
(2015) 04 KAR CK 0152
In the Karnataka High Court
Case No : I.T.A. No. 1010 of 2008

Diffusion Engineers Ltd.

APPELLANT

Vs

The Deputy Commissioner of Income Tax

RESPONDENT

Date of Decision : 17-04-2015

Acts Referred:

Income Tax Act, 1961 — Section 30, 31, 32, 32A, 33

Citation : (2015) 3 AKR 744 : (2015) 376 ITR 487 : (2015) 232 TAXMAN 441

Hon'ble Judges : Vineet Saran, J;S. Sujatha, J

Bench : Division Bench

Advocate : A. Shankar and M. Lava, for the Appellant; Jeevan J. Neeralgi, Advocates for the Respondent

Judgement

S. Sujatha, J.—This appeal is filed by the assessee challenging the order passed by the Income Tax Appellate Tribunal (hereinafter referred to as the "Tribunal") Bangalore "B" Bench, dated 30.6.2008 pertaining to the assessment years 1992-93 and 1993-94.

2. The facts in brief are:

"that the appellant is a company form of organization, which is engaged in the production of engineering related products. The appellant company on 9.10.1991 entered into an agreement with an English company based in United Kingdom (U.K.) under name and style "Wall Colmony Limited" (WCL) for the procurement of a technology called "Colmonoy Sweat-on-Paste". In consideration of the transfer of technical know how, the appellant company agreed to pay WCL a sum of 50,000 pounds in three equal instalments. For the assessment years 1992-93 and 1993-94, the assessee claimed 100% deduction on amount expended towards procuring technical know-how as revenue expenditure falling under Section 37 of the Income Tax Act, 1961 (hereinafter referred to as the "Act" for brevity). The Assessing Officer (AO) rejected the said claim of the assessee and brought the said expenditure under Section 35AB of the Act. Being aggrieved, the assessee carried the matter in appeal before the CIT (Appeals) which was

allowed, against which the revenue preferred appeals before the Tribunal. The Tribunal rejected the appeals filed by the department. Being dissatisfied, the department filed appeals before this Court in ITA No. 214 and 215/2002 for both the assessment years. This Court after hearing the parties allowed the appeals filed by the revenue and remanded the matter back to the Tribunal to consider the grounds urged by both the parties and to pass an order in accordance with law.

The Tribunal, in the light of the directions issued by this Court considered the matters afresh and after hearing the parties, allowed the appeals filed by the revenue. This common order passed for both the assessment years 1992-93 and 1993-94 is assailed by the assessee in this appeal."

3. We have heard Sri A Shankar, learned counsel appearing for the appellant-company as well as Sri Jeevan J. Neeralgi, learned counsel appearing for the revenue at length and perused the material on record.

The appeal is admitted on the following substantial questions of law:

"a. Whether the Tribunal was justified in law in holding that the amount expended for producing technical know-how be allowed as expenditure under Section 35AB instead of Section 37 of the Income Tax on the facts and circumstances of the case?

b) Whether the Tribunal erred in not holding that deduction contemplated under Section 35AB is only in respect of a capital nature and the deduction of a revenue nature is allowable under Section 37(1) of the Income Tax Act?"

4. The relevant clauses of the agreement entered into between the appellant-company and the WCL are extracted and reproduced below:

"2. Technical Know-how:

2.1 Subject to receipt by WCL of payment by DEPL of the sum specified in to Clause 3.2.1 and below WCL shall supply to DEPL such written details and descriptions of the Technical know-how for imparting to DEPL an adequate knowledge of the Technical Know-how practiced by WCL at the date of this Agreement for production of the Product.

2.2 To assist DEPL to manufacture and produce the Product in India WCL shall provide instruction to DEPL as follows:--

2.2.1 WCL shall give access to WCL's facilities in the UK for the purpose of practical training in and to study Technical know-how to not more than two of DEPL's production personnel for not more than an aggregate of five days.

3. Payment by DEPL:

3.5 Without prejudice to any breach by DEPL of any of its obligations hereunder this Agreement shall be null and void if payment by DEPL under Clause 3.1 and 3.2 to WCL is not received. However, it is a condition precedent to the grant of

permission by the Reserve Bank of India that the total payments made in accordance with the aforementioned clauses should not exceed 8% of the value of sales made by DEPL pursuant to this Agreement within the period of 10 years from the date hereof or within the period of 7 years from the date of the commencement of commercial production of the Product, whichever first expires.

4. Confidentiality:

4.2 DEPL acknowledges that Technical Know-how and the copyright in all written printed photographed or duplicated matter supplied by WCL under or in connection with this Agreement shall belong to WCL and all such written printed photographed or duplicated matter shall be handed back to WCL on determination of this Agreement.

4.3 DEPL during the life of this Agreement and thereafter shall take all steps necessary to preserve the secrecy of Technical Know-how communicated to it or its representatives and shall not disclose the same to any third party (except those of its officers or employees whose duties cannot be fulfilled without such disclosure) for as long as the same are not freely available to the public.

6. Chromium Monoborides

6.5. DEPL will enable representatives of or persons authorized by WCL at all reasonable times to visit the places where it manufactures and produces the Product and there to inspect the testing system used and the records of tests made in respect of Indian C.M.'s and to inspect any additional documents relevant to the inspection compliance with the said specifications, and to select and take away and keep free of charge a reasonable number of samples for testing.

6.7. WCL will in using its rights of control and inspection strive to cause to DEPL no more inconvenience than is reasonably necessary to assure itself that the foregoing provisions of this Clause 6 are complied with by DEPL and as to the preservation of WCL's reputation in relation to the product.

7. Trade Marks:

DEPL acknowledges and agrees that all trade marks and trade names and in particular (without limitation) "Colmonoy" and "Colmonoy Sweat-on-Paste" are and will remain the exclusive property of WCL and/or any Associated Company of WCL and may be used by DEPL only while this Agreement is in force on Products to be exported with the prior approval in writing of WCL (such approval not to be unreasonably withheld) for the purposes of this Agreement. DEPL shall be entitled to use its own trademark or trade name for use on the Product sold within India.

9. Manufacture

9.4 DEPL shall be entitled to sub-licence the manufacture and sale of the Product and the use of the Technical Know-how under this Agreement to any other

person firm or corporation in India should this be necessary to enable DEPL to comply with its requirements and obligations under this Agreement. The terms of such sub-licence shall however be subject to the agreement of WCL as well as the other parties concerned and shall be subject to the approval of the Government of India.

11. Termination:

11.2. Either party shall have the right to give notice of termination (to operate 30 days after being given) if the other party has committed a serious breach of its obligations under this Agreement and (if such breach is capable of remedy) has failed to remedy the same within 14 days of a written notice calling on it to do so and specifying the nature of the breach.

12. Exclusions:

12.1. No rights or licences (whether express or implied) are granted by WCL under or by virtue of this Agreement except those which are specifically set out therein, and no such rights or licenses shall continue to have effect after the termination of this Agreement except so far as specific provision is made therein for such continuing effect."

5. Learned counsel appearing for the appellant, placing reliance on these clauses of the agreement, argued that at no point of time absolute transfer of rights over the know how was made by WCL Company to the assessee i.e., there was no absolute acquisition of the technical know how by the assessee, as it was only a transfer of right to use the technical know-how. The effective control of the know how always remained with the WCL and thus, the expenditure incurred towards procurement of know how was a revenue expenditure and not a capital expenditure, as no enduring benefit accrued to the assessee in the course of his business. The learned counsel drew our attention to the CBDT Circular dated 12.6.1985 wherein it is provided as under:

"15.2 As a consequence of this amendment, the deductions allowable under Section 35A of the Income-tax Act in respect of any expenditure of a capital nature incurred on the acquisition of patent rights or copyrights and under section 35AB in respect of expenditure on know-how have been withdrawn with effect from the assessment year 1999-2000."

6. Learned counsel further contended that the provisions of Section 35AB are applicable only in the cases of capital expenditure and if it is revenue expenditure, then the provisions of Section 37 shall apply. In support of his contentions, reliance was placed on:

"(1) Commissioner of Income Tax Vs. Swaraj Engines Ltd., (2008) 216 CTR 365 : (2009) 309 ITR 443 : (2008) 171 TAXMAN 495

(2) Shriram Pistons and Rings Ltd. Vs. Commissioner of Income Tax, (2008) 219 CTR 228 : (2008) 103 DRJ 312 : (2008) 307 ITR 363 : (2008) 171 TAXMAN 81

(3) CIT v. Empire Jute Co. Ltd - [124 ITR 151 (SC)]

(4) CIT v. Sayaji Industries Ltd. - [81 DTR 418 (GUJ)]

(5) Commissioner of Income Tax Vs. Molex (India) Ltd., (2011) 238 CTR 65 : (2012) 344 ITR 156 : (2010) 194 TAXMAN 52 "

7. The learned counsel appearing for the revenue supported the order passed by the Tribunal and relied on the Judgment of the Madras High Court in the case of Commissioner of Income Tax Vs. Drilcos (India) Pvt. Ltd., (2004) 192 CTR 383 : (2004) 266 ITR 12 and the Judgment of the Apex Court in Drilcos (India) (P) Ltd. Vs. Commissioner of Income Tax, (2012) 252 CTR 349 : (2012) 348 ITR 382 : (2012) 210 TAXMAN 267 .

8. Section 35AB(i) of the Act reads thus:

"35AB(i) Subject to the provisions of sub-section(2), where the assessee has paid in any previous year (relevant to the assessment year commencing on or before the 1st day of April, 1998) any lump sum consideration for acquiring any know-how for use for the purposes of his business, one-sixth of the amount so paid shall be deducted in computing the profits and gains of the business for that previous year, and the balance amount shall be deducted in equal instalments for each of the five immediately succeeding previous year."

9. As explained in the case of MOLEX (INDIA) LTD., (supra) the following three factors have to be necessarily present to attract the said provision:

"(1) Payment by Lumpsum consideration

(2) For acquiring any know-how for use

(3) For the purposes of business

then, one-sixth of the amount expended shall be deducted in computing the profits and gains of the business for that previous years, and the balance amount shall be amortized for the next five succeeding years in equal instalments."

10. This provision was inserted by Finance Act 1985 with effect from 1.4.1986 and was in the Statute Book upto 31st March 1999.

11. Section 37(i) of the Act reads thus:

"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."

12. Thus, what could be inferred from this is that only the revenue expenditure falling under Sections 30 to 36 of the Act is attracted and not the capital expenditure.

13. The Budget Speech of Finance Minister, 1985-86 specifies the object for inserting Section 35AB with effect from 1.4.1986 the relevant paragraph of which is produced herewith:

"With a view to providing further encouragement for indigenous scientific research, I propose to provide that lump sum consideration received by scientists for the know-how developed by them would be spread over a period of three years and charged to tax accordingly. I also propose to provide that industry may write off the lump sum consideration paid for acquiring know-how in six annual instalments. In cases where the know-how has been developed in Government laboratories, Universities, laboratories owned by public sector companies and other recognized institutions, the write-off would be permitted over a period of three years."

14. The memo explaining provisions in Finance Bill 1995 as regards deduction in respect of expenditure on know how reads thus:

"44. It is proposed to insert a new section 35AB in the Income-tax Act to provide that any lump sum consideration paid by a taxpayer for acquiring any know-how for use for the purposes of his business will be allowed as deduction by spreading it equally over six years, namely, the year in which the lump sum consideration is paid and the five immediately succeeding years. Where the know-how is developed in a laboratory, university or institution referred to in subsection (2B) of section 32A, the consideration shall be spread equally over three years.

45. For the purposes of this section, "know-how" means any industrial information or technique likely to assist in the manufacture or processing of goods or in the working of a mine, oil well or other source of mineral deposits (including the searching for, discovery or testing of deposits or the winning of access thereto)."

15. CBDT Circular dated: 12.6.1985 as regards depreciation to be allowed on intangible assets reads thus:

"15.2 As a consequence of this amendment, the deductions allowable under Section 35A of the Income-tax Act in respect of any expenditure of a capital nature incurred on the acquisition of patent rights or copyrights and under section 35AB in respect of expenditure on know-how have been withdrawn with effect from the assessment year 1999-2000."

16. In the case of CIT v. Swaraj Engines (supra), the Apex Court has held that "if the expenditure is found to be revenue in nature then Section 35AB may not apply. However, if it is found to be capital in nature then the question of amortization and spread over as contemplated, under Section 35AB would certainly come into play".

17. In the case of Shriram Pistons and Rings Ltd. (supra), the Delhi High Court was considering the question whether the amount paid by the assessee to a collaborator Company is a revenue expenditure or not, in the context of use of

technical know how. It is held thus:

"32. Applying the various principles that have been laid down, we find that there was in fact no absolute transfer of any right in the documentation given by Riken to the assessee. The assessee was entitled to use the technical know-how for a period of five years or for a lesser period, in case the agreement was terminated before that. The assessee did not have a free hand to sublicense the technical know-how and that was possible only with the prior written permission from Riken. For all other matters, the assessee was liable to treat as confidential all inventions, drawings, documents, specifications etc. furnished by Riken to the assessee. Even though the assessee was entitled to use the name of Riken in the marketing of its products but that right would cease upon the expiry or termination of the agreement.

33. As already noted, the agreement was valid only for a period of five years but could be terminated earlier. There is no magic in the word "sold" used in clause 5.0 of the agreement because on a reading of the agreement as a whole, it appears to us that what was transferred to the assessee was only a right to use the technical know-how of Riken and there was no sale of the technical know-how which the assessee could exploit. The assessee's rights were hedged in with all sorts of conditions, clearly making it a case of right to use the technology and not sale of the technical know-how."

18. In the case of Deputy Commissioner of Income Tax v. Sayaji Industries Ltd., (Guj), it is held at para-23 as under:

"23. To our mind, therefore, the provisions of s. 35AB of the Act can apply only in case of capital expenditure and of course, provided the conditions set out therein are fulfilled. In such a case, during the period when s. 35AB remained in operation, the assessee could claim benefit thereof. However, such provision would not apply to a revenue expenditure even if the same was incurred for acquisition of technical know-how. Deduction on such expenditure was available even before the introduction of s. 35AB of the Act and such deduction cannot be curtailed or limited by applying s. 35AB. In that view of the matter, taking such an expenditure out of s. 37(1) of the act, would not arise".

19. In the case of Drilcos (India) Pvt. Ltd., Madras High Court relied on the judgment of CIT v. Tamil Nadu Chemical Products Ltd., case rendered prior to the judgment of the Apex Court in Swaraj Engines Ltd., (Supra) and has observed that Section 35AB of the Act are applicable in the context of the case where no know-how was made available to the assessee in the manner required.

20. The said judgment of the Madras High Court was carried in Appeal before the Apex Court wherein, it was held that "it is true that on account of certain disputes which arose between the parties, the balance amount was not paid by the assessee to the American Company. However, the word "for" in section 35AB of the Act, which is a preposition in English grammar, has to be emphasized while interpreting section 35AB of the Act. Section 35AB of the Act says that the

expenditure should have been incurred for the purposes of the business of the assessee. In the present case, the technical assistance agreement was entered into between the assessee and the American company for acquiring know-how which was, in turn, to be used in the business of the assessee. Once section 35AB of the Act comes into play, then section 37 of the Act has no application." This was a case, where the main focus of the court was with respect to certain dispute as regards the full payment of consideration not being paid by the assessee to the collaborator company. No finding is given on the application of the law rendered in the case of Swaraj Engines Ltd. (Supra).

21. We have given our anxious consideration to the relevant clauses of the agreement and the judgments cited at the bar. Now, first we have to decide whether the amount expended for procurement of technical know-how is revenue expenditure or capital expenditure.

22. The agreement clauses referred to above make it clear that the assessee had only the right to use the know-how procured from WCL and there was no absolute acquisition of the technical know-how by the assessee. The technical know-how supplied by the WCL to the assessee-Company is an adequate knowledge of the technical know-how, practiced by the WCL at the date of the agreement for production of the produce with certain conditions, which establishes that the control was with the WCL. The consideration paid is for imparting the knowledge of "know-how" to the assessee's personnel.

23. In clause-9 "manufacture", it is stipulated that subject to performance by the assessee of his obligations under the agreement, WCL shall grant licence to the assessee to manufacture the product during the life of the agreement. And during the life of the agreement, WCL shall not grant such licence in India to any other person, Company, whether body corporate or not, partnership firm, Corporations etc. without obtaining prior consent from WCL. The "termination" clause at 11.2 stipulates that either party shall have right to give notice of termination (to operate 30 days after being given) if the other party has committed a serious breach of its obligations under this agreement and in the "exclusion" clause, it is specified that no rights or licences are granted by WCL under or by virtue of the agreement except those which are specifically set out therein, and no such rights or licences shall continue to have effect after the termination of the agreement except so far as specific provision is made for such continuing effect. A reading of these clauses makes it clear that the no absolute acquisition of the technical know-how was made by the assessee. In our view, the period of agreement itself is not the determinative test to arrive at the nature of expenditure whether revenue or capital. Considering the over all clauses of the agreement, we are of the opinion that amount expended by the assessee for procurement of technical know-how is in the nature of revenue and not capital.

24. Section 35AB of the Act is applicable if the expenses incurred are held to be capital in nature. As we have noticed, the terms and conditions of the agreement

entered into between the parties demonstrates that the amount expended are revenue in nature and does fall under Section 37 of the Act as held by the Apex Court in the case of Swaraj Engine Ltd. (Supra).

25. Another aspect of the matter is that to attract the provisions of Section 35AB of the Act, the three main factors i.e. 1) Payment of lumpsum consideration, 2) acquiring any know how and 3) for the purpose of business, have to be compulsorily satisfied. As noticed above, there is no absolute acquisition of the technical know how by the assessee, no enduring benefit has accrued to the assessee. No ownership or domain right was enjoyed by the assessee. In such circumstances, we are of the view that the amount expended by the assessee towards procurement of "know-how" is revenue in nature and Section 35AB of the Act is not attracted. The arguments advanced by the Revenue that irrespective of the expenditure, whether revenue or capital, if it is technical know Section 35AB of the Act are attracted, cannot be accepted in view of the law laid down by the Apex Court in the case of Swaraj Engines Ltd. (Supra).

26. The Budget speech of the Finance Minister, memo explaining the provisions in Finance Bill and the CBDT Circular dated 12.6.1985 fortifies that Section 35AB is an enabling provision inserted with effect from 01.04.1986 to provide further encouragement for indigenous scientific research and not to limit or curtail the Powers of Section 37 of the Act already existing. The reading of Section 37 of the Act makes it more clear that any expenditure not being expenditure of the capital nature described in Sections 30 to 36 shall be allowed in computing the income chargeable under the heads "profits and gains in the business or profession". It means that Section 35AB is applicable only if the expenditure is in the nature of capital expenditure. Though the Commissioner of Income Tax (Appeals) has held that the expenditure incurred by the assessee is revenue in nature, falling under Section 37 of the Act, the Tribunal failed to appreciate the same in the right perspective and has come to a conclusion that Section 35AB being a specific Provision for technical know, general Provision of Section 37 of the Act is not applicable, which is not sustainable, in view of the judgments discussed above and in terms of the contract. We are thus to allow this appeal for two reasons. Firstly, there is no "acquisition" of technical know-how as contemplated under Section 35AB of the Act, and secondly, Section 35AB would not apply to a revenue expenditure.

27. As we have discussed earlier, judgment of the Apex Court in Drilcos (India) (Supra) is distinguishable and not applicable to the facts of the case. On the other hand, the later judgment of the Apex Court rendered in the case of Swaraj Engines (Supra) is squarely applicable to the facts of the case.

28. For the foregoing reasons, we allow this appeal by setting aside the order of the Tribunal and answering the substantial questions of law in favour of the assessee and against the Revenue holding that the expenditure incurred by the assessee towards the procurement of technical know how by paying a lumpsum consideration for use in the course of business is a revenue expenditure falling u./

s 37 of the Act and the provisions of Section 35AB of the Act are not applicable to the present case.

Accordingly, the appeal stands allowed.