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

\+ **ITA No. 1226 OF 2010**

% Decision Delivered On: 26.7.2011

KYUNGSHIN INDUSTRIAL MOTHERSON LIMIT . . APPELLANT
THROUGH: Mr. C.S. Aggarwal, Sr. Advocate with Mr. Prakash Kumar, Advocate.

VERSUS

COMMISSIONER OF INCOME TAX ...RESPONDENT
THROUGH: Mr. Sanjeev Sabharwal, Advocate.

CORAM :-

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

A.K. SIKRI, J. (oral)

Admit.

1. Following questions of law arise for consideration:-

(i) Whether the income Tax Appellate Tribunal was justified in law in sustaining a disallowance of ₹ 14,50,000/- out of the total claim of expenditure of ₹ 58,00,000/- u/s 37(1) of the Income Tax Act, 1961, being the Royalty paid to M/s Kyungshin Industrial Co. Ltd., South Korea by treating 25% of the expenditure to be on capital account?

(ii) Whether on true and correct interpretation of the "Technical Assistance and Licensing Agreement" dated 21.10.1997 between M/s Kyungshin industrial Co. Ltd., South Korea and the assessee, the Income Tax Appellate Tribunal was justified n law in holding that the expenditure of account of Royalty involves both capital and revenue outlays?"

2. With the consent of the parties we have heard the matter finally and proceed to decide the same.

3. First the facts in brief.

The appellant company (hereinafter referred to as 'the assessee') is engaged in the business of manufacturing of integrated wiring harness, mainly for automobile industry in India. The Company is 50:50 Joint Venture between Motherson Sumi System Limited and Kyungshin Industrial Corporation, Korea. It had entered into "Technical Assistance and Licence Agreement" dated 21.10.1997 with M/s Kyungshin Industrial Co. ltd. a company formed under the laws of Korea (hereinafter referred to as the KIC) which had agreed to provide the assessee technical assistance. Under this Agreement, the KIC was obliged to provide the assessee technical information and grant right and license to manufacture, process, assemble, use and sell in the sales territory, integrated wiring harness and such other products as may be mutually agreed to by the parties and also provide such technical services as may be required for manufacturing and

selling the products by the appellant. Such an assistance was to be provided for a period of 5 years which expired on 31.07.2003. However by supplementary agreement dated 18.11.2003, the aforesaid agreement was renewed for further period of 5 years. As per Article 7 of the Agreement dated 21.10.1997, the assessee was obliged to pay a running royalty @ 5% of net sales in the territories of India and 7% of net sales by way of exports. The payment was to be made after withholding taxes to the authorities. Since Article 7 of the aforesaid Agreement has bearing on the outcome, the same is being reproduced below:-

> "Article 7-Consideration
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> 7.1 In consideration of the grant of Licence and the Technical Information, KIM agrees to pay to KIC a running royalty @ 5% (five percent) of the Net Sales Price of the Products for domestic sales and 7% (Seven percent) of Net Sales Price for direct export sales of the Products.
> The payment of royalty shall be valid for a period of 5(five) years from the date of Commencement of production of the Product. The royalty of 5%(Five percent) for domestic sales and 7% (Seven Percent) for direct export sales respectively shall be made after deduction or withholding all taxes imposed in the territory in respect of and required by law to be deducted or withheld from such payment, KIM shall be responsible for payment to the relevant taxation authorities in the territory. KIM shall also provide KIC with the relevant tax certificates evidencing the payment of such taxes."

4. Article 11 of the Agreement provided that the said agreement can be terminated in the event of either party remaining in breach of any of its obligations for more than 60 days. For the instant assessment year 2002-03, the assessee filed its return of income on 30.10.2002, declaring an income of ₹29,25,936/-. In this return, the assessee had debited an amount of ₹58,00,000/- from the Profit & Loss Account toward payment of royalty. The aforesaid amount was paid as per the "Technical Assistance Licensing Agreement" entered on 21.10.1997 between the KIC and the assessee.

5. The Assessing Officer by an order dated 31.3.2005 u/s 143 (3) of the Act, computed taxable income at ₹ 44,75,000/-. In the process the Assessing Officer (AO) made a disallowance of ₹14,50,000/- being 25% of the total royalty payment of ₹58,00,000/- claimed by the assessee which was paid to the KIC, by treating the same as capital expenditure. It was done on the premise that developing a new design of product which will ultimately be manufactured, represents capital asset, will give the assessee a benefit of enduring nature. Following are the detailed findings of the AO on this aspect:

(a) The study of clauses of the Agreement clearly indicates that the technical knowledge obtained through this Agreement from the foreign company secured to the assessee an enduring advantage and benefits of the same

was available to the assessee for its manufacturing and industrial process.

(b) As far as royalty payments are concerned, the foreign company makes available to the assessee its procedures, designs, experience and technical know-how in respect of new products. Though the duration of the agreement is 5 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 knowledge of enduring nature.

(c) The assessee has paid a royalty for the acquisition of an exclusive privilege of manufacturing and selling the products. The acquisition of such a right may be treated partly towards capital and partly toward the revenue. The Supreme Court in the case of ***Southern Switch Gear Ltd.*** Vs. ***CIT,*** 232 ITR 359 and the Madras High Court in the same case reported in 148 ITR 272 held that 25% of such royalty expenses constitutes capital expenditure as it gives rise to the assessee a benefit which is of enduring nature and thereby constituting a capital asset.

Thus, 25% of royalty payment of `58 lacs which comes to ₹ 14,50,000/- was disallowed by AO treating it as capital expenditure.

6. In appeal, the CIT (Appeals) confirmed the action of the Assessing Officer and dismissed the appeal of the appellant, by his order dated

4.10.2005. Even the Tribunal, by the impugned order dated 7.8.2009, has confirmed the action of the Commissioner of Income Tax (Appeals) in upholding the disallowance made by the Assessing Officer of ₹ 14,50,000/- out of the royalty payment of ₹ 58,00,000/- by treating 25% of royalty paid as capital expenditure. It has substantially adopted the same reasoning as given by the AO & CIT (A) and rested its decision by heavily relying upon ***Southern Switch Gears Ltd.*** (supra).

7. The assessee had argued that the expenditure was allowed in the previous two years by the AO. However, the Ld. Tribunal was of the view that the rule of consistency cannot be invoked in this case because after realizing the mistake, the proceedings for third year were reopened to disallow a part of the expenditure as capital expenditure.

8. We may mention here that it was also the case of the assessee that the whole of the expenditure ought to have been capitalized in the first year. In such a case, the assessee would be entitled to get deduction of the expenditure u/s 35AB in six years. Alternatively, if it was capitalized in respective years, the assessee would be entitled to deduction u/s 35AB for and up to assessment year 1998-99 and deduction of depreciation on capital expenditure thereafter. This contention was repelled on the ground that these matters were not taken up before the lower authorities and, therefore, they do not arise out of the orders of the lower authorities.

9. Assailing the aforesaid order, present appeal is preferred which is admitted on the question of law specified in the beginning of the order. It is however clear that the question is as to whether the payment of royalty under the Act is on capital account or it is revenue. We may mention that 75% of the expenditure is treated as revenue outlay, therefore, whether balance 25% could be on capital account or not is the precise issue.

10. Mr. C.S. Aggarwal, learned Senior Counsel appearing for the assessee submitted that the Tribunal has failed to appreciate that the assessee company has acquired no capital asset under the agreement, in all what assessee had been granted was an exclusive privilege for manufacturing and selling products that too for a limited period of five years. It is submitted that where even if an expenditure has been incurred for obtaining advantage of enduring benefit, it cannot be regarded as capital expenditure as held by the Supreme Court in the case of ***Empire Jute Co. Ltd.*** Vs. ***CIT***, 124 ITR 1 (SC) He specifically referred to the following discussion in that case:-

> "If the advantage consists merely in facilitating the asessee's trading operations or enabling the management and conduct of the assessee's business to be carried on more efficiently or more profitably while leaving the fixed capital untouched, the expenditure would be on revenue account, even though the advantage may endure for an indefinite future. The test of enduring benefit is, therefore, not a certain or conclusive test and it cannot be applied blindly and mechanically without regard to the particular facts and circumstances of a given case.

11. His further submission was that the judgment of the Madras high Court in the case of Southern Switch Gear Ltd. 148 ITR 272 and upheld by the Supreme Court is not applicable on the facts of the instant case and argued that the issue was squarely covered in favour of the assessee in the following cases:-

(i) ***Denso Haryana P. Ltd.*** Vs. ***CIT***, (ITA No. 381/2009 dated 5.11.2010 (Del.)
(ii) ***CIT*** Vs. ***Sharda Motor Industrial Limited,*** 319 ITR 109 (Del).
(iii) ***Climate Systems India Ltd.*** Vs. ***CIT,*** 319 ITR 113 (Del.)
(iv) ***CIT*** Vs. ***J.K. Synthetics Ltd.*** 309 ITR 371 (Del.)

12. In the alternative, he submitted that in case it is held that the Tribunal was right in upholding 1/4th of the expenditure incurred representing royalty payment as capital expenditure, it is prayed that directions may be given to allow depreciation u/s 32(1) (ii) of the Income Tax Act, 1961 on the 1/4th of the expenditure incurred representing royalty payment treated as capital expenditure.

13. Learned counsel for the respondent, on the other hand, strongly relied upon the reasoning given by the authorities below and submitted that judgment in the case of ***Southern Switch Gears Ltd*** *(supra)* was fully applicable and the appeal should be dismissed.

14. After considering the contentions of both the parties and on perusal of various clauses of the Agreement entered into between the assessee and

the KIC, we are of the opinion that entire payment of ₹ 58 lacs is to be treated on revenue account and it was not proper to treat 25% of the aforesaid payment as capital in nature. The facts noted above would disclose that the royalty of ₹ 58 lacs paid by the appellant company to the KIC was only towards utilizing the knowledge, process and patents etc. and not for the transfer of such assets to the appellant company. Moreover, the assessee had paid the royalty to its joint venture partner @ 5% on the net selling price biannually after deducting a withholding tax @20% on such amount of royalty. The royalty agreement is duly approved by the Reserve Bank of India. Since, royalty paid by the assessee is a running royalty based upon the sales made by the assessee in India or abroad is purely of revenue linked as it is linked to revenue item "sales'. It, therefore, qualifies as business expenditure u/s 37 (1) of the Act.

15. In identical circumstances, this Court in ***Denso Haryana P. Ltd.****(supra)* reversed the order of the Tribunal of 1/4th disallowance of payments made for use of know-how holding that the entire expenditure was revenue expenditure as no asset, whatsoever, had been acquired by the assessee by making such payment

16. We also find that the assessee had been incurring the expenditure regularly under the terms of the aforesaid agreement. The said

expenditure was allowed in the assessment years 1999-2000, 2000-01 and 2001-02. The revenue itself has not taken consistent stand with regard to the treatment given to the payments of royalty made under the same "Technical Assistance and Licensing Agreement" dated 21.10.1997 to the KIC.

17. We do not agree with the view of the learned CIT (A) that principle of consistency is not applicable.

18. The questions are thus decided in favour of the assessee, as a result, this appeal is allowed.

(A.K. SIKRI)
JUDGE

(M.L. MEHTA)
JUDGE

JULY 26,2011
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