
(1997) 12 MAD CK 0128
In the Madras High Court
Case No : Tax Case No. 532 of 1986

S.R.P. Tools Ltd.

APPELLANT

Vs

Commissioner of Income Tax

RESPONDENT

Date of Decision : 24-12-1997

Acts Referred:

Income Tax Act, 1961 — Section 147, 28

Citation : (1999) 237 ITR 684

Hon'ble Judges : P. Thangavel, J; N.V. Balasubramanian, J

Bench : Division Bench

Advocate : Deokinandan, for the Appellant; K.M.L. Majele, for the Respondent

Judgement

N.V. Balasubramanian, J.—The assessee is a company engaged in the business of manufacture of motor vehicle accessories. The assessee entered into a technical collaboration agreement with Mitsubishi Heavy Industries Ltd., Tokyo (for short "MHI") on 10th April, 1972, according to which the Japanese company provided technical know-how to the assessee-company for the manufacture of certain precision tools such as, hobs, gear shaper cutters, broaches, shaving cutters, etc. The assessee-company agreed to pay, according to the agreement, a lumpsum amount of thirty four millions of Japanese Yen in four instalments in US Dollars and the assessee-company was also obliged to pay royalty at 4 per cent. of the selling price of the products manufactured commencing from the fourth year. The assessee paid a sum of Rs. 9,40,250 to MHI under the technical collaboration agreement and claimed the same as revenue expenditure to be deductible as such from business income for the asst. yr. 1975-76, and the ITO initially allowed the claim of deduction of the assessee which was debited to the P&L a/c under the head, "technical know-how charges". The ITO, subsequently, reopened the assessment, and in the assessment proceedings, he called for the agreement of technical collaboration and after considering the terms of the agreement of technical collaboration, he came to the conclusion that the assessee had acquired assets of an enduring nature, as the assessee had right to

use the technical know-how even after the expiry of the agreement and, therefore, he held that the payment of Rs. 9,40,250 was capital in nature and not admissible as revenue expenditure. He also disallowed the claim of the assessee towards the provision made towards gratuity. The assessee preferred an appeal challenging the order of the reassessment made by the ITO both on the ground of jurisdiction and on the merits of the case. The CIT(A) upheld the order of the ITO as regards the jurisdiction of the ITO to reopen the assessment. He also held that the assessee was not entitled to allowance on provision made towards gratuity. As regards the payment towards technical know-how charges, he held that the assessee had the benefit of technical information received even after the expiry of the agreement in the manufacture of the products, but the only restriction that was imposed was that the assessee was not entitled to mark the products as provided under art. 9 of the agreement. He came to the conclusion that the assessee by obtaining information, did not merely improve the products, but started manufacturing new products and in this view of the matter, he held that the amount paid cannot be regarded as revenue expenditure, but should be regarded as capital expenditure and dismissed the appeal preferred by the assessee.

2. Aggrieved by the order of the CIT(A), the assessee preferred an appeal before the Tribunal. The Tribunal held that the reopening was justified. It also held that the payment made by the assessee under the technical collaboration agreement was capital in nature and confirmed the view of the CIT(A) disallowing the claim for provision for gratuity and dismissed the appeal preferred by the assessee.

3. Aggrieved by the order of the Tribunal, the assessee sought for and obtained a reference and the following questions of law have been referred for our consideration :

"1. Whether, on the facts and in the circumstances of the case, the Tribunal was right in holding that the reopening under s. 147(b) of the IT Act, 1961 is valid ?

2. Whether, on the facts and in the circumstances of the case, the Tribunal was right in holding that the expenditure on gratuity and technical know-how fee are not allowable deductions ?"

4. Mr. P. P. S. Janarthana Raja, learned counsel for the assessee fairly has not addressed arguments on the question of jurisdiction of the ITO to reopen the assessment or the disallowance made by the ITO towards the provision of gratuity. His principal argument was that the Tribunal was not correct in holding that the payment made by the assessee for the technical know-how should be regarded as capital expenditure. He also produced a copy of the technical collaboration agreement entered into between MHI and the assessee dt. 10th April, 1972 and, referred to the relevant articles. He submitted that the agreement was entered into for adopting better production methods and for improving the quality and for taking up the manufacture of other types of products and the assessee was granted only a licence and, therefore, it cannot

be stated that the assessee obtained an enduring advantage and acquired assets which are capital in nature. He submitted that under art. 6 of the agreement, the assessee had a right to use the technical information for the manufacture of the products even after the expiry of the agreement, but the assessee was not entitled to mark the products as provided under art. 9 of the agreement, and, therefore, the payment made is revenue in nature. He placed reliance on a decision of this Court in Commissioner of Income Tax, Tamil Nadu-III Vs. Madras Rubber Factory Ltd., and submitted that the technical information obtained by the assessee was for running the business and therefore, it must be regarded as revenue in nature. He further placed reliance on a decision of the Bombay High Court in the case of Commissioner of Income Tax, Bombay City-I Vs. Tata Engineering and Locomotive Co. Pvt. Ltd., and submitted that the fact that the assessee was empowered to use the technical knowledge even after the expiry of the agreement does not come in the way of holding that the payment was revenue in nature. The next decision that was relied upon by the learned counsel for the assessee is the decision of a Full Bench of the Andhra Pradesh High Court in Praga Tools Ltd. Vs. Commissioner of Income Tax, , wherein the Andhra Pradesh High Court held that merely because the assessee was permitted to use the technical information after the expiry of the agreement would not make the royalty payment as capital in nature. He strongly placed reliance on a decision of the Delhi High Court in the case of Shriram Refrigeration Industries Ltd. Vs. Commissioner of Income Tax, Delhi-I, and submitted that where the object of the agreement was to benefit the running of the factory, the payment could be regarded as revenue in nature. The further submission of Mr. Janarthana Raja, learned counsel for the assessee was that the decision of the Supreme Court in Jonas Woodhead and Sons (India) Ltd. Vs. Commissioner of Income Tax, is distinguishable as that case dealt with the payment made for setting up of a plant.

5. Mr. C. V. Rajan, learned counsel for the Revenue, on the other hand, submitted that there is a positive finding by the CIT(A) that the assessee by entering into technical collaboration with MHI started manufacturing new products and, therefore, the payment should be regarded as capital in nature. He also referred to the relevant articles in the agreement and submitted that according to the decision of the Supreme Court in Jonas Woodhead & Sons (India) Ltd. case, cited supra, where the assessee obtained a new plant with complete new process and complete new technology for the manufacture of the new products, the payment made by the assessee should be regarded as capital in nature.

6. We have carefully considered the submissions of the learned counsel for the parties. It is necessary to scan the various articles of the agreement entered into between the assessee and MHI. The preamble portion of the agreement positively provides that the purpose of the agreement was to adopt better production methods, improving the quality and taking up the manufacture of other types of products. Under art. 2, the assessee was granted an exclusive licence and right to use and obtain the technical information knowledge and

experience including the technical assistance and training of technical personnel for the purpose of manufacture of products in India and selling the products. We have seen the nature of technical information provided under art. 3 of the agreement and a study of art. 3 indicates that the assessee was keen on the production of the products and other matters connected with the manufacture of the products. The technical assistance required to be rendered by the foreign company relates to the inspection of the sample products submitted by the assessee and training the personnel in the foreign country. It is permissible for MHI to depute its technicians for the purpose of carrying out the works relating to the manufacture of the products. Though the agreement makes a distinction between the payments of consideration, the assessee was required to pay a lump sum for the first 3 years and from the commencement of the fourth year, the assessee agreed to pay royalty at a fixed percentage on the sales and it is apparent that the assessee was required to pay lump sum in the initial years as there would be teething problems during the initial years and soon after the assessee established its market for the products, the amount was to be paid by way of royalty at a fixed percentage of the sales. The period of agreement is provided for in art. 6 of the agreement and it is no doubt true that the assessee was given a right to use the technical information for the manufacture of the products even after the expiry of the period of the agreement, but the assessee was not entitled to mark the products after the expiry of the agreement with the wordings, "manufactured by SRP Tools Ltd. under technical collaboration of Mitsubishi Heavy Industries Ltd., Japan", as provided for in art. 9 of the agreement. There are other usual articles found in the agreement. A close study of the agreement clearly shows that the assessee was entitled to draw upon the technical information for the manufacture of the products and the object of the agreement is for the running of the business and not for setting up any new factory. The assessee no doubt, on the basis of the finding of the CIT(A) started manufacturing new products, but, on that account, it cannot be stated that the object of the assessee in entering into the agreement and making the payment was not for running of the business. It is impermissible, in our view, when construing the nature of the payment to concentrate on one particular clause of the agreement for the manufacture of certain new products. The products cannot be new for all time to come as the novelty attached to the new product would wane off and the tag of newness of the products would wear off after some years of production. Therefore, the expression, "new" in any production would lose its charm after some years of production and in the changing economic scenario and rapid technological development, the word, "new" has only an ephemeral value. That apart, a distinction must be made in case where the knowledge was acquired to set up a new plant from those cases where the assessee had the right to get the technical know-how for the running of the business. The cumulative effect of the entire agreement has to be seen. The assessee is an existing company and though it entered into an agreement for the manufacture of new products, the knowledge that was obtained can neither be regarded as capital in quality nor the entire amount fund can be branded as capital in nature.

7. That apart, the nature of the agreement is such that it could not be stated that the assessee had acquired absolutely any asset and merely because a lump sum amount was paid, it is not possible to hold that it will assume a different character of acquisition of knowledge. A study of various articles of the agreement also shows that the assessee had mere access to the information which was essential for carrying on its business activities and for running its business efficiently and it is not of much significance that some of the products manufactured by the assessee are new products. Another significant aspect that is noticed is that the assessee has an existing business and even assuming that certain new products are manufactured with the aid and assistance of the technical knowledge obtained under the technical collaboration agreement, it cannot be stated that the assessee obtained a new plant with a complete new process and complete new technology for the manufacture of the products. The test laid down by the Supreme Court in *Jonas Woodhead & Sons (India) Ltd.* case, cited *supra* that whether the assessee obtained a new plant with complete new process and new technology has to be seen in the light of the other tests laid down by the Supreme Court, viz., whether there was an improvisation of existing business or a new business was set up and whether on the expiry of the agreement, the assessee could manufacture the product that had been set up with the collaboration of the foreign company. In effect, the cumulative effect of the various terms and conditions of the agreement have to be considered in the determination of the question whether the payment can be regarded as revenue in nature or capital in nature. The various articles in the technical collaboration agreement clearly show, as seen earlier, that the assessee was granted only a licence giving the right to use the technical knowledge and even after the expiry of the agreement, though the assessee was not prohibited from using the knowledge, there was a clear mandate against the assessee not to use the mark on the products indicating that the products were manufactured not with the technical collaboration of the foreign company. Considering the object of the agreement, namely, it is for adopting better production methods and improving the quality and also taking up the manufacture of products, we are of the opinion that the Tribunal was not correct in focussing on only one clause of the agreement and then to come to the conclusion that the expenditure was capital in nature.

8. Let us now consider the decisions relied upon by the learned counsel for the parties. The first decision that was relied upon by the learned counsel for the assessee is the decision of this Court in the case of *CIT vs. Madras Rubber Factory Ltd.* (*supra*) wherein this Court held as under :

"Technical or commercial knowledge acquired by a trader or industrialist is of this kind, enduring, if not everlasting. Expenditure to acquire it cannot be disallowed merely because knowledge dies hard. It is only where the expenditure bears on the fixed capital or other capital structure of the assessee that it can be regarded as capital in nature. Where the expenditure, although enduring in character has its impact on the running for the business, there can be no doubt that it is out

and out revenue expenditure. If the position were otherwise, practically any item of revenue outgoing in the day-to-day running of a business can be broken up and dissected in an effort to discover in it some fractional element or other of a capital nature, merely on the score that the resulting benefit or advantage tends to pay in the business. This, however, is not the law."

The decision makes it clear that where the expenditure had an impact on the running of the business, the expenditure should be regarded as revenue expenditure and, on the other hand, if the nature of the advantage derived from the agreement enures in the capital field of the assessee, then the expenditure can be regarded as capital in nature. It is inevitable that in any collaboration agreement the knowledge acquired would enure beyond the contract period but that would not by itself show that the expenditure should be regarded as capital in nature. But, where the knowledge acquired was used to run the business efficiently even after the contract period, the payment made for the use of the knowledge is liable to be regarded as revenue in nature. Therefore, we are of the view that the Tribunal was not correct in holding that the amount is capital in nature as there is no prohibition against the assessee from using the technical knowledge even after the contract period.

9. A similar view was also taken by the Bombay High Court in CIT vs. Tata Engg. & Locomotive Co. (supra) wherein the Bombay High Court laid down the following proposition of law to decide the question whether the expenditure can be regarded as capital or revenue in nature :

"Technical know-how cannot be called a tangible asset. Technical know-how and technical advice for the time being cannot in these days of technological and scientific development and consequent change in production techniques, be treated as a capital asset. The length of the period of agreement is not of much consequence, if the nature of advice made available is such that it cannot be called a capital asset. Merely because an assessee who has entered into a contract with regard to know-how is entitled to use the know-how even after the agreement has expired, it does not mean that he has acquired a benefit of an enduring nature. Agreement of foreign collaboration where foreign know-how is availed of in lieu of payment is in substance a transaction of acquiring the necessary technical information with regard to the technique of production. Instead of employing persons having knowledge of techniques and utilising their knowledge, technical know-how is acquired. Technical know-how made available by a party to such an agreement does not stand on the same footing as protected rights under a registered patent."

The Bombay High Court also in the abovesaid decision has taken a view that merely because the assessee was entitled to use the knowledge even after the contract period does not mean that the assessee had acquired an asset of enduring nature. The test laid down by the Bombay High Court is that the length of the period of the agreement is not determinative of the question and what is essential is to see the substance of the transaction and if the substance of the

transaction shows that the technical knowledge obtained was towards the better method of production of the articles produced by the assessee, then, it cannot be said that the assessee had acquired any asset of enduring nature and the amount paid for drawing up the technical knowledge should be regarded as revenue in nature.

10. In *Shriram Refrigeration Industries Ltd. vs. CIT* (supra), the assessee entered into a technical collaboration agreement for the manufacture of sealed compressors for air-conditioners and refrigerators on 26th June, 1961, and the commercial production started in October, 1964, and the business was set up in the accounting year ending September, 1965. The question that arose before the Delhi High Court was whether a sum of Rs. 2,39,084 paid towards collaboration agreement can be regarded as revenue expenditure. The Delhi High Court held that the object of the agreement was to obtain the benefit of technical assistance for the running of the business and it could not be stated that the assessee had acquired any knowledge or asset of enduring nature. The facts of the decision of the Delhi High Court, in our opinion are similar to the facts of the case and in the collaboration agreement in the instant case, the assessee had only a licence and there was no parting of any secret formula in favour of the assessee-company and the assessee had merely an access to certain technical information regarding production and improving the quality of the products and therefore, the payment cannot be said to be capital in nature.

11. The decision of the Supreme Court in *Jonas Woodhead & Sons (India) Ltd.* case, cited supra, relates to a case where the payment was made for the setting up of a factory. Learned counsel for the Revenue strongly placed reliance on the following observations of the Supreme Court in the above said decision :

"The question whether a particular payment made by an assessee under the terms of the agreement forms a part of a capital expenditure or revenue expenditure would depend upon several factors, namely, whether the assessee obtained a completely new plan with a complete new process and completely new technology for manufacture of the product or the payment was made for the technical know-how which was for the betterment of the product in question which was already being produced; whether the improvisation made, is part and parcel of the existing business or a new business was set up with the so-called technical know-how for which payments were made; whether on expiry of the period of agreement the assessee is required to give back the plans and designs which were obtained, but the assessee could manufacture the product in the factory that has been set up with the collaboration of the foreign firm; the cumulative effect on a construction of the various terms and conditions of the agreement; whether the assessee derived benefits coming to its capital for which the payment was made."

It is not clear from the facts found by the Tribunal that the assessee obtained technical knowledge for the setting up of a new plant and for manufacture of completely a new product with the aid and assistance of technology of the

foreign company. Furthermore, as we have already seen, the assessee had an existing business and, on the mere fact that certain new products are sought to be manufactured, it cannot be stated that it had set up a new plant with a new technology and the cumulative effect of the various terms of the agreement clearly show that the expenditure cannot be regarded for acquiring a capital asset by the assessee. Though the assessee had a right to use the technical know-how even after the completion of the agreement, that fact itself would not be conclusive to hold that the payment was of capital nature. The question whether the payment can be regarded as revenue or capital in nature depends upon the object of the expenditure and the effect of the expenditure and the impact of the expenditure in the business carried on by the assessee and for that purpose, it is necessary to bear in mind the business exigencies on the basis of which the agreement had been entered into. We have carefully perused the terms of the agreement and the various articles of the agreement clearly show that the assessee was given only a licence and had access to the information for the running of the business of the assessee. No doubt, as found by the CIT(A), the agreement was for a new product, but on that factor, it cannot be stated that the assessee acquired an enduring advantage in the capital field. We have seen that the nature of the agreement was essentially for drawing up the technical knowledge for the running of the business. Therefore, we are of the opinion that the Tribunal was not justified in holding that the amount paid under the agreement should be regarded as capital expenditure. Hence, we are of the view that the second question in so far as it relates to the payment of technical know-how is concerned, it should be answered in favour of the assessee.

12. Learned counsel for the assessee has not seriously disputed the finding of the Tribunal regarding the reopening of the assessment under s. 147(b) of the Act and also the view of the Tribunal that the expenditure on gratuity was not allowable.

13. In fine, we answer the questions of law referred to us as under :

First question of law : It is answered in the affirmative and against the assessee.

Second question of law : The question consists of two parts. In so far as it relates to the expenditure on gratuity is concerned, the Tribunal was right in holding that it is not an allowable expenditure. In so far as it relates to the payment of technical know-how fee is concerned, the Tribunal was not correct in holding that the payment of technical know-how fee is not allowable expenditure. We answer the questions of law referred to us in the above manner. However, in the circumstances of the case, there will be no order as to costs.