
(1981) 07 MAD CK 0008
In the Madras High Court
Case No : Tax Case No. 254 of 1975

MR. Electronic Components Ltd.

APPELLANT

Vs

Commissioner of Income Tax

RESPONDENT

Date of Decision : 08-07-1981

Acts Referred:

Companies Act, 1956 — Section 43A(2)
Income Tax Act, 1961 — Section 256(1)

Citation : (1982) 11 TAXMAN 130

Hon'ble Judges : Sethuraman, J

Bench : Single Bench

Advocate : S.V. Subramaniam, Subbaraya Aiyar, Padmanabhan and Ramamani, for the Appellant; J. Jayaraman and Mrs. Nalini Chidambaram, for the Respondent

Judgement

Sethuraman, J.—This is a reference u/s 256(1) of the income tax Act, 1961, referring the following question:

Whether, on the facts and circumstances of the case, the Tribunal was right in holding that a portion of the royalty paid to the foreign company under the technical aid agreement was capital in nature?

The assessee was incorporated on 31st December, 1962, as a private limited company. It became a public company u/s 43A(2) of the

Companies Act of 1956. It carries on the business in manufacture and sale of Morganite Volume Controls. It wanted to manufacture carbon tracks

and switch parts and assembling switches in India. M/s. Morganite Registers Ltd. is a company incorporated under the English Companies Act in

the U.K. It will be referred to as the foreign company hereafter. The foreign company was a manufacturer and distributor of carbon tracks,

potentiometers and other products, which have a world-wide reputation for their

quality and durability. The assessee-company was originally formed with the intention of manufacturing and of marketing in India the products of the foreign company and its associates and also of such additional products as may be mutually agreed upon between the foreign company and the assessee-company. The assessee was desirous of being given the right to ask the foreign company for guidance as to its development as well as technical knowledge which the foreign company had in procuring and marketing the products. The assessee-company also requested the foreign company to render technical advice and assistance for the furtherance of its objects which the foreign company agreed to do, render or procure upon the terms and conditions. An agreement was entered into on 6th September, 1963, between the assessee-company and the foreign company. In the agreement it was stated that the foreign company was formed with a nominal equity capital of Rs. 10,00,000 out of which 5,000 shares of Rs. 100 each had already been issued to and fully subscribed by Indian shareholders. The shareholders in the Indian company being desirous that the foreign company should enable the Indian company to manufacture fully the products in India and to sell them under the terms of the technical agreement wanted the machinery described in the first schedule to the said agreement to be supplied by the foreign company. The foreign company agreed to render technical aid and to supply the plant and machinery on the basis that equity shares in the Indian company of a value of Rs. 3,00,000 would be allotted and issued to it. The Indian shareholders, who subscribed to this agreement, agreed to take up 2,000 shares of Rs. 100 each in the Indian company. The Government of India by its letter, dated 29th December, 1962, approved the arrangement of the foreign company holding shares in the Indian company for a nominal value not exceeding Rs. 3,00,000 and also to the payment of royalty as provided for in the agreement of technical aid, the terms of which were contained in a draft marked as annex. A to the main agreement. The foreign company was to sell to the Indian company the requisite machinery, and if its value was less than Rs. 3,00,000, then to the extent of the difference between Rs. 3,00,000 and the value of the machinery, shares had to be issued in favour of the foreign company for cash consideration. The technical aid agreement was to be entered into as soon as the

Indian company was in a position to do so. The agreement was not assignable. There were also suggestions in it for amending the memorandum and articles of association.

2. The main features of the technical aid agreement, which is found as annex. A to the main Agreement, may now be referred to. It adverts to the foreign company having been requested to render technical advice and assistance, and supply formula and information within its possession for the furtherance of the Indian company's objects. The foreign company was appointed as consultant and technical adviser for a period of ten, years from the date of commencement of production of the goods contemplated by the assessee. The period of ten years was liable to be extended at the option of the foreign company for a further period of ten years. So long as the Indian company performed its obligations under the agreement, the foreign company agreed to provide to and procure for the Indian company such technical assistance and advice, and offer such formula, and information as could be made available by the foreign company to enable the Indian company to manufacture the products in India. Clause 4(a) contemplated the foreign company affording training at its works in England to men selected by the Indian company from time to time. The employees under training were to be paid by the Indian company. The foreign company was also to send its staff to India to assist the Indian company on the construction and equipment of its works and on processes and manufactures. The amount payable to the said staff sent on deputation was to be determined by the foreign company, and paid for by the Indian company. In any case, where the foreign company considered that the Indian company could manufacture and sell economically in India any products additional to the products described in the first schedule to the agreement, the foreign company would give to the Indian company an opportunity to manufacture such additional products: See clause 5(a). Sub-clause (b) of clause 5 laid down the procedure to be adopted in making an offer to the Indian company for manufacturing additional items. The foreign company under clause 6 agreed as consultant and technical adviser to disclose to the Indian company from time to time all technical informations within its competence relating to the manufacture of the products in India and to give to the Indian company the full

benefit of its knowledge, research, and experience in relation to the manufacture of the products and the marketing and distribution thereof. The foreign company had also agreed to grant necessary licences to be used in India in connection with the manufacturing rights. The licences to manufacture would cease upon the termination of the present agreement. The Indian company was permitted to use all the trade marks, brand names, trade names and design of the foreign company, as were appropriate to the manufactures by, and products, of the Indian company. The period during which the trade marks, etc., were available was also coterminous with the main agreement. The foreign company could not without the consent of the Indian company be engaged in the importation into or sale in India of any products manufactured by the Indian company under the terms of the agreement. Wherever the demand for the products was in excess of the manufacturing capacity of the Indian company the products were to be imported from the foreign company and sold in sufficient quantities so as to meet and satisfy the demands of the Indian market in full. The Indian company agreed to purchase its requirements of material components or half-finished products from the foreign company. The agreement contemplated also the Indian company exporting the goods manufactured at economical and competitive prices, but the right to export was not exclusive. Clause 9 provides for the consideration payable under the agreement, and runs as follows:

9. (a) In consideration of rights granted by Morganite (foreign company) to the company (Indian company) under this agreement the company shall

pay to Morganite in respect of each year or other financial period of the company a fee by way of royalty of 5 per centum (which will be subject to

deduction of Indian Taxes) on the annual net sales of the products by the company in such year or other financial period.

3. The net sales were taken to be the total of the invoices rendered by the Indian company to third parties for the products supplied, excluding

freight and insurance charges and the value of all components imported by the Indian company. The Indian company was to keep at its usual place

of business books of account, which would be open for inspection by the foreign company in order to enable it to verify for itself the amount

payable to it. The payments were to be made in sterling in the U.K. on the expiration of one month from the date on which the accounts were

certified by the Indian company's auditors. Interest was payable in case of default of payment within the period of one month. Clause 10(a) provided that in consideration of the technical information imparted and the secrets disclosed by the foreign company to the Indian company and the exclusive rights conferred on the Indian company to manufacture products by processes discovered and/or perfected by the foreign company, the Indian company agreed to use its best endeavours to preserve, and increase the goodwill and business connection in respect of all such products in India. The Indian company agreed to confine its activities only to the manufacture and sale of the products contemplated by the agreement. Only with the written consent of the foreign company, any other product could be manufactured or dealt with by it. The Indian company was to keep the information passed on to it in strict confidence, and all plans, drawings, specifications and descriptions furnished by the foreign company to the Indian company were to be the property of the foreign company and on the termination of the agreement by any means or for any cause whatsoever were to be delivered to the foreign company. Any information relating to the improvement discovered in the course of the manufacture by the Indian company had to be passed on to the foreign company, and the foreign company was to be entitled to the sole and exclusive benefit thereof.

4. Production of the articles contemplated by the agreement commenced from 1st December, 1966. We are now concerned with the assessment years 1968-69 to 1972-73. The relevant previous years ended on 30th June, 1967, to June 30, 1971. The Indian company in its assessment claimed deduction of the amount paid to the foreign company in accordance with the terms of the agreement described above. The amount so claimed came to Rs. 66,181, Rs. 1,52,880, Rs. 1,65,000, Rs. 2,00,720 and Rs. 3,37,676 for the respective years. The ITO took the view that the deduction claimed by the assessee pertained not only to the use of trade marks, designs, licences of the foreign company, but also for the supply of technical know-how which gave the assessee an advantage of enduring nature. He, therefore, disallowed 50 percent of the royalty as capital expenditure.

5. The assessee appealed against the assessments. The appeals for 1968-69 to

1970-71 came up for consideration before one AAC and the appeals for the other two years before his successor. The AAC who disposed of the appeals relating to the first set of the years held that the royalty was paid for the use of the technical knowledge which was closely linked up with the manufacturing activities and that, since the payment was made only to acquire technical information enabling the Indian company to carry on its business and earn profits, the entire payment of royalty was to be allowed as revenue expenditure. The AAC, who disposed of the appeals for 1971-72 and 1972-73, took a different view. In his opinion, there was justification for treating a part of the royalty paid, for the technical know-how and other services rendered by the foreign company, as capital expenditure. He considered that 25 percent of the royalty should be disallowed as capital expenditure and modified the assessments accordingly. The result was that there were two sets of appeals before the Tribunal. For the first three years, appeals were filed by the ITO and for the second two years they were filed by the assessee. The Tribunal which dealt with all the appeals together in its order dated 19th April, 1974, held that a portion of the royalty paid represented capital expenditure and that the AAC, who dealt with the last two years, had correctly and reasonably apportioned the capital element in the expenditure at 25 percent. The result was that the AAC's order for the assessment years 1971-72 and 1972-73 was affirmed and the order of his predecessor for the earlier years was modified. The assessee has brought the matter on reference contesting the disallowance of 25 percent as capital expenditure.

6. In the submission of the assessee the entire expenditure was allowable as revenue expenditure as the assessee had actually paid for the machinery either in the shape of shares or otherwise. He (the assessee's counsel) pointed out that initially the Indian company agreed to pay a lump sum of ₹ 10,000 and that as the Govt. of India did not approve of this arrangement, the foreign company agreed to forgo this payment subject to the Indian company paying a 5 percent royalty on the sale of the manufactured products. It was also stated that actually there was no service rendered in the erection of the machinery by it as two of the Indian engineers, who were working in the foreign company's establishment in the

U.K. were deputed to the Indian company and were taken over by it as its employees. His point was that the payment was wholly referable to the technical services rendered by the foreign company.

7. For the department the submission was that this is a case where the assessee had started the manufacture of a new product with the assistance of the technical aid agreement, that the manufacture was being done for the first time and that the payment made for technical assistance would in such a case involve an initial outlay, which would be capital expenditure. It was also contended that the Indian company had the benefit of the agreement for a reasonably long period, viz., 10 years in the first instance with an option of renewal for a further period of ten years and that, therefore, there was what can be called "enduring benefit". Several decisions were referred to in this context by both sides.

8. In *Jonas Woodhead and Sons (India) Ltd., Madras Vs. Commissioner of Income Tax, Madras*, the assessee entered into an agreement with an English company for the manufacture in India of all types of springs and suspensions for road and rail vehicles manufactured by the English company. The technical information and know-how in the possession of the English company was to be passed on to the Indian company-assessee. There also the information relating to the setting up of the plants for the manufacture of the products including drawings, specifications, etc., were to be communicated to the Indian company-assessee. The agreement provided for payment of royalty dependent on the turnover of the manufactured products. The ITO treated 1/4th payment of royalty as consideration for services provided by the English company of an enduring nature. He, therefore, disallowed the relevant amount as capital expenditure and his order was confirmed by the AAC and by the Tribunal. In dealing with the reference against the order of the Tribunal it was observed at p. 60 as follows:

...ultimately the question has to be decided on the basis of the terms of the particular agreement and the only general principle that can be derived from the decisions is that under the terms of an agreement, if the assessee acquired a benefit of enduring nature that will constitute "acquisition of an asset" and any amount paid for the same would constitute "capital expenditure" and, on the other hand, if the assessee had acquired merely

technical knowledge or knowledge for the manufacture of any particular item for a specified duration, then he had acquired only a licence to use

the other party's patent and knowledge and the amount would constitute "revenue expenditure".

9. The rationale behind the above view is obvious. No two agreements of this kind contain identical terms.

10. Thus, the matter has to be decided only on the terms of the agreement under consideration. In order to illustrate the way in which the matter

has been considered in the deckled cases, we may briefly refer to some of the recent decisions. In Commissioner of Income Tax Vs. Lucas-T.V.S.

Limited (No. 1), the assessee was granted the exclusive right and licence to make use, exercise and vend various items of electrical equipment for

vehicles and engines and services tools. The Appellate Tribunal held that the entire technical fees paid by the assessee was liable to be allowed as

deduction. When the matter came before this court on reference, the conclusion of the Tribunal was affirmed on the ground that in that particular

case even the stock which remained in the hands of the assessee after the expiry of the period of the licence had to be sold within a period of one

year and the royalties payable therefor were to be paid. It was considered that there was no scope for any manufacture of fresh articles on the

basis of the know-how obtained from the foreign company.

11. In Commissioner of Income Tax Vs. I.A.E.C. (Pumps) Ltd., the agreement provided for the use of the patents and designs of the foreign

collaborator for a period of ten years with an option to renew the same with the approval of the Government of India. The ITO held that 15

percent of the annual payments was alone allowable as revenue expenditure. The AAC increased this allowable expenditure to 50 percent. The

Tribunal allowed the entire amount paid. It was found on reference that what was granted by the foreign company was only a licence and what was

paid to the foreign collaborator was only a licence fee and not any price for the acquisition of any capital asset. It was, therefore, held by this court

that the entire payment was allowable as a revenue expenditure.

12. In Additional Commissioner of Income Tax and Another Vs. Southern Structurals Ltd., the foreign company agreed to participate in the equity

capital of the Indian company. One of the terms of the agreement provided that

after the expiration of the agreement the assessee would be free from any further obligation to pay any amount to the foreign company, while the assessee-company would have the continued use, free of charge, of all information made available by the foreign company during the period of the agreement. It was held that such a payment was capital expenditure, as there was an enduring benefit obtained in consideration of the expenditure claimed.

13. The cases discussed above exemplify the two terminals between which such cases fall. The case of Additional Commissioner of Income Tax and Another Vs. Southern Structurals Ltd., illustrates those categories where there is an enduring benefit. The two other cases show that the agreements made available licences of technical know-how, trade marks and patent rights. While the expenditure is clearly capital where there is an enduring benefit, it would be revenue if it is for the use of the know-how limited to a period, even though there may be an option for renewal for a specified period. The cases that fall in between the terminals would require examination on facts, as there is a likelihood of the expenditure being capital in part and revenue in part. The determination of the exact percentage of the capital and the revenue element in the payment has to a large extent to be left to the fact-finding authority.

14. It is thus necessary to analyse the terms of the agreement in the present case to find out how far the terms bear on the revenue or capital character of the expenditure. From the technical aid agreement it is clear that the foreign company had undertaken to advise the Indian company on the construction and equipment of its works and also on processes and manufactures. The foreign company agreed also to enable the Indian company to produce additional products in any case where the foreign company considered that the Indian company could manufacture and sell economically such products. Thus, there were terms in the agreement which provided for technical assistance in the matter of the designing and construction of the factory and for fresh items of manufacture. The consideration provided in clause 9(a) was in respect of the rights granted by the foreign company to the Indian company. Even assuming that actual assistance in the matter of construction has not been availed of by the Indian company for some reason or other-there is no clear finding on this aspect-still in

so far as clause 9(a) provided for payment for services including those in the matter of the construction of factory, the amount has to be described as capital expenditure. In such cases, we have to find out the object of the expenditure. If the object of the expenditure was with reference to the erection of the factory, then to that extent the revenue would be entitled to disallow that portion of the expenditure as not relating to the carrying on of the business. Similarly, in so far as part of the consideration is attributable to the manufacture of fresh items, as no other consideration has been provided for the manufacture of fresh items excepting those under clause 9(a), there would be an element of acquisition of a right exploitable in future. Pro tanto, it does not relate to the running business. It is in this sense that we have to hold that part of the expenditure was clearly capital in nature. In para 11, the Tribunal observed as follows:

(5) Since some of the rights conferred under the agreement relate to setting up of the profit earning apparatus, structure and framework of the business of the assessee resulting in an enduring benefit and advantage to the business and since some of the rights under the agreement relate to routine business operation carried on by the assessee for earning profit and since a composite fee is paid by way of royalty for all the services rendered by Morganite, there is every justification to disallow portion of the royalty paid as relating to capital expenditure.

(6) Since an asset and an advantage of enduring benefit of the assessee's business is thus acquired and brought into existence as a result of the technical aid agreement, it is immaterial that the payment was made once for all or was made periodically.

These are the considerations which are relevant to the point in question and cannot be considered as alien to the solution of the problem of the expenditure being partly capital in nature. On the facts herein, we are satisfied that the Tribunal was justified in principle in making an allocation of the royalty paid between capital and revenue. The question is, accordingly, answered in the affirmative and in favour of the revenue. The revenue will be entitled to its costs. Counsel's fee Rs. 500.