M/S. JONAS WOODHEAD AND SONS LTD., MADRAS

v.

THE COMMISSIONER OF INCOME TAX, MADRAS

FEBRUARY 11, 1997

[S.C. AGRAWAL AND G.B. PATTANAIK, JJ.]

Income Tax Act, 1961 : Section 37.

Income Tax—AYs. 1967-68 and 1968-69—Business expenditure—Royalty—Assessee, an Indian company, collaborated with a foreign company for giving technical information and know- how for setting up plant for manufacture of products—For technical know-how and services srendered, assessee was liable to pay to the foreign company royalty at a certain percentage of gross turnover of such products—Assessee could continue manufacture even after expiry of agreement—Held : The entire amount of royalty paid by the assessee not a revenue expenditure even though it related to gross turnover—High Court rightly upheld Appellate Tribunal's view that 25% of the royalty was capital expenditure and, therefore, not allowable as revenue expenditure.

Income—Tax Business expenditure—Capital or revenue—Test to determine—Stated.

The appellant-assessee, a limited company which has been carrying on the business of manufacture of automobiles springs, entered into an agreement with a foreign company for manufacture of all types of springs and suspension for road and rail vehicles. Under the terms and conditions of the agreement between the parties it was stipulated that the foreign firm would give the assessee the technical information and know-how relating to the setting up of a plant suitable for manufacture of the products as well as the technical know-how relating to the setting up of the plant itself, the drawings, estimates, specifications, manufacturing methods, blue prints of production and testing equipment and other data and information necessary to manufacture the product. The agreement also provided that in consideration of the information to be furnished and services to be rendered to the assessee by the foreign firm the assessee shall pay a royalty at a certain percentage of the gross turnover of the products.

A The Income Tax Appellate Tribunal held that 25% of the amount paid by the assessee to the foreign company was capital expenditure under Section 37 of the Income Tax Act, 1961 for the Assessment Years 1967-68 and 1968-69. The said decision, in a reference, was upheld by the High Court. The High Court considered the different clauses of the agreement and held that the assessee had acquired a benefit of enduring nature, B which would constitute "acquisition of an asset and amount paid for the same would constitute capital expenditure". Being aggrieved by the High Court's judgment the appellant-assessee preferred the present appeal.

Dismissing the appeal, this Court

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HELD : 1. The question whether a particular payment made by an assessee under the terms of the agreement forms a part of capital expenditure or revenue expenditure would depend upon several factors, namely, whether the assessee obtained a completely new plat with a completely new process and new technology for manufacture of the product or the payment D 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 the 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 E 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. [1150-C-E]

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Alembic Chemical Works Co. Ltd. v. *CIT,* 177 (1989) ITR 377, referred to.

2. In the instant case, the Income Tax Appellate Tribunal having considered the different clauses of the agreement and having come to the G conclusion that under the agreement with the foreign firm what was set up by the assessee was a new business and the foreign firm had not only furnished information and the technical know-how but also rendered valuable services in setting up of the factory itself and even after the expiry of the agreement there is no embargo on the assessee to continue to H manufacture the product in question, it cannot be held that the entire

payment made is a revenue expenditure merely because the payment is required to be made at a certain percentage of the gross turnover of the products as royalty. The High Court was fully justified in answering the reference in favour of the revenue and against the assessee. [1156-A-C]

CIT **v.** *CIBA of India Ltd.,* **69 (1968) ITR 692,** *CIT* **v.** *Lucas-TVS Ltd.,* **110 (1977) ITR 338,** *CIT* **v.** *Sarada Binding Works,* **102 (1976) ITR 187,** *Agarwal Hardware Works (P) Ltd.* **121 (1980) ITR 510,** *CIT* **v.** *Tata Engineering & Locomotive Co. Pvt. Ltd.,* **123 (1980) ITR 538,** *Empire Jute Co. Ltd.* **v.** *CIT,* **124 (1980) ITR 1 and** *Alembic Chemical Works Ltd.* **v.** *CIT,* **177 (1989) ITR 377, referred to.**

CIVIL APPELLATE JURISDICTION : Civil Appeal Nos. 1575-76 of 1980 etc.

From the Judgment and Order dated 20.11.78 of the Madras in T.C. No. 117 of 1974.

Ms. Janki Ramachandran for the Appellant.

P.A. Choudary, Ranbir Chandra, C. Radhakrishan and B.K. Prasad for the Respondent.

The Judgment of the Court was delivered by :

G.B. PATTANAIK, J. These two appeals by special leave at the instance of the assessee are directed against the order of the Madras High Court answering the question posed in favour of the revenue and against the assessee. The Income-tax Appellate Tribunal, Madras Bench, referred the following question to the Madras High Court for its opinion :

> "Whether, on the facts and in the circumstances of the case, the Tribunal was right in holding that 25% of the amount paid by the assessee as royalty to Messrs Jonas Woodhead & Sons., was capital expenditure and therefore not allowable as revenue expenditure under the provisions of the Income-tax Act, 1967, for the assessment years 1967-68 and 1968-69?"

The aforesaid question of law arose out of order of the Appellate Tribunal arising out of assessment proceedings for the assessment years 1967-68 and 1968-69. The assessee, a limited company incorporated in

A March 1963 to carry on the business of manufacture of automobiles springs entered into an agreement with M/s. Jonas Woodhead and Sons Ltd., (hereinafter referred to as "foreign company") of United Kingdom for manufacture of all types of spring and suspension for road and rail vehicles. Under the terms and conditions of the agreement between the parties it B was stipulated that the foreign firm will give the assessee the technical information and know-how relating to the setting up of a plant suitable for manufacture of the products as well as the technical know-how relating to the setting up of the plant itself, the drawings, estimates, specifications, manufacturing methods, blue prints of production and testing equipment and other data and information necessary to manufacture the product and C to set up proper and efficient plants. The said agreement between the parties also provide that in consideration of the information to be furnished and services to be rendered to the assessee by the foreign firm the assessee shall pay a royalty at the rates of the licensed products, turnover of the assessee to be calculated in accordance with the provisions of the agree- D ment. The production of the assessee commenced on 1.1.1966 and in terms of the agreement the assessee made payments of Rs. 24,000 and Rs. 47,000 respectively to the foreign firm for assessment years 1967-68 and 1968-69 as royalty. In the assessment proceedings the Income-Tax officer disallowed 1/4th of the aforesaid payments on the ground that such payment E represented the consideration for service provided by the foreign company of an enduring nature and is, therefore, a capital receipt. The assessee preferred appeals before the Appellate Assistant Commissioner and being unsuccessful therein preferred second appeal to the Income-tax Appellate Tribunal. The Tribunal having dismissed the second appeal an application was filed by the assessee under Section 256(1) of the Income-tax Act for F referring the question of law as already indicated to the High Court of Madras for being answered. The High Court by the impugned judgment answered the question in favour of the revenue and against the assessee. The assessee thereafter moved this Court and on leave being granted, these appeals have been registered. In answering the question posed in favour of G the revenue the High Court considered the different clauses of the agreement between the parties and is of the opinion that the assessee acquired a benefit of enduring nature which will constitute "acquisition of an asset and amount paid for the same would constitute capital expenditure". The High Court also came to conclusion that the payment stipulated under clause 12 of the agreement by the assessee to the foreign firm was not the H

remuneration for using of the rights granted by the foreign firm but a composite payment for all the services rendered and information furnished by the said foreign firm to the assessee in the setting up of the factory as well as in the manufacture of the licensed products in that factory. The judgment of the High Court has since been reported in 117 (1979) ITR 55. Mrs. Janaki Ramachandran, the learned counsel appearing for the appellant contended that the High Court was in error in answering the question in favour of the revenue on a finding that the payment was made to the foreign company for obtaining advantage of enduring benefit in as much as it does not offer advantage of enduring nature acquired by an assessee which could be held to be a capital expenditure. According to the learned counsel the payments made by the assessee to the foreign firm for the technical know-how and assistance rendered by the said foreign firm enabled the assessee to carry on its business more efficiently and more profitably leaving fixed capital untouched and, therefore, the said payment or any part of it cannot be held to be a capital expenditure. In support of this contention reliance was placed on the decision of this Court in the case of *Empire Jute Co. Ltd.* v. *Commissioner of Income-Tax,* 124 (1980) ITR 1. According to the learned counsel for the appellant a technical know-how or technical advice received from a foreign firm cannot be held to be a tangible asset and any payment made to the foreign firm for such know-how is nothing but a revenue expenditure. The learned counsel places reliance on the decision of Bombay High Court reported in 123 (1980) ITR 539. The learned counsel also urged that the payment required to be made by the assessee to the foreign firm was merely for the better conduct and improvement of the existing business and as such was revenue in nature and can't held to be a capital expenditure.

Mr. Chaudhary, the learned counsel appearing for the revenue on the other hand contended that the question whether a particular payment made by the assessee would form a part of revenue expenditure or capital expenditure would depend upon the relevant facts and the terms and conditions of the agreement between the parties under which the payment is made. According to the learned counsel the various clauses of the agreement having been analysed and the Tribunal having found that the foreign firm not merely provided the technical know-how for manufacturing the product but also gave plan and designs and established the factory for manufacture of the products and the business concerned being totally

A new business and even after the conclusion of the agreement period the assessee was required merely to return the plans and designs, but there was no embargo on the assessee to manufacture the product in question and the payments under the agreement being of a composite nature the Tribunal was fully justified in holding the part of the payments made by the assessee did form the capital expenditure and the High Court was B wholly justified in answering the reference in favour of the revenue.

The question whether a particular payment made by an assessee under the terms of the agreement forms a part of capital expenditure or revenue expenditure would depend upon several factors, namely, whether C the assessee obtained a completely new plan with a complete new process and completely new technology for manufacture of the product or the payments 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 the part and parcel of the existing D 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 E the agreement; whether the assessee derived benefits coming to its capital for which the payment was made. This court in the case of *Alembic Chemical Works Co. Ltd.* v. *Commissioner of Income Tax, Gujarat,* 177 (1989) ITR 377 has indicated that "in the infinite variety of situational diversities in which the concept of what is capital expenditure and what is revenue arises, it is not possible to form any general rule even in the F generality of cases, sufficiently accurate and reasonable comprehensive, to draw any clear line of demarcation". This Court further held that there is no single definitive criterion which by itself is demarcative, whether a particular outlay is capital or revenue. And therefore, "once for all" test as well as the test of "enduring benefit" may not be conclusive. Consequently, the various terms and conditions of the agreement, the advantages derived G by an assessee under the agreement, the payment made by the assessee under the agreement, are all to be taken in account and then it has to be decided whether the whole or a part of the payment thus made is a capital expenditure or a revenue expenditure.

H In the case of *Commissioner of Income-Tax, Bombay City I* v. *CIBA*

of India Ltd., 69 (1968) ITR 692, the question for consideration was whether the contribution payable by the assessee at the rate of 6 per cent of the net ceiling price of firm categories which the assessee produced on getting the formulae, scientific data, working rules and prescriptions pertaining to the manufacture or processing of products discovered and developed in the Swiss company's laboratory can be held to be a business expenditure or is a capital expenditure. This Court held on consideration of the agreement between the parties that the assessee did not become entitled exclusively even for the period of the agreement, to the patents and trademark of the Swiss company; it had merely access to technical knowledge and experience in the pharmaceutical field which the Swiss company commanded. The assessee on that account have a mere license for a limited period of a technical knowledge of the Swiss company with the right to use the patent and trademark of that company. The assessee acquired under the agreement merely the right to trade for the purpose of carrying on its business as a manufacturer or dealer and obtained the technical knowledge of Swiss company for limited period. By making a technical knowledge available the Swiss company did not part with any asset of its business, nor did the assessee acquire any asset or advantage of an enduring nature for the benefits of its business and, therefore, the said contribution was merely a revenue expenditure or a business expenditure.

In the case of *Commissioner of Income-Tax* v. *Lucas- T.V.S. Limited,* 110 (1977) ITR 338, the question for consideration before the Madras High Court was whether the payments made under the collaboration agreement with the foreign firm by the assessee for the exclusive right and licence to make various items of electrical equipments for vehicles by the foreign firm is a capital expenditure or revenue expenditure. The Madras High Court came to the conclusion that since under the agreement the assessee had no right to manufacture fresh articles on the basis of the know-how which had obtained from the foreign firm after the expiry of the period of license, the payments made by the assessee to the foreign firm for the technical know-how will be in the nature of a licence fee and will constitute an expenditure in computation of profits and gains and cannot be held to be a capital expenditure.

In the case of *Commissioner of Income-Tax, Madras (Central)* v. *Sarada Binding Works,* 102 (1976) ITR 187, the question for consideration

A was whether the consideration for a transaction which consist of partly a fixed annual sum and partly a periodical payment at a certain percentage of the profits earned by the assessee from the said business would be treated in its entirety as a capital expenditure or a revenue expenditure. The Madras High Court came with a conclusion that the fixed sum paid towards part of the consideration will be a capital payment while the B periodical payment of sum which are definite and which depend upon the future profits cannot be treated as a capital expenditure. In other words, the Court answered the question that since the payment in question to be made by the assessee was not related to any specified sum but a percentage of the profits to be earned which were indefinitive in nature. Such payment C could be treated only as a revenue expenditure.

In the case of *Agarwal Hardware Works (P) Ltd.* v. *Commissioner of Income-Tax, West Bengal-I,* 121 (1980) ITR 510, the question for consideration before the Calcutta High Court was whether the payments made by the assessee to a foreign firm for use of certain patents would be a capital D expenditure or a revenue expenditure. The Calcutta High Court on consideration of the agreement between the parties came to the conclusion that since patents are not useable after termination of the agreement and the payments are indefinitive in nature based on production of goods, the assessee does not acquire any capital asset and, therefore, such payments E made under the agreement are for the purpose of business and derive business expenditure.

In the case of *Commissioner of Income-Tax, Bombay City-I* v. *Tata Engineering & Locomotive Co. Pvt. Ltd.,* 123 (1980) ITR, 538, the question F for consideration before the Bombay High Court was whether the payments made by the assessee to the foreign firm for the technical know-how and the technical advice would be a capital expenditure or a revenue expenditure. The Court answered the question that since under the agreement the assessee did not acquire a benefit of enduring nature and the so-called foreign know-how which is availed of in lieu of payment is in G substance a transaction of acquiring the necessary technical information with regard to the technique of production and as such it cannot be held to be a capital expenditure and is a revenue expenditure.

In the case of *Empire Jute Co. Ltd.* v. *Commissioner of Income-Tax,* H 124 (1980) ITR 1, the question for consideration before this Court was

whether the payments made by the assessee for purchase of "loom hours" was in the nature of a capital expenditure or a revenue expenditure. In the said case the assessee company was carrying on the business of manufacture of jute and was a member of Indian Jute Mills Association. The agreement had been entered into between the members associations restricting the number of working hours per week for which the mills were entitled to work their looms. The assessee company purchased "loom hours" from four other mills for a sum of Rs. 2,03,255/- during the assessment year 1960-61 and claimed deduction treating the same as a revenue expenditure. The Tribunal accepted the assessee's contention and had allowed deduction but on a reference being made, the High Court had held that the amount paid by the assessee for purchase of "loom hours" was in the nature of capital expenditure and as such no deduction could be claimed. This Court reversed the decision of the High Court and held that the acquisition of additional "loom hours" did not add to the fixed capital of the assessee; the permanent structure of which the income was obtained remained same. The expenditure incurred for the purpose of operating the looms for longer working hours was primarily and essentially related to the operation of working of the looms which constituted the profit making apparatus of the appellant and was expenditure laid out as a part of the process of profit earning. It was an outlay of business in order to carry it on and to earn a profit out of this expense as an expense of carrying it on; it was a part of the cost of operating the profit earning apparatus and was clearly in the nature of revenue expenditure. The Court further observed as under :

> "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. It is not every advantage of enduring nature acquired by an assessee that brings the case within the principle laid 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. If the advantage consists merely in facilitating the assessee's trading operations or enabling the management and conduct of the assessee's business to be carried on more efficiently or more profitably while leaving the fixed capital untouched, the expenditure would be on revenue account, even

A though the advantage may endure for an indefinite future. The test of enduring benefit is, therefore, not a certain or conclusive test and it cannot be applied blindly and mechanically without regard to the particular facts and circumstances of a given case."

B Thus the so-called test of obtaining enduring benefit was held not to be a conclusive test and could not be applied blindly and mechanically without regard to the particular facts and circumstances of a given case.

In the case of *Alembic Chemical Works Co. Ltd.* v. *Commissioner of Income-Tax, Gujarat,* 177 (1989) ITR 377, the question for consideration C was whether the lump-sum payment made by the assessee for obtaining the know-how to produce higher yield and sub-culture of high yielding strain of Penicillin would be a capital expenditure or a revenue expenditure. The Tribunal had rejected the claim of the assessee holding the expenditure to be a capital expenditure. On appeal to this Court it was held :

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"(i) It would 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 know-how at any particular stage in this fast changing area of medical science. The state of the art in some of these areas of high priority research is E constantly updated so that the know-how could not be said to bear the element of the requisite degree of durability and non-ephemerality 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 F readily pigeon-holing an outlay, such as this, as capital.

(ii) In the infinite variety of situational diversities in which the concept of what is capital expenditure and what is revenue arises, it is well nigh impossible to formulate any general rule, even in the generality of cases, sufficiently accurate and reasonably com- G prehensive, to draw any clear line of demarcation. However, some broad and general tests have been suggested from time to time to ascertain on which side of the line the outlay in any particular case might reasonably be held to fall. These tests are generally efficacious and serve as useful servants; but as masters they tend to be H overexacting.

(iii) The question in each case would necessarily be whether the tests relevant and significant in one set of circumstances are relevant and significant in the case on hand also. Judicial metaphors are narrowly to be watched, for, starting as devices to liberate thought, they end often by enslaving it.

The idea of "once for all" payment and "enduring benefit" are not to be treated as something akin to statutory conditions; nor are the notions of "capital" or "revenue" a judicial fetish. What is capital expenditure and what is revenue are not eternal verities but must needs be flexible so as to respond to the changing economic realities of business. The expression "asset or advantage of an enduring nature" was evolved to emphasise the element of a sufficient degree of durability appropriate to the context.

There is also no single definitive criterion which, by itself, is determinative 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."

It would thus appear that the courts have applied different tests like starting of a new business on the basis of technical know- how received from the foreign-firm, exclusive right of the company to use the patent or trademark which it receives from the foreign firm, the payments made by the company to the foreign- firm whether a definite one or dependent upon certain contingencies, right to use the technical know-how of production or the activity even after the completion of the agreement, obtaining enduring benefit for a considerable part on account of the technical informations received from a foreign-firm, payment whether made "once for all" or in different instalments co- relatable to the percentage of gross turnover of the product to ultimately find out whether the expenditure or payment thus made makes a accretion to the capital asset and after the court comes to the conclusion that it does so then it has to be held to be a capital expenditure. As has been held by this Court and already indicated in *Alembic Chemical Work's* case [177 (1989) ITR 377] no single definitive criterion by itself could be determinative and, therefore, bearing in mind

A the changing economic realities of business and the varieties of situational diversities the various clauses of the agreement are to be examined. But in the case in hand the Tribunal having considered the different clauses of the agreement and having come to the conclusion that under the agreement with the foreign firm what was set up by the assessee was a new business and the foreign firm had not only furnished information and the technical B know- how but rendered valuable services in setting up of the factory itself and even after the expiry of the agreement there is no embargo on the assessee to continue to manufacture the product in question, it is difficult to hold that the entire payment made is a revenue expenditure merely because the payment is required to be made on a certain percentage of the C rates of the gross turnover of the products of the income as royalty. In our considered opinion, in the facts and circumstances of the case the High Court was fully justified in answering the reference in favour of the revenue and against the assessee. These appeals are accordingly dismissed but in the circumstances without any order as to costs.

D **G.B. PATTANAIK, J.** The question referred to the High Court by the Income-tax Tribunal under Section 256(1) of the Income Tax Act and answered by the High Court in favour of the revenue and against the assessee relates to the assessment years 1969-70, 1970-71 and 1971-72 and the identical matter was the subject matter of Civil Appeal Nos. 1575-76 E of 1980 in relation to two earlier assessment years 1968-69 and 1969-70. In view of our decision in Civil Appeal Nos. 1575-76 of 1980 these appeals are dismissed but in the circumstances without any order as to costs.

V.S.S. Appeals dismissed.