

(1996) 02 KL CK 0051

In the High Court Of Kerala

Case No : Income-tax Reference No's. 2 to 5 of 1991

Commissioner of Income Tax

APPELLANT

Vs

Polyformalin (P.) Ltd.

RESPONDENT

Date of Decision : 20-02-1996

Acts Referred:

Income Tax Act, 1961 — Section 37

Citation : (1996) 221 ITR 276

Hon'ble Judges : V.V. Kamat, J;G. Sivarajan, J

Bench : Division Bench

Advocate : P.K.R. Menon and N.R.K. Nair, for the Appellant; Jose Joseph, A.K. Joseph and V.V. Asokan, for the Respondent

Judgement

G. Sivarajan, J.—In these referred cases, two questions were referred for the decision of this court. They are as follows :

" 1. Whether, on the facts and in the circumstances of the case, the Tribunal is right in law in holding that the payments are in the nature of revenue expenditure ?

2. Whether, on the facts and in the circumstances of the case, the Tribunal is right in law and fact in holding that the capital element in the payment would have been fully paid for by the payment made for the year 1976-77 and is not the above finding (or surmises) based on no material and perverse ?"

2. The assessee is a private limited company having the main objects to manufacture, otherwise deal in formaldehyde, polyester/urea/phenol resin, pentaerythritol, hexamine and their derivatives including other organic and synthetic chemicals. The assessee entered into an agreement with Arborites Pvt. Ltd. company, which was functioning adjacent to the premises which carried on business of manufacture of urea formaldehyde resin. The agreement was entered into with the said company for the supply of technical know-how. The assessee entered into a collaboration agreement on May 23, 1975, with Arborites Private

Limited for the production of urea formaldehyde resin. The term of the agreement was initially for a period of five years, but it was provided that the term can be extended subject to further agreement between the parties. As per the agreement, Arborites Private Limited transferred its technical know-how and the right to use the trade mark to the assessee. The assessee was required to keep the technical know-how in confidence, It was also provided that information about further improvements in the technical know-how was also agreed to be transferred to the assessee. In consideration of the transfer of the technical know-how, the assessee-company was to pay to Arborites Private Limited a royalty calculated at the rate of Rs. 100 per ton of the contract product manufactured. The assessee entered into a further agreement on May 28, 1975, with Arborites Pvt. Ltd. as per which the latter has transferred its plant and machinery to the assessee for a price fixed at Rs. 1,00,000 and vacated the rental premises occupied by it. A third agreement was entered into on March 22, 1978, purporting to be by way of clarification of the agreement dated May 23, 1975, which provided that there was no absolute transfer of the technical know-how, the ownership in respect of which continued with Arborites Pvt. Ltd. and the assessee was only entitled to the use of it for a period of five years on payment of royalty, as agreed to between the parties.

3. For the assessment year 1976-77, which is the first assessment year during which the aforesaid arrangement has been entered into, the assessee claimed deduction of Rs. 34,779 paid by way of royalty under the agreement as an item of revenue expenditure. The Income Tax Officer disallowed the said claim holding that the expenditure was of a capital nature. On appeal by the assessee, the Appellate Assistant Commissioner allowed the claim for deduction holding that the royalty paid constitutes revenue expenditure. On appeal by the Department, the Tribunal held that part of the payment of royalty under the agreement attributable to the initial manufacture would be capital in nature and the rest of the payments would be revenue in nature. Accordingly, the Tribunal held that the amount of royalty paid in the first year will be treated as capital expenditure and the royalty to be paid in subsequent years will be revenue expenditure.

4. Accordingly, the claim of the assessee for deduction of a sum of Rs. 34,779 which represents royalty payment, was held to be of capital nature. This matter was taken up before this court in reference at the instance of the Revenue. The following two questions were referred to this court (at page 37 of 161 ITR) :

" 1. Whether, on the facts and in the circumstances of the case, the Tribunal was right in law in holding that there was a capital element in the royalty payment and the amount of Rs. 34,779 which represented the royalty paid, relating to the assessment year 1976-77, should be attributed to such capital expenditure and the royalty payable for the remaining four years should be considered as revenue payment ?

2. Whether, on the facts and in the circumstances of the case, the Tribunal was right in holding that in respect of Rs. 34,779 allocated towards capital, the same

would go to constitute the cost of plant and, therefore, appropriate depreciation and development rebate should be allowed thereof ?"

5. After setting out the facts of the case, this court posed the question thus (at page 39 of 161 ITR) :

" Only two questions arose for decision and those questions are ; (1) whether the royalty paid is a revenue expenditure or whether it is an expenditure of a capital nature, and (2) if of a capital nature, whether the assessee is entitled to depreciation and development rebate as part of the cost of its machinery and plant."

6. With reference to the aforesaid question posed for consideration, this court proceeded to consider the legal principles applicable to decide the question as to whether a particular expenditure is of capital nature or of revenue nature. In that context, this court referred to the decision of the Supreme Court in M.K. Brothers (P) Ltd. Vs. Commissioner of Income Tax, Kanpur, . In that decision, the Supreme Court referred to its earlier decision in Assam Bengal Cement Co. Ltd. Vs. The Commissioner of Income Tax, West Bengal, and observed at page 43 of the report as follows :

"As observed by this court in the case of Assam Bengal Cement Co. Ltd. Vs. The Commissioner of Income Tax, West Bengal, , 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. If any such asset or advantage for the enduring benefit of the business is"thus acquired or brought into existence it would be immaterial whether the source of the payment was the capital or the income of the concern or whether the payment was made once and for all or was made periodically. The aim and object of the expenditure would determine the character of the expenditure whether it is a capital expenditure or a revenue expenditure. The source or the manner of the payment would then be of no consequence."

7. The Supreme Court in the said decision has also quoted the following observations of Lord Cave L. C. in Atherton v. British Insulated and Helshy Cables Ltd. [1925] 10 TC 155 (HL) with approval at page 908 in Commissioner of Income Tax, West Bengal II, Calcutta Vs. Coal Shipment (P) Ltd., :

" But when an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think that there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable riot to revenue but to capital."

8. The observations of the Supreme Court in Empire Jute Co. Ltd. Vs.

Commissioner of Income Tax, to the effect that if disbursement is made for acquisition of a source of profit or income, it would ordinarily, in the absence of any other countervailing circumstances, be in the nature of capital expenditure are also relevant in this context.

9. This court had also occasion to consider the nature of the royalty paid on acquisition of the sole selling agency right of McDowell and Co. by the assessee at the rate of Re. 1 per case of liquor sold. In that case, this court considering the nature of the payment held that the expenses incurred by way of royalty paid was of a capital nature. This court in the decision, in the case of the assessee itself in Commissioner of Income Tax Vs. Polyformalin (P.) Ltd., referred to earlier had also considered the later decision of the Supreme Court in Scientific Engineering House (P) Ltd. Vs. Commissioner of Income Tax, Andhra Pradesh, , which deals with the nature of expenditure incurred for acquisition of technical know-how by way of designs, drawings, charts, plans and other literature and held to be of capital nature, which would add to the cost of the plant and machinery and observed that the drawings, designs, charts, plans, processing data and other literature comprised in the documentation service will be a book falling within the definition of "plant". This court after discussing the legal principles governing the situation, without considering the factual situation in the case, assumed the fact found by the Tribunal and observed as follows (page 41 of 161 ITR) :

" As earlier observed, the question relates to the claim for deduction of the royalty paid as a revenue expenditure during the accounting period. Now, that we have found it is an expenditure of a capital nature, the assessee is not entitled to deduction of the same. The assessee will, however, be entitled to depreciation and development rebate as found by the Tribunal. The latter part of question No. 1 as to what will be the nature of such expenditure in future does not arise for decision in the present assessment proceedings. "

10. We do not find from the above observations of this court any consideration and finding as to whether the expenditure incurred in the case on hand would be of capital nature or of revenue nature by applying the principles laid down by the Supreme Court and referred to in the said decision. Regarding the findings entered by the Tribunal as to the nature of royalty payment for the subsequent years, though the first question referred for the decision of this court took in the said aspect also, this court left open the question as to what will be the nature of such expenditure in future. This court further observed that the second part of the question relating to royalty does not arise for decision in the present assessment proceedings and, therefore, they declined to answer the same.

11. In these referred cases, we are concerned with subsequent assessment years 1977-78, 1978-79, 1979-80 and 1980-81. For these years also, the assessing authority relying on its finding for the assessment year 1976- 77 held that royalty payment is of capital nature. But the appellate authority following its earlier decision for the assessment year 1976-77 held that royalty payment is of

a revenue nature. The Income Tax Appellate Tribunal on appeal by the Department confirmed the order of the first appellate authority mainly relying on the findings entered by the Tribunal in the appeal for the assessment year 1976-77.

12. We find that this court in the referred case for 1976-77 has set out the legal principles for determination as to the nature of a particular expenditure whether as capital or revenue. We also found that this court has neither considered nor entered a finding as to whether on the facts and circumstances of the case on hand, the expenditure can be said to be one of capital nature or revenue in character. We also found that the authorities and the Tribunal had also followed their decisions rendered for the year 1976-77 in these proceedings. The Income Tax Appellate Tribunal, according to us, has not considered the matter in the light of the settled principles of law laid down by the Supreme Court and set out in the decision of this court in the case of the assessee itself for the year 1976-77.

13. In the above circumstances, we think that the appropriate course would be to set aside the orders passed by the authorities and by the Tribunal. We accordingly quash and set aside these orders and remit the proceedings to the assessing authority to decide the matter afresh in the light of the observations contained in this judgment.

14. In view of the above, we decline to answer the question referred to us. We order accordingly,

15. A copy of this judgment under the seal of this court and the signature of the Registrar shall be sent to the Income Tax Appellate Tribunal, Cochin Bench, Ernakulam, for passing consequential orders.