

* **IN THE HIGH COURT OF DELHI AT NEW DELHI**

RESERVED ON: 17.08.2012
PRONOUNCED ON: 29.08.2012

+ ITA No.1450/2010, CM APPL.12283/2012,
ITA No.1451/2010, CM APPL.12275/2012,
ITA No.1640/2010, CM APPL.12282/2012,
ITA No.1652/2010, CM APPL.12284/2012, and
ITA No.825/2011

CIT Appellant in all Appeals

Through: Mr. N.P. Sahni, Sr. Standing Counsel
in all the Appeals.

versus

MODI REVLON PVT. LTD. Respondent in all Appeals

Through: Mr. Salil Kapoor with Mr. Vikas Jain,
Advocates in all the Appeals.

CORAM:

MR. JUSTICE S. RAVINDRA BHAT

MR. JUSTICE R.V. EASWAR

MR. JUSTICE S.RAVINDRA BHAT

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1. The revenue appeals against order of the Income Tax Appellate Tribunal (ITAT) in ITA Nos. 5/Del/2009, 2063/Del/2009, 155/Del/2009 and 3083/Del/2009 dated 18-12-2009.

2. The following questions of law arise in the present appeals:

(1) *Whether the ITAT erred in holding that royalty paid by the assessee could be capitalized only to the extent of 5% (instead of 25% held by the Appellate Commissioner)*

(arising in ITA Nos. 1451 & 1652/2010 and 825/2011)

(2) *Whether the disallowance of publicity expenses, set aside by the ITAT is in error of law*
(arising in ITA Nos. 1450 & 1640/2010)

(3) Whether the ITAT erred in setting aside the disallowance of consultancy charges, under Section 40A (2) of the Income Tax Act;

(arising in ITA Nos. 1451, 1652/2010 & 825/2011)

3. The facts in brief are that the assessee, an Indian company, is the result of a joint venture (JV) between Modi Mundipharma Pvt. Ltd. (MMPL) and Revlon Mauritius Ltd. (RML) for manufacturing and marketing Revlon products in India and neighboring countries on an exclusive basis. MMPL and RML had invested in the ratio of 74:26 to form the assessee-company. In terms of the JV agreement, MMPL was responsible for the setting up, manufacturing, distribution and marketing Revlon products in the designated territory. RML was to provide know-how, trade mark, etc. The assessee entered into a technical know-how agreement with Revlon Mauritius Ltd. for supply of technical know-how to manufacture the goods. Under the said agreement, in consideration for the supply of know-how, the assessee has to pay, every year, royalty (net of taxes) at the rate of 5 %, on domestic sales and 8 %, on export sales. During the year, the assessee paid royalty of ₹. 4,73,06,822 to RML in pursuance of the grant of right to use the technical know-how. The assessing officer disallowed this royalty expenditure stating that the amount paid to the licensor was not expenditure wholly and exclusively incurred for the business of the assessee and that it was incurred partly for the business of the sister concerns of the assessee, i.e., its contract manufacturer M/s. Kamakhya Cosmetics and Pharmaceuticals Pvt. Ltd., and its distributor M/s. Win Medicare Ltd. It was held that deduction of royalty could be allowed in the hands of the assessee on the basis of the proportion of its sales to the total sales on which royalty is calculated and payable to the licensor. The assessing officer treated part of royalty payment as capital in nature, and disallowed 25%, of such royalty payment. The AO's objection while capitalizing 25 per cent, of the royalty paid was on account of his opinion that the know-how agreement was open ended in terms of duration and that the assessee had

exclusive right to use the know-how and patents and the new products developed by the licensor. The Appellate Commissioner, on appeal by the assessee held that capitalization of 25% was unjustified; the amount was reduced to 5%. The ITAT allowed the assessee's appeal, on this aspect, and dismissed that of the revenue.

4. The assessee had claimed publicity expenses of ₹. 30.51 lakhs during the year, for promotion of the "Revlon" brand. The AO disallowed ₹.14.57 lakhs, holding that such proportionate amount could not be attributable to the assessee's business. This was confirmed by the CIT (A). The ITAT considered the submissions of the parties, and observed that the agreement entered into by the assessee with WMPL obliged the latter only to bear the cost of advertising and other expenses relatable to the customer sector and that the expense for brand promotion was that of the assessee exclusively. It was also held the agreement with WMPL did not in any manner preclude the assessee undertaking that expenditure, since it was a purely commercial decision, entitled to promote the brand, as its exclusive user. The ITAT went by the previous years' practice, where such expenditure had been allowed by the AO.

5. During the AY, the assessee paid ₹.88.98 lakhs to MMPL as consultancy charges under the agreement dated 1-1-1995. This payment to MMPL was for the latter's advice concerning day-to-day conduct of management of the assessee-company in respect of setting up and monitoring of distribution and marketing management, manufacturing of Revlon products according to the latter's internationally applicable specifications and standards, suggesting changes in the product design and the specifications based on market feedback of new products, product advertising policies and campaign, price negotiations of various inputs from the suppliers, etc. The assessing officer alleged that consultancy charges were nothing but an arrangement to siphon off part of the assessee's profits to its sister concern and JVs. The assessing officer allowed ₹.30 lakhs as directors' remuneration and disallowed ₹. 58.98 lakhs under

Section 40A(2), holding it as unreasonable and excessive. The Commissioner (Appeals) deleted this disallowance holding that the assessing officer wrongly concluded that no services had been rendered by MMPL. The Commissioner (Appeals) held that rendering of services by MMPL was proved from the records, and no disallowance was warranted under Section 40A (2). The revenue's appeal to the ITAT on this score was rejected.

6. The revenue argues that the fact that the know-how agreement between the assessee and Revlon Mauritius was a continuing one, and the time agreed to originally had long since passed. This, coupled with the fact that the Revlon brand was given over exclusively to the assessee by its owner, is a clear pointer to its conferring an enduring capital advantage to the former. Thus, the conclusion drawn by the AO that disallowance to the extent of 25% of royalty payment was warranted. Counsel for the revenue relied on the judgment of the Madras High Court in *Commissioner of Income Tax v Madras Rubber Factory* (1983) 144 ITR 678 to say that the royalty resulted in the foreign brand owner imparting to the assessee an advantage that “*on operational matters might tend to outlast, and endure beyond, the contract period*” clearly amounting to a capital advantage of an enduring nature. Reliance was also placed on the judgment in *CIT v. Kirloskar Cummins Ltd.* [1993] 202 ITR 36 (SC) and the judgments reported as *Commissioner Of Income Tax, vs. I.A.E.C. (Pumps) Ltd.*, 1998 (232) ITR 316 (SC).

7. On the question of consultancy charges it was argued that the AO given cogent and sound reasons for not allowing more than ₹. 30 lakhs. This was based on the permissible limit of remuneration payable to a company, under the Companies Act. The assessee had incurred more than ₹. 58 lakhs in excess of that limit. Moreover, the AO reasoned that the amount paid as consultancy was excessive, regard being had to the nature of activities of MMPL, since production and distribution were undertaken by other sister concerns, on behalf

of the assessee. Therefore, the so called consultancy charges were a mode to claim exaggerated amounts, disproportionate to the services rendered. The CIT (A) and the ITAT fell into error in interfering with the findings of the AO, which were based on the appreciation of documents. The assessee had a duty to explain how such expenses were reasonable. It failed to do so.

8. On the third aspect, the revenue's Counsel highlighted that the two sister concerns were assigned specific and substantial duties, i.e. manufacturing and distribution of the Revlon products, of which the assessee was the licensee. They were also given the responsibility of bearing the advertising and promotion charges and expenses. In spite of this, the AO reasonably allowed more than 50% of the "brand promotion" expenditure. However, the ITAT set aside the disallowance. The mere circumstance that in previous years, the expenditure had been allowed would not amount to a binding practice, especially when it is not legally tenable. Furthermore, the Tribunal's reasoning that the brand promotion expenditure was based on a commercial decision, cannot be sustained. If every commercial decision were to be let alone, the Income Tax authorities would be bereft of jurisdiction and would be obliged to accept, uncritically, such arguments on their face value.

9. Learned counsel for the Assessee argues that the Revenue's contention is groundless. On the question of payment of royalty, it was submitted that the material on record showed that the original know-how license agreement was entered into on 14.01.1994 and was in force till August 2002; it was in accordance with the approval of the Central Government. The royalty payment in the Assessment Year in question was in terms of the Supplementary Agreement dated 16.09.2003. It is clear that the royalty payable was for the continued use of the brand and patents owned by the licensor company. This was a clear indicator that no asset of enduring nature, vested in the assessee's favor, justifying the AO to hold that 25% of the expenditure in that regard had

to be treated as capital. It was further submitted that merely because two sister concerns were engaged in the distribution and production of Revlon products did not mean that the Assessee was not the licensee. The Assessee does business affairs in the most efficient manner possible which meant in turn that it gave the job of production to one sister concern and distribution of the product to another. Further, the evidence showed that royalty liability was not passed on to the product manufacturer. The benefit of know-how, for manufacturing of the products was given for this purpose without any obligation to pay royalty to the licensor. Consequently, the payment of royalty was revenue in nature and could not be classified as capital expenditure. Learned counsel relied upon the judgment of this Court in *CIT v. Sharda Motor Industrial Limited* 319 ITR 109 and that of the Supreme Court in *Commissioner of Income Tax v. CIBA of India Limited* 69 ITR 692 (SC) and submitted that as long as the licensee or the beneficiary did not become entitled exclusively to use the patent or the know-how as its owner, mere access to technical knowledge or specific process did not amount to accrual of a capital advantage. It was submitted that the decision in *Sharda (supra)* is instructive on the question as to whether the licensing arrangement which merely allows access to technical knowledge as against absolute transfer has to be seen in the context of certain parameters such as license tenure; whether the licensee can create further rights in favor of third parties as regards use of technical knowledge; whether there is any restriction or prohibition with regard to assuring of confidential information received by the licensee to the third parties without consent of the licensor; whether license transfer benefits once and for all; whether on expiry of the term the licensee has to return plans, designs and other process knowledge to licensor even though it may continue to manufacture the product; whether any secret or process of manufacture was sold by the licensor to the licensee.

10. It was submitted in the present context that the royalty payable was in respect of the brand and the technical know-how available to the assessee with regard to manufacture and sale of Revlon products in India for the duration of the agreement. The revenue did not point to any factor that could have justified the conclusion that the benefit of the licensing arrangement accrued once and for all and that right to use any technical know-how or process was obtained finally. Such being the case, the benefit of the technical know-how and the brand did not vest once and for all thereby resulting in creation of an asset of enduring nature.

11. Learned counsel for the Assessee further submitted that as far as brand promotion expenses are concerned, there was nothing in the Income Tax Act nor were there any materials on record suggestive of the fact that the Assessee could not claim them. It was submitted that even though one of its sister concerns, i.e. the distributor had to bear normal advertising expenses; the fact remained that as brand licensee, in a highly competent consumer market, the Assessee had to stay ahead of its competition and thus engage itself in brand promotional activities. This had to be distinguished from advertisements. Learned counsel here underlined the fact that the AO did not reject the expenses claimed in its entirety and it allowed as much as 50%. However, the reasoning of the AO and the CIT (Appeals) in disallowing the sum of ₹.14.87 lakhs was tenuous and unsustainable. It was submitted that having accepted the fact that the Assessee could spend amounts for brand promotion activities, the tax authorities could not dictate as to what proportion of such expenses were justified. Learned counsel submitted that such expenses is not supported by legal authority and the partial disallowance was correctly set-aside by the Tribunal in its impugned order.

12. It was lastly urged by learned counsel that as regards the consultancy charges payable to MMPL, the AO did not reject this head of expenditure

outright; but instead allowed only ₹.30 lakhs, rejecting the balance of ₹.58.98 lakhs. The reasoning for the AO holding the amount in excess of ₹.30 lakhs to be disproportionate was unsustainable. Learned counsel submitted that the finding of the AO and as endorsed by the CIT(Appeal) that the maximum amount payable in terms of the Companies Act was ₹. 30 lakhs per month, was based upon a reading of the provision which pertained to public limited companies. The Assessee in this case was not a public limited company and the cap of ₹. 30 lakhs, indicated in Schedule XIII, Part II, Section II, Clause 1(B) of the Companies Act was, therefore, inapplicable in its case. The AO clearly, therefore, fell into error of law in holding that such a cap was warranted. It was submitted that in this regard, the Tribunal noticed that there was sufficient evidence before the AO indicative of the MMPL actively involving itself in the day-to-day activities of the Assessee. The MMPL also had disclosed consultancy charges, having received from the Assessee, in its returns, and paid Income Tax. It was submitted that the Tribunal correctly relied upon the judgment of the Supreme Court in *Commissioner of Income Tax, A.P. v Dhanrajgiriji Raja Narsinghji* 91 ITR 544 (SC)

Analysis and Reasoning

13. Before discussing the rival submissions, it would be essential to extract the relevant portion of the know how agreement below:

“THIS AGREEMENT dated as of July 27, 1994 between REVLON MAURITIUS LIMITED, a Mauritius Corporation (“Licensor”) and MODI-REVLON PRIVATE LIMITED, an Indian Corporation (“Licensee”).

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2. LICENSE GRANTS.

2.01 Know How License. Subject to the provisions of this Agreement, from the Effective Date, Licensor hereby grants to Licensee the exclusive right to use the Know How, in any Plant approved by Licensor, in

accordance with the processes, specifications and recipes thereof in connection with the manufacture, marketing, sale and distribution of Revlon Products in the Territory.

2.02 Patent License. Subject to the provisions of this Agreement, from the Effective Date, Licensor hereby grants to Licensee the exclusive right to use the Patents in the manufacture, distribution and sale of Revlon Products in the Territory.

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4. **FURTHER LICENSES.**

4.01 Contract Manufacturer. Licensee shall not assign or sublicense any of its rights or obligations hereunder without the prior written consent of Licensor. If Licensee desires to appoint a Contract Manufacturer to manufacture Revlon Products, Licensee may do so only if (i) Licensee first submits to Licensor such information about such proposed Contract Manufacturer as Licensor may reasonably require, (ii) such proposed Contract Manufacturer agrees to be bound by the obligations of the Licensee hereunder and (iii) Licensor, in its sole discretion, consents in writing.

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7. **CONSIDERATION AND TAXES.**

7.01 Royalty. In consideration of the grant of license rights to it hereunder, Licensee shall pay to Licensor during the subsistence of this Agreement a royalty of 5% net of taxes, of its Net Sales per annum (the "Royalty").

7.02 Quarterly Installments. The Royalty shall be paid in quarterly installments by the Licensee within 45 days following the close of each fiscal quarter with respect to Net Sales achieved during such fiscal quarter.

7.03 Sales Beyond Termination. In the event of termination of this Agreement, the Royalty shall be payable within 30 days after such termination for the portion of the calendar quarter up to the date of such termination.

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10. TERM OF AGREEMENT.

Unless earlier terminated in accordance with the terms hereof, this Agreement shall remain in full force and effect from the Effective Date for the period contained in the Foreign Collaboration Approval letter issued by the Indian Government. The Parties shall made prompt application for such letter and shall make application in due time for renewal or replacement of this Agreement....”

14. The question of whether royalty payments constitute capital or revenue expenditure has been the subject of frequent consideration by courts. The traditional view of whether the payment secures an asset of enduring nature, was held, in *Gotam Lime Syndicate Vs. CIT*, (1966) 59 ITR 718 (SC) and *Empire Jute Co v Commissioner of Income Tax* (1980) 124 ITR 1 (SC) to be inadequate. The new approach to considering whether expenditure is capital or revenue, was taken further, in the decision reported as *Alembic Chemical Works v Commissioner Income Tax* AIR 1989 SC 1913 = (1989) 177 ITR 377 (SC).

15. In *Commissioner of Income-Tax, Bombay City I v. CIBA of India Ltd* (1968) 69 ITR 692 the assessee, an Indian subsidiary of a Swiss Company was engaged in the development, manufacture and sale of pharmaceuticals products. The Swiss company entered into an agreement with the assessee which, enabled the latter to use technical and research know how for working out patents, upon payment of consideration of by the assessee. The assessee was bound by confidentiality, regarding data and information connected with the manufacturing process. The Swiss company, granted to the assessee exclusive right and licence in India, in respect of, the patents mentioned in the schedule to the agreement, enabling the assessee to make use of, exercise rights, and sell the inventions as well as use the trade mark set out in the second schedule (to the agreement), in India. The Court held that:

"...In the case in hand it cannot be said that the Swiss Company had wholly parted with its Indian business. There was also no attempt to part

with the technical knowledge absolutely in favour of the assessee. The following facts which emerge from the agreement clearly show that the secret processes were not sold by the Swiss Company to the assessee: (a) the licence was for a period of five years, liable to be terminated in certain eventualities even before the expiry of the period; (b) the object of the agreement was to obtain the benefit of the technical assistance for running the business; (c) the licence was granted to the assessee subject to rights actually granted or which may be granted after the date of the agreement to other persons; (d) the assessee was expressly prohibited from divulging confidential information to third parties without the consent of the Swiss Company; (e) there was no transfer of the fruits of research once for all: the Swiss Company which was continuously carrying on research and had agreed to make it available to the assessee; and (f) the stipulated payment was recurrent dependent upon the sales, and only for the period of the agreement. We agree with the High Court that the first question was rightly answered in favour of the assessee."

16. In *Empire Jute Co* (supra), the assessee manufactured jute. It was a member of the Jute Mills Association (formed to protect the trade of its members, by regulating the production of the mills, of its members). The members had entered into a working time agreement, whereby the number of working hours per week for which the mills were entitled to work their looms was restricted. The assessee had purchased "looms hours" from four other mills. The issue was whether the money spent for purchase of "loom hours" was revenue or capital expenditure. The Supreme Court's observations are instructive in this context:

".....The Revenue, however, contended that by purchase of loom hours the assessee acquired a right to produce more than what it otherwise would have been entitled to do and this right to produce additional quantity of goods constituted addition to or augmentation of its profit making structure. The assessee acquired the right to produce a larger quantity of goods and to earn more income and this, according to the Revenue, amounted to acquisition of a source of profit or income which though intangible was never-the-less a source or "spinner" of income and the amount spent on purchase of this source of profit or income, therefore, represented expenditure of capital nature. Now it is true that if disbursement is made for acquisition of a source of profit or income, it would ordinarily, in the absence of any other countervailing circumstances, be in the nature of capital expenditure. But we fail to see

how it can at all be said in the present case that the assessee acquired a source of profit or income when it purchased loom hours. The source of profit or income was the profit making apparatus and this remained untouched and unaltered. There was no enlargement of the permanent structure of which the income would be the produce or fruit. What the assessee acquired was merely an advantage in the nature of relaxation of restriction on working hours imposed by the working time agreement, so that the assessee could operate its profit- earning structure for a longer number of hours. Undoubtedly, the profit earning structure of the assessee was enabled to produce more goods, but that was not because of any addition or augmentation in the profit making structure, but because the profit making structure could be operated for longer working hours. The expenditure incurred for this purpose was primarily and essentially related to the operation or working of the looms which constituted the profit earning apparatus of the assessee. It was an expenditure for operating or working the looms for longer working hours with a view to producing a larger quantity of goods and earning more income and was, therefore, in the nature of revenue expenditure."

The Supreme Court also presciently observed that there may be cases where the test of "enduring benefit" may breakdown in that though expenditure incurred may result in advantage of enduring benefit, the money spent, may still be, on revenue account. The Supreme Court observed that the nature of advantage had to be viewed in a commercial sense and it was only when the advantage was in the capital field that the expenditure would be disallowable. It also held that if the advantage merely facilitates the assessee's trading operations or helps it to carry on business with greater efficiency, or profit, at the same time leaving the fixed assets intact, the expenditure would be classifiable as revenue expenditure regardless of its conferring enduring benefit. The test of enduring benefit is not therefore a formula universally applicable. As observed by the Supreme Court in *Alembic Chemical Works (supra)* the test of enduring benefit – to determine whether expenditure is to the capital or revenue account, is a broad one but should not be applied inflexibly:

"some broad and general tests have been suggested from time to time to ascertain on which side of the line the out-lay 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 over-exact- ing.”

17. The decision in *Jonas Woodhead and Sons (India) Ltd. v. CIT* [1997] 224 ITR 342 (SC) is relevant, especially the following observations:

"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, the exclusive right of the company to use the patent or trademark which it receives from the foreign firm, the payment made by the company to the foreign firm whether a definite one or dependent upon certain contingencies, the 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 information 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 an 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."

18. The tests evolved over a period have disapproved the applicability of the “once and for all” payment approach. A more structured test has been commended, which would take into account several factors, such as license tenure; whether the licensee can create further rights in favor of third parties as regards use of technical knowledge; whether there is any restriction or prohibition with regard to use of confidential information received by the licensee to the third parties without consent of the licensor; whether license transfer benefits once and for all; whether on expiry of the term the licensee has to return plans, designs and other process knowledge to licensor even though it may continue to manufacture the product; whether any secret or process of manufacture was sold by the licensor to the licensee.

19. The know-how agreement between Revlon Mauritius and the assessee initially was for a period contained in the foreign collaboration letter issued by the FIPB, Government of India, dated 14-1-1994; (that fixed the duration of

the agreement was ten years from the date of agreement or seven years from the date of commencement of commercial production). The seven year period expired on 29-8-2002. The assessee had requested the Government on 21-7-2003 for extension of technical collaboration agreement. Approval to this was granted by letter dated 6-8-2003. The supplement agreement dated 16-9-2003 was executed between RML (Licensor) and the assessee, made effective from 1-10-2003. Clause 1 of the said supplement agreement reads as under:

“The agreement will continue from 1-10-2003 until such time as both parties mutually decide to terminate the agreement.”

In terms of Clause 3 of the agreement, it was treated as part of the original assessment except as modified. Consequently all the terms and conditions remained unchanged. The original know-how licence agreement was dated 14-1-1994 and royalty payments in terms of that agreement were made till August 2002, i.e., for a period of seven years. The payment of royalty in the year under assessment was made in terms of supplement agreement dated 16-9-2003. The Tribunal therefore concluded that there was no question of any fresh input of know-how/technology and the payments were only in respect of continued use of brand name and patents owned by the foreign company. Hence no benefit of enduring nature was derived by the assessee against these payments of royalty.

20. According to various clauses of the know-how licence agreement read along with the supplement agreement royalty payable as net sales of taxes the know-how was provided by the contract manufacturer in terms of Clause 4.01 of the agreement. This was for the limited purpose of manufacture of Revlon products only. The responsibilities of the contract manufacturer were clearly defined in the agreement between the assessee-company and the contract manufacturer, according to which obligation relating to royalty payment was not passed on to the contract manufacturer. The entire benefit of the know-how was meant for manufacturing the products to be supplied to the company and

there was no obligation of the contract manufacturer (i.e. the assessee's sister concern) to pay royalty to the licensor.

21. The fact that the assessee chose to manufacture through a contractor, i.e. its sister concern, in this Court's opinion does not undermine its status as a licensee, responsible to pay the royalty. That the assessee was the exclusive licensee of the brand, in the territories, is not a relevant factor. If ownership of the brand continued with the Revlon Mauritius, as it did, in this case, the fact that it did not wish to license its know how or patent to anyone else would be a wholly extraneous circumstance. Quite often, brand owners do not – for strategic or business reasons- wish to allow more than one licensee to operate in a defined territory. It could be considerations of exclusivity, avoid intra territory licensee competition, or so on. Therefore, the exclusive nature of the license is not a relevant factor, at least in this case- which could have legitimately weighed with the revenue authorities. As far as the indefinite time period is concerned, the original license was not indefinite; the supplementary agreement no doubt does not indicate a terminus *quo*. However, that factor is rendered insignificant, because the supplementary agreement expresses the term (of the arrangement) to be the duration of the Central Government approval. Moreover, the arrangement can be terminated. Clause 12.01 of the agreement stipulates that upon expiration or termination of this agreement, the licensee shall have no right to exploit or in any way to use the know-how and shall forthwith discontinue all use of the know-how and shall not thereafter use the know-how. Furthermore, there is nothing in the agreement suggestive of any vesting of the know-how, or part of it, or the goodwill in the brand, in the licensee/ assessee. In these circumstances, this Court is of the opinion that the revenue's arguments about the royalty amount being really in the nature of capital expenditure, is meritless. The Tribunal's findings on this point are therefore, upheld.

22. As far as the second aspect, i.e. expenditure for promotion of the brand is concerned, there is no doubt that the dealer's functions extend to advertising the products of the assessee, manufactured by the sister concern. On this aspect, Section 37 of the Income Tax Act would be relevant. The said provision reads as follows:

“SECTION 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".

Explanation : For the removal of doubts, it is hereby declared that any expenditure incurred by an assessee for any purpose which is an offence or which is prohibited by law shall not be deemed to have been incurred for the purpose of business or profession and no deduction or allowance shall be made in respect of such expenditure.

(2B) Notwithstanding anything contained in sub-section (1), no allowance shall be made in respect of expenditure incurred by an assessee on advertisement in any souvenir, brochure, tract, pamphlet or the like published by a political party.

The applicable test as to what constitutes expenses “*laid out or expended wholly and exclusively for the purposes of the business or profession*” was explained in *Gordon Woodroffe Leather Manufacturing Co. v. CIT* [1962] Supp. (2) SCR 211. The correct approach, said the Court, which has to be taken in all such cases is to see whether:

“was the sum of money expended on the ground of commercial expediency and in order indirectly to facilitate the carrying on of the business”

Again, in *Sasson J. David v Commissioner of Income Tax* [1979] 118 ITR 261 (SC) the Supreme Court outlined the correct test of commercial expediency as

the guiding principle to decide whether the expenditure was to facilitate profits, as follows:

(iii) that the sum of money was expended on the ground of commercial expediency and in order indirectly to facilitate the carrying on of the business of the assessee”

In *Smith Kline and French (India) Ltd. vs. CIT*, (1992) 193 ITR 582 (Karnataka), it was held that in normal commercial sense and in common parlance sales promotion and publicity are activities aimed at gaining goodwill in the market. They need not be confined to media propaganda but can involve indirect approaches. The judgment of a Division Bench of this Court in *Commissioner of Income Tax v Adidas India Marketing (P) Ltd* 195 Taxman 256 has recognized that brand promotion exercises undertaken through media campaigns, schemes, programmes etc are essential for propagation of the brand. The necessity (or lack of it) is not something which income tax authorities can go into; as long as it is voluntarily undertaken by the business enterprise for profit earning, it would be entitled to claim relief under Section 37 (1).

23. In the present case, the AO was conscious of the fact that brand promotion expenses are a necessary ingredient in marketing strategies. Therefore, he allowed about 50% of those expenses. However, the reasoning for disallowance of the rest, i.e. that the assessee could claim only a proportion of such expenses, since advertising expenses were to be borne by the sister concern dealer, and that the proportion was in respect of its territory, was not upheld. This Court does not see any fallacy in the Tribunal's approach or reasoning, on this aspect. One is not unmindful of the concerns of a business which engages in sale of consumer items, and faces continuous competition. Brand promotion enhances the visibility of given products or services, and are often perceived as conferring a competitive advantage on those who adopt those strategies or schemes. Expenditure towards that end is based on pure

commercial expediency, which the revenue in this case, ought to have recognised, and allowed. The revenue's arguments on this point too are insubstantial.

24. The last aspect pertains to the payment of consultancy charges. On this aspect, the Tribunal's findings are as follows:

"11. We have considered the rival contentions and found from the record that the consultancy charges have been paid in lieu of MMPL for providing various advices as discussed in the above paragraph. Mr. U.K. Modi has represented one of the joint venture parties, MMPL, as director, in the business of collaboration with RML. We found him as an instrument in negotiating the collaboration as representative of MMPL for which he himself gave his personal undertaking. We also found that Mr. U.K. Modi did not render any services in his capacity as director of the assessee-company and is not being paid any remuneration to work as a director. Sufficient evidence was produced before the assessing officer to indicate that MMPL was actively involved in the day-to-day activities of the assessee-company. MMPL has duly incorporated the consultancy charges in its income and paid due taxes thereon, it cannot be said that agreement was entered for siphoning off of income to the sister concern. In view of the decision of CIT v. Dhanrajgirji Raja Narasingirji (1973) 91 ITR 544 (SC), it is upon the assessee to decide what expenses are to be incurred or what is required for business purposes and it is not open to the revenue to prescribe as to what expenses are to be incurred by the assessee. The categorical finding recorded by the Commissioner (Appeals) with regard to reasonableness of the consultancy charges paid has not been controverted by the learned departmental representative, we therefore do not find any reason to interfere with the order of the Commissioner (Appeals) for deleting disallowance made by the assessing officer by invoking the provisions of Section 40A(2)."

The relevant extracts from the Consultancy Agreement between the assessee and MMPL are as follows:

"AGREEMENT dated as of January 1, 1995 by and between MODI-REVLON PRIVATE LIMITED, an Indian Corporation ("Modi-Revlon") having its Registered Office at 1400 Hemkunt Tower, 98, Nehru Place, New Delhi 110 019, India and MODI-MUNDIPHARMA LIMITED, an

Indian corporation (“MM”), having its registered office at 1400 Hemkunt Tower, 98 Nehru Place, New Delhi 110-019, India.

3. Consultation to Modi-Revlon.

(a) MM shall provide consulting advice concerning day-to-day conduct of the management of Modi-Revlon, including recommendations concerning the appointment and dismissal of employees and advice concerning Modi-Revlon’s outside dealings, and shall assist Modi-Revlon in the development of its business in accordance with the terms of the Shareholders’ Agreement, the TM License and the Know How License.

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4. Compensation.

(a) Modi-Revlon agrees to pay MM an amount in rupees equal to US\$200,000 per calendar year, commencing with 1995, plus an amount equal to one percent of the Net Sales of Modi-Revlon in each calendar year in excess of US\$ 15,000,000; provided, however, that the aggregate remuneration payable to MM hereunder shall not exceed the sum of US\$ 300,000 per annum.

(b) The compensation payable to MM stated in paragraph 4(a) and the determination of the U.S. dollar equivalent of the Net Sales of Modi-Revlon shall be paid and determined, as applicable, in Indian Rupees at the exchange rate in effect for purchasing U.S. Dollars with Indian Rupees as of the last day of each calendar year, as published in the Wall Street Journal.

5. Term.

This Agreement shall continue until December 31, 1997 at which time or anytime thereafter it shall be terminable by either party upon three months notice to the other party. This agreement shall terminate in the event of the termination of the Shareholders’ Agreement.”

In *Dhanrajgiriji Raja Narsinghji* (supra), the Supreme Court considered the question of such payments and ruled as follows:

“we find no support for this contention from the language of Section 10(2)(xv). That provision does not make any distinction between civil litigation and criminal litigation. In fact, expenses incurred in connection with litigation with are not separated dealt with under that

provision. In our opinion, it makes no difference whether the proceedings are civil or criminal. All that the court has to see is whether the legal expenses were incurred by the assessee in his character as a trader. In other words, whether the transaction in respect of which proceedings are taken arose out of and was incidental to the assessee's business. Further, we have to see whether the expenditure in question was bona fide incurred wholly and exclusively for the purpose of business : see Commissioner of Income tax Vs. Birla Cotton Spinning and Weaving Mills Ltd."

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...The Tribunal has come to the conclusion that the expenditure in question has been incurred. The contention that as the Government was conducting the prosecution, there was no necessity for the assessee to engage his own lawyers is not substantial. It was for the assessee to decide how best to protect his own interest. It was the duty of the assessee to see that the prosecution was properly conducted. He was interested in successfully prosecuting the case. The fact that he did not leave the carriage of the case in the hands of the prosecuting agency of the Government is no ground for disallowing the expenditure. It is not open to the department to prescribe what expenditure an assessee should incur and in what circumstances he should incur that expenditure. Every businessman knows his interest best. So far as the apportionment is concerned we are not told why we should not consider the same as a reasonable estimate."

It would be useful to recollect the decision of the Supreme Court in **S.A. Builders Ltd. v. CIT** (2006) 289 ITR 26 (SC) where it was held that the revenue cannot place itself in the arm chair of businessman or in the position of the Board of Directors and assume the role of deciding what is the reasonable expenditure having regard to the circumstances of the case. The Appellate Commissioner's order in this case, contains the following reasons:

"MMPL has been actively associating with the appellant in various services such as manpower planning and recruitment, sales review, preparation of marketing plans, product advertising and promotional policies, budgeting, motivational schemes etc identified in Para 10.1 by the agreement....Without any evidence to the contrary, it cannot be said that Mr. Modi has not rendered services as a representative of MMPL. If it is so, the services rendered by him for MMPL but would take the character of a

gratuitous payment or payment received in spite of not rendering any services. Such finding can only be made in the case of MMPL and that too after examining the various documents in relation to services rendered by him for MMPL. In any case, rendering of services by MMPL is amply proved from the records and therefore, in my opinion, no disallowance appears warranted when considered with further discussion in the ensuing Paras.”

25. This Court notices that in order to determine whether the payment is not sustainable, the AO has to first return a finding that the payment made is excessive, under Section 40-A (2) of the Income Tax Act. If it is found to be so, then the AO has to determine what constitutes the fair market value of the services rendered and disallow the difference between what is claimed and what is such value determined (as fair market value). Apart from the fact that no such exercise was undertaken by the AO, the Court sees that the assessment order went off into a tangent, in following a method that was clearly inapplicable. The annual cap of ₹. 30 lakh payable to managerial personnel applied to public limited companies, and not those such as the assessee. This aspect was noticed by the CIT (A) who set aside the disallowance. The Tribunal upheld that finding. Such view (of admissibility of similar consultancy charges) is supported by several decisions, which have been noticed in the detailed order of the CIT (A). This Court finds no valid grounds to interfere with those findings, which are both sound and reasonable.

26. In the light of the above discussion all the questions of law are answered in favour of the assessee, and against the revenue. The appeals therefore, fail and are dismissed.

S. RAVINDRA BHAT
(JUDGE)

R.V. EASWAR
(JUDGE)

AUGUST 29, 2012