IN THE HIGH COURT OF GUJARAT AT AHMEDABAD

TAX APPEAL No. 326 of 2000

For Approval and Signature:

HONOURABLE MR.JUSTICE AKIL KURESHI
HONOURABLE MS.JUSTICE HARSHA DEVANI

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1 Whether Reporters of Local Papers may be allowed to see the judgment ?

2 To be referred to the Reporter or not ?

3 Whether their Lordships wish to see the fair copy of the judgment ?

4 Whether this case involves a substantial question of law as to the interpretation of the constitution of India, 1950 or any order made thereunder ?

5 Whether it is to be circulated to the civil judge ?

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DY C I T - Appellant(s)
Versus
SAYAJI INDUSTRIES LTD. - Opponent(s)

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Appearance :
MR.VARUN K.PATEL for Appellant(s) : 1,
MR JP SHAH for Opponent(s) : 1,

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CORAM : HONOURABLE MR.JUSTICE AKIL KURESHI

and

HONOURABLE MS.JUSTICE HARSHA DEVANI

Date : 03/07/2012

ORAL JUDGMENT

(Per : HONOURABLE MR.JUSTICE AKIL KURESHI)

1. Revenue is in appeal against the judgement of the Income Tax Appellate Tribunal ("the Tribunal" for short) dated 15.9.1999. While admitting this appeal, the following substantial questions of law were framed :

> *"[1] Whether the Appellate Tribunal is right in law and on facts in directing the assessing officer to allow deduction of expenses amounting to Rs.1,64,512/- under section 37(4), in respect of guest house expenses?*
>
> *[2] Whether the Appellate Tribunal is right in law and on facts in deleting the disallowance of Rs.1,16,219/- made under section 37(3) read with rule 6D of the Income Tax Rules?*
>
> *[3] Whether the Appellate Tribunal is right in law and on facts in deleting the disallowance of Rs.23,23,880/- made under section 35AB read with section 37 of the Act?"*

2. Insofar as the question No.1 is concerned, it arises out of the decision of the Tribunal deleting the disallowance confirmed by CIT (Appeals) of Rs.1,64,512/- under section 37(4) of the Income Tax Act, 1961 ("the Act" for short) as guest house expenses. The expenses incurred by the assessee towards guest house charges included rent on guest house, food, beverages etc., as also depreciation on furniture and fixtures, salary of staff and electricity expenses. The CIT (Appeals) allowed the depreciation on furniture and fixtures, but confirmed the disallowance of the remaining expenses. The issue was carried in appeal by the assessee before the Tribunal. The Tribunal reversed such decision of the CIT (Appeals), upon which, the revenue has raised this question before us.

3. The counsel for the revenue pointed out that such question is squarely covered in favour of the revenue by virtue of the decision of the Apex Court in case of **Britannia Industries Ltd. v. Commissioner of Income Tax and another**, reported in (2005) 278 ITR 546 (SC), wherein the Apex Court held that section 37(4) of the Act provides for only specific items of expenditure allowable towards guest house expenses. Counsel for the respondent assessee was unable to dispute this position. In that view of the matter, we answer the question in the negative, that is, in favour of the revenue and against the assessee. Decision of the Tribunal is to that extent reversed.

4. The question No.2 arises in the following background. The assessee had, before the Assessing Officer, claimed expenditure for reimbursement of cost incurred by the employees on conveyance, telephone and trunk call charges, laundry, typing charges, etc. during the out station tour for the purpose of business. The Assessing Officer, applying sub-section (3) of section 37 of the Act and rule 6D of the Income Tax Rules, 1962 ("the Rules" for short), disallowed a sum of Rs.1,16,219/- out of total claim made by the assessee. Such disallowance was confirmed by the CIT (Appeals) upon which, the assessee approached the Tribunal. The Tribunal relying on decision of Calcutta High Court in the case of **Commissioner of Income Tax v. Vidyutt Metallics Ltd.**, reported in (1993) 203 ITR 779 (Calcutta), upheld the assessee's contention that such expenditure could not be limited by application of section 37(3) of the Act or rule 6D of the Rules. The Tribunal opined that such statutory provisions would limit the expenditure incurred on travelling to the extent of stay in hotels confining it

to daily allowances referred to in rule 6D and not to any other expenses incurred, provided the expenditure is wholly and exclusively laid out for the purposes of business. The Tribunal proceeded to delete such disallowance observing that, “Having considered the nature of the expenditure incurred, we are satisfied that those expenditures were incurred for the purpose of business. Therefore, we delete the disallowance and allow the ground of appeal.”.

5. Appearing for the revenue, counsel Shri Varun Patel submitted that the Tribunal committed serious error in deleting the disallowances made by the Assessing Officer and confirmed by the CIT (Appeals). He placed reliance upon a decision of Division Bench of the Delhi High Court in the case of **Bharat Commerce & Industries Ltd. v. Commissioner of Income Tax**, reported in 119 TAXMAN 560, wherein interpreting section 37(3) of the Act and rule 6D of the Rules, the High Court held that there was no provision in rule 6D(2) to break the period of tour outside headquarters into two portions, one relating only to traveling and the second relating only to actual stay at the place of destination. The High Court was of the opinion that the limitations provided in rule 6D(2) of the Rules cover the entire expenditure incurred by an employee both on actual travelling as well as during the period of the stay at any particular place for the purpose of business.

6. On the other hand, learned counsel Shri Manish Shah for the respondent – assessee opposed the ground of appeal of the revenue contending that the Tribunal has correctly applied the statutory provisions. Looking to the nature of expenditure, the same were not required to be limited and were not covered

under section 37(3) of the Act and rule 6D of the Rules. He relied upon the decision of the Calcutta High Court in case of **Commissioner of Income Tax v. Vidyutt Metallics Ltd.**, (supra). In the said decision, the High Court opined that section 37(3) of the Act read with rule 6D of the Rules would limit only those expenditure incurred for stay in the hotels and confined it to daily allowances and would extend to any other expenditure, provided it is wholly and exclusively laid out for the purposes of business.

7. Having thus heard the learned counsel for the parties and having perused the decisions on record, we find that the Tribunal deleted disallowance not on the ground that such expenses were laid out after the employee completed the journey to the destination. If that had been so, the decision of the Division Bench of the Delhi High Court in the case of **Bharat Commerce & Industries Ltd. v. Commissioner of Income Tax** (supra) would have applied. However, the Tribunal deleted the disallowances primarily on the ground that section 37(3) of the Act would limit expenditure incurred on travelling to the extent of stay in hotels confining it to daily allowances referred to in rule 6D and would not extend to any other expenses incurred, provided the expenditure is wholly and exclusively laid out for the purposes of business. Sub-rule (2) of rule 6D of the Rules provides the limit to which such expenditure can be granted as a deduction. Clause (b) of sub-rule (2) thereof pertains to expenditure other than travelling, including hotel expenses or allowances as paid in connection with such travel. Thus, section 37(3) of the Act read with rule 6D of the Rules would come into operation and limit the expenses incurred by an employer in connection with the

travelling by an employee, including the hotel expenses or allowances paid in connection with such travel.

8. The Tribunal was, thus, correct in holding that other business expenses as long as they were wholly and exclusively for the purpose of business would not be governed by such limiting provision contained in section 37(3) of the Act read with rule 6D of the Rules. The Tribunal held that such expenses were so expended. With respect to some of the expenses, there may be some fleeting doubt in our mind since the Tribunal's reasonings are rather brief. However, the amount being not very significant and the Tribunal's ultimate conclusion being largely factual, we are not inclined to remit this issue for further consideration and terminate it here.

9. Subject to above observation, we answer the question in affirmative, that is, against the revenue and in favour of the assessee.

10. This brings us to the last remaining but elaborately argued question. The issue pertains to application of section 35AB of the Act and arises in following factual background. The assessee, a company engaged in manufacturing of starch and other similar products, during the year under consideration relevant to assessment year 1989-90, paid a sum of Rs.20,35,335/- and described it as technical know-how fees. The assessee further expended a sum of Rs.2,88,545/- and described as technical service fees. Thus, total sum of Rs.23,23,880/- of expenditure incurred by the assessee, of which the assessee claimed total deduction as a revenue expenditure, came up for consideration before the Assessing

Officer. The Assessing Officer was of the opinion that such expenditure would fall within section 35AB of the Act. The assessee when called upon by the Assessing Officer, contended that the provisions of section 35AB of the Act are applicable only in respect of capital expenditure and not in respect of revenue expenditure. The assessee further contended that the company while acquiring such know-how, obtained no ownership right on such information and know-how was furnished by the foreign company to the assessee under an agreement. The assessee also contended that such technical know-how was for the purpose of production of its existing items which are being manufactured by the assessee company since many years.

11. The Assessing Officer, however, did not accept the contentions of the assessee. He though agreed that such expenditure was revenue in nature, was of the opinion that the same would be covered within section 35AB of the Act. The assessee, therefore, could not claim entire deduction thereof in the assessment year under consideration, but had to amortize the same as provided under the said section and spread over the benefit over a period of six years.

12. Dissatisfied with such decision of the Assessing Officer, the assessee carried the matter in appeal. Before the CIT (Appeals), the assessee in addition to contending that being a revenue expenditure, could not be brought out of section 35AB of the Act, further contended that the provision of section 35AB of the Act is enabling provision.

13. The CIT (Appeals), however, rejected the assessee's

appeal. He was of the opinion that section 37(1) of the Act, which covers expenditure not being in the nature of the expenditure described in sections 32 to 36, would not apply in the present case by virtue of the provisions contained in section 35AB of the Act. He was of the opinion that since section 35AB of the Act makes a specific provision to treat the expenditure incurred for acquisition of technical know-how by way of lump sum payment, even if such a payment was revenue in nature, would not fall within sub-section (1) of section 37 of the Act.

14. Undeterred, assessee carried the matter before the Tribunal. The Tribunal by the impugned judgement reversed the decisions of the revenue authorities. The Tribunal noted that as per the agreement, all information and know-how furnished by the foreign company remains the property of that company; the payment was made as a lump sum consideration to such foreign company for only use of the know-how for the purpose of its running business for a limited period. The Tribunal noted that undisputedly, there was no purchase of the same from the foreign company. The Tribunal thereafter noted several decisions on the issue whether payment made for right to use or access to technical knowledge could be treated as revenue or capital expenditure. The Tribunal in its concluding portion, proceeded to allow the assessee's appeal holding that the case of the assessee was not covered under section 35AB of the Act. The Tribunal made following observations :

> *“8. In the case before us, we have already noticed that according to the assessee, it had not purchased or obtained ownership of the technical know-how from the foreign company. On the other hand, the assessee is*

only a licensee by which it can use the know-how for the purpose of its business temporarily for which the lump sum payment has been made. Therefore, the present case is not covered by the provision of section 35AB as rightly held by the Tribunal, Calcutta Bench. Therefore, considering the entire circumstances of the case, we are of the view that section 35AB has no application in the present case and the assessee is entitled to deduction u/s 37(1) of the Act."

15. It is this view of the Tribunal which is under challenge at the hands of the revenue. Learned counsel Shri Varun Patel for the revenue vehemently contended that the Tribunal committed grave error in allowing the assessee's appeal. He submitted that section 35AB of the Act is widely worded and includes any expenditure incurred for acquisition of technical know-how. Concept of ownership here is not material. He further submitted that once an expenditure, whether revenue or capital, is covered under section 35AB of the Act, by virtue of very language of sub-section (1) of section 37 of the Act, the assessee cannot claim any benefit thereof under section 37 of the Act.

16. In support of his contentions, counsel placed heavy reliance on the decision of the Madras High Court in the case of **Commissioner of Income Tax v. Tamil Nadu Chemical Products Ltd.**, reported in (2003) 259 ITR 582, wherein a Division Bench of the Madras High Court expressed an opinion that during the period when section 35AB of the Act remained effective, any expenditure towards acquisition of know-how, irrespective of whether it is a capital or a revenue expenditure, was to be treated only in accordance with section 35AB and the deduction allowable in respect of such know-how was 1/6th of the amount paid as lump sum consideration for acquiring

know-how.

16.1 Counsel also relied on the decision of the M. P. High Court in the case of **Commissioner of Income Tax v. Bright Automotives And Plastics Ltd.**, reported in (2005) 273 ITR 59. In the said decision, however, the principal question pertained to interpretation of term “acquiring” in section 35AB of the Act. The High Court opined that such term has to be given a liberal meaning and in order to attract the rigour of section 35AB of the Act, it may not be necessary for the assessee to actually become an absolute owner of the know-how. The High Court also opined that for the purpose of said section, nature of expenditure whether revenue or capital, is of no consequence.

17. On the other hand, Shri Manish Shah, counsel for the respondent-assessee opposed the appeal contending that the expenditure in question was purely revenue in nature. The same was, therefore, not covered under section 35AB of the Act. Such provision was made to encourage acquisition of know-how to improve the quality and efficiency of Indian manufacturing. He submitted that the assessee acquired the know-how for a limited period and never enjoyed any ownership or domain right over such technicality. The know-how was utilized for manufacturing of its existing items, neither new manufacturing unit was established nor new item of manufacturing was introduced.

17.1 Counsel pointed out that even the Assessing Officer who agreed that the expenditure in question was a revenue expenditure. CIT (Appeals) did not disturb this finding. The

Tribunal gave detailed reasons to hold that the expenditure was revenue in nature.

17.2 Counsel, therefore, submitted that if that be so, section 35AB of the Act would have no applicability since such provision was made as an enabling provision and not for limiting the benefits which were already existing. In this respect, counsel drew our attention to the C.B.D.T. Circular No.421 dated 12.6.1985 wherein with respect to deduction in respect of expenditure of know-how, it was clarified that, “With a view to providing further encouragement for indigenous scientific research, the Finance Act, 1985, has inserted a new section 35AB in the Income-tax Act.”

17.3 Counsel placed heavy reliance on the decision of the Apex Court in the case of **Commissioner of Income Tax v. Swaraj Engines Ltd.**, (2009) 309 ITR 443 in which the Apex Court had an occasion to examine the decision of Punjab & Haryana High Court on the question of applicability of section 35AB of the Act. To this decision, we would revert at a latter stage.

18. From the submissions made before us, central question that calls for our consideration whether in fact the revenue is justified in applying section 35AB of the Act, or whether the assessee, as held by the Tribunal, was correct in contending that the said provision would have no application. Before going to such question, we may recall that the Assessing Officer, in clear terms, held that the expenditure was revenue in nature. CIT (Appeals) did not disturb this finding, but proceeded to hold that the same would be hit by section 35AB of the Act and

therefore, not allowable deduction under section 37(1) of the Act. The Tribunal noted the nature of such expenditure. Significant features thereof were that the assessee had not purchased or obtained ownership of such technical know-how from the foreign company. The assessee was merely a licensee under which license it could use a know-how for the purpose of its business temporarily. For such acquisition of know-how, the assessee paid lump sum payment. It had also come on record before the Tribunal that such technical know-how was used for the purpose of manufacturing the existing items which the assessee was manufacturing since years. In short, without saying so many words, the Tribunal also confirmed the view of the revenue authorities that the expenditure was revenue in nature. If that be so, the question arises whether deduction of such expenditure can be limited by applying section 35AB of the Act.

19. As already noted, as clarified by the CBDT circular dated 12.6.1985, such provision was made in the statute in Finance Act, 1995 (with effect from 1.4.1985) with a view to providing further encouragement for indigenous scientific research. Section 35AB of the Act, which was later on deleted with effect from 31.3.1999, reads as under :

> *"S. 35AB. Expenditure on know-how. (1) Subject to the provisions of sub-section (2), where the assessee has paid in any previous year any lump sum consideration for acquiring any know-how for use for the purposes of his business, one-sixth of the amount so paid shall be deducted in computing the profits and gains of the business for that previous year, and the balance amount shall be deducted in equal installments for each of the five immediately succeeding previous years.*

[2] Where the know-how referred to in sub-section (1) is developed in a laboratory, university or institution referred to in sub-section (2B) of section 32A, one-third of the said lump sum consideration paid in the previous year by the assessee shall be deducted in computing the profits and gains of the business for that year, and the balance amount shall be deducted in equal installments for each of the two immediately succeeding previous years.

Explanation – For the purposes of this section, "know-how" means any industrial information or technique likely to assist in the manufacture or processing of goods or in the working of a mine, oil well or other sources of mineral deposits (including the searching for, discovery or testing of deposits or the winning of access thereto)."

19.1 Sub-section (1) of section 35AB of the Act provides for a deduction for any lump sum payment made by the assessee for acquiring any know-how for use for the purpose of its business. Such deduction, however, was to be spread over a span of six years, during each of the six years starting with the year when such expenditure was incurred, the assessee being eligible for deduction of the one-sixth of the total expenditure.

20. The moot question is whether such provisions contained in section 35AB of the Act would cover also revenue expenditure. In this context, we may peruse the decision of the Apex Court in case of **Commissioner of Income Tax v. Swaraj Engines Ltd.** (supra) more closely. The said decision was rendered in an appeal filed by the revenue challenging the decision of the Punjab & Haryana High Court in the case of **Commissioner of Income Tax v. JCT Electronics Ltd.**, reported in (2008) 301 ITR 290 (P&H). In that case, the assessee had claimed a deduction of a sum of Rs.26.65 lakhs

(rounded off) paid to one M/s Kirloskar Oil Engines Ltd. as royalty on the basis of an agreement for the purpose of acquiring technical know-how for the manufacturing of diesel engines. The Assessing Officer was of the opinion that such expenditure was covered under section 35AB of the Act and the same could not be treated as a revenue expenditure. After considering the assessee's reply, the Assessing Officer applied section 35AB of the Act to such expenditure. The assessee approached the Commissioner (Appeals) against such a decision contending that under the said agreement, the assessee had not become the owner of the technical know-how and no benefit of enduring nature had been received by the assessee. The CIT (Appeals) granted benefit to the assessee to the extent such expenditure represented the royalty calculated on the basis of the sales including excise duty and sales tax. The CIT (Appeals) held that such expenditure was revenue in nature and accordingly, allowed the assessee's appeal. The Department, thereupon, approached the Tribunal. The Tribunal rejected the revenue's appeal. The Tribunal referred to various clauses of the agreement between the assessee and the know-how provider to hold that such expenditure was revenue in nature. When the matter reached the High Court at the hands of the revenue, the High Court rejected the appeal on a somewhat different ground. The High Court held and observed that effort of the revenue to bring the expenditure within the domain of section 35AB of the Act was totally misplaced since the pre-condition for application of section 35AB of the Act was that the payment had to be a lump sum consideration for acquiring any know-how. Such pre-condition was not satisfied. On this basis, the High Court dismissed the appeal. It was this decision of the High Court which came up for consideration

before the Apex Court in the case of **Commissioner of Income Tax v. Swaraj Engines Ltd.** (supra). The Apex Court observed that, *"At the same time, it is important to note that even for the applicability of section 35AB, the nature of expenditure is required to be decided at the threshold because if the expenditure is found to be revenue in nature, then section 35AB may not apply. However, if it is found to be capital in nature, then the question of amortization and spread over, as contemplated by section 35AB, would certainly come into play."*. With the above observations, the Apex Court proceeded to remand the matter before the High Court observing that such question needs to be decided authoritatively by the High Court as it was an important question of law, particularly, after insertion of section 35AB.

21. This decision is significant for our purpose and we have taken note of the background leading to the appeal before the Apex Court due to such reason. The Apex Court decision would suggest that for determining whether certain expenditure would fall within section 35AB or not, it would be important to examine the nature of the expenditure. If it is found that the same is revenue in nature, the question of applicability of section 35AB of the Act would not arise. On the other hand, if it is found to be capital in nature, then the question of amortization and spreading over, as contemplated under section 35AB of the Act would come into play. It was in this background that the Apex Court desired that this question, that is, the question of the nature of expenditure, whether revenue or capital, be first decided before final answer to the applicability or otherwise of section 35AB could be given. We may recall that the Punjab & Haryana High Court in the

decision under challenge before the Supreme Court had not given any clear finding on this aspect though the Tribunal had confirmed the view of the CIT (Appeals) that the expenditure was revenue in nature. It was precisely for this reason that the Apex Court remanded the proceedings for authoritatively declaration on this point by the High Court.

22. In addition to the decision of the Apex Court in the case of **Commissioner of Income Tax v. Swaraj Engines Ltd.** (supra), we also would like to place reliance on the clarificatory circular issued by the C.B.D.T. bringing out the nature of the benefit being provided under section 35AB and the purpose for introduction of such provision in the statute. Such provision, as was clarified, was made with a view to providing further encouragement for indigenous scientific research. Thus, such statutory provision was made for making available the benefits which were hither to not available to the manufacturers while incurring expenditure for acquisition of technical know-how. To the extent such expenditure was covered under section 35AB of the Act, amortized deduction spread over six years was made available. If such expenditure was capital in nature, prior to introduction of section 35AB of the Act, no such deduction could be claimed. With introduction of section 35AB, to encourage indigenous scientific research, such deduction was made available. Such a provision cannot be seen as a limiting provision restricting the existing benefits of the assessee. In other words, the revenue expenditure in the form of acquisition of technical know-how which was available as deduction under section 37(1) of the Act, was never meant to be taken away or limited by introduction of section 35AB of the Act. In the Ninth Edition, Volume-I of Palkhivala, while explaining the provisions

of section 35AB of the Act, following has been observed :

> *"This section allows deduction, spread over six years, of a lump sum consideration paid for acquiring know-how for the purposes of business even if later the assessee's project is abandoned or if such know-how subsequently becomes useless or if the same is returned. The section, which is an enabling section and not a disabling one, should be confined to that consideration which would otherwise be disallowable as being on capital account. A payment for acquiring know-how or the use of know-how which is one revenue account is allowable under section 37, and does not attract the application of this section at all."*

23. To our mind, therefore, the provisions of section 35AB of the Act can apply only in case of capital expenditure and of course, provided the conditions set out therein are fulfilled. In such a case, during the period when section 35AB remained in operation, the assessee could claim benefit thereof. However, such provision would not apply to a revenue expenditure even if the same was incurred for acquisition of technical know-how. Deduction on such expenditure was available even before the introduction of section 35AB of the Act and such deduction cannot be curtailed or limited by applying section 35AB. In that view of the matter, taking such an expenditure out of section 37(1) of the Act, would not arise.

24. We are unable to concur with the view of the Madras High Court in case of **Commissioner of Income Tax v. Tamil Nadu Chemical Products Ltd.** (supra), which was in any case rendered prior to the decision of the Apex Court in the case of **Commissioner of Income Tax v. Swaraj Engines Ltd.** (supra).

25. Before closing, we may clarify that in the present case, the Assessing Officer himself proceeded on the basis that the expenditure was revenue in nature. In that view of the matter, the interpretation that we have adopted would apply and the case of the assessee would not fall under section 35AB of the Act. In a given case, if the expenditure is held to be capital in nature, further question of applicability of section 35AB of the Act may arise. In essence, therefore, each case would have to be examined separately and on the strength of material on record. Learned counsel Shri Patel however requested that the matter be remanded to the Assessing Officer for consideration whether the expenditure was capital or revenue in nature. We find that when the Assessing Officer had himself held that it is revenue expenditure, there would be no purpose of such a remand.

26. In the result, the third question is answered in the negative, that is, against the revenue and in favour of the assessee. Appeal is allowed in part and disposed of accordingly.

[AKIL KURESHI, J.]

[HARSHA DEVANI, J.]

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