2011:DHC:14173-DB

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

\+ **ITA No.383 of 2009**
with
ITA No.987 of 2010
ITA No.1242 of 2010
ITA No.1247 of 2010

RESERVED ON: JANUARY 24, 2010
% PRONOUNCED On: MARCH 30, 2011

1) ITA No.1242 of 2010

COMMISSIONER OF INCOME TAX . . . Appellant

through : Ms. Prem Lata Bansal, Sr. Standing Counsel.

VERSUS

M/s. ORACLE INDIA PVT. LTD. . . .Respondent

through: Mr. M.S. Syali, Sr. Advocate with Ms. Mahua Kalra, Advocate.

2) ITA No.1247 of 2010

COMMISSIONER OF INCOME TAX . . . Appellant

through : Ms. Prem Lata Bansal, Sr. Standing Counsel.

VERSUS

M/s. ORACLE INDIA PVT. LTD. . . .Respondent

through: Mr. M.S. Syali, Sr. Advocate with Ms. Mahua Kalra, Advocate.

3) ITA No.987 of 2010

COMMISSIONER OF INCOME TAX . . . Appellant

through : Ms. Prem Lata Bansal, Sr. Standing Counsel.

VERSUS

ORACLE INDIA PVT. LTD. . . .Respondent

through: Mr. M.S. Syali, Sr. Advocate with Ms. Mahua Kalra, Advocate.

CORAM :-
HON'BLE MR. JUSTICE A.K. SIKRI
HON'BLE MR. JUSTICE M.L. MEHTA

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. For orders see, ITA No.383 of 2009.

(A.K. SIKRI)
JUDGE

(M.L. MEHTA)
JUDGE

MARCH 30, 2011
pmc

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4) ITA No.987 of 2010

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through : Ms. Prem Lata Bansal, Sr. Standing Counsel.

VERSUS

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through: Mr. M.S. Syali, Sr. Advocate with Ms. Mahua Kalra, Advocate.

CORAM :-
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3. Whether the Judgment should be reported in the Digest?

Yes

A.K. SIKRI, J.

1. In all these appeals, filed under Section 260A of the Income Tax Act (hereinafter referred to as 'the Act') by the Revenue, parties are common. Whereas the Revenue is the appellant, same assessee is the respondents in all these appeals. Further though different assessment years are involved, there is singular question of law which has arisen for consideration.

2. ITA No.383 of 2009 which relates to the Assessment Year 1999-2000 was admitted on the following question of law:

> "Whether on the facts of the present case, Tribunal was justified in law in allowing deduction of ₹17,10,24,600 disallowed by the AO under Section 92 read with Section 37(1) of the Act being royalty paid by the assessee to its holding company beyond 30% of the sub-licensing fees earned by the assessee?"

Question of law in all other appeals is identical and there is only difference of amount which is involved. Before we delve into the niceties, a brief narration of facts stating the background under which this question has arisen for consideration would be apt. For the sake of convenience, we may record facts from ITA No.383 of 2009, which would cover other cases as well. Brief facts entailing the present appeal are stated as under:

3. The assessee is a 100% subsidiary of Oracle Corporation, USA and was incorporated with the object of developing, designing, improving, producing, marketing, distributing, buying, selling and importing of computer software. The assessee is entitled to sub-licence the software developed by Oracle Corporation, USA to its local clients. The assessee imports master copies of the software from Oracle Corporation, USA. These are then duplicated on blank discs, packed and sold in the market along with the relevant brochures and information by way of a sub-

license. The assessee pays a lump sum amount to Oracle Corporation, USA for the import of the master copy and in addition thereto it also pays royalty at 30% of the list price of the licensed products. For the year under consideration, the assessee filed its return on 31.12.1999 declaring income at ₹12,27,40,360/-. The said return was processed under Section 143(1) of the Act on 14.09.2000. The case was selected for scrutiny and notice under Section 143 (2) of the Act was issued.

4. While framing the assessment order, the Assessing Officer (AO) disallowed certain expenditure and made certain additions. It is not necessary to deal with other items except the one on which the question of law has arisen. It was further noticed by the AO that during the year, the assessee had claimed to have paid an amount of ₹35,00,88,000/- to M/s. Oracle Corporation on account of royalty for duplicating and sub-licensing of software to its customers. It may be mentioned here that the assessee company is 100% subsidiary of M/s Oracle Corporation, USA. It was explained by the assessee that royalty was being paid at maximum of 30% of the Indian published price of the Oracle Software for sub-licensing. However, the AO noted that the total revenue earned by the assessee at Delhi unit involved in sub-licensing of software was

to the extent of ₹98,16,72,000/-. Out of which the assessee had earned the following receipts:

(a)	Software Licensing Fee	₹59,68,78,000/-
(b)	Software Technical Support Service Receipts	₹26,00,08,000/-
(c)	Consultancy Charges	₹4,01,20,000/-
(d)	Trading receipts	₹7,93,81,000/-
(e)	Sale of Software Documentation	₹52,85,000/-

Considering that the receipts disclosed on account of software sub-licensing on which the assessee is paying royalty for sub-licensing is only at ₹59,68,78,000/-, the assessee was required to explain as to why provision of Section 92 should not be invoked since even if the royalty is paid at 30% of the sale consideration the amount payable was only to the extent of ₹17.90 Crores. Being dissatisfied by the explanation furnished by the assessee in this regard and for the reasons recorded in the order of assessment the disallowance of ₹17,10,24,600/- was made by the AO under Section 92 read with Section 37(1) of the Act on account of payment of royalty beyond 30% of the sub-licensing fee earned by the assessee. The assessment was, however, framed by determining total taxable income at ₹38,36,55,851/-.

5. Feeling aggrieved by the assessment order, the assessee preferred the appeal before the CIT (A), which was allowed partly by the CIT (A). Insofar as the issue of royalty is concerned, the CIT (A), however, upheld the disallowance made by the AO on the ground that a significant amount of profit had been siphoned off to M/s. Oracle Corporation, USA by paying royalty by ignoring the saleable price of the product. As regards the applicability of provisions of Section 92 of the Act, the CIT (A) after examining the facts of the case and also the relevant rules in this regard held that the provisions of Section 92 of the Act coupled with Rule 10 and 11 were squarely applicable to the case of the assessee. Consequentially, the disallowances of royalty of ₹17,10,24,600/- was sustained for the specific reasons recorded in the order. Further, the assessee had also contended before the First Appellate Authority that the AO ought to have allowed provisions of leave encashment amounting to ₹30,67,728/- created by the assessee during the year. However, the aforesaid ground was rejected by the CIT (A) by *inter alia* observing that no such provision was claimed by the assessee for the Assessment Year 1998-99 for denying the benefit of the aforesaid claim made by the assessee.

6. The order of the CIT (A) was not accepted by the assessee on this issue and by the Revenue on other issues which led to filing appeals by both the parties before the Income Tax Appellate Tribunal (hereinafter referred to as 'the Tribunal'). The appeals filed by the assessee have been allowed on the aforesaid issue and the appeals of Revenue have been dismissed in terms of impugned consolidated order dated 29.08.2008.

7. On the issue at hand, the Tribunal had held that the assessee would be entitled to get the deduction in respect of entire amount paid by it to parent company by way of royalty. The order of the Tribunal further reveals that according to it, pre-condition for invoking the provisions of Section 92 of the Act, viz., there is no profit or less than ordinary profit accruing to the resident assessee on account of business connection between the resident and non-resident has not been established. Therefore, Section 92 of the Act would have no application to the facts of this case. The Tribunal has concluded that since the assessee itself had declared profits of amount of ₹1227.40 lacs in the return for the income for this year, it was not the case of no profit. The Tribunal has also answered another facet of Section 92 of the Act, viz., as to whether it can be said that the profits earned by the assessee are less than the ordinary by holding that the AO did not bring

on record any comparable case as to what is the ordinary profit in this type of business. Thus, the Revenue has not discharged its onus by proving that the profit being earned by the assessee is ordinary profit in this type of business and hence, Section 92 of the Act could not be invoked.

8. Ms. P.L. Bansal, learned Sr. Standing Counsel appearing for Income Tax Department, made a fervent attack on the aforesaid conclusion of the Tribunal holding that Section 92 of the Act would not be applicable. She was vehement in her submission that the order of the AO as well as CIT (A) were replete with adequate justification invoking the provisions of Section 92 of the Act which were glossed over by the Tribunal. She highlighted the fact that in the income tax return, the assessee had shown its total receipts from software sub-licensing to the tune of ₹59,68,78,000/- and sale of software documentation was ₹52,85,000/- only on which the assessee was profiting royalty to its parent company for sub-licensing sale of software duplicating in India. The affairs were managed in such a manner that the Indian Published Prize (IPP) was taken into consideration while calculating royalty at 30%. However, the software was sold at a lesser rate and income received on this account was ₹59.68 Crores. 30% thereof amounted to ₹17.9 Crores only whereas actual royalty paid was ₹35.01 Crores, as it was calculated on higher amount, viz., IPP.

Thus, stressed the learned Senior Standing Counsel, the affairs were arranged in such a manner that though the assessee was earning lesser revenue, it was paying more royalty, even at its own loss. In this backdrop, according to the learned Senior Counsel, the AO had rightly disallowed ₹17,10,24,600/- (₹35,00,88,000 - ₹17,90,63,400/-).

9. Predicated on these facts, the learned counsel proceeded to make following submissions with legal arguments:

1) The expenses were to be allowed under Section 37 of the Act. However, when IPP was not the genuine basis, as it was not the price at which the commodity was sold by the assessee in India and no effort was made by the assessee with the parent company to get it changed to payment of royalty on actual sales, this was clearly superfluous and therefore, not permissible under Section 37(1) of the Act.

2) Section 92 of the Act was the second step after finding justification of the expenses under Section 37 of the Act. The Tribunal had not done any exercise or looked the matter from the point of view of Section 37 of the Act and straightaway jumped to second step. Ms. Bansal's submission was that first provisions of Section 37 were to be applied as per which burden

was on the assessee to demonstrate as to how IPP was arrived at.

3) She also submitted that the Tribunal erred in not giving any weightage to the submission that ordinary revenue and royalty was paid at actual price and agreement was arrived at by the assessee with its parent company should not have been accepted on its face value.

10. Mr. M.S. Syali, learned Senior Counsel, appeared for the assessee countered the aforesaid submissions of Ms. Bansal. He stressed that the conclusion of the Tribunal was based on correct understanding of the law. Rather the approach of the AO was impermissible, who had mixed up the provisions of Section 37 and Section 92 of the Act. His submission, in this behalf, was that Section 37 is expenses oriented in nature and the focus of this provision was to see whether expenses incurred were wholly or exclusively for the purpose of business to entitle the same for deduction. On the other hand, Section 92 of the Act was pricing oriented. On this aspect, the learned Senior counsel pointed out that the price fixed as per the agreement was Arm's Length Price which was accepted even by the Transfer Pricing Officer (TPO) after holding appropriate inquiry. He referred to the orders dated 10.03.2005 (*sic.*) passed by the Joint Commissioner of Income Tax in his capacity

as TPO-II under Section 92CA(3) accepting the price as ALP for the Assessment Year 2002-03 in the following words:

> "After examination of the documentation and economic analyses contained therein the Arm's Length Price (ALP) of the international transactions, as declared by the assessee in Form 3CEB, annexed to the return of income is accepted."

Orders to similar effect accepting this price by the TPO for other Assessment Years were also produced before us. The learned Senior counsel pointed out that the AO was conscious of these facts as is evident from the reading of the assessment order passed for the Assessment Year 2003-04 wherein it was *inter alia* recorded as under:

> "Although the Transfer Pricing Officer after examination of the company's transfer pricing documentation accepted the international transaction as per the Transfer, Pricing adopted by the company vide order dated 27.01.2006. Payment of royalty was decided by the TPO with respect to the provisions of Section 92CA of the I.T. Act, whereas the disallowance made on the issue here is in view of the fact that the payment made has been found not to be wholly and exclusively for business purpose of the assessee and hence is being made U/s 37(1) of the I.T. Act."

11. He, thus, argued that it is clear that the AO was wrong in mixing up the provisions of Section 92CA and Section 37 of the Act thereby falling into legal error. It was also the argument of the learned Senior counsel that the assessee was making payments of royalty to its parent company under the same agreement on the same basis right from the Assessment Year

1994-95. However, in respect of Assessment Years 1994-95 to 1998-99, this expenditure was not even questioned and royalty paid in those years was allowed as expenditure in toto. The decision by Income Tax Appellate Tribunal, Mumbai Bench in the case of ***Reuters India Pvt. Ltd. Vs. Deputy Commissioner of Income Tax*** (in ITA Nos.1089 & 4744/Del/04) was referred to in addition to the orders passed by the Income Tax Appellate Tribunal, Delhi Bench in the case of ***Assistant Commissioner of Income Tax Vs. Nestle India Ltd.*** **[94 TTJ (Del.) 53]**.

12. Insofar as first decision in ***Reuters India Pvt. Ltd. (supra)*** is concerned, the purpose was to show that in order to determine the applicability of Section 92 of the Act to see as to whether the profits could be termed as no profit or lesser ordinary profit, it was for the AO to bring on record comparable case to find out as to what is the ordinary profit in the type of business. If that exercise is not done, the profits by the assessee could not be treated as the case of 'no profit or lesser ordinary profit'.

13. Insofar as decision in ***Nestle India Ltd. (supra)*** is concerned, the same was pressed into service for limited purpose, viz., burden was upon the AO to prove that the circumstances stipulated in special provision (like Section 92 of the Act in the instant case) and not upon the assessee. Though at the same

time, under provisions of Section 37(1) of the Act, the primary burden to substantiate the claim of deduction of expenditure lay on the assessee.

14. We have given our thoughtful consideration to the respective submissions. From the aforesaid narration, the salient features which have emerged on record in the present case may first be recapitulated. The same are as under:

    (i) There is an agreement between the assessee and its parent company which provides for payment of royalty @ 30% of IPP of the Oracle Software appliances.

    (ii) This agreement is approved by the Reserve Bank of India. The copy of the RBI Notification was filed before the AO who has mentioned about it in the assessment order. This Notification categorically permits the remission of foreign currency upto 30% of IPP. However, we may hasten to add that for the purpose of Section 92, this may not be a relevant factor and therefore we are not influenced by the same.

    (iii) The price fixed is accepted as Arm's Length Price by the TPO under Section 92 of the Act.

(iv) From the Assessment Years 1994-95 to 1998-99, royalty paid as per the aforesaid agreement by the assessee to its parent company was allowed.

15. Section 92 of the Act, which is held to be applicable by the AO reads as under:

> "**Section 92.Computation of income from international transaction having regard to arm's length price.**
>
> (1) Any income arising from an international transaction shall be computed having regard to the arm's length price.
>
> Explanation.-For the removal of doubts, it is hereby clarified that the allowance for any expense or interest arising from an international transaction shall also be determined having regard to the arm's length price.
>
> (2) Where in an international transaction, two or more associated enterprises enter into a mutual agreement or arrangement for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises, the cost or expense allocated or apportioned to, or, as the case may be, contributed by, any such enterprise shall be determined having regard to the arm's length price of such benefit, service or facility, as the case may be.
>
> (3) The provisions of this section shall not apply in a case where the computation of income under sub-section (1) or the determination of the allowance for any expense or interest under that sub-section, or the determination of any cost or expense allocated or apportioned, or, as the case may be, contributed under sub-section (2), has the effect of reducing the income chargeable to tax or increasing the loss, as the case may be, computed on the basis of entries made in the books of account in respect of the previous year in which the international transaction was entered into."

16. If the conditions mentioned in this provision are satisfied, this Section empowers the AO to determine the amount of profits which is reasonably deemed to have been derived from there. In the process, the AO is authorized to include such amount in the total income of the respondent (assessee herein). For the purpose of assumption of jurisdiction under this provision, it is necessary to establish:

    (a) Business is carried between a resident and a non-resident;

    (b) Close connection between resident and a non-resident ;

    (c) The course of business between the resident and a non-resident is so arranged that the business transacted between them provides to the resident either (i) no profits, or (ii) less than the ordinary profits, which might be expected to arise in the business.

17. The first two conditions are undoubtedly satisfied. It is, thus, to be examined as to whether it is a case where the transaction between the assessee and its parent company, viz., payment of royalty @ 30% on IPP instead actual sale price has resulted in no profit or less than the ordinary profits which might be expected to arise in the business. The assessee has declared

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an income of ₹1227.40 lacs. Thus, it is not a case of 'no profits'. The neat question is as to how one is to determine as to whether the profits are less than the ordinary profits which might be expected to arise in the business? Obviously, this can be found only when exercise is undertaken comparing the income of the assessee with other comparable business enterprises in India. However, the AO did not do this exercise at all. He did not bring on record any comparable case to find out what is ordinary profit in this type of business. Definitely, onus in this behalf under the provisions of Section 92 of the Act lay on the AO. This pertinent aspect coupled with the fact that price fixed is acceptable as Arm's Length Price by the TPO under Section 92 of the Act itself is sufficient to clinch the issue in favour of the assessee.

18. In this backdrop, we have to examine whether such an expenditure could still be disallowed and the opinion of the AO was correct that in the aforesaid scenario, the payment made cannot be treated to be wholly and exclusively for business purpose of the assessee to enable it to cover the same under Section 37(1) of the Act. As noted above, Ms. Bansal, learned counsel for the Revenue had argued that since the payment of royalty on TPO was not the genuine basis as the goods had not been sold at IPP, but at much lesser price, payment of royalty on IPP rather than on actual sales is superfluous and not

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permissible under Section 37(1) of the Act. It is difficult to accept such an argument. Once it is held that the payment of royalty by the assessee to its parent company is not hit by the provisions of Section 92 of the Act and the price fixed is ALP as determined by the TPO himself, there is no reason to hold that the expenses would not be allowed under Section 37(1) of the Act. This provision reads as under:

> "**Section 37: General**
>
> (1) Any expenditure (not being expenditure of the nature described in sections 30 to 36 and not being in the nature of capital expenditure or personal expenses of the assessee), laid out or expended wholly and exclusively for the purposes of the business or profession shall be allowed in computing the income chargeable under the head "Profits and gains of business or profession".

19. It is, thus, clear that what is to be seen is that the expenditure was incurred by the assessee in the course of business and had nexus with the business of the assessee. It could not be disputed that the payment of royalty is a business expenditure, which was expended wholly and exclusively for the purpose of business of the assessee. The nature of the expenses is also not such which would fall in any of the exceptions carved out under Section 30 and 36 of the Act. Once these conditions are satisfied, the expense is to be allowed in toto as business expenditure, and the Revenue cannot sit in the arm's chair of the assessee and decide as to how affairs of the business are to

be run and wasteful or excessive expenditure is to be curtailed. The question of commercial expediency is to be judged by the assessee and not by the AO. Following test was laid down in the case of ***Atherton Vs. British Insulated & Helsby Cables Ltd.*** reported as **10 TC 155, 191 (HL)** in the following terms:

> "A sum of money expended, not of necessity and with a view to a direct and immediate benefit to the trade, but voluntarily and on the grounds of commercial expediency and in order indirectly to facilitate the carrying on the business, may yet be expended wholly and exclusively for the purposes of the trade."

The above test was quoted with approval and applied by the Supreme Court in the case of ***Eastern Investments Ltd. Vs. Commissioner of Income Tax*, 20 ITR 1**.

20. It is well-settled that it is not open to the Department to adopt a subjective standard of reasonableness and disallow a part of business expenditure as being unreasonably large, or decide what type of expenditure the assessee should incur and in what circumstances. This was so held by the Supreme Court in the case of ***Commissioner of Income Tax Vs. Walchand*, 65 ITR 381** which principle has thereafter been often repeated and remains the bedrock of Section 37 of the Act till date. Thus, the jurisdiction of the AO is only confined to deicide "Profits and gains of business or profession", i.e., whether the expenditure claimed was actually and factually expended or not and whether it was wholly and exclusive for the purposes of

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business. Reasonableness of the expenditure can be considered only from this limited angle for the purpose of determining whether in fact amount was spent or not.

21. Mr. Syali, learned Senior Counsel was right in his submission that Section 37 was expenses oriented in nature and the focus of this provision was to see whether expenses incurred were wholly or exclusively for the purpose of business to entitle the same for deduction. The AO committed serious error in mixing the provisions of Section 92 and Section 37 of the Act.

22. The upshot of the aforesaid discussion leads us to conclude that the Tribunal was justified in law in allowing the deduction disallowed by the AO being royalty paid by the assessee to its holding company. Resultantly, these appeals warrant to be dismissed, but there shall be no orders as to cost.

(A.K. SIKRI)
JUDGE

(M.L. MEHTA)
JUDGE

MARCH 30, 2011
pmc