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

Reserved on: 07.01.2015
Pronounced on: 30.01.2015

\+ **ITA 614/2014**

COMMISSIONER OF INCOME TAX-VI ..... Appellant

versus

M/S. YUM RESTAURANTS (I) PVT. LTD. ..... Respondent

\+ **ITA 619/2014**

COMMISSIONER OF INCOME TAX-VI ..... Appellant

versus

M/S. YUM RESTAURANTS (I) PVT. LTD. ..... Respondent

\+ **ITA 661/2014**

COMMISSIONER OF INCOME TAX-VI ..... Appellant

versus

M/S. YUM RESTAURANTS (I) PVT. LTD. ..... Respondent

\+ **ITA 710/2014**

COMMISSIONER OF INCOME TAX-VI ..... Appellant

versus

M/S. YUM RESTAURANTS (I) PVT. LTD. ..... Respondent

\+ **ITA 151/2012, C.M. APPL.14484/2012, 14485/2012 & 14486/2012**

COMMISSIONER OF INCOME TAX ..... Appellant

versus

YUM RESTAURANTS INDIA PVT. LTD. ..... Respondent

+ **ITA 152/2012, C.M. APPL.14478/2012, 14479/2012 & 14480/2012**

COMMISSIONER OF INCOME TAX ..... Appellant

versus

YUM RESTAURANTS INDIA PVT. LTD. ..... Respondent

+ **ITA 158/2012, C.M. APPL.14481/2012, 14482/2012 & 14483/2012**

COMMISSIONER OF INCOME TAX ..... Appellant

versus

YUM RESTAURANTS INDIA PVT. LTD. ..... Respondent

Through : Ms. Suruchii Aggarwal, Sr. Standing Counsel with Sh. Aamin Aziz, Advocate, for appellants in ITA Nos. 614/2014, 619/2014, 661/2014 and 710/2014.

Sh. Kamal Sawhney, Sr. Standing Cousnel with Sh. Sanjay Kumar, Jr. Standing Counsel, for appellants in ITA Nos. 151/2012, 152/2012 and 158/2012.

Sh. Nageswar Rao, Sh. Shailesh Kumar and Ms. Sayaree Basu Mallik, Advocates, for respondents in ITA Nos. 614/2014, 619/2014, 661/2014, 710/2014, 151/2012, 152/2012 and 158/2012.

CORAM:
HON'BLE MR. JUSTICE S. RAVINDRA BHAT
HON'BLE MR. JUSTICE R.K. GAUBA

MR. JUSTICE S. RAVINDRA BHAT

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1. In these appeals under Section 260A of the Income Tax Act, 1961, the following substantial questions are framed, after hearing counsel for the parties:

(i) Did the Income Tax Appellate Tribunal (ITAT) err in accepting the assessee/respondent's plea that *"service income"* declared for the concerned years was *"business income"* and not *"income from other sources"* as argued by the revenue, in the circumstances of the case;

(ii) Was the assessee's claim for royalty payment deduction not sustainable in law, on account of the operation of Explanation to Section 37 (1) of the Income Tax Act, 1961 since the said amounts could not have been collected on account of lack of approval of the Secretariat for Industrial Assistance (SIA);

(iii) Whether, on the facts of the case, the ITAT could have deleted the addition made from out of administrative expenses since they related to another company YRMPL, which had apparently no office and had not incurred any expenses;

(iv) Whether ITAT was correct in law and on facts in failing to give direction in respect of disallowance on account of non-business use of some specific assets;

(v) Did the ITAT commit an error in law in not appreciating that the expenses for food tasting and trials were incurred to develop food items/flavors that would be used by the assessee for a number of years, and to develop items of enduring nature, that should have, therefore, been capitalized;

(vi) Was the ITAT correct in upholding the assessee's claim for provisional liability in the context of the revenue's contention that such claim was not based on any scientific method or on any reasonable past experience?

2. All the questions are common to these appeals and, therefore, would be discussed together. The facts in brief are that the assessee had filed its return of income on 28.10.2002 declaring total income at NIL. The return was selected for scrutiny assessment and a notice was issued. The Assessing Officer (AO) felt that assessee's accounts were of complex nature and he duly sent them for special audit. This reference was challenged before this High Court; ultimately the special audit order was upheld. The Special Auditor handed over the report on 5.10.2005.

3. The assessee was incorporated as an Indian Company and is engaged in the business of Pizza Hut ("PHILLC") and Kentucky Fried Chicken ("KFCEEC") restaurants in India. It had entered into a technology license agreement with Kentucky Fried Chicken International holdings Inc. and Pizza Hut international LLC to operate KFC Restaurants and Pizza Hut in India. In terms of those agreements, the assessee could (and did) enter into franchise agreements with various entities in India to operate such restaurants.

4. The main source of assessee's income is service income, also called stewardship fees, and Supply Chain Management fees (hereinafter referred to "SCM"). This service income is governed by an agreement entered into by the assessee with M/s. Tricon Restaurant International Inc. (renamed as

"Yum Restaurant International SWC" and referred as "YRI" hereinafter). This agreement was entered on 01.04.2001. In terms of the agreement, the assessee was under an obligation to provide assistance:-

i) to existing and future licensees in India, Mauritius, Pakistan, Sri Lanka and such other areas upon which the parties may agree from time to time;

ii) In providing Tricon Restaurant International Inc. with such reports concerning the above matters as may be reasonably required by them from time to time.

iii) In collection and onward remittance of license fee, and such other fees as may be payable by the licensees, to KFCIH and PHILLC.

iv) In acting generally on behalf of Tricon Restaurant International Inc. in a liaison capacity in connection with the existing and the potential licensees and/or such other matters. The agreement *inter alia*, stated:

> *"Providing assistance to existing and future licensees in India, Mauritius, Pakistan, Sri Lanka and such other areas upon which the parties may agree from time to time; Providing TRI with such reports concerning the above matters as may be reasonably required by them from time to time.*
>
> *Collection and onward remittance of license fee, and such other fees as may be payable by the licensees, to KFCIH and PHILLC. Acting generally on behalf of TRI in a liaison capacity in connection with the existing and the potential licensees and/or such other matters."*

For these services the assessee was entitled to a fee equal to 110% of all costs reasonably incurred by it in the performance of such service. The other

important source of income was Supply Chain Management Fees. This is recognized income as per agreement entered into with supplier of materials to the franchise.

5. The assessee has earned service income aggregating to Rs.12,67,04,206/-. The AO treated this service income as "income from other sources". The AO held that in earlier assessment years, the service income received was equivalent to the cost incurred, whereas in the concerned assessment year, the income received was equivalent to 110% of the expenditure. The assessee's claim for deduction of royalty was likewise rejected on the ground that it was a prohibited "technical fee" for which SIA approval had been given for a period of 7 years, after lapse of which it could not be claimed in the form of royalty. The third issue pertained to disallowance of expense towards office premises, which it shared with a sister concern, YRPM. Here too, the CIT(A) accepted the assessee's contentions. The fourth question decided by ITAT was in respect of use of business assets: the AO held that some assets were of a personal nature given to the assessee's employees and had to, therefore, be disallowed. The Appellate Commissioner ("CIT(A)") accepted the assessee's contentions on this question and ruled that the income had to be treated as business income. It was held that the services provided were

> *"...of multifarious nature viz. provision of support services to franchisees, collection and remittance of royalty to brand holders in the US, assistance provided for R&D activity, etc. Against such services, service income equivalent to 110% of all costs incurred has been earned by the appellant. The act and course of services provided by the appellant constitute a systematic organized activity conducted with a special purpose*

as the provision of services is not an isolated transaction but the same has been continuously provided since A.Y. 1998-99 and as informed the appellant continuing even in the present date. Hence, the earning of service income cannot be classified under any other head but business income since all the essential parameters of classifying the said activity as business are fulfilled in the facts and circumstances of present case. Further, it not in dispute that the entire expenditure debited in the P&L account has been accepted by the A.O. as business expenditure. Now, if expenditure is held to be business expenditure, service income computed on the basis of 110% of such expenditure cannot be anything but Business Income. Although, the AO has propositioned that the service income earned by the appellant is not a Business Income but Income from Other Sources, however, in complete contradiction, the expenditure which forms the basis for computation of the service income has been held to be business expenditure…. In my view, the existence and operation of the Pizza Hut Restaurants and KFC Restaurants in various cities across India can be seen by any body and needs no proof. These outlets are either operated by the appellant or operated through franchisees. These franchisees have been provided with support services on behalf or the brand holders as discussed earlier. In addition to the provision of these services to the franchisee, the appellant has also provided services to the brand holders in USA by way of collection and remittance of royalty, providing them services by way of research and development etc. All such activities visible and there is evidence to substantiate these activities. There exists a contractual agreement under which the services have been provided, and the service income has been earned, received and accounted for as such, all of which remains uncontroverted."

6. These findings were affirmed by the ITAT. The ITAT also noted the CIT(A)'s observations that for all previous assessments, this income had been treated as business income. Before this Court, the revenue urged that no commercial activity was discernible on the assessee's part to earn the

said service fee and that no business assets were deployed. It was submitted that the mere earning of some income in a mechanical manner or the accretion of certain sums on a regular basis would not mean that it is business income; while its receipt as income cannot be denied, its essential character or true description is as income from other sources.

7. Under Section 2 (24) of the Income Tax Act, 1961 "income" includes business income and profits from business. Section 2 (13) defines "business" *in the following manner:*

> *"(13) "business" includes any trade, commerce or manufacture or any adventure or concern in the nature of trade, commerce or manufacture;"*

Long ago, in Narain Swadeshi Weaving Mills vs The Commissioner of Excess Profits Tax AIR 1955 SC 176 *it was held the term "business"* has to be given a broad meaning:

> *"Whether a particular activity amounts to any trade, commerce or manufacture or any adventure in the nature of trade, commerce or manufacture is always a difficult question to answer. On the one hand it has been pointed out by the Judicial Committee in Commissioner of Income-tax v. Shaw Wallace & Co. ((1932) I.L.R. 59 Cal. 1343), that the words used in that definition are no doubt wide but underlying each of them is the fundamental idea of the continuous exercise of an activity. The word "business" connotes some real, substantial and systematic or organised course of activity or conduct with a set purpose. On the others hand, a single and isolated transaction has been held to be conceivably capable of falling within the definition of business as being an adventure in the nature of trade provided the transaction bears clear indicia of trade. The question, therefore, whether a particular source of income is business or not must be decided according to our ordinary notions as to what a business is."*

This test of "some real, substantial and systematic or organised course of activity or conduct with a set purpose" to determine whether an activity was *business, was affirmed in Commissioner Income Tax v Distributors (Baroda) (P) Ltd.* AIR 1972 SC 288. Again, in *Barendra Prasad Ray & Ors v Income Tax Officer* AIR 1981 SC 1047 the Supreme Court held that:

> *"the word business is one of wide import and it means an A activity carried on continuously and systematically by a person by the application of his labour or skill with a view to earning an income."*

In view of this settled position, there is no scope for interference with the findings of the CIT (A) and the ITAT on this aspect. This Court thus holds that the "service income" declared by the assesse for the relevant years is business income (Rs.12,67,04,206/-, for 2002-03 in ITA 151/2012, Rs. 12,38,00,000/- for 2003-04 in ITA 152/2012; Rs. 20,26,00,000/- for AY 2006-07 in ITA 158/2012; Rs. 12,77,00,000/-for AY 2004-05 in ITA 614/2014; Rs. 15,71,00,0001- for AY 2005-06 in ITA 619/2012; Rs. 7,61,32,0001- for AY 2007-08 in ITA 661/2014; Rs 10,98,31,254/- for AY 2008-09 in ITA 710/2014).

8. The appeals of the revenue, on the above question, have to fail. The question framed is accordingly, answered in favour of the assessee and against the revenue.

Question No. 2

9. As mentioned earlier, the assessee's business relates to the operation and development of Pizza Hut and Kentucky Fried Chicken restaurants in the Indian sub-continent. For this purpose, the assessee company had

entered into a technology licence agreement on 01.04.1995 with Kentucky Fried Chicken IH (KFCIH). Similarly, another technology licence agreement was executed by the assessee with the Pizza Hut on 15.01.1996. In terms of these agreements, the assessee had the right to use the technology and system in the business of operating service restaurant such as Kentucky Fried Chicken restaurant outlets and Pizza Hut. In both the agreements, it was settled that for grant of licence as a technology, a licence fee would be payable by the assessee which is equivalent of 5% of sales, net of taxes. According to the assessee, effective rate of technology licence fee, therefore, works out to 6.038%. This has been worked out by the assessee as under:

1) Licence fee 5.00%
2) TDS 0.75%
3) R & D Cess 6.038%

10. It is undisputed that the SIA, Union Government had granted approval to the assessee to establish a wholly owned subsidiary in India to open KFC Restaurants. The assessee could, in terms of the arrangement, enter into development agreement with other concerns to open new outlets. During the accounting periods relevant to the concerned assessement years, it entered into agreements with number of entities namely Devyani International (P) Ltd., Speciality Restaurants and Dodsal Corporation. These concerns have set up new outlets. As per the agreements between the assessee and the developers/franchisees, continuing fees at 6.3 per cent on sales is required to be paid by the franchisee to the assessee. It had received a sum of Rs. 3,37,05,801 during the accounting period relevant to the assessment year

2002-03 and other amounts for the later years in dispute. Terming as continuing fees, the assessee had, from the franchise, remitted royalty aggregating to Rs. 3,23,10,030/- to the principals abroad. The AO disallowed this payment of royalty to the principal holding that the Central Government had restricted royalty payment in its initial approval, and the assessee was permitted to pay technical service fee only. The AO felt that technical service fee and royalty were distinct and separate. It was held that the assessee termed the "technical service fee" as "royalty" to evade the condition in the SIA approval which restricted payment of technical service fee for seven years. Observing that payments were made to the parent companies by the assessee, the AO was of the opinion that their constituting payments in lieu of dividend could not be ruled out.

11. The CIT (A), on being approached by the assessee, went on to consider the documents, and held as follows:

> *"9.13. The contents of the assessment order, material on record and the written submissions and arguments made by the appellant have been considered by me. The impugned payment of Rs.3,23,01,939 has been made by the appellant towards licence fee paid pursuant to the technical licence agreements with the owners of the technology and systems and claimed as a business expenditure. Against the expenditure of Rs. 3,23,01,939, the appellant has directly earned an income of Rs. 3,37,05,801 as continuing fee from the franchisees, which is an undisputed fact. Thus, there is accrual of direct income against impugned expenditure claimed as business expenditure by the appellant. Therefore, in my view, the expenditure of Rs.3,23,01,939 paid as licence fee and shown as royalty payment in the balance sheet deserves to be allowed as a business expenditure. Further, the main contention of the Assessing Officer for making the disallowance is that the appellant was permitted to remit*

technical fees as per the Government approvals whereas the appellant remitted royalty which, according to the Assessing Officer's interpretation (of all the relevant documents), the appellant was forbidden to do. However, the Asses sing Officer has not made out a case that the disallowance of the impugned amount is on account of infraction of any law. Thus, the whole approach in the assessment order, on this issue, is based on mere technicalities without any importance being attached to the real sum and substance involved. In my view the Assessing Officer has grossly erred in making such a high pitched disallowance so lightly without any real application of mind to the substance of the matter. As regards the various observations made in the assessment order, the appellant has been able to successfully meet all these observations as discussed in the preceding paragraphs and, therefore, the same need not be repeated again. The assessment order also stresses the omission on the part of the appellant to report the impugned payment of Rs. 3,23,01,939 under section 40A(2)(b) in the tax audit report. As clarified by the appellant the impugned payment is not covered under section 40A(2)(b) irrespective of this clarification the impugned payment cannot be said to be excessive or unreasonable taking into account the fact that the licence fee/royalty has been paid at 5 per cent (net of taxes) as per the Government approvals and also the aforesaid transaction being in the nature of an international transaction, the Transfer Pricing Officer vide its order dated February 18, 2005 has held the same to be at the arm's length price. Thus, the disallowance of Rs. 3,23,01,939 being without any basis, is deleted.

9.14 In view of the above discussion, the disallowance of Rs.3,23,01,939 made by the Assessing Officer being without any basis is deleted and the appeal is allowed on this ground."

12. The ITAT went into the documents and materials afresh and concluded, on this point, as follows:

"The main reason for disallowing the royalty payment by the assessee to M/s. KFC International Holding Inc. and M/s. Pizza Hut with whom it had entered into technology licence agreement

is that the Government of India has permitted the assessee to pay technical fees which is restricted to seven years and the assessee is paying it as a royalty. The learned Commissioner of Income-tax (Appeals) has deleted the disallowance on the ground that the assessee has earned an income of Rs.3,37,05,801 as continuing fees from the franchise, because of this technology licence agreement. It has been permitted to collect the fees on behalf of KFC International and Pizza Hut. This permission is in pursuance to the technology licence agreement. The Assessing Officer failed to bring on record any material that the assessee has infringed any law in conducting its business. We have perused the relevant material and also the written submissions of the assessee reproduced by the learned Commissioner of Income-tax (Appeals). In our opinion, the Assessing Officer has misread the approvals granted by the Government of India while arriving at a conclusion that the assessee has not been remitting the payment as per the approvals. In the approval SIA has used expression "royalty as well as fee for technical services" loosely and interchangeably. Apart from all these things, the tax rate for remitting a royalty as well as fee for technical service is 15 per cent. plus the research and development cess. The assessee has paid both these amounts while remitting the payment. The expense is directly related to its business. It has been incurred wholly and exclusively for running the franchises within India. Therefore in our opinion the learned first Appellate Authority has appreciated the facts and circumstances in right perspective and has rightly deleted the disallowance."

13. Mr. Kamal Sawhney and Ms. Suruchii Agarwal, on behalf of the revenue contended that the ITAT fell into error in not seeing that royalty could not be claimed as a deduction because it was not part of the assessee's expenses. It was submitted additionally that since the technical fee permitted to be remitted was only for a period of seven years, the assessee could not lawfully have collected any amount under a different nomenclature, thereby

effectively circumventing the conditions imposed for approval given by SIA. This, it was submitted, amounted to violating the law, and fell within the mischief of Explanation to Section 37 (1). Mr. Nageshwar Rao, learned counsel for the assesse, on the other hand, argued that given the wording of Explanation to Section 37 (1) and the circumstances of this case, there could have been no finding except that royalty was deductible as it was a "pass through" made over directly to the non-resident entities. It was also argued that the revenue could not contend otherwise, because the AO had not probed into the question of whether the royalty element had to be taxed and whether the quantum was excessive, but had merely sought to disallow the amount on technicalities.

14. The income and expenditure account of the assessee has been examined, in addition to the contentions made by the parties. The Press Note, which the CIT (A) took into account, issued by SIA unit of the Ministry of Commerce, reads as follows:

> *"PRESS NOTE NO.2 (2003 SERIES)*
>
> *Subject Liberalization of Foreign Technology Agreement policy and procedures*
>
> *In pursuance of its commitment to progressively liberalise the FDI regime, the Government has reviewed its policy governing the payment of royalties under Foreign Technology Collaboration.*
>
> *2. Presently, wholly owned subsidiaries are permitted to make payment of royalty up to 8% on exports and 5% on domestic sales to their offshore parent companies on the automatic route without any restriction on the duration of the royalty payments.*

However, royalty payments by other companies are allowed for a period not exceeding seven years from the date of commencement of commercial production or ten years from the date of agreement, whichever is earlier.

3. With a view to further liberalising the foreign technology collaboration agreement policy and extending a uniform policy dispensation, it has now been decided that all companies, irrespective of the extent of foreign equity in the shareholding, who have entered into foreign technology collaboration agreements may henceforth be permitted on the automatic approval route, to make royalty payments at 8% on exports and 5% on domestic sales without any restriction on the duration of the royalty payments. The ceiling on payment of lumpsum fee/ royalty on the automatic route would continue to apply in all cases."

The Central Government's clarification issued to the assessee, pursuant to its query about the payment of royalty, dated 29/30-09-2003, reads as follows:

"Subject: This Ministry's approval letter of even number 10-12-1993 clarification regarding duration of royalty payment.

Dear Sirs,

I am directed to refer to your letter dated 18.08.2003 on the above mentioned subject and to clarify that In terms of the Press Note No. 9 (2000 Series) and Press Note No. 2 (2003 series) the company can continnue to make payment to M/s Pizza Hut Inc and M/s. KFC International Holdings Inc. within the specified limits under the automatic route without any restriction on the duration of the royalty payments."

15. The AO's finding was that payment of royalty was being made to circumvent the condition in the SIA approval that restricted payment of technical license fee for a period of 7 years. It is observed that the period of

seven years continued till the financial year 2001-02 (i.e. the relevant assessment year under consideration), as YRIPL had entered into the agreement with KFCIH in April 1995 (expiring in April 2002) and with PHILLC in January 1996 (expiring in January 2003). Furthermore, royalty was allowed under the automatic route under the liberalized foreign direct investment regime of the Government of India, as per the terms of the Press Note No 9 (2000 series) and subsequently, though after a short gap, under Press Note No 2 (2003 series). The finding that YRIPL acted contrary to law or as held by the Ld. AO is thus, undermined by the clarification obtained by it with respect to the notifications of the Union Government by letter dated 29/30-09-2003, which confirms these facts. In fact, in the said letter, the Central Government of India too used the term 'royalty' and not 'technical license fee', while clarifying that, in terms of the liberalized policy, YRIPL may remit royalty under the automatic route within the prescribed limits. It is also not in dispute that royalty payments were made under the normal banking channels. In fact, the SIA – in this case - had used the terms 'technical license fee' and 'royalty' loosely and interchangeably. The ITAT further concluded that, *"The AO failed to bring on record any material that assessee has infringed any law in conducting its business"* and that the *"AO has misread the approvals granted by the Govt of India while arriving at a conclusion that assessee has not been remitting the payment as per the approvals."*

16. Section 37(1) of the Act- and its explanation, read as follows:

> *"37. (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".

Explanation.—For the removal of doubts, it is hereby declared that any expenditure incurred by an assessee for any purpose which is an offence or which is prohibited by law shall not be deemed to have been incurred for the purpose of business or profession and no deduction or allowance shall be made in respect of such expenditure.

17. In terms of provisions of the Act, taxable income is determined after permissible admissible business deductions, which are spelt out in Sections 29 to 36. Those expenses which do not fall under those provisions are nevertheless deductible under the residuary Sections 37 if they, or any of them, satisfy the conditions mentioned in the provision. The conditions are first, expenditure must be revenue expenditure and not in the nature of capital expenditure; second, it must be laid out or expended wholly and exclusively for the purpose of the business or profession carried on by the assessee; third, it must not be of the nature described in Sections 30 to 36; fourth, expenditure should not be personal expenditure of the assessee; fifth, expenditure should have been incurred in the previous year; and finally, expenditure should not have been incurred for the purpose which is an offence or which is prohibited by law (Explanation to Section 37 (1)).

18. The courts have interpreted the phrase "expended wholly and exclusively for the purpose of business" and held that expenditure incurred, motivated by "commercial expediency", is a deductible expenditure under Section 37 (1) to arrive at taxable income under the Act. This term means everything that serves to promote trade and commerce and includes every

means suitable to that end. The term is of wide import and expenditure; it includes such expenditure as a prudent man may incur for the purpose of his business (*Calcutta Landing and Shipping Co. Ltd. v. CIT* [1967] 65 ITR 1 (Cal)). It was held that a sum of money expended not of necessity, and with a view to directly and immediately benefit to the trade, but voluntarily and on ground of commercial expediency, in order to indirectly facilitate the carrying on of the business, may yet be expended wholly and exclusively for the purposes of the trade (*Usher's Wiltshire Brewery Ltd. v. Bruce* [1914] 6 T. C. 399 ; *Smith v. Incorporated Council of Law Reporting for England and Wales* [1914] 6 T. C. 477; *Sree Meenakshi Mills Ltd. v. CIT* [1967] 63 ITR 207 (SC)).

19. In examining a claim for deduction on the ground of commercial expediency, what is to be seen is not whether it was compulsory for the assessee to make the payment, but whether it was of commercial expediency. As long as the payment is made for the purposes of the business, and not by way of penalty for infraction of any law, the same would be allowable as a deduction (*Sri Venkata Satyanarayana Rice Mill Contractors Co. v. CIT* [1997] 223 ITR 101 (SC)). The commercial expediency of a businessman's decision to incur a particular expenditure cannot be tested on the touchstone of strict legal liability to incur such expenditure. Such decisions are to be taken from a business point of view and have to be respected by the authorities, regardless of the fact that it may appear, to the latter, to be expenditure incurred unnecessarily or avoidably. In the present case, the ITAT recorded a finding that the royalty was for business purposes and what is more, payable to the assessee's foreign principals. Its character as an

expense - collected for payment to the said foreign party-has not been disputed. In the circumstances, the assessee's claim that it was for business purposes alone, and no other reason, could not have been rejected by the AO. The question of law is, therefore, answered against the revenue and in favour of the assessee.

Question No. 3

20. The facts necessary to answer this question are that the assessee had, at the relevant time, a wholly owned subsidiary, Yum! Restaurant India P. Ltd. The main object of this company was to carry out advertising, marketing and promotion of KFC, Pizza Hut and other brands owned or acquired in future by the assessee. This company was incorporated on June 8, 1999. The AO observed that the said company was operating from the premises of the assessee. The AO, therefore, ruled that all administrative expenses in connection with advertisement, marketing and promotional activities of YRMPL to be allocable to that company. Therefore, as a corollary, the assessee could not bear the overhead expenses at YRMPL. The AO allocated or apportioned the expenses in equal parts, i.e., 50 per cent for YRMPL and 50 per cent for the assessee. This was upset by the CIT(A) and the ITAT, who held in favour of the assessee. The revenue contends that the ITAT fell into error, because the allocation of expenses claimed by the assessee, on proportionate basis was justified in the circumstances, because YRMPL was not incurring any expense and all its expenditure was borne by the assessee.

21. This Court notices that the CIT (A) deleted the disallowance. The ITAT went through the record and found that YRMPL was incorporated on 08.06.1999 as a 100% owned subsidiary of the assessee, to carry out its advertisement, marketing and promotion activities and various franchisees. The assessee had entered into a tripartite agreement with its franchise and YRMPL. In terms of such agreements, the franchise was to pay AMP contribution to YRMPL. The assessee did not have to pay separate contributions. YRMPL was to carry out the activities on no profit no loss basis. The AO disallowed the expenses attributable to YRMPL; the ITAT held that the AO:

> *"ought to have not disallowed any such amount because ultimately it is the assessee who has to contribute for all these sums. The assessee can bear the cost of administrative expenses alleged to be incurred by YRMPL or it can separately remit the amount to YRMPL towards such cost. From both angles, it is the assessee or its franchise who has to contribute this amount. The Assessing Officer, therefore, has erred in carving out the disallowance. The learned Commissioner of Income-tax (Appeals) has rightly deleted this disallowance and we do not find any force in this ground of appeal. It is rejected."*

22. This Court is of the opinion that the findings of the ITAT cannot be faulted. The ultimate effect on the revenue would be the same, whether the assessee bore administrative expenses and costs of YRMPL or it remitted such amount to YRMPL, its wholly owned subsidiary, towards such costs. The final effect is revenue-neutral. Having regard to these circumstances, this court holds that the question of law framed in this regard is to be answered in favour of the assessee.

Question No. 4

23. The AO noticed that the assessee failed to produce registers maintained for the fixed assets. In the AY 1999-2000, it transferred its business undertaking at Bangalore and Delhi as a going concern. Such assets continued to be shown as fixed assets even through in the AY 2002-03, depreciation was claimed on such non-existent assets. The AO observed that re-assessment for year 1999-2000 was ordered under Section 148 of the Income-tax Act and also that depreciation was claimed in respect of assets, purchased for the benefit of employees and utilised by such employees. He thereafter made a reference that expenses were found to be incurred, even though asset purchases during the assessment year 2002-03 were not found recorded in the books. On the basis of these, the AO disallowed the depreciation aggregating to Rs. 1,35,67,376. This finding was appealed. The assessee urged that as far as assets used by the employees are concerned, perquisite value was included as part of the salary of such employees. The assessee stated that had those assets not been provided to the employees under the terms and conditions of employment, the assessee would have reimbursed the cost of those assets for personal use up to a limited specified purpose. The CIT(A) considered these aspects and held that the assessee had produced schedule of assets before the AO. It was held that though there could be some discrepancy but that did not result in disallowance of the total depreciation. For AY 1999-2000, the CIT (A) directed the AO to give effect to the outcome of assessment proceeding in the AY 1999-2000 in this year too. The ITAT held, on this issue that:

> *"25. On due consideration of the facts and circumstances, we are of the view that the Assessing Officer has highlighted certain discrepancies in the maintenance of written down value of the*

> *assets as well as identification of each assets. There may be some shortcomings but that does not mean that the assessee was not having any asset and they were not used for the purpose of business. In our opinion, the Assessing Officer ought to have identified each item and find out how that item is treated in the block of assets, if it is established that those assets were not used for the purpose of the assessee's business then he should make out a case for disallowance of depreciation. By making general observation, he cannot deny the total claim of the depreciation of the assessee. Taking into consideration these aspects, we do not find any merit in this ground of appeal. The learned Commissioner of Income-tax (Appeals) has already directed the Assessing Officer to give effect to the outcome of 1999-2000. The depreciation disallowed in the assessment year 1999-2000 would be considered for disallowance in this year also. The effect of outcome in the assessment year 1999-2000 would be given after giving an opportunity of hearing to the assessee."*

It is, therefore, evident that the revenue's argument is only in respect of a remand directed by the ITAT. That remand directed the AO to give effect to the outcome of AY 1999-2000 after providing opportunity of hearing to the assessee, for the subsequent period. For the later years, the ITAT held the amounts were also taxed in the hands of the employees as perquisites and relied on the decision of *Sayaji Iron and Engg Co vs. CIT* (253) ITR 749 (Guj.) The ITAT accepted the contention that under the block of asset concept, individual assets lose their identity when merged in the block and accordingly, actual physical possession and use of asset is inessential.

24. Learned counsel for the revenue contended that the ITAT's findings are not justified. Once the assets were purchased by the assessee's employees, it could not claim depreciation. The assessee, on the other hand, contended that though the assets were purchased by its employees, this was

in accordance with the prevailing policies. The assessee was, in terms of the employment of each of its personnel, entitled to such concessions, as it was bound to reimburse the cost of the assets. In these circumstances, the individual identity of the assets was lost in the block. It was, therefore, argued that the ITAT's judgment is sound and does not call for interference.

25. The revenue does not dispute the ITAT's finding that as part of its emolument policy, the assessee reimburses expenses incurred by its employees on purchase of furnishings. Such reimbursements are made by the assessee to the employees only to the extent of their entitlement (determined on the basis of their grade or level in terms of their appointment letters). These expenses cannot be, therefore, termed as personal to the assessee's employees, but are for its business purposes. In these circumstances, there is no infirmity with the order of ITAT.

Question No. 5:

26. This issue arises, because the assessee, as part of its business expenses, claimed deduction for "food tasting and development" expenses. The assessee argued that it has continuously developed new flavours and food items to keep its customer base. It claimed that these expenses were incurred for food tasting and trials; it also incurred certain expenses for studying demographic trends. According to the assessee, these expenses were revenue in nature. The AO treated these expenses as capital in nature. The CIT and the ITAT allowed the assessee's appeal.

27. Learned counsel for the revenue relied upon the order of the AO and stated that the expenditure was of a capital nature, since it would result in an

enduring benefit. Counsel submitted that whenever a new or popular recipe or flavour is developed, that would constitute a capital asset, as it would result in an enduring benefit to the business. Counsel for the assessee, on the other hand, highlighted that the expense towards food tasting was a recurring one, and there was a dynamic involved in the process. Arguing that not all new recipes and flavours would succeed and that it is not always possible to launch new recipes without some advice of such expert tasters, it was submitted that for the assessee's business to thrive and continue to attract clientele, it was essential to develop new flavours and adapt to new markets. Thus, counsel stated, such expenditure properly falls in the revenue field.

28. One of the earliest decisions to indicate a test for distinguishing between capital expenditure and revenue expenditure was in *Assam Bengal Cement Co. Ltd. v Commissioner of Income Tax, West Bengal* [1955] 27 ITR 34(SC). The Supreme Court, in that judgment stated as follows:

> *"If the expenditure is made for acquiring or bringing into existence an asset or advantage for the enduring benefit of the business it is properly attributable to capital and is of the nature of capital expenditure. If on the other hand it is made not for the purpose of bringing into existence any such asset (or) advantage but for running the business or working it with a view to produce the profits it is a revenue expenditure."*

Re-visiting the entire issue, nearly three and a half decades later, the Court in *Alembic Chemical Works Ltd. v Commissioner of Income Tax* 1989 (177) ITR 377, traced the developments in the law:

> *The question in each case would necessarily be whether the tests relevant and significant in one set of circumstances are relevant and significant in the case on hand also. Judicial metaphors, it is truly said, are narrowly to be watched, for, starting as devices to liberate thought, they end often by enslaving it. The non-determinative quality, by itself, of any particular test is highlighted in B. P. Australia Ltd. v. Commissioner of Taxation of the Commonwealth of Australia [1966] AC 224 (PC). Lord Pearce said (at p. 264) :*
> *"The solution to the problem is not to be found by any rigid test or description. It has to be derived from many aspects of the whole set of circumstances some of which may point in one direction, some in the other. One consideration may point so clearly that it dominates other and vaguer indications in the contrary direction. It is a common sense appreciation of all the guiding features which must provide the ultimate answer. . .".*
> *The idea of "once for all" payment and "enduring benefit" are not to be treated as something akin to statutory conditions ; nor are the notions of "capital" or "revenue" a judicial fetish. What is capital expenditure and what is revenue are not eternal verities but must needs be flexible so as to respond to the changing economic realities of business. The expression "asset or advantage of an enduring nature" was evolved to emphasise the element of a sufficient degree of durability appropriate to the context."*

Emphasizing that unless there is a "degree of endurability and permanence" to the result of the expenditure or that there is "the element of the requisite degree of durability and non-ephemerality to share the requirements and qualifications of an enduring capital asset…" the Court cautioned that one should be "a little slow and circumspect in too readily pigeon-holing an outlay such as this as capital." The Court then concluded as follows:

> *"..There is also no single definitive criterion which, by itself, is determinative as to whether a particular outlay is capital or revenue. The 'once for all' payment test is also inconclusive.*

> *What is relevant is the purpose, of the outlay and its intended object and effect, considered in a common sense way having regard to the business realities. In a given case, the test of 'enduring benefit' might break down. In CIT v. Associated Cement Companies Ltd. [1988]* 172 ITR 257 *(SC) at p. 262, this court said:*
> *"As observed by the Supreme Court in the decision in Empire Jute Co. Ltd. v. CIT [1980]* 124 ITR 1 *(SC), that there may be cases where expenditure, even if incurred for obtaining an advantage of enduring benefit, may, none the less, be on revenue account and the test of enduring benefit may break down. It is not every advantage of enduring nature acquired by an assessee that brings the case within the principles laid down in this test. What is material to consider is the nature of the advantage in a commercial sense and it is only where the advantage is in the capital field that the expenditure would be disallowable on an application of this test ....."*

29. In the present case, it is not disputed that the assessee is engaged in the restaurant business. As part of its commercial activity, it strives to develop new recipes to develop its clientele, or expand it. The amounts expended towards such development are part of its business. Possibly, some recipes may be viable; equally possibly, all of them may be unviable. The mere possibility of the result of such exercise being a popular or long lasting recipe would not make the expenditure capital in nature. As such, it cannot be held that the food tasting development charges would result in a capital advantage of an enduring nature.

Re Question No. 6

30. In respect of this issue, the facts are that the assessee made certain provisions on the basis of the mercantile system of accounting followed by it, at the end of the year. The AO held that this provision was not utilised by

the assessee in the next assessment year. He, therefore, held that the excess provision deserves to be disallowed. The CIT (A) deleted the disallowance, stating that the provision was made for certain expenses and that if the provision was not exhausted by the assessee, it did not mean that there was no possibility of that kind of expenditure arising when the provision was made. The ITAT affirmed this decision (of the CIT), holding as follows:

> *"31. On due consideration of the facts and circumstances, we do not see any reason to interfere in the order of the learned Commissioner of Income-tax (Appeals). The assessee has made the provision by keeping in view past experience and the possibility of certain expenses. It has filed the details exhibiting the nature of intending expenses. It is a separate issue that such occasion did not arise to incur those expenses but that does not mean that when the provision was made it was not bona fide. If some amount remained unutilised it will be offered for tax in the next assessment year. Hence, this ground of appeal is rejected."*

It was argued by the revenue that the ITAT's reasoning is unsustainable because unless a provision for expenses is made on a scientific basis, it cannot be allowed. On the other hand, the assessee's counsel contended that the provision was made keeping in mind past experience.

31. Here, this Court recollects the decision of the Supreme Court in *Bharat Earth Movers v. Commissioner of Income Tax* [2000] 245 ITR 428 (SC) is of relevance. The Court had on that occasion observed as follows:

> *"The law is settled: If a business liability has definitely arisen in the accounting year, the deduction should be allowed although the liability may have to be quantified and discharged at a future date. What should be certain is the incurring of the liability. It should also be capable of being estimated with reasonable certainty though the actual quantification may not be possible. If*

these requirements are satisfied the liability is not a contingent one. The liability is in present though it will be discharged at a future date. It does not make any difference if the future date on which the liability shall have to be dis charged is not certain . . . A few principles were laid down by this court, the relevant of which for our purpose are extracted and reproduced as under:
(i) for an assessee maintaining his accounts on the mercantile system, liability already accrued, though to be discharged at a future date, would be a proper deduction while working out the profits and gains of his business, regard being had to the accepted principles of commercial practice and accountancy. It is not as if such deduction is permissible only in the case of amounts actually expended or paid;
(ii) just as receipts, though not actual receipts but accrued due are brought in for Income-tax assessment, so also liabilities accrued due would be taken into account while working out the profits and gains of the business ;
(iii) a condition subsequent, the fulfilment of which may result in the reduction or even extinction of the liability, would not have the effect of converting that liability into a contingent liability ;
(iv) a trader computing his taxable profits for a particular year may properly deduct not only the payments actually made to his employees but also the present value of any payments in respect of their services in that year to be made in a subsequent year if it can be satisfactorily estimated."

32. In the present case too, it is evident that the provision made by the assessee was based on past experience. Both the CIT (A) and the ITAT held this method was not objectionable. Besides doubting the estimation, the AO has not stated whether, in fact, such past experience did not constitute a rational basis for making provision. In these circumstances and in the light of the law declared in *Bharat Earth Movers (supra),* this question has to be answered in favour of the assessee and against the revenue.

33. In view of the foregoing discussion, the appeals of the revenue have to fail and are dismissed.

S. RAVINDRA BHAT
(JUDGE)

R.K. GAUBA
(JUDGE)

JANUARY 30, 2015