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IN THE INCOME TAX APPELLATE TRIBUNAL
MUMBAI BENCH "L", MUMBAI

Before ShriP.M.Jagtap, Accountant Member
&Shri N.V. Vasudevan, Judicial Member.

I.T.A. No. 6622/Mum/2009.
Assessment Year : 2005-06.

AND

C.O.No.170/Mum/2010
(In ITA No. 6622/Mum/2009)
Assessment Year : 2005-06.

M/s Cabot India Ltd., C/o Kalyaniwalla&Mistry, Army &Nevy Bldg., 3rd Floor, 148, Mahatma Gandhi Road, Fort, Mumbai-400 001. PAN AAACU1414F	**Vs.**	Dy. Commissioner of Income-tax 1(1), Mumbai.
Appellant/Cross Objector.		Respondent.

AND

I.T.A. No.857/Mum/2010
Assessment Year : 2005-06.

Dy. Commissioner of Income-tax, 1(1), Mumbai.	**Vs.**	M/s Cabot India Ltd. Mumbai.
Appellant.		Respondent.

Assessee by : ShriM.M.Golavala.
Departmentby : Smt. Malathi R. Sridharan.

O R D E R

Per P.M. Jagtap, A.M. :

These two appeals, one filed by the assessee being ITA No. 6622/Mum/2009 and other filed by the Revenue being ITA No. 857/Mum/2010, are cross appeals which are directed against the order of learned CIT(Appeals)-15, Mumbai dated 23-11-2009 and the same are being disposed of by this single composite order along with the cross objection filed by the assessee being C.O. No. 170/Mum/2010.

2. At the time of hearing before us, ground No.4 raised in the appeal of the assessee claiming benefit of variation to the extent of (+/ -) 5% in respect of transfer pricing adjustment has not been pressed by the learned counsel for the assessee. The same is accordingly dismissed as not pressed.

3. The common issue raised in the remaining grounds of the assessee's appeal as well as ground No.2 of the Revenue's appeal relates to the addition of Rs.2,06,48,218/- made by the AO on account of transfer pricing adjustment which has been sustained by the learned CIT(Appeals) to the extent of Rs.1,37,65,579/-.

4. The assessee in the present case is a company incorporated in India which is engaged in the business of manufacturing of carbon black. M/s Cabot Corporation, Boston, USA (the parent AE) is holding 60% shares of the assessee company. During the year under consideration, the assessee company entered into international transactions with its various Associated Enterprises (AEs) including payment of royalty amounting to Rs.5,62,67,879/- made to Cabot Corporation, USA. The assessee company had entered into a foreign technology collaboration agreement with Cabot Corporation, USA dated December 19,1990 for

modernization of Carbon black plant under energy conservation scheme. As per the said agreement, royalty was payable at the rate of 2% on the domestic sales. The said agreement was renewed in April, 1998 whereby the rate of royalty payable by the assessee was retained at 2%. A supplementary agreement, however, was entered into on 19-01-1999 whereby the rate of royalty for Trade Grade of the product manufactured by the assessee was increased to 3%. Another agreement was entered into on 3rd July, 2004 whereby the rate of royalty payable by the assessee to Cabot Corporation was increased to 5% on Carcass product whereas the rate of royalty of Trade Grade product was retained at 3%. The increase in the rate of royalty on Carcass product was made effective from November 27, 2003. Accordingly a total royalty payment of Rs.5,62,67,860/- was made by the assessee to Cabot Corporation in the year under consideration, the details of which are as under :

Grade	Amounts (Rs)
Carcass (5%)	2,66,19,453
Trade (3%)	2,25,15,217
	4,91,34,670
Add : R&D cess	24,56,733
	5,15,91,403
Add: Short provision	
For preceding year	46,76,457
Total	5,62,67,860

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5. In its transfer pricing study/analysis, the payment of royalty made to Cabot Corporation, USA as above was claimed to be at arm's length by the assessee

company on the basis of Comparable Uncontrolled Price (CUP) method adopted by it. When this matter relating to computation of arm's length price in relation to the international transactions was referred by the AO to the TPO u/s 92CA(1), the TPO noted from the supplementary agreement dated 3rd July, 2004 that no reasons were specifically assigned for the enhanced royalty rate of 5% agreed to be paid by the assessee to Cabot Corporation for Carcass product. On perusal of the said agreement, he also noted that there was no change in the terms of technology that was being supplied by Cabot Corporation, USA to the assessee company and the only reason given for increasing the rate of royalty was new regulations with regard to approval for payment of royalty under automatic rout. He, therefore, required the assessee to explain the increase in the rate of royalty payable on the carcass grade of products to 5% as against 2% agreed earlier. In reply, an elaborate submission was made on behalf of the assessee justifying the said increase on various grounds. The said submission was considered and discussed by the TPO in respect of each and every material point raised by the assessee giving his finding thereon in paragraph No. 5.1.3 of his order as under :

(a) The assessee has entered into an agreement with the ARs for transfer of technology on an on-going basis. The collaboration agreement dated 7th August, 1990 was approved by the Reserve Bank of India. There is no change in the terms of the agreement governing the flow of technology / know-how etc., which the AE was to provide to the assessee. All the subsequent agreements entered between the Assessee and the AE are by way of Supplementary agreement, wherein only the operating part in respect of the rate of royalty payable by the recipient of the technology to the provider of the technology is altered. There is no alteration in the scheme of services / benefits which are intended to be provided by the AE to the assessee. That the AE is a world leader in the manufacturing carbon black is not challenged here. It is because of the technological advantage enjoyed by the parent (AE) that the assessee is able to cater to the growing Indian market. The Indian

company is almost fully held (97.54%) by the parent company. Nothing has been brought on record, which goes to suggest that the AE has transferred or had intended to transfer technology / know-how over and above the one stipulated in agreement dated August, 1990.

(b) The assessee has taken the contention that major improvement activity was started in the Carcass unit because of which the quality of the product increased, variability got decreased, etc. The assessee has given figures pertaining to March, 2003 to March, 2006 in support of the improvement recorded in the manufacturing of the product as a result of the technological support received from AE. In this regard, it may be pointed out that all these strides recorded by the assessee very much formed the part of the technological agreement already entered by the assessee with the AE in the year 1990. There is nothing in the supplementary agreement, which is enabling the assessee to record better performance. The supplementary agreement is only enhancing the rate of royalty payable to the AE. The technology that is being transferred is on continuous basis and is governed by the clauses of the technological collaboration agreement initially entered in the year 1990which got renewed in the year 1998.

(c) The assessee has also taken the argument that the parent, namely Cabot Corporation, USA is engaged in significant R & D activity for its plant located in Massachusetts and Texas. The advances in product and process developments are passed on to the subsidiaries. It is also contended by the assessee that for the F.Y. ending Sept. 2004 Cabot Corporation had spent USD 53 Millions, which got increased to USD 59 Millions for the year ending Sept.,2005. According to the assessee, the R & D to sales ratio of the AE works out to be 2.8%. The assessee has given the accounts of the AE in support of the contention taken. On perusal of the accounts of the AE, it is seen that the amounts sepnt by Cabot Corporation for the year ending Sept., 2003 was USD 64 Millions, a fact, which has been conveniently ignored by the assessee while making a case for itself. That the AE of the assessee is indulging into substantial R & D is not challenged here. What is challenged here is the rate of higher royalty that the assessee must pay to the AE for receiving the same technological services. No case has been made by the assessee with regard to the higher recoveries that

are warranted to be made by the parent from the subsidiaries word-wide in order to compensate for continued R & D activities.

(d) The assessee has also submitted that it is likely to get benefited in future from the Research and Development under-taken by the AE. The contention taken by the assessee deserves to be rejected on the face of itself. The subjective assessment of the future benefit cannot be the arguments for enhanced rate of royalty that the assessee needs to pay, over and above what it is getting within the confines of the agreement already in existence. The future benefit, in any case, would have accrued to the assessee, had the rate of royalty be not revised from 2% to 5%. There is nothing on record that goes to suggest that the future benefits of the technology likely to be received from the AE would not have accrued to the assessee without the payment of higher rate of royalty. On the contrary, it is surprising that the payment of royalty at a higher rate is sought to be justified by the assessee when the profits of the assessee are declining. The operating profile of the assessee is worth noting in this regard.

Item	Year I A.Y. 03-04 (in Crores)	Year II A.Y. 04-05 (in Crores)	Year III A.Y. 05-06 (in Crores)
Turnover	148.77	153.72	145.87
Gross Profit	26.74	15.11	0.28
Operating Profit	12.46	1.17	(17.04)
Net Profit	8.62	0.93	(10.68)
Total Cost	137.51	153.06	164.09
GP/Sales %	18	9.83	0.19
NP/Sales %	6	0.60	(07.32)
OP/Sales %	8	1.15	(11.68)
OP/TC %	9	1.16	(10.38)

As is evident from the above, during the last 3 years the turnover of the assessee has hardly changed (On the contrary, it has declined from Rs.148.7 crores in A.Y. 2003-04 to Rs.146.77 crores in A.Y. 2005-06). The total costs of the assessee have increased from Rs.137 crores in the A.Y. 2003-04 to Rs.164 crores in the A.Y. 2005-06. The

operating profits of the assessee have gone down sharply during this period. In fact, during the year in question, the assessee is making operating losses. The business may make profits or losses as a result of acquisition of technology, but when a contention is taken with regard to the better performance and productivity achieved by the assessee as a result acquisition of such technology, then the contention taken cannot stand in total disregard to the performance on record. The contradiction between the contention taken by the assessee with regard to the higher productivity and the performance achieved as a result of higher royalty payments cannot be more apparent. Accordingly, the contention taken by the is rejected.

(e) The assessee has submitted a chart for the royalty charged by the AE from other countries. As per the chart submitted by the assessee, the royalty paid at a rate of 5% weighs favourably to the rate paid by the subsidiaries in Australia, Indonesia etc.In this regard, it must be appreciated hat the assessee is using a CUP method for bench-marking this transaction. Accordingly, one controlled Transaction cannot be compared with another Controlled Transaction. Besides, the geographic and economic differences prevailing in other countries have to be considered while examining them on the basis of CUP method. Even so, the assessee has not provided sufficient information in respect of the royalty charged by the AE from its subsidiaries located in the Asia Pacific region. As per he chart given, the rate of royalty obtainable in case of Malaysia is 3.5% which is far less than being paid by the assessee at a rate of 5%. Accordingly, the contention taken by the assessee is rejected on this count also.

(f) The assessee has further submitted that the data culled from the website of SIA with regard to the approval given by the Govt. of India for payment of royalty in chemical industry justify the payment of royalty to the AE at the rate agreed for this year. The assessee has submitted that for this industry, the approved rate of royalty ranges from 3% to 8% of sales. As the royalty paid at a rate of 5% very much falls within this range, therefore, as per CUP method the same should said through to be considered to be at arm’s length. The fallacy in the argument of the assessee is quite bizarre: For, (i) the data picked up for comparison is not contemporaneous as all the figures are pertaining to the year 2000, 2001 & 2002. During these years, the rate

of royalty paid by the assessee could be considered to be comparables to the approved rates of SIA Theassessee is seeking to compare the higher rate of royalty payable for this year against the royalty payable by the other companies in the earlier years. (ii) Most of the royalty payable by the Indian companies is to their overseas parent, which is in the nature of Controlled Transactions and cannot be bench-marked while applying CUP method. (iii) The data itself is insufficient and fails to provide any basis to the price setting mechanism whereby the requirement of the business mandated payment of royalty at a higher rate for the technology / know-how sought to be received by the assessee by entering into a supplementary agreement to that effect. In view of this, the argument of the assessee is rejected.

(g) The assessee has further submitted that in the post liberalization era in the country, the barriers of the industry insulations are getting broken. The assessee has submitted that if the same technologies were to be acquired from an outsider it would have charged not less than 10% of the fees. The argument of the assessee is hypothetical in nature. It defies the basic principle of transfer pricing. Transfer Pricing is all about considering the controller Transactions of an assessee with its AEs with the uncontrolled transactions, of independent parties. There is nothing hypothetical about it. If, sufficient data regarding the Uncontrolled Transaction is not obtainable or is not reliable enough, then a different method as provided in the Act has to be considered to determine the arm's length nature of the transactions. The liberalized regime enables the companies to have access to various technologies and make payments for them, which were restricted so far. But it cannot be an argument for making higher payment for receiving the same service. The assessee has failed to establish that it has received a technological benefit, over and above, the agreement entered with the AE in the year 1990 and 1998, so as to call for a higher rate of royalty in the year in question. Indeed, the only reason for making payment of royalty at a rate higher than the prevailing rate that once can make out from a reading of the supplementary agreement is the liberalization regime of the economy rather than any hitherto unextended service to be rendered by the AE to the assessee."

In view of the above discussion, the explanation offered by the assessee justifying increase in the rate of royalty of carcass grade of products was not accepted by the TPO and adopting the rate of royalty at 2% on the said product as arm's length price, he held that the royalty paid by the assessee in excess of 2% was liable to be disallowed. On the basis of TPO's report, addition of Rs.2,06,48,218/- was made by the AO to the total income of the assessee on account of transfer pricing adjustment in the assessment completed u/s 143(3) vide an order dated 22-12-2008.

6. Against the order passed by the AO u/s 143(3), an appeal was filed by the assessee before the learned CIT(Appeals) challenging therein inter alia the addition made by the AO on account of transfer pricing adjustment. During the course of appellate proceedings before the learned CIT(Appeals), the submissions made before the TPO justifying the increase in rate of royalty paid on carcass grade of products were reiterated on behalf of the assessee and after reproducing the same in his impugned order, the learned CIT(Appeals) decided the issue relating to addition made on account of transfer pricing adjustment vide paragraph No.7.4 to 7.7 of his order which read as under:

> "7.4 I have perused the assessment order, the TPO's order and detailed submission along with the evidences of technology and support provided by the foreign principal in lieu of royalty payment. The appellant has paid royalty to parent company on
>
> a) a tread grade carbon black of 3% of sales.
> b) On carcass grade carbon black or 5% of sales.
>
> 7.5 In the preceding year on carcass grade carbon black the royalty was paid at 2% but this year since the same was enhanced to 5% it lead to disallowance of 3%. It is relevant to add that royalty paid on other interconnected trade grade carbon black at 3% has been accepted as a CUP by the TPO s being at arms length price.

7.6 It is a fact that the appellant has extensively documented and substantiated the benefits denied by he appellant in lieu of Royalty payment. This documentation justifies the payment of royalty but the rate (2% or 5%) is subject matter of dispute. It is seen from the commentary filed y the appellant during the appellate proceedings that there is no technological differences between tread grade carbon black on which 3% royalty has been paid and the carcass grade carbon black where it has jumped to 5% this year. The only difference is of minor nature and that relates to pellet size. Therefore once the rate of 3% is accepted as CUP for the trade grade the same rate necessary must apply to carcass grade. More so when they are closely interrelated and almost identical. It may not be out of place to mention that this rate compares favourably with that charged by Cabot Corporation to the other group entities of Cabot in the Asia Pacific region.

7.7 In view of what is stated above, I restrict the transfer pricing adjustment/disallowance to 2% of royalty paid in respect of car cases grade carbon black so as to bring it par 3% rate for trade grade carbon black. In monetary terms Rs.1,37,65,579/- is confirmed and Rs.68,82,639/- is deleted."

7. The learned CIT(Appeals) thus adopted the rate of royalty at 3% on carcass grade of products as arm's length price and restricted the addition of Rs.2,06,48,218/- made by the AO on account of transfer pricing adjustment to Rs.1,37,65,579/- allowing a relief of Rs.68,82,639/-. Aggrieved by the order of the learned CIT(Appeals), the assessee and Revenue both have raised this issue in the present appeals filed before the Tribunal.

8. We have heard the arguments of both the sides and also perused the relevant material on record. Although the learned counsel for the assessee has made elaborate submissions with reference to the details and documents furnished in his paper book including the written submissions filed before the authorities below in an attempt to explain and justify the increase in the rate of royalty from 2% to 5% agreed to be paid by the assessee to Cabot Corporation, USA, we find that the issue

involved in the present case is relating to the addition made on account of transfer pricing adjustment and for deciding the said issue, what is relevant to be seen is whether the rate at which royalty was paid by the assessee to its associate enterprise viz. Cabot Corporation, USA is at arm's length price or not. The justifiability of increase in rate of royalty from 2% as paid in the earlier year to 5% in the year consideration alone, therefore, is not relevant to decide the said issue. As a matter of fact, the royalty at the rate of 2% was paid by the assessee to its associate enterprise itself and the said transaction thus was a controlled transaction which cannot be taken as a bench mark for deciding as to whether the royalty paid by the assessee to M/s Cabot Corporation at the rate of 5% was at arm's length. This exercise of ascertaining whether the royalty so paid is at arm's length has to be done independently as per the procedure laid down in the relevant provisions of the Act as well as the rules prescribed. In this regard, it is observed that royalty paid at the rate of 5% was claimed to be an arm's length price by the assessee on the basis of CUP method. The AO, on the other hand, has not referred to any method specifically and made the addition on account of transfer pricing adjustment taking the rate of 2% at which royalty was paid by the assessee in the earlier years as a bench mark. As already observed by us, the said royalty at the rate of 2% was paid by the assessee company to its associate enterprise and the same, therefore, could not be taken as a comparable uncontrolled price.

9. At the time of hearing before us, the learned representatives of both the sides have accepted in reply to a query raised by the Bench that the product manufactured by the assessee being unique and the technology or technical input provided by Cabot Corporation, USA also being unique one, it is very difficult to find out a case involving supply of similar technology or technical input so as to ascertain a comparable uncontrolled price paid for the royalty. It is no doubt true

that the results derived from applying the CUP method will generally be the most direct and reliable measure of an arm's length price for the controlled transaction. However, it is also true that the success of the said method is subject to the condition that an uncontrolled transaction has no differences with the controlled transaction that would affect the price and if at all there are any differences, they are only minor differences that have a definite and reasonably ascertainable effects on price for which appropriate adjustments can be made. While many factors are to be considered in determining the comparability of transaction, similarity of products or services will have the greatest effect on comparability under this method. Comparability under this method depends on close similarity with respect to various factors including especially the quality of product, the contractual terms etc.

10. It is observed that there is, however, no data available in the present case in respect of uncontrolled comparable transactions which have a similarity or at least a close similarity with the transactions of the assessee with its associate enterprise M/s Cabot Corporation, USA involving payment of royalty and in the absence of the same, we are of the considered view that CUP method adopted by the assessee for transfer pricing analysis cannot be considered as most appropriate method to determine the arm's length price. In our opinion, the arm's length price needs to be determined by the most appropriate method, determinationof which would depend, inter alia, on the nature of transactions, functions performed by the associated enterprise etc. Rule 10C(2) of Income Tax Rules, 1962 prescribes the following factors which are relevant for determination of the most appropriate method :

> "(2) In selecting the most appropriate method as specified in sub-rule (1), the following factors shall be taken into account namely :-

(a) the nature and class of the international transaction;

(b) the class or classes of associated enterprises entering into the transaction and the functions performed by them taking into account assets employed or to be employed and risks assumed by such enterprise;

(c) the availability, coverage and reliability of data necessary for application of the method;

(d) the degree of comparability existing between the international transaction and the uncontrolled transaction and between the enterprises entering into such transactions;

(e) the extent to which reliable and accurate adjustments can be made to account for differences, if any, between the international transaction, and the comparable uncontrolled transaction or between the enterprises entering into such transactions;

(f) the nature, extent and reliability of assumptions required to be made in application of a method."

11. In our opinion, if the facts of the present case are considered in the light of the above factors, CUP method cannot be regarded as most appropriate method for determining arm's length price of the royalty paid by the assessee to M/s Cabot Corporation, USA as thereis no data available in respect of uncontrolled transactions which are similar or at least closely similar to the transactions of the assessee company with its associated enterprise Cabot Corporation, USA. We, therefore, set aside the order of the learned CIT(Appeals) as well as that of the Assessing Officer on this issue and restore the matter to the file of the AO with a direction to do the exercise of determining the arm's length price by applying the most appropriate method keeping in view the facts and circumstances of the case and after affording proper and sufficient opportunity to the assessee of being heard. The relevant grounds of the assessee's appeal on this issue as well as ground No.2 of the Revenue's appeal are accordingly treated as allowed for statistical purposes.

12. In ground No.1 of its appeal, the Revenue has challenged the action of the learned CIT(Appeals) in deleting the entire addition of Rs.5,62,67,879/- made by the AO treating the royalty expenditure as capital expenditure.

13. During the course of assessment proceedings, the claim of the assessee for deduction on account of royalty paid to M/s Cabot Corporation, USA was examined by the AO from the foreign technology collaboration agreement between the assessee company and M/s Cabot Corporation, USA. On such examination, he was of the opinion that the royalty has been paid by the assessee for modernization of carbon black plant under energy conservation scheme in order to be competitive and to improve performance. He held that the assessee thus has acquired technology in terms of collaboration agreement and the quid proquo for acquiring the technology was that the assessee was required to pay an annual royalty at percentage of sales. He held that the payment of royalty thus was in lieu of technical know-how received by the assessee from the foreign company and the same being in the nature of enduring advantage to the assessee company, the royalty was capital expenditure. For this conclusion, he relied on the decision of Hon'ble Supreme Court in the case of Southern Switch Gear Ltd. (232 ITR 359) wherein it was held that grant of technical aid fees for setting up factory and right to sell the product as per collaboration agreement was not allowable as revenue expenditure and it was to be treated as capital expenditure.

14. The decision of the AO disallowing the royalty payment by treating it as capital expenditure was challenged by the assessee in an appeal filed before the learned CIT(Appeals). During the course of appellate proceedings before the learned CIT(Appeals), elaborate submission was made on behalf of the assessee in support of its claim that payment of royalty was a revenue expenditure which, as

summarized by the learned CIT(Appeals) in his impugned order is reproduced hereunder :

(a) The appellant has been in the business of manufacturing carbon black for more than 40 years;
(b) the foreign company was required under the terms of the agreement to render technical advice and assistance in connection with manufacture in the same field, where the company was already manufacturing and doing business;
(c) by incurring the said expenditure, the appellant did not enter into a new business or a new field or acquire any asset;
(d) in the context of the current competitive business environment, such an expenditure is nothing but a day-to-day expenditure intended to improve the efficiency and profitability of the existing business.
(e) The Assessing Officer accepts that the expenditure has been incurred to improve the profitability of the Company- his subsequent inference that the expenditure is capital is wholly erroneous.
(f) The Appellant has not acquired any know-how by way of an asset. It is only entitled to the use of know-how to assist in its manufacturing process.
(g) The reference by the Assessing Officer to Section 32 is misconceived, because the appellant is not the owner of the technical know-how. The denial of deduction under Section 37 on the ground that the payment is covered under Section 32 is legally and factually erroneous.
(h) The reliance on the decision in Southern Switch Gear Ltd. v/s. CIT (232 ITR 359) is misconceived in fact and law.
(i) The general thrust of the agreement is for receiving of technical information and not for outright sale of proprietary rights, as the appellant is the non-exclusive licensee in India with no right to sub-license.
(j) The appellant has ISO certification and has to constantly endeavour not only to maintain high technical standards for its own survival but also keep itself competitive in its line of business.
(k) The Assessing Officer erred in ignoring the assessment record of the appellant, wherein this expenditure has been allowed as a revenue expenditure right from 1990.
(l) The Assessing Officer also erred in ignoring the decision of the Commissioner of Income Tax under Section 263 in Assessment Year

2003-2004, when this matter was looked into, and thereafter the proceedings were dropped.

15. In support of the above submission, reliance was placed on behalf of the assessee on the following judicial pronouncements.

i	Alembic Chemical Works Co. Ltd. v/s C.I.T.	177 ITR 377 (S.C.)
ii	C.I.T. v/s Telco	123 ITR 538 (Bom.)
iii	Antifriction Bearings corporation Ltd. v/s C.I.T.	114 ITR 335 (Bom.)
iv	Kirloskar Pneumatic co. Ltd. v/s C.I.T.	136 ITR 746 (Bom.)
v.	Bajaj Tempo v/s C.I.T.	

16. The submission made on behalf of the assessee on this issue was examined by the learned CIT(A) in the light of material placed on record before him including the relevant agreements entered into between the assessee company and Cabot Corporation, USA. He found that the silent features of the said agreements as relevant to the issue under consideration were as under :

"4.4 As part of the Technology Package, Cabot will provide technical data and instructions concerning the following additional grades of carbon black, not presently made by the company, which the reactor described in (1) above has the capability to produce; N299, N357, N234 & N351.

4.5 All plant, layout and standard designs and technical data comprising the Technology package shall have been used in commercial operation and proven in at least four (4) plans of Cabot. The Technology Package will be

in such a form that a competent local engineering firm should be able to complete the detailed design."

4.6 Thereafter, Article IV provides for certain technical services and, in particular, training of the appellant employees.

4.7 Under Article XI, the assessee is required to maintain strick confidentiality and is not permitted to part with information to any third party.

4.8 Under Article XII, there is no right of assignability or sub licensing unless the parent company gives written consent and agrees on the terms and conditions such sub licensing."

17. After analyzing the above features of the agreement, the following facts were found to have emerged by the learned CIT(Appeals) which, according to him, were material for consideration :

i) The appellant is a single factory, single product company manufacturing carbon black since 1963.
ii) It has ISO certification and has to constantly endeavour to maintain high technical standards for its own survival and to keep itsels competitive.
iii) The general thrust of the agreement is for receiving of technical information and assistance and not for outright sale of proprietary rights.

18. After having considered the above facts emerging from record and keeping in view the decision of Hon'ble Supreme Court in the case of Alembic Chemical Works Co. Ltd. v/s C.I.T. (supra) as well as that of Bombay High Court in the case of Kirloskar Pneumatic Co. Ltd. v/s C.I.T. 136 ITR 746, the learned CIT(Appeals) concluded the issue in favour of the assessee for the following reasons given in para 4.12 and 4.13 of his impugned order :

"4.12 Considering the above judgments, I hold the expenditure is only for the betterment and improvement of the very same line of business which the assese is carrying on for more than 40 years. The business environment is changing so quickly that Indian companies need to respond proactively for sheer survival. After economic liberalization, keeping abreast of the latest developments, updating knowledge, using newer, better and improved techniques of production, and tools of management is a necessity for Indian companies to function in an environment where world class companies are permitted to enter. It has to be borne in mind that the assessee has only the right to use the relevant information and knowledge and the same cannot be transferred or disclosed to any third party. Further, being the holder of ISO certification, the assessee is required to adhere to international quality standard, and to maintain certification, a regular flow of information is necessary. Having regard to the cited decisions, it must be held that the assessee did not acquire any asset or advantage of an enduring nature. Such expenditure merely enables the assessee to improve its efficiency and profitability without touching the capital structure, and the same is, therefore, revenue in nature.

4.13 The reliance placed by the Assessing Officer on Explanation 4 below Section 32(1) is misconceived. The appellant is not the owner of the knowhow. Further, the said Explanation applies only for the purposes of Section 32(1). The said Explanation cannot decide what is revenue or capital. It is only an enabling provision for claiming depreciation. It is not a disabling provision for claiming revenue expenditure. Also, the reliance by the Assessing Officer on the decision of Southern Switch Gear Ltd. (232 ITR 359) is equally misconceived. In the judgment of the Madras High Court (148 ITR 272) only 25% of the royalty had been disallowed and 75% had been duly allowed as revenue expenditure. Even so, the said decision needs to be confined to its own peculiar facts, as the head notes of both the judgments state that there were clauses in the Collaboration Agreement contemplating setting up of a factory. It is under these peculiar facts that 25% of the royalty expenditure was treated as capital. In the instant case, the factory of the appellant was set-up in 1963, and the expenditure incurred in the current year can under no circumstance be equated with the setting up of a factory. The appellant has been engaged in the same field of manufacture for more than 40 years."

19. The learned CIT(Appeals) also noted that payment of royalty made by the assessee to M/s Cabot Corporation, USA right from year 1990 was claimed and allowed as a revenue expenditure. He further noted that this issue was a subject matter of proceedings u/s 263 for assessment year 2003-04 and the learned C.I.T. after examining all the relevant aspects did not consider it fit to withdraw the deduction allowed by the AO on account of royalty payment treating the same as revenue expenditure. Keeping in view the rule of consistency as well as the reasons given in paragraph No. 4.12 and 4.13 of his impugned order extracted above, the learned CIT(Appeals) held that royalty paid by the assessee to Cabot Corporation, USA was allowable as revenue expenditure and accordingly he deleted the disallowance made by the AO on this issue.

20. We have heard the arguments of both the sides and also perused the relevant material on record. The learned DR at the time of hearing before us has mainly relied on Article 2 of the Technology Agreement between assessee and Cabot Corporation, USA whereby plans, layouts, designs and technical data required for a carbon black reactor were to be supplied by the USA Company to the assessee company as part of technology package. She has pointed out that technical data, standard designs and plans for improving the processing and handling, pelletizing and drying systems was also to be supplied by the USA Company to the assessee company. She contended that it was thus a clear case of transfer of technology by the USA company to the assessee company and the payment made for such transfer in the form of royalty was a capital expenditure as rightly held by the AO. However, as pointed out by the learned counsel for the assessee, plans, layouts, designs and technical data as per Article 2 of the technology agreement were to be supplied by the USA company to the assessee company for reinforcing carbon black reactor capable of utilizing preheated air at 650 degree C. Similarly, essential

data, standard designs and plans were to be supplied for improving the processing and handling, pelletizing and drying systems in use by the company at the plant as on the date of the agreement in order to increase the throughput of carbon black. As rightly held by the learned CIT(Appeals) on interpretation of Article 2 of the technology agreement, the thrust was thus for the betterment and improvement of the very same line of business in which the assessee company was engaged for more than 40 years. Moreover, the assessee was given only the right to use the relevant information and knowledge by the US company and it was not allowed to transfer or disclose the same to any third party. The assessee thus cannot be said to have acquired any asset or advantage of enduring nature and the expenditure on payment of royalty was incurred merely to improve its efficiency and profitability.

21. In the case of Alembic Chemical Works Co. Ltd. v/s C.I.T. (supra),Hon'ble Supreme Court has held that the improvisation in the process and technology in some areas of the enterprise was supplemental to the existing business and there being no material to hold that it accounted to a new or fresh venture, the payment made was on account of revenue expenditure. Hon'ble Supreme Court further held that the relevant agreement pertained to a product already in the line of the assessee's established business and not to a new product. What was stipulated in the agreement was in respect of improvement in the operations of existing business and its profitability not removed from the area of the day to day business of the assessee's established enterprise. It was held that the financial outlet under the agreement was for the better conduct and improvement of the existing business and it was thus expenditure of revenue nature. In the case of Kirloskar Pneumatic Co. Ltd. v/s C.I.T (supra), the assessee was manufacturing air compressor. It entered into an agreement with G mainly to acquire technical knowhow for manufacture and sale of certain products. G agreed to provide drawings and information and

keep the assessee informed about research and development. The fees agreed to be paid was inclusive of lump-sum consideration for the drawings and royalty of 2% for the right to use patents in the name of G. In these facts and circumstances, it was held by the Hon'ble Bombay High Court that while construing such agreement, they must be considered as a whole without putting emphasis on various clauses in isolation. It was held that the intention of the assessee was to acquire technical knowledge or knowhow for certain period and the drawings acquired were part of technical knowledge. It was held that the assessee thus did not acquire any asset or benefit of enduring nature and the payments made under the agreement were allowable as revenue expenditure.

22. It may also be pertinent to note here that a similar payment of royalty under the same technology agreement was made by the assessee right from the year 1990 and the deduction claimed for the same as revenue expenditure was allowed consistently by the Department in the earlier years. As further noted by the learned CIT(Appeals) in his impugned order, this issue was the subject matter of proceeding u/s 263 for assessment year 2003-04 and the learned C.I.T. after examining the same, did not find any error in the order of the AO allowing the deduction claimed by the assessee on account of payment of royalty being expenditure of revenue nature. As such, considering all the facts of the case and keeping in view the decision of Hon'ble Supreme Court in the case of Alembic Chemical Works Co. Ltd. v/s C.I.T. (supra) as well as that of Hon'ble Bombay High Court in the case of Kirloskar Pneumatic Co. Ltd. v/s C.I.T (supra) and the rule of consistency, we find no justifiable reason to interfere with the impugned order of the learned CIT(Appeals) holding that the expenditure incurred by the assessee on payment of royalty was revenue in nature and deleting the

disallowance made by the AO treating the same as capital expenditure. The same is, therefore, upheld and ground No.1 of the Revenue's appeal is dismissed.

23. In its cross objection, the assessee company has raised its alternative claim that if the expenditure on payment of royalty is held to be a capital expenditure, depreciation thereon may be allowed. As we have already upheld the impugned order of the learned CIT(Appeals) allowing the said expenditure as revenue expenditure, the issue raised by the assessee in its cross objection has become infructuous. We, therefore, dismiss the cross objection filed by the assessee as the same has become infructuous.

24. In the result, the appeal of the assessee as well as that of the Revenue is treated as partly allowed as indicated above whereas the cross objection of the assessee is dismissed.

Order pronounced on this 31st day of May, 2011.

Sd.	Sd.
(N.V. Vasudevan)	(P.M. Jagtap)
Judicial Member	Accountant Member

Mumbai,
Dated: 31st May, 2011.

Wakode

Copy to :

1. Appellant
2. Respondent
3. C.I.T.
4. CIT(A)
5. DR, D-Bench.

(True copy)

By Order

Asstt. Registrar,
ITAT, Mumbai Benches, Mumbai.