

(1989) 04 BOM CK 0001

In the Bombay High Court

Case No : IT APPEAL NOS. 3372 AND 5309 (BOM.) OF 1985

FIRST Income Tax OFFICER

APPELLANT

Vs

AUTOMOBILE PEUGGEOT.

RESPONDENT

Date of Decision : 24-04-1989

Acts Referred:

Citation : (1989) 30 ITD 329

Hon'ble Judges : N. R. Prabhu, A.M.

Bench : Division Bench

Judgement

Per N. R. Prabhu, A.M. - These are departmental appeals relating to assessment years 1981-82 and 1982-83. We shall deal with the appeal for the assessment year 1981-82. The grounds of appeal are as under :

(1) The CIT (A) erred in holding that the amount of Rs. 94,77,784 received by the assessee-company from M/s. Mahindra & Mahindra Ltd. in terms of agreements dt. 6-11-1979 and 6-3-1980 for supply of technical know-how for manufacture of PEUG-EOT engine XDP 4.90 cannot be brought to tax under the heed royalty ?

(2) The CIT (A) erred in holding that even if the payment is in the nature of royalty, the source cannot be said to be in India and hence cannot be subjected to tax as royalty in India ?

(3) The CIT (A) erred in holding that the payment represents fees for technical services, that services were rendered outside India and that the income would accrue outside India, and on that ground further holding that the amount cannot be brought to tax ?

(4) The CIT (A) erred in directing the ITO to exclude the sum of Rs. 94,77,784 from the total income ?

It would be necessary to set out the facts of the case in brief detail.

The assessee is a foreign company incorporated in France and had entered into an agreement with M/s. Mahindra & Mahindra Ltd. for supply of technical data in the manufacture of diesel engine XDP 4.90. The agreement was dated 6-11-1977 and there was also a supplementary agreement dt. 6-3-1980. A sum of 15 million French Francs were to be paid to the assessee in terms of this agreement. The agreement was to remain in force for a period of five years and the period has to be reckoned from the date of agreement itself. The payment under the agreement was to be made in three instalments : (i) on the agreement being recognised by the Govt. of India; (ii) on supply of the technology; and (iii) on expiry of 48 months from the date of agreement or actual commencement of production whichever were early. Before the Income Tax Officer, the claim was that the payment received from the Indian company was totally exempt from tax having regard to the terms of the agreement and also having regard to the Treaty for Avoidance of Double Taxation between the Governments of France and India. The ITO, however, did not accept the contention of the assessee. He was of the opinion that there was no transfer of technology as was alleged, because several restrictions were placed on the Indian company, and these were spelt out in the agreement. The agreement also stipulated that the Indian Company should not manufacture more than 25,000 units in any given year. In view of the restrictive covenants in the agreement, the ITO was of the opinion that the payment under the agreement was for a mere user of technology. He further held that the technology made available to the Indian Company was the standard technology which included designs, formulae, data etc. available with the assessee at the relevant time. Such payment having regard to the definition of the term industrial or commercial profits as contained in Article III (5) of the Agreement for Avoidance of Double Taxation (herein referred to as "Treaty") was not in the nature of industrial or commercial profit. This Article, according to the ITO, clearly excluded from the concept of industrial or commercial profit payment of royalties. He, in this view, brought to tax a sum of Rs. 94,77,784 being the rupee equivalent of 5 million French Francs representing the first instalment paid on 27-5-1980 for the assessment year 1981-82.

When the matter was carried in appeal, the CIT (A) accepted the claim of the assessee. He was of the view that the agreement had to be read in totality. The impugned payment was to be made, whether the Indian company had made use of the technology supplied by the assessee or not. He was further of the view that the extended definition of royalty u/s 9(I) (vi) of the IT Act could not be invoked for bringing to tax this amount. Even if the amounts received were to be held to be of the nature of royalty, according to the CIT (A), the situs would then become significant. Adverting to the provisions of similar Treaty with Belgium, the CIT (A) held that such a conclusion would be inescapable for the simple reason that the Treaty with Belgium had provided that the royalties would be deemed to be income in India. There was no such clause in the French Treaty, though the same was negotiated and agreed prior to the Belgium Treaty. He, for the reasons stated by him in his order, therefore held that the payment that was

held to be taxable by the ITO represented fees for technical services and not royalty or industrial or commercial profits.

2. It is contended by the learned Departmental Representative that the view taken by the CIT (A) is erroneous inviting our attention to Article III of the Treaty, it is contended that the industrial or commercial profits of an enterprise of one of the Contracting States shall not be subject to tax in the other Contracting State unless the enterprise has permanent establishment situated in that other contracting State. Article III (5) defines industrial or commercial profits and specifically excludes royalties and similar payments as referred to in para 2 of Article VII of the Treaty, wherein royalties have been defined as payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific works, cinematograph films, patents, models, designs, plans, secret processes or formulae, and trademarks. It would be clear from the above definition that the payment made by the Indian company to the assessee could but only be in the nature of royalty and therefore it would not be in the nature of industrial or commercial profits and hence taxable in India. It is further submitted that the view taken by the CIT (A) that the payment was for rendering technical service therefore has to be rejected. Inviting further our attention to the decision of the Supreme Court in the case of Performing Right Society Ltd. and Another Vs. Commissioner of Income Tax and Others, it is submitted that the income accrues, where the services are rendered or whereas in this case, the technology has been exploited and it cannot be gainsaid, that the technology was to be exploited in India. The specious plea of the assessee that the fee has to be paid regardless of whether the technology was exploited in India or not would not detract from the merits of the departmental case. It is far-fetched even to conceive that a payment would be made be made for procurement of the use of the technology and thereafter the same would not be put to any use. Our attention was also invited to the decision of the House of Lords in Rolls-Royce Ltd. v. Jeffrey (Inspector of Taxes) [1965] 56 ITR 580 where it was held that if a payment has been received for the supply of technical know-how, such receipt should be treated as forming part of the trading receipt of the party and this party was not parting with its assets but were tracing in them as part of its development of the general trade. It is further submitted that a reference to the agreement would make it very clear that what was supplied to the Indian company was not the technology which existed at the time of the agreement. The agreement clearly stipulates that the assessee was to communicate to the Indian company details of all improvements and engineering changes affecting the manufacture of the engine or any parts, components or other elements thereof. The assessee was also under obligation to the Indian company to send two samples of the improved parts, components or other elements. The improvements for this purpose has been defined as any modification development or technical or manufacturing process introduced into the Engine which makes it more competitive or more efficient or more versatile or more adaptable or to enable it to be manufactured more efficiently or more

cheaply. There is prohibition in the agreement that any proposed modification, improvement or engineering changes by the Indian company could be done only with an advance notice in writing to the assessee. These and several other clauses as embodied in part C of the agreement under the title Modifications, Quality, Industrial Property, Secrecy would clearly show that there has to be a continuous dialogue on technical matters between the assessee and the Indian company and the assessee was contract-bound to bring to the notice of the Indian company all the developments in the field of manufacture of the engine. This would clearly dispel any doubts should there be any that the user was of technology which was taken off the shelf. It is further submitted that the agreement further envisages usage of technology only in India and prohibits production of more than 25,000 units per annum. A reading of the agreement would clearly go to show that what was contemplated was the user of the technology and not the outright transfer. Since the user is in India, the payment to be received has to be considered as income accrued in India and such income would be exigible to Indian Income Tax. The CIT (A) was led away by certain extraneous and irrelevant considerations like the absence of clauses in the Treaty like the one which existed in the Belgium Treaty under which income was to be deemed in India, if the royalty is for user of technology in India.

3. The learned counsel for the assessee, Sri S. E. Dastur on the other hand contends that in the event of a conflict between the tax laws of the contracting States and the Treaty, the provisions of the latter have to prevail. This is an accepted position. His arguments are three-fold. In the first instance, it is contended that the payment is only for the transfer of technology to India. Secondly, the payment received under the agreement was for technical services and was not in the nature of royalty and in this connection, he relied on the various clauses of the agreement. Our attention was also invited to Article XVI of the Treaty wherein it has been laid down that the amounts paid by an enterprise of one of the Contracting States for technical services furnished by an enterprise of other Contracting State shall not be subject to tax in the first mentioned contracting State except in so far as such amounts are attributable to activities actively performed in the first mentioned Contracting State. Since no activities have been carried on by the assessee-company in India, the technical service fees received by it cannot be taxed in India. The third limb of his argument is that it is not the accrual of income that matters but as per the Treaty, it is the source of the income. It is submitted that the source is not in India. The amount would be not taxable even if the income were to be held as accruing in India. In this case, the source is not in India. The source could be the agreement which was signed in France or the technology which has transferred in France or the payment which was received in France. It would be evident that the source was not in India even if one or more of the above is considered as the source. It is thereafter submitted that the decision relied upon by the senior Departmental Representative of the Supreme Court decision in *Performing Right Society Ltd.s* case (supra) in fact supports this view. In that case, the Supreme Court has

clearly held that the income could accrue or arise in India without there being a source in India. Thus, it is claimed that even if the income is held to be earned as a result of the exploitation of the technology provided by the assessee to the Indian company, the same would not be taxable as the source is situated outside India. It is in this context that the CIT (A) has highlighted the relevant clauses in the Belgium Treaty, as contained in Article XII (2). In the said clause, it has been spelt out that royalties shall be deemed to arise in a Contracting State when the payer is in that State. There is no such clause in the French Treaty and therefore one has to go only by the source. There is a similar provision in the Japanese Treaty. Article X (e) of the Japanese Treaty lays down that Royalties and similar payments paid as consideration for the use of, or for the right to use, in one of the Contracting States, any copyrights, artistic or scientific works or equipments, patents, designs, secret processes and formulae, trade marks, cinematograph films and other like properties and fees for technical services rendered in that connection, shall be treated as income from sources within that Contracting State. The Treaty with Japan was entered on 13th June, 1960 and the Treaty with Belgium was entered in 1975. The date of notification of the French Treaty was in the year 1970. It would therefore appear that the omission to have similar provision in the French Treaty was a conscious one and was to tax royalties only on the basis of the situs of the source.

Elaborating further on the issue that the source and accrual need not necessarily coexist at the same place, assessee relies on the decisions reported in *Kusumben D. Mahadevia Vs. Commissioner of Income Tax, Bombay City*, and *RANI AMRIT KUNWAR Vs. COMMISSIONER OF INCOME TAX, C.P. and U.P.*, . In *Mrs. Kusumben D. Mahadevias* case (supra) the Bombay High Court held that though the source of dividend, viz., shares, was situated in British India, the income from that source accrued in the Baroda State. The matter was of course decided against the assessee. It is claimed by Sri Dastur that the decision was an authority for the proposition that the income could accrue in one place though the source could be in a different place. The decision in *Raja Bahadur Kamakshya Narain Singh of Ramgarhs* case (supra) which is a Privy Council decision is an authority for the proposition that the source is the covenant under which the receipts follow and in this case, according to the learned counsel, it is that agreement. That was a case where royalty was being paid under a lease agreement and the Privy Council took the view that income was flowing from the covenant in the lease. In the case reported in *Rani Amrit Kunwars* case (supra) the Court was concerned about the taxability of the amounts received by the assessee who was the wife of the Ruler of Kalsia State. The Court took the view that the amount received by the assessee from the Kalsia State was taxable as income which must be deemed to have accrued to the assessee in British India u/s 4(2) of the Indian Income Tax Act. At p. 582, the Court has observed that the source does not mean a legal concept but something which a practical man would regard as a real source of income. The Court further observed that if the husband of the assessee is bound to pay a certain sum periodically under an order of a Court or

under an agreement, the order or the agreement may be deemed to be the source of the income. This decision also, according to the learned counsel, would support its view that the source of income is the agreement and not its user as has been claimed by the Departmental authorities.

In *Princess Maheshwari Devi of Pratapgarh, Poona Vs. Commissioner of Income Tax*, the Court took the view that the assessee was to receive alimony from her husband and a decree to that effect was passed. The Bombay High Court held that the decree resulted in a transaction in which the right of the assessee to get maintenance from her ex-husband was recognised and given effect to. It was the decree that was the definite source of the income.

All these cases, according to the assessee, would clearly go to show that the source in this case could only be the agreement or the technology that was parted with. And since this had happened at Paris, the source should be deemed to be situated in Paris. Even the payment has been received in Paris. In these circumstances, the income or no part thereof is exigible to tax in India.

4. We have heard the parties to the dispute and in our opinion, the order passed by the CIT (A) deserves to be reversed. In the first instance, there has been no transfer of technology as has been alleged by the learned counsel for the assessee. It would be evident from the agreement between the assessee and the Indian company that under the agreement only a right to use and exploit the technology has been granted to the Indian company. The agreement, as per its terms has prohibited the Indian company from furnishing the technology to any person outside the territory of India without the express written consent of the assessee. During the period of agreement, the production of engines by the Indian company shall be limited to a maximum of 25,000 units per year. The Indian company was to apply at its own cost all important modifications decided by the assessee regarding the engine or any parts, components or other elements thereof. Unless otherwise agreed, the Indian company shall make all efforts to comply with all the instructions and provisions of the specifications documents furnished to it. Even where the Indian company desires to carry out any minor modification, it should prior to such introduction, as far as practicable discuss these with the assessee with a view to obtaining the assessee's consent which of course shall not be withheld unreasonably. These and similar covenants in the agreement would clearly go to show that there has been no transfer simpliciter but only the right of user or exploitation.

Then again, the technology that was furnished to the Indian company though initially was one that was available in the files, had to be updated as set out in Part C of the agreement under the heading MODIFICATIONS, QUALITY, INDUSTRIAL PROPERTY, SECRET. The assessee was required to communicate to the Indian company all details of improvements, engineering changes etc. Thus, there was to be a continuous dialogue between the assessee and the Indian company in the matter of supply of updated technology for the manufacture of the engines. It would thus be clear that this is not off-the-shelf transfer as has

been alleged.

The second contention of the assessee that the payment is for technical know-how services has also to be rejected. The Treaty between India and France has clearly defined what would constitute royalty which would not form part of the industrial and the commercial profits of a foreign contracting party. Article VII (2) of the Treaty deals with the terms royalty and we have adverted to that Article in the earlier part of this order. Even at the risk of repetition royalty would mean payments, *inter alia*, of any kind received as a consideration for the use or for the right to use, models, designs, secret processes or formulae, or for information concerning industrial, commercial or scientific experience. It cannot be gainsaid that the impugned payment was for the purpose of sharing scientific information or for getting designs, secret processes and formulae. This would clearly be covered by the definition given to the term royalty under Article VII (2) of the Treaty. The last limb of the agreement of the assessee is that it is not the accrual that matters, but the source which was relevant in the matter of taxability of the royalty. The assessee no doubt has canvassed in support of its arguments certain provisions in the Treaties with Belgium and Japan. We however feel the absence of provision in the Treaty between India and France similar to provisions in the Belgium and Japan Treaties is not very relevant. We have to decide whether having regard to the facts of the case, it could be said that the source of the receipt from Indian company was in India or was a source outside India. We are not impressed by the arguments of the assessee that the source in this case could either be the agreement or the technology, as the technology was parted with in Paris and as the agreement was signed. The agreement or for that matter, the technology by itself cannot give rise to any income. Unless the same is transferred to a party for exploitation in India, no income could accrue to the assessee. The argument that once the agreement is signed the payment becomes due and therefore regardless of whether there is exploitation or not, the assessee would be entitled to the payment has to be rejected. The agreement has to be approved by the Govt. of India and the terms of the agreement has to be given effect to by the Indian company. A hypothetical situation of the above nature is not likely to arise. In our view, it is the exploitation of the asset that is the source of the income. As observed (*supra*), the agreement or the technology standing in isolation or together cannot give rise to any income. The agreement is for the transfer of technology for user in India. It is the user that is relevant and that has taken place in India. We agree with the assessee that a situation could arise where the source is in one place and the accrual in a different place. The source is the user of the technology or its exploitation, and since the user or exploitation had taken place in India, the source should be deemed to be in India. In the case of *Mrs. Kusumben D. Mahadevia* (*supra*), on which reliance has been placed by the assessee's counsel, the Court has no doubt held the source of income from dividend is the shares though the dividend might accrue in some other place. This is because to receive dividend income, what is absolutely essential is the ownership of the shares and

nothing more. Similarly, the decision where the Courts have taken the view for the receipt of alimony or periodical payment, the source could be the agreement or the court decree would be also of little assistance. Once the decree or the agreement is signed, the receipts automatically flow without the recipient having to do anything more. This is not the case here. In this case, the payment is made for exploitation of the technology transfer. It is the activity resulting in exploitation which gives rise to the income.

We may further add that since we are of the view that the facts in the cases relied upon are not similar and for that reason not much assistance can be drawn upon from them, it would be profitably to go into the meaning of the word source. "Source understood in common parlance would mean origin or a fountain head. Can we, on the facts of the case consider technology or the agreement or both as the source ? The answer to this has to be in negative. Indirect assistance can also be drawn from the decision of the Calcutta High Court in the case of Performing Right Society Ltd. and Others Vs. Commissioner of Income Tax and Others, . This decision has been affirmed by the Supreme Court in Performing Right Society Ltd.s case (supra). That was a case where the assessee had an agent in India and through its agent entered into an agreement with All India Radio for broadcasting of musical works belonging to him. The question before the Court was whether the broadcasting fees paid to the society in England accrued in India. While dealing with this issue, the Court opined that the source of income was the broadcasting of music in India. The facts can be said to be analogous. In this case, the source of income could be said to be the exploitation of technology in India.

We shall further refer to the decision of the Allahabad High Court in the case of Seth Shiv Prasad Vs. Commissioner of Income Tax, . There, the Court has reproduced the observation of the Privy Council regarding the meaning of the word source. "Source means not a legal concept but something which a practical man would regard as a real source of income. At p. 18 the Court has further observed : "A source of income, therefore, may be described as the spring or fount from which a clearly defined channel of income flows. It is that which by its nature and incidents constitutes a distinct and separate origin of income, capable of consideration as such in isolation from other sources of income, and which by the manner of dealing adopted by the assessee can be treated so". It would be evident if these observations of the Court are applied to the facts of the case, the source could be in India and not in Paris, as claimed.

The fact that under the Belgium Treaty or the Japan Treaty there is a provision which states that royalty should be deemed to arise in a contracting State when the payer was in that State and there was no such provision in the Treaty between India and France, to our mind, is not going to make any difference. The issue has to be decided as has been done by us independently and without reference to the Treaties with other countries. As observed earlier, having regard to the agreement, it would be evident that the source is in India, the amount

therefore becomes taxable in India.

To sum up : (i) the payment is made for usage of the technology and not transfer simpliciter thereof, (ii) the payment by its very character is in the nature of royalty, and (iii) the source is in India-all the ingredients for taxation of this amount are therefore present, and in the circumstances, the order of the CIT (A) cannot be upheld. We, therefore, reverse his order and uphold that the payment made by the assessee to the Indian company is taxable under the Indian Income Tax Act.

5. That takes us with the appeal for the assessment year 1982-83. The grounds of appeal are as under :-

(1) The CIT (A) erred in holding that the amount in question received by the assessee is neither royalty nor fees for technical services nor industrial or commercial profits taxable in India.

(2) The CIT (A) erred in directing the ITO to exclude the sum of Rs. 1,66,50,290 from the total income of the assessee.

6. While giving relief to the assessee for this year the CIT (A) has relied on his order for A. Y. 1981-82. This order has stands reversed. The facts for this year being the same as in the earlier assessment year, we shall also reverse the findings of the CIT (A) for this year.

7. In the result, the appeals are allowed.