
(1989) 11 CAL CK 0015

In the Calcutta High Court

Case No : Income-tax Reference No. 93 of 1983

Commissioner of Income Tax

APPELLANT

Vs

National Engineering Industries Ltd.

RESPONDENT

Date of Decision : 16-11-1989

Acts Referred:

Income Tax Act, 1961 — Section 37

Citation : (1990) 85 CTR 98 : (1991) 190 ITR 525 : (1990) 53 TAXMAN 248

Hon'ble Judges : Suhas Chandra Sen, J; Bhagabati Prasad Banerjee, J

Bench : Division Bench

Advocate : A.C. Moitra, for the Appellant; R.N. Bajoria, J.P. Khaitan and A.K. Dey, for the Respondent

Judgement

Suhas Chandra Sen, J.—The Tribunal has referred the following two questions of law u/s 256(2) of the Income Tax Act, 1961 :

"1. Whether, on the facts and in the circumstances of the case and on a correct construction of the agreement dated September 2, 1963, the Tribunal misdirected itself in law in holding that the conclusion of the Commissioner of Income Tax to the effect that under the said agreement the assessee had been able to start a new line of production and had obtained a benefit of enduring nature was misconceived and not tenable in law ?

2. Whether, on the facts and in the circumstances of the case, and on a correct construction of the agreement dated September 2, 1963, the Tribunal was right in holding that the payment of Rs. 10,19,693 made by the assessee to the foreign company is allowable as revenue expenditure ?"

2. In the assessment order for the assessment year 1973-74, the Income Tax Officer allowed a sum of Rs. 1,19,693 paid by the assessee-company to the Federal-Mogul-Bower-Bearings, a company incorporated in USA, as royalty. After the assessment was completed, the Commissioner of Income Tax took the view that the amount was not allowable as deduction and passed an order u/s 263

directing the Income Tax Officer to disallow the above expenditure.

3. The assessee preferred an appeal to the Tribunal. The Tribunal was of the view that the assessee had acquired a licence for the use of know-how and the amount in dispute was paid in terms of the licensing agreement and was allowable as business expenditure. The Commissioner of Income Tax has questioned the correctness of the decision of the Tribunal in this reference.

4. The point of the payment of royalty for user of technical know-how has been gone into and decided in a number of cases. It was held by Romer LJ. in the case of *Handley Page v. Butterworth* [1935] 19 TC 328 (HL) that secret knowledge was as much a person's capital asset as was the patent monopoly, the capital asset of the patent. A person may allow his capital asset to be used by other persons. In the case of out and out sale of a capital asset the money that is received by the transferor must be a capital receipt and the expenditure will be a capital expenditure from the point of view of the transferee.

5. But if the payment is not for out and out sale of a capital asset, then it has to be seen what the assessee has acquired. The expenditure incurred by a transferee for mere user of technical know-how of another person for a limited period of time will be generally of a revenue nature.

6. The problem that has arisen in this case has to be solved bearing in mind the basic principle of law which has been enunciated in a number of cases by various courts and applied by the Supreme Court in several cases.

7. The material facts of the case as noted by the Tribunal are as follows :

M/s. National Engineering Industries Limited, the assessee, entered into an agreement on September 2, 1963 with Mogul-Bower-Bearing Incorporated USA, a wholly owned subsidiary of Federal-Mogul-Bower-Bearing Incorporated USA (hereinafter described as the "foreign company"). By Article (ii) of the agreement, the foreign company granted the assessee-company an exclusive licence to manufacture licensed products in India and an exclusive licence to use and sell licensed products in all countries of the world. Article (iii) provided that the foreign company shall upon request communicate to the assessee from time to time engineering and manufacturing information including design, specification and formula relating to the manufacturing equipment, tools, dice, process and performance materials. Article (v) provided that National Engineering Industries Limited should pay royalties of 5% and 6% of the selling price (as reduced by the cost of imported materials) of the licensed products sold in India and exported by the assessee-company during the period of agreement. The agreement was initially for a period of ten years with an option of renewal for another five years. There was a clause for earlier termination of the agreement by either party upon the happening of certain events.

7. The Commissioner of Income Tax was of the view that payments had been made by the assessee-company to the foreign company under Article (v) for

setting up of the manufacturing process for the licensed products in India. The Commissioner of Income Tax was of the view that this expenditure must be treated as capital expenditure.

8. The Commissioner of Income Tax further was of the view that because the agreement had provided that the assessee shall not communicate the technical information to a third party without the consent of the foreign company and because this obligation will continue even after termination of the agreement, the expenditure was of capital nature and could not be treated as revenue expenditure.

9. The Tribunal, however, was of the opinion that the Commissioner of Income Tax had failed to grasp the true scope of the agreement. The Tribunal, on a perusal of the agreement, came to the view that the expenditure did not result in acquisition of a capital asset and, hence, was allowable as business expenditure.

10. The Tribunal has taken the following points into consideration for deciding the question before it :

(i) Under the agreement (and a supplementary agreement dated April 5, 1964) two types of expenditure were involved. The first related to an expenditure incurred up to June, 1968, when the plant for production of tapered roller bearings was put up. The expenditure incurred prior to that date by way of payments for designs, patents, etc., amounting to Rs. 1,524 lakhs were treated as capital expenditure. From the assessment year 1969-70 till the assessment year 1973-74, the royalty payments were allowed in the Income Tax assessments as revenue expenditure.

(ii) Prior to the manufacture of tapered roller bearings, the assessee was engaged in the manufacture of other types of bearings since 1950.

(iii) The royalty was wholly related to the production and manufacture of tapered bearings. The payment was solely related to the carrying on of manufacturing activities and was not connected to the capital structure or any asset of any enduring advantage.

(iv) The proprietary rights and the ownership in respect of patents, know-how and/or information remained with the foreign company. The assessee-company was merely granted a licence to use the patents and the royalty was for the user of the patents and not for the acquisition of any asset.

(v) Under the agreement, the assessee was prohibited from communicating the know-how to a third party without the consent of the foreign company.

(vi) The agreement contemplated manufacture of a new type of bearing and new plant and machinery were installed for this purpose. That, however, did not make the payment of royalty a capital expenditure. Technical know-how provided by the foreign company was utilised in making new types of bearings.

(vii) There was a specific provision in the agreement that the technical

information provided by the foreign company would remain the legal and absolute property of the foreign company. After determination of the agreement, if there was no default on the part of the assessee, the assessee could continue to use the knowledge for the manufacture of tapered roller bearings. That, however, did not mean that an asset of any enduring advantage had been acquired by the assessee.

11. Having regard to the basis features of the agreement in our view, the Tribunal was right in concluding that the expenditure incurred by the assessee was in the process of course on of its business. The expenses incurred for the installation of plant and machinery for the production of the new type of bearing were earlier held to be on capital account. But, after the production commenced, the royalty that was paid for user of the technical know-how and information must be treated as revenue expenditure. The assessee did not acquire any tangible asset by payment of these royalties. The capital structure of the business of the assessee also did not improve in any way because of these payments. After the installation of plant and machinery the expenses that were incurred were in the process of carrying on the business.

12. On behalf of the Revenue, it has been contended that the assessee had started a new line of business. Therefore, the expenditure must be treated as on capital account. That the assessee had set up a new plant for the production of a new type of bearing cannot be denied. The cost of setting up of the new plant must be treated as on capital account. There is no dispute on this point. The Tribunal has held that the entire expenditure incurred up to the stage of setting up of plant and machinery will have to be capitalised. But the question in this case is how are the royalty payments to be treated after the manufacturing process started.

13. The question of allowability of expenditure incurred for use of scientific data, patents and trade marks was gone into exhaustively by the Supreme Court in the case of Commissioner of Income Tax, Bombay Vs. Ciba of India Ltd., . In that case, an agreement which was to be in force for a period of five years from January 1, 1948, was entered into by Ciba of India Limited with Ciba Limited of Basle, a Swiss company. By the agreement, the Indian company was given full and sole right and licence to use certain specified trade-marks. In consideration of the right to receive scientific and technical assistance, the Indian company agreed to make contribution of a percentage of the net sale price of the products, The payments were to be made for the technical consultancy and technical service rendered and research work done by the foreign company as also for the cost of raw materials used for experimental work and royalties on trade marks used by the Indian company. The Indian company agreed not to divulge to third parties without the consent of the Swiss company any confidential information received under the agreement or to assign the benefit of the agreement or to grant sub-licences of the patents and trade marks without the consent of the Swiss company. After the termination of the agreement, the

patents, trade-marks and other materials and designs were to be returned to the Swiss company and the Indian company was prohibited from communicating any such information, scientific data or materials to any person. It was held by the Supreme Court that the payments made by the Indian company was allowable as business expenditure u/s 10(2)(xv) of the Indian Income Tax Act, 1922. In that case, the Supreme Court pointed out that the assessee had not become entitled exclusively even for the period of the agreement to the patents and trade marks of the Swiss company. It had merely access to the technical knowledge and experience of the Swiss company. The assessee was a mere licensee for a limited period of the technical knowledge of the Swiss company with the right to use the patents and trade marks of the company, The Swiss company had not parted with any asset of the business by making the technical knowledge available to the assessee nor did the assessee acquire any asset or advantage of an enduring nature for the benefit of its business.

14. The facts in the case of Commissioner of Income Tax, Bombay Vs. Ciba of India Ltd., and of the instant case are very similar. On behalf, of the Revenue, a distinction was sought to be made between the period of the licence in the Ciba case and the instant case. In the case of Commissioner of Income Tax, Bombay Vs. Ciba of India Ltd., , the licence was for five years only, whereas in the instant case, the licence was for ten years.

15. This, in our view, does not make any difference to the principle. If a house is taken for business purposes for five or ten years, the monthly rent paid will be deductible as revenue expenditure. The crucial test is whether the assessee had acquired any asset of enduring benefit. The right to use the technical knowledge of the foreign company was certainly an advantage. The assessee was able to venture into a new line of product with the technical know-how supplied by the foreign company. But the asset that was used by the assessee remained the property of the foreign company. The assessee merely had a right of user of that asset in the course of carrying on of the business of the assessee. The payment which was made by the assessee was for the user and not acquisition of the technical know-how. The assessee was a mere licensee. It has not been shown from the agreement that the assessee had become an exclusive owner of the technical know-how.

16. On behalf of the Revenue, our attention was drawn to a judgment of the Supreme Court in the case of Scientific Engineering House (P) Ltd. Vs. Commissioner of Income Tax, Andhra Pradesh, . On the strength of this decision, it was argued that drawings, designs, charts, plant, processing data and other literature are to be treated as capital assets. Any expenditure incurred in connection with such assets are to be treated as capital expenditure. The assessee may be entitled to claim depreciation on such assets ; but the expenditure could not be treated as revenue expenditure.

17. I am unable to uphold this contention. The case before the Supreme Court was not a case of payment of royalty by a licensee for user of technical know-

how, patents, designs, trade marks, etc. On the contrary, the Supreme Court pointed out (at p. 95 of 157 ITR 95) :

"The tenor of the agreement clearly shows that the various documents such as drawings, designs, charts; plans, processing data and other literature included in documentation service, the supply whereof was undertaken by the foreign collaborator, more or less formed the tools by using which the business of manufacturing the instruments was to be done by the assessee and for acquiring such technical know-how through these documents, lump sum payment was made. In other words, the payment of Rs. 80,000 under each of the agreements was principally for rendition of documentation service. It is, therefore, clear that this expenditure was incurred by the assessee as and by way of purchase price of the drawings, designs, charts, plans, processing data and other literature, etc., comprised in "documentation service" specified in Clause 3. The expenditure, therefore, was undoubtedly of a capital nature as a result whereof a capital asset of technical know-how in the shape of drawings, designs, charts, plans, processing data and other literature, etc., was acquired by the assessee."

18. Because the assessee had paid the purchase price and had become the owner of the asset, the assessee had claimed depreciation allowance u/s 32 of the Income Tax Act. Such depreciation allowance can only be claimed by an owner of "buildings, machinery, plant or furniture". In the instant case, the ownership of the technical know-how and drawings and designs remained with the foreign company. The assessee had only a right of user for a limited period and that too under certain restrictions. The principles laid down by it in the case of Commissioner of Income Tax, Bombay Vs. Ciba of India Ltd., will clearly apply to this case.

19. I was referred to the judgments of several other High Courts on behalf of the Revenue. But, in view of the clear enunciation of the law by the Supreme Court, it is not necessary to refer to these judgments.

20. Both the questions are, therefore, answered in the affirmative and in favour of the assessee.

21. There will be no order as to costs.

Bhagabati Prasad Banerjee, J.

22. I agree.