical fee could not be allowed as a revenue expenditure. Discussion on this aspect is in the following terms:

> "A perusal of the above clauses clearly indicates that the technical knowledge the assessee-company obtained through this agreement from the foreign company secured to the assessee an enduring advantage and benefit in that the same was available to the assessee for its manufacturing and industrial processes even after the

> manufacture of transformers of all kinds and types. T foreign company also makes available to the assessee procedures, designs, experience and technical know-how in respect of the same. Though the duration of the agreement is five years, the assessee even after the expiry of the period, could use the methods of production, procedure, experiments, improvements which had been made available to them in pursuance of the agreement. Thus, the assessee had acquired a knowledge of enduring nature. Further, apart from the technical know-how supplied by the foreign company and the grant of any of the scheduled products or to grant or make available to any other person, firm or company any manufacturing information, licences, rights for any one of the scheduled products in India, thus conferring an exclusive benefit on the assessee-company to manufacture and sell the scheduled products. The conferment of an exclusive benefit to manufacture and sell the articles which are the subject-matter of the agreement cannot be said to be a part of a mere know-how agreement. The right to make or manufacture certain goods exclusively in India should be taken to be an independent right secured by the assessee from the foreign company which is of an enduring nature. Therefore, the principle laid down by this Court in *Transformer & Switchgear Ltd.* v. *CIT* [1976] 103 ITR 352, *Fenner Woodroffe & Co. Ltd.* v. *CIT* [1976] 102 ITR 665 and *M.R. Electronic Components Ltd.* v. *CIT* [1982] 136 ITR 305, straightaway applies, and, therefore, the entire technical fees cannot be allowed as a revenue expenditure."

8. The Madras High Court thus held that the payment of royalty against the said technical know-how received by the assessee had the element of capital expenditure. Thereafter, it held that 25% of the said royalty paid should be capitalized and 75% should be treated as revenue expenditure, in the following manner:

> "We have, therefore, to hold, following the above said decisions of this court that in this case, the Tribunal is right in holding that 25% of the technical fee has to be taken as a capital expenditure and as such cannot be allowed as a revenue expenditure.

> paid, the ITO, the appellate authority as well as t Tribunal have all concurrently held that the disallowar of 25% of the royalty is justified. Under the terms of the know-how agreement, the royalty is payable on all switchgear products and the parts thereof sold on behalf of the Indian company at the rate of 2 ½% of the invoice value of all low tension switchgear products at 5% in all the high tension switchgear parts and a royalty of 7% in all switchgear products exported. Thus, it is seen that the assessee paid a royalty for the acquisition of an exclusive privilege of manufacturing and selling the products. The acquisition of such a right has rightly been treated partly towards capital and partly towards the revenue. The Tribunal has chosen to estimate the value of that portion of the royalty which is relatable to acquisition of right of an enduring nature. In this view, the Tribunal is right in holding that 25% of the royalty is to be disallowed."

9. The Supreme Court in ***Southern Switch Gear Ltd.*** Vs. ***Commissioner of Income Tax***, 232 ITR 359 upheld the aforesaid order. It is a short order dismissing the appeal, which reads as under:

> "We have perused the order of the High Court. We have also seen the agreement. We are not perused to hold that the view taken by the High Court is erroneous; the appeals are dismissed. There will be no order as to costs."

10. Significantly, the assessee had filed the appeal and not the Department. Thus, the assessee wanted that entire 100% expenditure be treated as revenue expenditure. Appeal was, however dismissed and thus, it is clear that this plea of the assessee was not accepted thereby implying that expenditure was treated as capital expenditure. However, the revenue had not gone into the appeal and therefore, whether 75% expenditure

not, was not the matter, which arose for consideration be Supreme Court. From the judgment of the Madras High Court, two things become apparent:

a) The benefit accrued in favour of the assessee was treated as that of enduring nature and therefore, in the first instance it was held that it is capital expenditure.

b) At the same time, this expenditure was apportioned between capital and revenue expenditure. However, it is not discernible from the judgment as what was the basis of holding that 25% of the technical fee only is to be treated as capital expenditure and 75% thereof was to be allowed as the revenue expenditure. The High Court has stated that the Tribunal was right in apportioning the expenditure in the aforesaid manner, but what was the basis on which the Tribunal has upheld is not spelt out in the judgment of the Madras High Court. Significantly, the ITO, CIT (A) as well as the Tribunal had taken this view that 25% of the royalty be disallowed as revenue expenditure and this concurrent finding of fact was accepted by the High Court.

11. In the present case, however, the Tribunal has not undertaken any such exercise, *viz.*, on what basis 25% of the royalty is to be capitalized. The Tribunal has simply followed the judgment in ***Southern Switch Gear Ltd.*** (supra) for this purpose without

noticed the subtle distinction that in the present case, had treated the entire expenditure as capital expenditure. If one goes by the judgment of the Madras High Court, it cannot be disputed that the benefit is of enduring nature and therefore, at least, part thereof has to be capitalized.

12. We are, therefore, of the opinion that while apportioning the sum between capital and revenue expenditure, the Tribunal should have given the rationale for coming to such a conclusion. As that has not been done, we set aside the impugned order and remit the case back to the Tribunal for discussing this aspect specifically. Parties shall appear before the Tribunal on December 21, 2009.

(A.K. SIKRI)
JUDGE

(SIDDHARTH MRIDUL)
JUDGE

November 06, 2009.
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