

THE EIMCO K.C.P. LTD. MADRAS
v.
COMMISSIONER OF INCOME TAX, MADRAS

FEBRUARY 25, 2000

[D.P. WADHWA AND SYED SHAH MOHAMMED QUADRI, JJ.]

Income Tax Act, 1961 :

Sections 35-A and 256(1)—Allowable expenditure—Appellate Company, an Indo-American joint venture, allotted equity shares to the American Company equivalent to the value of technical know-how supplied—Deduction of value of technical know-how claimed as revenue expenditure—Income Tax Officer treated it as capital expenditure and allowed 1/14th as allowable expenditure—While an appeal was pending before the Appellate Assistant Commissioner—The Commissioner of Income Tax held the expenditure not allowable—Appellate Assistant Commissioner later on dismissed the appeal—Income Tax Appellate Tribunal allowed the appeal—High Court on reference answered in favour of Revenue—On appeal Held, allotment of equity shares was reimbursement for the technical know-how, which can never be termed as expenditure much less revenue expenditure.

Section 263—Interference with orders of Income Tax Officer—Held, the Commissioner of Income Tax could not interfere with the order on a point which was directly in appeal before the Appellate Assistant Commissioner.

An American and an Indian company collaborated and floated the appellant company with an authorised capital of Rs. 1,00,00,000 consisting of 10,00,000 equity shares of Rs. 10 each. Each of them agreed to subscribe to Rs. 4,70,000 out of which Rs. 2,80,000 was to be paid as initial contribution. The American company contributed technical know-how which was valued at Rs. 2,35,000 and paid the balance in cash. In the assessment year 1969-70, the appellant company claimed deduction of Rs. 2,35,000 as revenue expenditure for the said technical know-how. The Income Tax Officer treated this sum as capital expenditure and allowed only 1/14th of it under Section 35-A of the Income Act, 1961. The Commissioner of Income Tax during pendency of the appeal before the Appellate Assistant Commissioner held that the amount in question could not be treated as expenditure so granting 1/14th of the said amount as capital expenditure

A was erroneous. Thereafter, the Appellate Assistant Commissioner dismissed the appeal. The Income Tax Appellate Tribunal allowed the appeal of the appellant company holding the said amount to be revenue expenditure.

B On a reference under Section 256(1) of the Act, High Court answered in favour of the Revenue. Hence this appeal.

Dismissing the appeal, this Court

C HELD : 1. On the facts and in the circumstances of the case, the Commissioner of Income Tax could not interfere with the orders of the Income Tax Officer on a point which was directly in appeal before the Appellate Assistant Commissioner. [1188-D-F]

D *Commissioner of Income Tax, Bombay v. Anritlal Bhogilal & Co.*, 34 ITR 30, relied on.

Ramlal Onkarnal v. Commissioner of Income Tax, Assam, 44 ITR 578; *Kelpunj Enterprises v. Commissioner of Income Tax, Kerala*, 108 ITR 294, approved.

E 2. The appellant by allotting equity shares of Rs. 2,80,000 to the American Company reimbursed its contribution by way of know-how, which can never be treated as expenditure much less an expenditure laid out wholly and exclusively for purposes of the business of the appellant. This know-how was acquired to produce higher yield and improve the quality of the product, which the assessee-company was already manufacturing. The allotment of equity shares to the American company, in the circumstances of the case, cannot be termed as "expenditure much less revenue expenditure". [1191-B-F]

G *Alembic Chemical Works Co. Ltd. v. Commissioner of Income Tax, Gujarat*, (1989) 177 ITR 377, relied on.

CIVIL APPELLATE JURISDICTION : Civil Appeal Nos. 4058-59 of 1994.

H From the Judgment and Order dated 17.1.83 of the Madras High Court in T.C. Nos. 1224 and 1225 of 1977.

M. Uttam Reddy, A.V. Rangam, B.A. Ranganadhan and G.I. A
Gopalkrishnan for the Appellant.

B.B. Ahuja, K.N. Shukla, K.C. Kaushik, Ms. Neera Gupta, Ms.
Sushma Suri, Arvind Kumar Sharma, Mrs. Anil Katiyar, V.K. Verma and
C. Ramesh for the Respondent.

The Judgment of the Court was delivered by

SYED SHAH MOHAMMED QUADRI, J. The judgment and order
passed by the Division Bench of the High Court of Madras in T.C. Nos.
1224 and 1225 of 1977 dated January 17, 1983 is subject-matter of challenge
in these appeals.

The appellant-assessee is a company registered under the Indian
Companies Act. It was incorporated in the year 1965. Two companies M/s.
Eimco Corporation Inc. (for short 'Eimco'), an American company, and
M/s. K.C.P. Ltd. (for short 'KCP'), an Indian Company, promoted the
appellant company. The authorised capital of the appellant was
Rs.1,00,00,000 consisting of 10,00,000 equity shares of Rs.10 each. Each
of them agreed to subscribe Rs.4,70,000 out of which each will have to pay
initially a sum of Rs.2,80,000 towards its contribution. Towards its share
Eimco contributed technical know-how consisting of right and license to
manufacture existing Eimco Sedimentation and filtration equipment, along
with the supply of and/or the agreement to supply general technical data
including manufacturing drawings in the form as used and possessed by
Eimco, relating to the sales, application, selection, material requirements,
manufacture, installation and operation of such equipment, including but
not limited to test procedures, instruction manuals, technical manuals,
general arrangement and detail drawings, flow charts, research and
development reports, sales manuals and bulletins, operating reports on
existing installations and installation and operation manuals. It valued the
know-how etc. at a sum of Rs.2,35,000 and paid the balance in cash as its
contribution. The Board of Directors of the appellant allotted equity shares
of Rs.2,35,000, being of the value of the know-how, to Eimco by resolution
passed on April 29, 1968. In the assessment year 1969-70, the appellant
claimed deduction of Rs.2,35,000 as revenue expenditure paid to Eimco
towards consideration for supply of technical know-how by it. By order
dated March 25, 1970, the Income Tax Officer treated that as a capital
expenditure and allowed 1/14th of the said amount as allowable expendi-

A ture under Section 35-A of the Income Tax Act (for short 'the Act'). The
appellant challenged that order before the Appellate Assistant Commis-
sioner on the ground that the whole expenditure ought to have been
allowed as revenue expenditure. While so, the Commissioner of Income
B Tax in exercise of its power under Section 263(1) of the Act revised the
said order of the Income Tax Officer dated March 25, 1970 holding that
the amount in question could not be treated as expenditure and that
granting 1/14th of the said amount as capital expenditure under Section
35-A was erroneous and prejudicial to the interest of the revenue and thus
set aside the same. Thereafter, the Appellate Assistant Commissioner
dismissed the appeal and directed that 1/14th amount be added back as
C income of the assessee. Against both the orders, the appellant filed appeals
before the Income-tax Appellate Tribunal. The Tribunal, on December 12,
1975, allowed appeals of the appellant taking the view that the said amount
was revenue expenditure of the appellant. At the instance of the Revenue,
the following two questions were referred to the High Court under Section
D 256(1) of the Act :

"(1) Whether on the facts and in the circumstances of the case,
the Commissioner could interfere, acting under Section 263
of the Income-tax Act, 1961 with the order of the Income-tax
Officer on a point which was directly in appeal before the
E Appellate Assistant Commissioner?

(2) Whether on the facts and in the circumstances of the case,
the sum of Rs.2,35,000 paid by the assessee company to the
foreign collaborator constitute revenue expenditure?"

F Both the questions were answered in favour of the Revenue and
against the assessee by the High Court in the impugned order.

Mr. M. Uttam Reddy, learned counsel appearing for the appellant,
did not seriously canvass the correctness of the impugned order in regard
to the first question and in our view rightly. Having regard to Section 263
G of the Income Tax Act and the decision of this Court in *Commissioner of
Income-tax, Bombay v. Amritlal Bhogilal & Co.*, 34 ITR 130 and judgments
of High Courts of Assam in *Ramlal Onkarmal v. Commissioner of Income-
tax, Assam*, 44 ITR 578 and of Kerala in *Kelpunj Enterprises v. Commis-
sioner of Income-tax, Kerala*, 108 ITR 294, which we approve, we confirm
H the answer to the first question recorded by the High Court.

Regarding the second question Mr. Reddy vehemently contended that the amount of Rs.2,35,000 was paid by the appellant to the foreign collaborator to acquire the know-how so it was revenue expenditure and ought to have been so held by the High Court. Mr. Shukla argued that know-how etc. were contributed by Eimco towards its share of the capital and that no amount was paid by the appellant to Eimco; allotment of shares to Eimco by the appellant could not be treated as expenditure incurred by it for purchase of know-how.

To appreciate the contention of Mr. Reddy, it may be necessary to quote Section 37(1) of the Income Tax Act here :

"37. *General.* - (1). Any expenditure (not being expenditure of the nature described in Sections 30 to 36 * * * and not being in the nature of capital expenditure or personal expenses of the assessee), laid out or expended wholly and exclusively for the purposes of the business or profession shall be allowed in computing the income chargeable under the head "Profits and gains of business or profession".

A plain reading of the above provision makes it clear that it is a residuary provision and allows an expenditure, not covered under Sections 30 to 36, in computing the income chargeable under head "profits and gains of business or profession", on fulfilment of the other requirements, namely, (i) the expenditure should not be in the nature of capital expenditure or personal expenses of the assessee; (ii) it should have been laid out or expended wholly and exclusively for the purposes of the business or profession; (iii) it should have been expended in the previous year.

The question is whether the amount in question can be treated as expenditure and whether it was expended wholly and exclusively for the purpose of the business of the appellant.

In support of his contention that Rs.2,35,000 were spent for purchase of technical know-how, so it is a revenue expenditure, Mr. Reddy relied upon a letter addressed by the Vice-President of the Eimco Corporation to the Director of K.C.P.Ltd. on April 14, 1965.

The relevant excerpts of the said letter read as under :

"In general, we agree that the organisation will follow that set forth

- A in the Memorandum and Articles of Association of the K.C.P.-Fives Lille - Cail Private Limited (a corporation of India), but with the following specific provisions to which we have agreed.
1. The Company will be organised and headquartered in India as an Indian Corporation with broad corporate powers.
 - B 2. The name of the company will be EIMCO-K.C.P. Private Ltd.
 3. There will be two subscribers for one share each - each partner will designate one subscriber.
 - C 4. Authorised capital is to be Rs. 1,00,00,000 consisting of 10,00,000 equity shares of Rs.10 each.
 5. Each partner will subscribe to Rs. 4,70,000; of this amount each will initially pay in Rs. 2,80,000 or equivalent after approval by the Government of India and before commencement of operation; and the balance of the amount subscribed will be contributed by each partner, in equal amounts, as and if required for operation of the business.
 - D 6. The amount initially paid in by Eimco will primarily consist of Eimco's know-how, valued at Rs. 2,35,000 and cash. Know-how consists of the right and license to manufacture existing Eimco Sedimentation and filtration equipment, along with the supply of and/or the agreement to supply general technical data including manufacturing drawings in the form as used and possessed by Eimco, relating to the sales, application, selection, material requirements, manufacture, installation and operation of such equipment, including but not limited to test procedures, instruction manuals, technical manuals, general arrangement and detail drawings, flow charts, research and development reports, sales manuals and bulletins, operating reports on existing installations and installation and operation manuals. The balance of the initial investment will be in cash."
 - E
 - F
 - G

A plain reading of the letter indicates that Eimco and K.C.P agreed to float the appellant company with authorised capital of Rs. 1,00,00,000 consisting of 10,00,000 equity shares of Rs.10 each. Each of them agreed to subscribe Rs. 4,70,000 out of which the amount equivalent to Rs. 2,80,000

H

was to be paid (after approval by the Government of India and before the commencement of operation). Eimco valued the know-how etc. at a sum of Rs. 2,35,000 and paid the balance in cash towards its contribution. A

What in effect was done by the appellant in allotting equity shares of Rs. 2,80,000 to Eimco, was to reimburse the contribution of Eimco by way of know-how, which can never be treated as expenditure much less an expenditure laid out wholly and exclusively for purposes of the business of the appellant. It is not a case where after the incorporation, the appellant-company in the course of the carrying on its business, spent the said amount for acquiring any asset. Reliance by Mr. Reddy on the judgment of this Court in *Alembic Chemical Works Co. Ltd. v. Commissioner of Income-Tax, Gujarat*, (1989) 177 ITR 377 is wholly inappropriate. There know-how was acquired to produce higher yield and sub-culture of high yielding strain of penicillin. The assessee-company was already engaged in manufacture of antibiotics including penicillin before it acquired the know-how. Therefore, it was a case of a running company acquiring know-how to increase its yield and quality of its product and for the better conduct and improvement of the existing business and therefore the amount spent on acquiring know-how was held to be revenue expenditure. B C D

In our view, the High Court has rightly concluded that allotment of equity share by the appellant to Eimco, in the circumstance of the case, cannot be termed as 'expenditure much less revenue expenditure' and rightly answered the question referred to it against the appellant-assessee. We find no merit in these appeals which are accordingly dismissed with costs. E

A.Q.

Appeals dismissed.