
(1986) 03 KL CK 0014

In the High Court Of Kerala

Case No : Income-tax Reference No's. 325 and 326 of 1980

Commissioner of Income Tax

APPELLANT

Vs

Polyformalin (P.) Ltd.

RESPONDENT

Date of Decision : 06-03-1986

Acts Referred:

Income Tax Act, 1961 — Section 256(1)

Citation : (1987) 60 CTR 196 : (1986) 161 ITR 36

Hon'ble Judges : P.C. Balakrishna Menon, J; M. Fathima Beevi, J

Bench : Division Bench

Advocate : P.K.R. Menon and N.R.K. Nair, for the Appellant; T.L.V. Iyer and P.S. Narayanan, for the Respondent

Judgement

Balakrishna Menon, J.—The Income Tax Appellate Tribunal, Cochin Bench, has referred the following questions to this court u/s 256(1) of the Income Tax Act:

"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 ?"

2. The assessee is a company incorporated on May 18, 1974, with the object of manufacturing and selling organic and synthetic chemicals. The company had its buildings constructed and machineries installed and it started producing formalin from February 24, 1975 onwards. The assessee entered into a collaboration agreement on May 23, 1975, with a neighbouring concern by name M/s.

Arborites (P.) Ltd. 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, M/s. Arborites (P.) Ltd. 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. 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 (P.) Ltd. a royalty calculated at the rate of Rs. 100 per ton of the contract product manufactured. There was a further agreement on May 28, 1975, as per which M/s. Arborites (P.) Ltd. 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. There was yet another agreement on March 22, 1978, by way of clarification of the agreement dated May 23, 1975, that there was no absolute transfer of the technical know-how, the ownership in respect of which continued with M/s. Arborites (P.) 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. The assessee claimed deduction of the royalty of Rs. 34,779 paid during the accounting period relevant to the assessment year 1976-77 as a revenue expenditure. The Income Tax Officer disallowed the claim for deduction holding that the expenditure was of a capital nature. In appeal, at the instance of the assessee, the Appellate Assistant Commissioner allowed the claim for deduction in the view that he took 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. The royalty of Rs. 34,779 paid during the relevant accounting period was accordingly held to be capital in nature to be added to the cost of machinery and plant and the assessee was held entitled to depreciation and development rebate admissible under the Act.

4. The assessment relates to the year 1967-77. The claim of the assessee was for deduction of Rs. 34,779 paid by way of royalty under the agreement as an item of revenue expenditure. 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.

5. In M.K. Brothers (P) Ltd. Vs. Commissioner of Income Tax, Kanpur, , the assessee company had by agreement with a partnership firm by name Sharma & Co. obtained the sole selling agency right of the products of the Kanpur Cotton

Mills owned by the British India Corporation. As per the agreement between the assessee and Sharma & Co., all the outstandings due from the latter to the British India Corporation were to be discharged by the assessee by way of deduction at a particular rate each year from the commission earned on the sale of the products of the Kanpur Cotton Mills. The assessee's claim that such payment effected by way of deduction during the relevant accounting period concerned was a revenue expenditure was not accepted by the Supreme Court. The Supreme Court observed at page 43:

"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."

6. The Supreme Court in Commissioner of Income Tax, West Bengal II, Calcutta Vs. Coal Shipment (P) Ltd., , quotes the following observation of Lord Cave L. C. in *Atherton v. British Insulated and Helsby Cables Ltd.* [1925] 10 TC 155 with approval at page 908 :

"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 not to revenue but to capital."

7. In the decision in *Empire Jute Co. Ltd. Vs. Commissioner of Income Tax*, , the Supreme Court observes at page 12 :

"Now it is true 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."

8. In *Commissioner of Income Tax Vs. Jacobs (P.) Ltd.*, , a Division Bench of this court had to consider the nature of the royalty paid on acquisition of the sole selling agency right of McDowell & Co. by the assessee at the rate of Re. 1 per case of liquor sold. This court considering the nature of the payment held that the expenses incurred by way of royalty paid during the relevant accounting period was of a capital nature and the assessee is not entitled to deduction of the

same as an item of revenue expenditure. In a recent decision of the Supreme Court in Scientific Engineering House (P) Ltd. Vs. Commissioner of Income Tax, Andhra Pradesh, , the expenditure incurred for acquisition of technical know-how by way of designs, drawings, charts, plans and other literature was held to be of capital nature which would add to the cost of the plant and machinery and the assessee was held entitled to depreciation and development rebate. After holding 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", the Supreme Court observed at page 97 :

"But apart from its physical form, the question is whether these documents satisfy the functional tests indicated above. Obviously, the purpose of rendering such documentation service by supplying these documents to the assessee was to enable it to undertake its trading activity of manufacturing theodolites and microscopes and there can be no doubt that these documents had a vital function to perform in the manufacture of these instruments ; in fact it is with the aid of these complete and up-to-date sets of documents that the assessee was able to commence its manufacturing activity and these documents really formed the basis of the business of manufacturing the instruments in question. True, by themselves, these documents did not perform any mechanical operations or processes but that cannot militate against their being a plant since they were in a sense the basic tools of the assessee's trade having a fairly enduring utility, though owing to technological advances, they might or would in course of time become obsolete. We are, therefore, clearly of the view that the capital asset acquired by the assessee, namely, the technical know-how in the shape of drawings, designs, charts, plants, processing data and other literature falls within the definition of " plant" and is, therefore, a depreciable asset.

Counsel invited our attention to the decision in Commissioner of Income Tax, Gujarat-II Vs. Elecon Engineering Co. Ltd., , where the Gujarat High Court has, after exhaustively reviewing the case law on the topic, held that drawings and patterns which constitute know-how and are fundamental to the assessee's manufacturing business are "plant". We agree and approve the said view."

9. In view of this recent pronouncement of the Supreme Court, it is unnecessary for us to refer to the various decisions of different High Courts cited at the Bar by counsel on both sides.

10. 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.

11. We, therefore, answer the first part of question No. 1 in the affirmative, that

is, in favour of the Revenue and against the assessee. The second part of the question relating to royalty payable for the remaining four years does not arise for decision in the present assessment proceedings and we decline to answer the same. Question No. 2 is answered in the affirmative, that is, in favour of the assessee and against the Revenue.

12. A copy of this judgment under the seal of the court and the signature of the Registrar will be forwarded to the Income Tax Appellate Tribunal, Cochin Bench.