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* IN THE HIGH COURT OF DELHI AT NEW DI

Reserved on: 22nd October, 2009.

% Pronounced on : 30th November, 2009.

1) **ITA No. 1119 of 2008**

Commissioner of Income Tax ... Appellant
through : Ms. P.L. Bansal, Advocate.

VERSUS

Flour Daniel India P. Ltd. ...Respondent
through: Ms. Shashi M. Kapila with Mr. R.R. Maurya, Advocates

2) **ITA No. 1141 of 2008**

Commissioner of Income Tax ... Appellant
through : Ms. P.L. Bansal, Advocate.

VERSUS

Flour Daniel India P. Ltd. ...Respondent
through: Ms. Shashi M. Kapila with Mr. R.R. Maurya, 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. These appeals were admitted and heard on the following substantial question of law:

2. The appeals relate to the assessment years 2002-03 and 2 in respect of the same assessee. For the sake of convenience, we take note of the facts relating to the assessment year 2002-03 out of which ITA No.1119 of 2008 arises. In this year, the respondent had filed return declaring "Nil" income. However, during the assessment proceedings, the Assessing Officer (AO) noticed that the assessee had claimed software expenses @ Rs.2,75,10,589/-. According to the AO, these expenses were capital in nature. He accordingly did not allow the entire expenditure as deduction and instead capitalization the same, allowed depreciation @ 30%. The CIT(A), however, reversed this assessment order of the AO treating the same as revenue in nature. The CIT(A) observed that the assessee had incurred expenses to the tune of Rs.2,75,10,589/- as software expenses, out of which, Rs.2,66,53,561/- was paid to the foreign company and Rs.8,57,028/- was in respect of AMC. CIT(A) further observed that the assessee had entered into an agreement with the foreign parent company, according to which, license had been granted for use of software and there was no sale of software. For usage of software, the amount was payable at USD 1.87 for every project hour. Thus, no enduring benefit had

confirmed by the Income Tax Appellate Tribunal (hereinafter referred to as 'the Tribunal') as well, which has resulted in dismissal of appeal preferred by the Revenue vide orders dated 12.10.2007. In fact by this order, the appeals relating to both the assessment years have been decided.

3. It is clear from the reading of this Explanation that receipt of royalty for transfer of all or any rights including by way of license in respect of a patent, invention, model, design, secret formula or process or trade mark or similar property would form part of income under Section 9. It is for this reason we find that royalty for transfer of intangible property would also be treated as income. However, this very explanation excludes such royalty if it is 'capital gain'. Therefore, while it cannot be disputed that when royalty is received by giving license for using intangible property, it may from part of income, but what is to be seen is as to whether the person paying such royalty incurs the expenditure as revenue or the capital expenditure. For this purpose, we fall back on the test, which are laid down by the Court for determining as to whether a particular expenditure is revenue or capital in nature. The test is that there should be a benefit of enduring nature to make it capital expenditure.

4. Learned counsel for the appellant submitted that since can be paid by giving license as well, that itself signifies that the present user would not have proprietary rights and thus, transfer of asset would not be material consideration for determination the nature of expenditure in case of intangible property. She also submitted that Explanation 2, reproduced above, further signifies that it is not necessary that royalties to be paid lump sum, it can be paid periodically as well. Thus, manner of payment was not decisive. Furthermore, under Section 32 of the Act "software was significantly included and Appendix-X also mentions it in the list of assets on which depreciation is allowable" therefore, the software was also an asset and could be treated as capitalized. She referred to the following judgments in support of her submission:

i) **Commissioner of Income-tax v. Hindustan Insecticides Ltd.** [253 ITR 520]

ii) **Commissioner of Income-tax v. Harsha Tractor Ltd.** [249 ITR 499]

iii) **Commissioner of Income Tax, Gujarat-II** *Vs.* **Elecon Engineering Co. Ltd.** [96 ITR 672]

iv) **Commissioner of Income-tax, Gujarat v. Elecon Engineering Co. Ltd.** [166 ITR 66]

the finding of fact arrived at by the two authorities below not be disturbed. She pointed out that there is no finding that there is any dilation of proprietary rights of the owner in favour of the assessee. Right given to the assessee was only right to use the software. Further, the assessee was to make payment on hourly basis in respect of actual use. Thus, it was not a case of right of property, but right in respect of propriety. She also submitted that nature of license stipulated in Section 32 of the Act was totally different as clarified in the case of ***Commissioner of Income Tax*** Vs. ***Davy Ashmore India Ltd.*** [190 ITR 626]. The determinative factor under Section 32 was that by license, there is transfer of "substance of rights", whereas in the present case, more licenses for user, as and when required by the assessee, was given. On this amount, even TDS was deducted which position was accepted by the Revenue as well. She also referred to the following discussion in the order of the Tribunal in this behalf to support her contention:

> "4. We have considered the facts of the case and rival submissions. It is seen that the instant case is not one of acquisition of software, but of licensing of software, under which the assessee has to pay royalty to its parent company @ USDs 1.87 per hour for use of the software in its office. The agreement of licensing does not confer any proprietary right on the assessee, not it dilutes the proprietary right of the parent company in the software

> license fees to its parent company, it is held that t expenditure was revenue in nature. Further, it is held tl in absence of proper opportunity granted to the assessee by the A.O. for explaining its case in this behalf, the learned CIT (A) was justified in entertaining evidence in the form of the agreement, the bills, the certificate from the Chartered Accountant and proof of payment of the tax deducted at source for effectively deciding the ground of appeal raised before him. Thus, ground no. 1 is dismissed."

6. In order to determine the issue, we will have to first take into consideration the business of the assessee and also the terms of the agreement entered into between the assessee and its parent company to the aforesaid payments were made. The assessee is engaged in the business of preparing designs and drawings for projects allotted by its group entities. For this purpose, it is required to make use of certain software packages like Plant Design Software (PDS) which it has taken on lease from Flour Intercontinental Inc. (FII), a group company based in United States. FII has taken these packages on a corporate license from another un-related entity. For using the software packages, the assessee pays royalty to FII at a fixed invoice per hour. The payment is made monthly on the basis of an invoice raised by FII on the assessee. The royalty is calculated taking into account the number of hours for which software packages are used by the

payment made is subject to tax withholding at source @ 1

the rate specified under Article 12 (2)(a)(i)(a) of the Double Tax Avoidance Treaty between India and the USA. In this backdrop, it is to be seen as to whether the assessee was merely using the asset, which was in the form of intangible property or transfer of a capital asset by the FII to the assessee by way of license or sale.

7. We may also point out that though the assessee was allowed to use the software, such software which is intangible property is also treated as asset. Section 9 of the Income Tax Act, which deals with 'income deemed to accrue' or arise in India, *inter alia* takes care of 'income by way of royalty' as well as stipulated in clause (vi) of sub-section (1) of Section 9 thereof. The royalty payable by certain persons specified in clauses (a) to (c) are treated as income for that purpose. Section 9, Explanation 2 thereof is relevant, which defines 'royalty' for the purpose of this Section reads as under:

> Explanation 2 : For the purposes of this clause, "royalty" means consideration (including any lump sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head "Capital gains") for - (i) The transfer of all or any rights (including the granting of a licence) in respect of a patent, invention, model, design, secret formula or process

(iii) The use of any patent, invention, model, design, sec formula or process or trade mark or similar property;

(iv) The imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill;

(v) The transfer of all or any rights (including the granting of a licence) in respect of any copyright, literary, artistic or scientific work including films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting, but not including consideration for the sale, distribution or exhibition of cinematographic films; or

(vi) The rendering of any services in connection with the activities referred to in sub-clauses (i) to (v);"

8. There is no quarrel with the proposition that under certain circumstances, software can also be treated as asset and expenditure thereon capitalized. However, what is to be found is as to whether in the present case, by incurring expenditure in terms of royalty, the assessee had acquired any benefit of enduring nature. It is only then the expenditure to be treated as capital expenditure, which is firmly established principle of law. Taking stock of various judgments, this Court defined the contours and legal principles to be kept in mind, by culling out various principles in the case of ***Commissioner of Income Tax*** Vs. ***J.K. Synthetics Ltd.*** [309 ITR 371].

be made on the basis of actual user, *i.e.*, as and when the s is used. Number of hours for which software is used was to be taken into account for this purpose as payments of royalty was on hourly basis. This would be in the nature of licensing the software without transfer of "substance of rights". The agreements signed between the parties eloquently bring forth this significant aspect. Neither any proprietary rights are conferred to the assessee nor does it dilute the proprietary right of the parent company in the software.

10. As far as the judgments cited by the learned counsel for the Revenue are concerned, they have no application in the facts of this case. All those cases are concerned with the definition of "plant" contained in Section 43(3) of the Income Tax Act. The Court held that drawings and patrons acquired from another company/parent company on the basis of which would amount to know-how forming the basis of business of assessee and therefore, would be treated as "plant" and would be amenable to depreciation under Section 32 of the Act. Those were the cases where not only drawings or technical know-how was acquired by the assessee and thus proprietary rights in respect of such

The Courts held that the assessees would be entitled depreciation. In the present case, however, the assessee has not claimed any such benefit and has treated the expenditure as revenue expenditure. Furthermore, here the proprietary rights in the software have not passed on to the assessee, who is merely using the same and making payment on hourly basis for the actual use. Such issue as to whether payment of this kind be treated as revenue or capital expenditure has come up for consideration before this Court *albeit* in different circumstances in few judgments, but the ratio thereof is clearly applicable. We are referring to a judgment of this Court passed in the case of ***Climate Systems India Ltd.*** Vs. ***Commissioner of Income Tax*** (ITA No.464/2009) decided on October 09, 2009. It was held:

> "Thus for transfer of technology, the assessee agreed to pay lump sum amount of US$ 1 billion. This payment is admittedly treated as capital expenditure by the assessee and has been shown as such. However insofar as payment of royalty is concerned which is an issue before us, that depends on the domestic as well as export sales. Quantum of the said sales would determine the extent of royalty to be paid and it will decrease or increase every year depending upon the decrease or increase in the sales. Significantly, this payment is not because of "transfer" of technology, but for providing "technical services". In such circumstance, we are of the opinion that this payment of royalty, which is a continuous process, should have been treated as revenue expenditure. In a recent judgment given by this Court in the case of ***Commissioner of***

sales. Holding that, the said payment would be in nature of revenue expenditure. This Court dealt with issue in the following manner:

> "3. Insofar as lump sum payment against transfer of technical knowhow provided by the Korean company is concerned, the assessee had admittedly shown these expenses as capital expenditure. It was the royalty paid during the year in question which was treated as revenue expenditure by the assessee. The CIT(A) found that as per the agreement, this royalty was running royalty payable every year, which depended upon the number of pieces produced of the aforesaid products, namely, catalytic converter and exhaust muffler.
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> 4. We are of the opinion that this finding of the CIT(A), as approved by the ITAT, is a finding of fact which is rightly arrived at as expenditure is purely a revenue expenditure, which is annual expenditure depending upon the quantum of production in the relevant year.
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> 5. In ***CIT*** v. ***J.K. Syntheticx Ltd.***, 309 ITR 371, after elaborately discussing the entire case law on the subject, the Court culled out the broad principles to determine as to whether expenditure in a particular case would be capital or revenue expenditure. One of the principle enumerated therein reads as under :-
>
> "(v) expenditure incurred for grant of licence which accords *"access"* to technical knowledge, as against, *"absolute"* transfer of technical knowledge and information would ordinarily be treated as revenue expenditure. In order to sift, in a manner of speaking, the grain from the chaff, one would have to closely look at the attendant circumstances, such as :
>
> a) the tenure of the licence,
> b) the right, if any, in the licensee to create further rights in favour of third parties.
> c) the prohibition, if any, in parting with a confidential information received under the licence to third parties without the consent of the licensor,
> d) whether the licence transfer the "fruits of research" of the licensor, "once for all",
> e) whether on expiry of the licence the licensee is

obtaining access to such secret process would ordinarily be construed as capital in nature."

11. We are thus of the opinion that the Tribunal has rightly decided the issue in favour of the assessee. Accordingly, these appeals are dismissed.

(A.K. SIKRI)
JUDGE

(SIDDHARTH MRIDUL)
JUDGE

November 30, 2009.
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