Madras Industrial Linings Ltd. vs Income-Tax Officer. on 23 February, 1990

Equivalent citations: (1990)37TTJ(MAD)59

ORDER

Per D. S. Meenakshisundaram, Judicial Member - This is an appeal by the assessee objecting to the order passed by the Commissioner of Income-tax, Tamilnadu-III, Madras, under section 263 of the Income-tax Act, 1961, dated 18-9-1986.

2. The assessee is a company engaged in the manufacture and sale of air pollution control equipment. Its income-tax assessment for the assessment year 1982-83, for which the previous year ended on 31-3-1982, was completed by the Income-tax Officer under section 143(3) of the Act by his order dated 29-12-1984. In the said assessment, the Income-tax Officer had allowed the assessees claim that the sum of Rs. 1,13,611 paid by the assessee to M/s. Environmental Elements Corporation, USA, as the second instalment of initial engineering fee, represented revenue expenditure. This was considered to be erroneous and prejudicial to the interests of Revenue by the Commissioner, who was of the view that this payment represented capital expenditure. He, therefore, initiated action under section 263 of the Act and called upon the assessee to show cause against his proposed action to revise the assessment order. After considering the assessees objections, the Commissioner held that under the agreement dated 27-10-1977 the assessee obtained the technical knowhow for manufacture of air pollution control equipments, that a new line of manufacture was stated using the knowhow and that the foreign company continued to use the knowhow was not at-all material, as in the hands of the assessee the purchase enabled them to embark upon a new line of manufacture which was an enduring benefit. The Commissioner, therefore, held that this was purely a capital expenditure and that the Income-tax Officer erred in allowing the same as revenue expenditure and, therefore, the assessment was clearly prejudicial to the interests of Revenue. He, therefore, under the powers vested in him under section 263 of the Act, directed the Income-tax Officer to modify the assessment by treating the expenditure incurred by the assessee for purchase of the knowhow as capital expenditure.

3. On the assessees further argument that if the expenditure was treated as capital, depreciation and investment allowance should also be granted, the Commissioner directed the Income-tax Officer to verify whether any capital asset had been brought into existence by the expenditure and if any asset had been brought into existence, after evaluating its cost, proper depreciation and other allowances should be granted in the prescribed particulars were furnished and the other formalities had been complied with.

4. The appellant feels aggrieved by this order of the Commissioner and has come up on appeal to the Tribunal objecting to the same. Shri Santhanakrishnan, the learned counsel for the appellant, submitted that the assessee is a company which was originally manufacturing industrial linings for various machinery and boilers since its inception in 1970, and that on 27-10-1977 it entered into an

agreement for technical collaboration with M/s. Enviornmental Elements Corporation, USA (hereinafter referred to as EEC), for the purpose of obtaining knowhow for manufacture of pollution control equipments. The learned counsel placed before us a copy of the said agreement, which is known as "Technology Licensing Agreement - Air Cleaning Systems - Wet Scrubber Technology". The learned counsel took us through the various articles of the agreement and pointed out that under article 3 of the agreement the assessee had to pay a sum of Rs. US $ 37,500 as initial engineering fee, that this amount was payable in three instalments as specified in article 3.02 and that the payment of Rs. 1,13,611 on 28-8-1981 represented the second instalment of 10,000 dollars after deduction of tax, remitted to EEC under article 3.02 sub-para 2. The learned counsel further submitted that the first instalment of US $ 10,000 was remitted by the assessee to EEC on 5-12-1978. He further stated that both these amounts were originally allowed by the Income-tax Officer in the assessment years 1980-81 and 1982-83 respectively as revenue expenditure. The learned counsel next referred us to article 4, which provided for payment of royalty at the rate of 3% of the net sales price for all domestic markets and at 5% of the nest sales price for export, markets of all licensed products. Shri Santhanakrishnan next referred to article 5, which provides for transfer of technical information. He particularly pointed out that there was no performance guarantee given by EEC to the assessee, as could be seen from Articles 5.03. He next referred to article 5.04 of the agreement as well as to page 14 of the paper book, whereby the second sentence in that article was omitted by a later assessment between the parties on 5-6-1978. Shri Santhanakrishnan referred to the term and termination of agreement contained in Article 6 and pointed out that after the expiry of the term of the agreement, the assessee was to have free right to use the technical information under the agreement but could not grant sub-licences to other parties as could be done under the agreement during its currency. He particularly emphasised article 6.04 which showed that the technical information given under the agreement by EEC to the assessee, who is the licensee, continued to be the property of EEC, which was to be kept secret and was not to be used by the assessee upon the termination of the agreement except as provided in article 6.01. Shri Santhanakrishnan next referred to article 7.02 and article 7.03 to point out that any improvements made by the assessee to the technical information shall become a part of the technical information given under the licence and belonged to the EEC. He next referred to article 8 which showed that there was no guarantee against patent infringement from the side of EEC in favour of the assessee. He also pointed out that under article 9 the assessee had to pay for any component parts which it may require, separately from the agreement. The learned counsel next referred to article 10 providing for warranties and exclusions and particularly to article 10.02 and stressed that it showed that there was no guarantee of quality given EEC and this article explained the absence of performance guarantee under this agreement. He next referred to article 12 which provided that this agreement was not assignable by the assessee without prior written consent of EEC. The last article relevant is the one contained in article 15 relating to trade marks and trade names. According to this article the assessee was prohibited from registering or using any of the trademarks or trade names of EEC without the prior written approval of EEC. This article further acknowledges that the assessee has no right nor any title whatsoever in or to any of the trademarks or tradenames of EEC. Then follows the Appendix-A containing the details of technical information of Air Cleaning Systems - Wet Scrubber Technology.

5. The learned counsel submitted that the assessee had entered into this agreement for manufacture of air pollution control equipment with its existing infrastructure, that it did not set up any separate or new industrial undertaking for this purpose, that it manufactured the articles with the existing machinery and infrastructure with certain modifications and additions. The learned counsel submitted that the payment of initial engineering fee specified in article 3 was for obtaining technical knowhow, that this technical knowledge obtained by the assessee under this agreement did not represent any advantage of an enduring nature to be regarded as capital expenditure, as held by the Commissioner of Income-tax. The learned counsel argued that every advantage of enduring nature need not be capital field could be considered as capital expenditure, his next submission was that the payment in question represented only revenue expenditure, which was rightly allowed by the Income-tax Officer and that the conclusion of the Commissioner to the contrary was incorrect and that the same should be vacated. In support of his submissions the learned counsel relied on the following decisions;

1. Empire Jute Co. Ltd. v. CIT [1980] 124 ITR 1/3 Taxman 69 (SC),

2. Time-Aids (India) (P.) Ltd. v. CIT [1978] 112 ITR 328 (Mad.),

3. Triveni Engg. Works Ltd. v. CIT [1982] 136 ITR 340 (Delhi),

4. Shriram Refrigeration Industries Ltd. v. CIT [1981] 127 ITR 746 (Delhi),

5. M. R. Electronic Components Ltd. v. CIT [1982] 136 ITR 305 (Mad.),

6. CIT v. Brakes India Ltd. [1982] 136 ITR 322 (Mad.),

7. CIT v. Sundaram Clayton Ltd. [1982] 136 ITR 315 (Mad.), and

8. Frick India Ltd. v. ITO [1983] 3 SOT 64 (Delhi) (SB).

Relying on these decisions the learned counsel contended that the assessees case was stronger case as could be seen from the various terms and conditions of the collaboration agreement, which was only a technology licensing agreement as its name indicated. He, therefore, argued that the expenditure claimed by the assessee should be allowed as revenue expenditure.

6. In the alternative the learned counsel submitted that if it is to be held that the expenditure in question was capital expenditure then the assessee would be entitled to both depreciation and investment allowance as such technical knowhow acquired by the assessee under this agreement should be regarded as "plant" as held by the Supreme Court in its recent judgment in the case of Scientific Engg. House (P.) Ltd. v. CIT [1985] 23 Taxman 66/ [1986] 157 ITR 86.

7. Shri V. P. Thiagi, the learned departmental representative submitted that what the assessee acquired was the knowledge and that the initial engineering fee stipulated in article 3 represented the purchase price of such knowhow specified in the appendix. Shri Thiagi submitted that the

various articles relied upon by the learned counsel only imposed certain limitations on the user of the knowhow acquired by the assessee but such limitations would not make any difference to the fact that what the assessee acquired was only a capital asset. and was therefore rightly treated as capital expenditure. In support of his arguments Shri Thiagi relied on the decision of the Supreme Court in the case of CIT v. Elecon Engg. Co. Ltd. [1987] 166 ITR 66, wherein it is held that technical knowhow, designs plans and documentation represented "plant" on which depreciation was admissible. The learned departmental representative further pointed out that the decisions of the Delhi High Court in Triveni Engg. Works Ltd.s case (supra), relied on by the assessees counsel was distinguishable on facts. He also submitted that the other decisions of the Madras High Court relied upon by the assessees counsel were distinguishable on facts and that the decision in M. R. Electronic Components Ltd.s case (supra) was really in favour of the Revenue. He therefore, submitted that the order of the Commissioner passed under section 263 of the Act was right and that the same should be upheld.

8. In his reply Shri Santhanakrishna, the learned counsel for the assessee pointed out that the decision of the Supreme Court in the case of Elecon Engg. Co. Ltd. (supra), would not be of any help to the revenue, as it was not concerned with the question whether the amount paid for obtaining technical knowhow was capital expenditure or revenue expenditure and that there was no dispute in the said case that the amount spent by the assessee for acquiring the technical knowhow was capital expenditure. The only question on which there was dispute was, whether such capital expenditure should be regarded as "plant", on which depreciation would be allowable. The learned counsel for the assessee also relied upon the decision of the Madras High Court in the case of CIT v. Madras Rubber Factory Ltd. [1983] 144 ITR 678, to contend that the expenditure claimed by the assessee in the present case was rightly allowed by the Income-tax Officer as revenue expenditure and that the Commissioners conclusion that it represented capital expenditure was erroneous.

9. We have carefully considered the submissions urged on both sides in the light of the materials placed before us and the case law referred to above. In our view the payment of Rs. 1,13,611 by the assessee to EEC representing the second instalment of initial engineering fee was rightly allowed by the Income-tax Officer as revenue expenditure and that the Commissioner of Income-tax erred in his conclusion that it represented capital expenditure. A perusal of the agreement entered into by EEC and the assessee on 21-10-1977 shows that it was only a technology licensing agreement for Air Cleaning Systems i. e., Wet Scrubber Technology. Article 2.01 grants the license in favour of the appellant company to use the technical information to design, make or have made licensed products in the territory of India and further grants non-exclusive license to sell, use and install incensed products that are made in the territory in accordance with the said technical information and to export the same to all countries except in those countries outside the territory where patents exist preventing such use or sale. Article 2.02 enables the appellant to sub-license the technical knowhow to other Indian companies on terms to be specified by the EEC and agreed upon by all parties. Article 3 of the agreement relating to Initial Engineering Fee, reads as follows :

> "3.0. Initial Engineering Fee 3.01. Upon the signing of the Licensing Agreement and in consideration of the initial Package of TECHNICAL INFORMATION to be furnished by ENVIRONMENTALELEMENTS, LICENSEE shall pay to

> ENVIORNMENTAL ELEMENTS and initial Engineering Fee of Thirty Seven Thousand Five Hundred Dollars in United States Currency (U. S. $ 37,500.00), such initial Engineering Fee not being subject to refund or application toward the payment of royalties under this Agreement.
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> 3.02. Payment of initial Engineering Fee shall be payable in three instalments as follows :
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> 1. One-third within thirty (30) days of the date when the Agreement is taken or record by the Government of India.
>
> 2. One-third within thirty (30) days after transfer of the knowhow documents by ENVIRONMENTAL ELEMENTS to LICENSEE.
>
> 3. One-third within thirty (30) days after receipt of initial order for Products covered under this Agreement."

We are concerned only with this article and the present payment is the second instalment made on transfer of knowhow by EEC to the appellant company.

9.1 Article 4 deals with royalty payable by the assessee to EEC on the sales of the Licensed Products. Article 5 provides for the transfer of technical information and reads as follows :

> "5.0 TRANSFER OF TECHNICAL INFORMATION 5.01 Within forty-five (45) days of ENVIRONMENTAL ELEMENTS receipt of the signed agreement and the first instalment of the initial Engineering Fee, ENVIRONMENTAL ELEMENTS will made available to LICENSEE by registered mail those items of a tangible nature that are listed in Appendix A. Other items of the TECHNICAL INFORMATION shall be made available to LICENSEE at appropriate locations selected by ENVIRONMENTAL ELEMENTS to representative of LICENSEE in accordance with Article 5.02 5.02 During the first six (6) months extending from the date of this agreement, ENVIRONMENTAL ELEMENTS shall, on terms to be mutually agreed upon with LICENSEE, provide office space and selected personnel to train representatives of LICENSEE TO use and apply the TECHNICAL INFORMATION.
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> 5.03 The services rendered by ENVIRONMENTAL ELEMENTS representatives will be in the form of counsel and advice as to LICENSEE. However, ENVIRONMENTAL ELEMENTS shall, to the extent feasible and to the extent personnel and facilities are available, upon request by LICENSEE, make special investigative or engineering studies for LICENSEE at a cost to be mutually agreed upon, subject to the approval of the Government of India."

The learned counsel for the appellant submitted that Article 5.02 was not acted upon by the parties and that further article 5.03 shows that there was no performance guarantee given by EEC in favour of the assessee-appellant. He further submitted that the last sentence in article 5.04 was deleted by a later Agreement dated 5-6-1978 entered into by the parties, a copy of which was submitted and placed at page 14 of the paper-book.

9.2 The learned counsel next referred to Article 6.01, which reads as follows :

> "6.01. This Agreement shall come into effect as soon as it has been executed by both parties and approval of the Government of India has been obtained. This Agreement shall extend for the term as previously defined in Article 1.04. Upon completion of the Term of Agreement, Licensee shall thereafter have the free right to use the aforesaid TECHNICAL INFORMATION."

The above article would show that on the completion of the term of the AGREEMENT, which was a period of five year of the Established commercial production, as per Article 1.04, the appellant would have a free right to use the aforesaid technical information. The next article that is relevant for the purpose is 6.04 which reads as follows :

> "6.04. Termination of the Agreement for any reason shall not be deemed to terminate any license to use that LICENSEE may have extended to its customers for which the applicable royalty has been paid to ENVIRONMENTAL ELEMENTS. However, LICENSEE recognises that the TECHNICAL INFORMATION is the property of ENVIRONMENTAL ELEMENTS, is to be kept secret and shall not be used by LICENSEE upon the termination of the Agreement except as provided in Article 6.01."

Article 7 deals with Secrecy and Exchange of information between the appellant and the EEC and reads as follows :

> "7.01 During the TERM OF THIS AGREEMENT, LICENSEE shall maintain in secrecy all TECHNICAL INFORMATION, including drawings, experience, data and the like, which it receives from ENVIRONMENTAL ELEMENTS and which is identified as confidential by ENVIRONMENTAL ELEMENTS, and shall use the same only for the purpose of his Agreement, LICENSEE shall require of its subcontractors a written commitment of secrecy of the same scope as that of LICENSEES obligation.
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> The obligation of secrecy shall not apply to the extent that the TECHNICAL INFORMATION (a) is now or hereafter becomes part of the public domain; or (b) is in possession of the recipient thereof at the time of its disclosure by the other party; or (c) is received in good faith from an independent third party who has a right to disclose the TECHNICAL INFORMATION.
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> 7.02 During the TERM OF AGREEMENT, the parties hereto shall exchange information concerning any improvements made relating to the design, manufacture or use of LICENSEE PRODUCTS. Any such improvements made by

ENVIRONMENTAL ELEMENTS shall become a part of the TECHNICAL INFORMATION licensed hereunder.

7.03 Licensee grants to ENVIRONMENTAL ELEMENTS a non-exclusive, irrevocable, royalty free license, with right to sublicense, throughout the world under any improvements under Article 7.02".

This article shows that the technical information provided by the Licensor EEC to the appellant continues to be the property of the Licensor, that any improvements made by the Licensee, relating to the design, manufacture or use of the LICENSED PRODUCTS become part of the technical information licensed under the Agreement and EEC gets a non-exclusive, irrevocable, royalty free license, with right to sublicense, throughout the world. Other articles are not relevant for the purpose. We would only refer to Article 15.01 which deals with TRADEMARKS and tradenames, and it reads as follows :

"15.01 LICENSEE shall neither register nor use an ENVIRONMENTAL ELEMENTS trademarks or tradenames without ENVIRONMENTAL ELEMENTS prior written approval. LICENSEE concedes that it has no rights nor any title whatsoever in or to ENVIRONMENTAL ELEMENTS trademarks or tradenames."

"B. Technical Standards and Standard Drawings C. One set of typical drawings, requisitions, installation instructions, application and design calculations, estimates and cost data for each different type LICENSED PRODUCT.

D. Applicable R & D Report and Records."

9.4 The original Agreement dated 21-10-1977 was amended as could be seen from the confirmation letter dated 1-6-1978 written by the assessee to EEC, According to para-h of this letter a new Article 15.01 is substituted for the original, which we have quoted above. It reads as follows :

"h) Article 15.01 shall be substituted by the following :

LICENSEE shall not be entitled to use any ENVIRONMENTAL ELEMENTS trademarks or tradenames for sales within India. The LICENSEE may use ENVIRONMENTAL ELEMENTS" trademarks or tradenames for export sales after obtaining ENVIRONMENTAL ELEMENTS prior written approval. LICENSEE concedes that it has no rights nor any title whatsoever in or to ENVIRONMENTAL ELEMENTS tradenames".

9.5 A new Article 3 is inserted by this letter dated 1-6-1978 and it reads as follows :

"i) The following shall be added as Article 3 :

The minimum Commercial Production of the LICENSED PRODUCTS during the period of THIS AGREEMENT shall be as follows and ENVIRONMENTAL ELEMENTS on their part shall render all technical assistance under this Agreement to enable the LICENSED to achieve the minimum production :

Rs.

First year of Established Commercial Production 900,000 Second year -do-

1,800,000 Third year -do-

2,700,000 Fourth year -do-

3,600,000 Fifth year -do-

4,500,000 Consequent to the said new Article 3, existing Articles 3 to 17 were re-numbered as articles 4 to 18.

9.6 A persual of the said Articles clearly establish that the appellant company was granted only a License to use the technical information provided by EEC, under this Licensing Agreement for manufacture of Air Pollution Control System, that is Wet Scrubber and other equipments as specified in Appendix-A to the Agreement used for effluent control for industrial, municipal and utility processes. The various clauses quoted above clearly establish that the technical information provided by EEC to appellant under this Agreement continues to remain the property of EEC, even though there is provision for granting sublicenses by the assessee with the previous approval of the Licensor on such terms and conditions as may be agreed between them and also for free use of such technical information after the expiry of the term of the Agreement entered into between the assessee and the EEC. It is the contention of the appellants learned counsel that the appellant company had made use of this technical knowhow for manufacture of Air Pollution Control Equipments with the existing machinery and the infrastructure available in its factory, with modifications and additions and that it had not set up any new separate industrial undertaking for the purpose of manufacturing Air Pollution Control Equipment under this licensing Agreement. This factual position stated by the appellants learned counsel was not disputed by the revenue. We are, therefore, unable to agree with the revenue that any capital asset or any enduring advantage had been obtained by the appellant company under this licensing agreement to constitute the payments in question as capital expenditure.

10 We are fortified in our conclusion by the latest decision of the Supreme Court in the case of Alembic Chemical Works Co. Ltd. v. CIT [1989] 177 ITR 377/43 Taxman

312. That was also a case of acquisition of knowhow by the assessee to produce higher yield and sub-culture of high-yielding strain of Penicillin for a lump-sum payment of U. S. $ 50,000 equivalent to Rs. 2,39,625 once for all. Their Lordships of the Supreme Court held that the financial outlay under the agreement was for the better conduct and improvement of the existing business and was revenue in nature and was allowable as a deduction in computing the business profits of the appellant. Their Lordships pointed out that the limitations placed in the agreement on the right of the appellant in dealing with the knowhow and the conditions as to non-partibility, confidentiality and secrecy of the knowhow, pertained more to the use of the knowhow than to its exclusive acquisition. Their Lordships further held that the improvisation in the process and technology in some areas of the enterprise was supplemental to the existing business and there was no material to hold that it amounted to a new or fresh venture. The further circumstances that the agreement pertained to a product already in the line of the appellants established business and not to a new product, indicated that what was stipulated was an improvement in the operations of the existing business and its efficiency and profitability not removed from the area of the day-to-day business of the appellants established enterprise. At page 390 of the report Their Lordships held as follow :

"It would, in our opinion, be unrealistic to ignore the rapid advances in research in antibiotic medical microbiology and to attribute a degree of endurability and permanence to the technical knowhow at any particular stage in this fast-changing area of medical science. That state of the art in some of these areas of high priority research is constantly updated so that the knowhow cannot be said to be the element of the requisite degree of durability and nonephemerality to share the requirements and qualifications of an enduring capital asset. The rapid strides in science and technology in the field should make us a little slow and circumspect in too readily pigeon-holing an outlay such as this as capital. The circumstance that the agreement in so far as it placed limitations on the right of the assessee in dealing with the knowhow and the conditions as to non-partibility, confidentiality and secrecy of the knowhow incline towards the inference that the right pertained more to the use of the knowhow than to its exclusive acquisition."

Again at pages 391 and 392 Their Lordships held as follows :

"The improvisation in the process and technology in some areas of the enterprise was supplemental to the existing business and there was no material to hold that it amounted to a new or fresh venture. The further circumstance that the agreement pertained to product already in the line of the assessees established business and not to a new product indicates that what was stipulated was an improvement in the operations of the existing business and its efficiency and profitability not removed from the area of the day-to day business of the assessees established enterprise.

> It appears to us that the answer to the questions referred should be on the basis that the financially outlay under the agreement was for the better conduct and improvement of the existing business and should, therefore, be held to be revenue expenditure. Reference may also be made to the observations of this court in CIT v. Ciba of India Ltd. [1968] 69 ITR 692.
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> There is also no single definitive criterion which, by itself, is determinative as to whether a particular outlay is capital or revenue. The once for all payment test is also inconclusive. What is relevant is the purpose of the outlay and its intended object and effect, considered in a common sense way having regard to the business realities. In a given case, the test of enduring benefit might break down. In CIT v. Associated Cement Companies Ltd. [1988] 172 ITR 257 (SC) at p. 262, this court said :
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> As observed by the Supreme Court in the decision in Empire Jute Co. Ltd. v. CIT [1980] 124 ITR 1, that there may be cases where expenditure, even if incurred for obtaining an advantage of enduring benefit, may, none the less, be on revenue account and the test of enduring benefit may break down in this test. What is material to consider is the nature of the advantage in a commercial sense and it is only where the advantage is in the capital field that the expenditure would be disallowable on an application of this test.....
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> In result, for the foregoing reasons, the appeal succeeds and is allowed and the question of law referred to the High Court for its opinion in ITR No. 78 of 1970 is answered in the affirmative and against the Revenue. The judgment under appeal is set aside."

11. When we examine the various Articles of the technology licensing agreement in the present case, in the light of the aforesaid ratio of the Supreme Court decision, it would be clear that the amount of Rs. 1,13,611 did not bring into existence any new asset or any enduring advantage in the capital field to the appellant, to hold that it represented capital expenditure. We would, therefore, respectfully follow the ratio of the decision of the Supreme Court quoted above and hold that the assessee was entitled to the deduction of this amount of Rs. 1,13,611 as revenue expenditure under section 37(1) of the Act and that the Income-tax Officer had rightly allowed the same while making the assessment for this year and that the CIT was not justified in revising the said assessment order by invoking his powers under section 263 of the Act. Accordingly, we cancel the order passed by the CIT under section 263 of the Act and restore the assessment made by the Income-tax Officer.

12. In view of the latest decision of the Supreme Court, which we have followed in the present case, we do not consider it necessary to examine in detail and discus any of the decisions cited by the learned counsel for both sides. Since we have accepted the appellants main plea, it is unnecessary to examine its alternative contention.

13. In the result, the appeal is allowed.