

**REPORTABLE**

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

+ **ITA No.572 of 2011**

% RESERVED ON: MAY 19, 2011  
PRONOUNCED ON: JULY 11, 2011

**COMMISSIONER OF INCOME TAX . . . APPELLANT**

through : Mr. Sanjeev Sabharwal, Sr.  
Standing Counsel.

*VERSUS*

**DESICCANT ROTORS  
INTERNATIONAL  
PVT. LTD. . . .RESPONDENT**

through: Ms. Shashi M. Kapila with Ms.  
Charu Kapoor, Advocates.

**CORAM :-**

**HON'BLE MR. JUSTICE A.K. SIKRI  
HON'BLE MR. JUSTICE M.L. MEHTA**

1. Whether Reporters of Local newspapers may be allowed to see the Judgment?
2. To be referred to the Reporter or not?
3. Whether the Judgment should be reported in the Digest?

**A.K. SIKRI, J.**

1. Before we reproduce the substantial questions of law, which are to be answered, we deem it appropriate to state the facts and circumstances under which these questions of law arise for consideration. The respondent-assessee was incorporated in

the year 1984 and has been engaged in the business of manufacturing of environmental control system such as Rotors, Heat Recovery Wheels, Desiccant Rotors, etc. For the Assessment Year 2005-06, the assessee filed its income tax return on 31.10.2005 declaring total income at ₹2,49,28,630/-. Along with the return, necessary documents including Profit and Loss account was filed. Books of accounts were also produced at the time of assessment and were examined by the Assessing Officer. On perusal of the Profit & Loss account, it was noticed by the AO that the assessee has debited an amount of ₹3,12,57,152/- on account of compensation paid towards settlement of dispute. On being asked to clarify the position, the assessee company furnished a note with relevant documents, vide letter dated 26.12.2007. In the notice, it was stated that the assessee has been exporting its products to one of its customers, viz., M/s Venmar Ventilation Inc. (hereinafter referred to as 'VENMAR'), Canada for selling their products. SEMCO Inc. USA had filed a suit against VENMAR for infringement of their registered patents in USA by selling the products of the assessee company. VENMAR settled the dispute with SEMCO by paying certain compensation to it. Subsequently, SEMCO instituted the proceedings against the assessee company a swell in the Court of USA alleging that sale of products by assessee to VENMAR amounted to infringement

of their registered patents. Since the cost of litigation was expected to be exorbitant, the assessee company after considering the advice of its legal representative, settled the dispute with SEMCO by making payment of US\$ 6,75,000. It was, thus, claimed by the assessee that the payment was compensatory in nature to compensate the loss incurred by SEMCO as a result of selling the product covered by patent held by SEMCO to VENMAR. The assessee also filed certain documents along with its submissions.

2. The contention of the assessee, before the AO, which has been remained consistent throughout, was that the assessee company had made the payment to SEMCO as a result of settlement arrived at and not on account of infringement of patent law, did not accept the AO. The AO was of the view that SEMCO had filed the Suit for damages and injunction due to infringement of SEMCO's United States Patent bearing No.4769053 caused by the assessee company and its customers for manufacturing and marketing the Energy Recovery Wheel products. Further, SEMCO had sued VENMAR in the same Court for infringement of SEMCO's patent by selling the assessee company's product in their patented territory and in those proceedings, the VENMAR had acknowledged that the patent held by SEMCO was valid and enforceable and thus, agreed not to sell the products that would infringe the patent of

SEMCO and accordingly compensated SEMCO for such infringement. In these circumstances, according to the AO, the amount paid by the assessee to SEMCO was nothing but a “penalty” or as something akin to penalty and the payment was made only due to infringement which would, in any way, resulted into a compensation. The AO, further, observed that violation of the patents/trademark, etc. is always prohibited by law and therefore, in view of the provisions contained in Explanation to Section 37(1) of the Income Tax Act (hereinafter referred to as ‘the Act’), the expenditure so incurred by the assessee was not allowable. The AO further took the view that the payment was made to avoid any conviction by the Court of Law for infringement of patent which is not a normal incident of business and therefore, it is not allowable as business expenditure. On this reasoning, the AO disallowed the payment of compensation paid by the assessee to settle the dispute and added the same to the assessee’s total income.

3. Feeling aggrieved, the assessee preferred an appeal before the CIT(A). The case as pleaded before the AO was reiterated before the CIT(A). It was exemplified by submitting that whatever allegations were levelled by SEMCO were denied and disputed in toto by the assessee and even the suit was defended for three years. However, keeping in view the cost of litigation and the advice given by its legal consultants, the

assessee found it expedient and proper to reach an out-of-Court settlement. The assessee company emphatically argued before the CIT(A) that the settlement was not on account of any infringement of any law inasmuch as no Court of law held anything or given any finding against the assessee company. It was, therefore, contended that the assessee's case is not covered by Explanation to Section 37(1) of the Act and therefore, the payment made in the course of carrying on assessee's business activity is to be allowed as business expenditure. The assessee also placed reliance on the decision of the Supreme Court in the case of **Prakash Cotton Mills Vs. Commissioner of Income Tax [201 ITR 684]**. After considering the AO's order and the assessee's submissions, the CIT(A) confirmed the AO's order in disallowing the assessee's claim of deduction of payment to SEMCO as a result of out of Court settlement in respect of the proceedings initiated by M/s SEMCO against the assessee company for infringement of their patent rights.

4. Still aggrieved, the assessee went in appeal before the Tribunal. In this appeal, the assessee has been able to convince the Tribunal. Accepting the contention of the assessee that the payment was not in the nature of any penalty and no such violation of patent law was held to be proved, and it was only in the nature of compensation due to settlement

- arrived at between the parties, the Tribunal has permitted it as allowable expenditure under Section 37 of the Act.
5. Section 37, which is a residuary provision, allows the expenditure as deductible while computing the income on the satisfaction of the following conditions:
- “a) Expenditure must not be governed by the provisions of Sections 30 to 36 of the Act;
  - b) The expenditure must have been laid out wholly and exclusively for the purposes of the business of the assessee;
  - c) The expenditure must not be personal in nature; and
  - d) The expenditure must not be capital in nature.”
6. The Explanation to sub-Section (1) of Section 37 of the Act has been inserted by the Finance (No.2) Act, 1988 with full retrospective effect from 01.04.1962 and provides:
- “For removal of doubts, it is hereby declared that any expenditure incurred by an assessee for any purposes, 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.”
7. The dispute revolves around the issue as to whether the aforesaid expenditure incurred by the assessee was for a purpose which would be treated as an “offence” or which is prohibited by law. If this be so, the expenditure is not allowable. The Tribunal has held that the expenditure incurred is not for a purpose which is an offence or which prohibited by a law. As there was no dispute that the expenditure was, in fact,

incurred which is neither personal in nature nor capital in nature and it was incurred wholly and exclusively for the purposes of business of the assessee, the Tribunal permitted the said expenditure thereby allowing the appeal of the assessee.

8. Against this order, present appeal is preferred which was admitted on the following substantial questions of law:

- “(i) Whether learned ITAT erred in holding that the payment by the assessee to SEMCO vide Settlement Agreement is not hit by the provisions in Explanation 1 to Section 37 of the Income Tax Act, 1961?
- (ii) Whether learned ITAT erred in deleting the addition of ₹3,12,57,152/- paid on Settlement of Dispute which was incurred wholly and exclusively for the purposes of business?”

9. Since the counsel for the parties were ready to finally argue the matter, the arguments were heard simultaneously with framing of aforesaid questions of law. On the conclusion of arguments, request from both the sides was made for filing the written submissions within one week. The same was granted. Though the learned counsel for the assessee has filed the written submissions, the learned counsel for the Revenue has not availed of this opportunity. In these circumstances, we proceed to decide the questions of law framed, on the basis of oral submissions of both the parties as well as written submissions tendered by the learned counsel for the assessee.

10. Mr. Sanjeev Sabharwal, learned counsel for the Revenue, argued that no doubt, the payment was made by the assessee to M/s SEMCO under the settlement before the judgment could be pronounced by the United States District Court, but the tenor of the said settlement would clearly reveal that such a settlement was arrived at accepting the fact that the assessee had violated/infringed the patent of SEMCO. Damages were paid by the assessee because of this infringement and such a payment, submitted the counsel, was for a purpose which is prohibited by law. His argument was that the law mandates not to infringe patent right of any person and once it is found that the assessee had violated the patent rights of SEMCO thereby compelling SEMCO to institute proceedings against the assessee, it would be a clear case where the payment was made for a purpose which is prohibited by law. Thus, the Explanation was fully applicable and expenses could not be treated as having been incurred for the purpose of business and no deduction is to be allowed on such expenses in the nature of penalty.
11. Learned counsel also took support from the reasons given by the AO as well as the CIT(A) in their respective orders. He pointed out that the CIT(A) had clearly held that it was a case where there was an infringement of United States Patent Law by the assessee. The goods were manufactured and sold by



the assessee to VENMAR for sale in US and Canada markets and as a manufacturer, the assessee could not escape the primary responsibility by stating that it was not directly involved in infringement. Further, for making a disallowance under Section 37 in respect of penalty, etc. finding by a competent Court was not a condition precedent to attract the Explanation to Section 37(1). According to the CIT (A), the Explanation simply states that if expenditure is incurred for any purpose, which is an offence, or which is prohibited by law, such expenditure will not be deemed to have been incurred for the purpose of business. The Explanation does even imply that there must be a finding of a Competent Authority or Court that an offence was committed or that any law was infringed. In fact, there may be numerous situations where expenditure is incurred for a purpose, which is prohibited by law, but there may not necessarily be any order of any authority or Court to this effect. Payment of protection money, *hafta* money, ransom, etc. are examples of such expenditure. There may not be any order prohibiting a person from making payment of protection money but nonetheless the payment will be for a purpose prohibited by law and would not be allowable under Section 37 of the Act.

12. Mr. Sabharwal further submitted that the expenditure was not compensatory in nature. It was incurred to avoid the penal consequence of the aforesaid infringement.
13. Ms. Shashi M. Kapila, learned counsel appearing for the assessee countered the aforesaid submission and sought to justify that the reasons given by the Tribunal in spite of its decision. Her first submission was that the provisions of the Explanation were not attracted *per se* as the expression “prohibited by law” occurring in the said Explanation is limited to law of land alone, i.e., Indian Law. Dilating on this submission, she argued that the expression “offence” and “prohibited by law” occurring in Explanation to Section 37(1) of the Act are not defined in the Act. However, Section 3(38) General Clauses Act, 1897 defines “**offence**” to mean “any act or omission made punishable by law for the time being in force”. The Calcutta High Court in the case of **Susanta Mukherjee Vs. Union of India [(1975) 94 CWN 412]** after referring to Section 3(38) of the General Clauses Act read with Articles 13(3), 366(10) and 372(1) of the Constitution of India and the decision of the Supreme Court in the case of **Edward Company Mills Vs. State of Ajmer [AIR 1955 SC 25]** observed in paragraph 13 of the judgment:

“13. It is abundantly clear from the foregoing references to various provisions of the Constitution that a person cannot be convicted of an offence except for violation of law in force at the time of commission of the act charged as

an offence. Therefore, in my opinion, the word “any law for the time being in force” as occurring in Section 3(38) of the General Clauses Act, 1997 must be construed as “any law for the time being in force” in India. Obviously it has no reference to any law of other countries of the world.”

14. According to her, similarly, the expression “prohibited by law” can only mean prohibited by law in force in India. The expression “prohibited by law” as used in the Explanation to Section 37(1) has the same contextual import as the expression “forbidden by law” as used in Section 23 of the Indian Contract Act, 1872. This came up for the consideration of the Full Bench in the case of ***Abdul Hameed Vs. Mohd. Ishaq [AIR 1975 All. 166]*** wherein the Allahabad High Court observed as under:

“12. The expression 'law' has not been defined in the Contract Act, nor in the U. P. General Clauses Act, 1904, but in the Central General Clauses Act. 1897, 'Indian Law' is defined in Section 3 (29) as below:--

" 'Indian law' shall mean any Act, Ordinance, Regulation, rule, order, bye-law or other instrument which before the commencement of the Constitution had the force of law in any Province of India or part thereof, or thereafter has the force of law in any Part A State or Part C State or part thereof, but does not include any Act of Parliament of the United Kingdom or any Order in Council, rule or other instrument made such Act."

This definition is applicable to all the Central Acts and Regulations made after the commencement of the General Clauses Act. The Contract Act was enacted in 1872 before the commencement of the General Clauses Act, 1897. Therefore, this definition is not directly applicable to the Contract Act, but there appears to be no reason why the principles contained in the above definition be not made applicable to even the earlier enactments. 'Law' must, therefore, include not only an Act and Ordinance but also

Regulations, rule, order, bye-Law or other instrument which has the force of law. Similar inference can be drawn from the provisions of the Constitution also. For the purposes of Article 13 of the Constitution the term law' includes any Ordinance, order, bye-law, rule, regulation, notification, custom or usage having in the territory of India the force of law.

13. Consequently, where any agreement is forbidden by an order of the competent authority having the force of law, it shall be an agreement forbidden by law as contemplated by Section 23 of the Contract Act.”

Ms. Kapila, thus, emphatically put that in view of the above, it is clear that the phrase “prohibited by law” as used in the Explanation to Section 37(1) of the Act contemplates law in force in India. Her submission was that in the present case, it is an undisputed fact that there is no violation of any patent laws within the territory of India. Section 2(m) of Indian Patent Act, 2005 defines patent as “patent for any invention granted under this Act”. Patent right is a statutory right and this right can be applicable only in such states which recognise this right. Patent is valid only in the country of registration. Therefore, a patent registered in USA, Canada, etc. is not a patent recognised by the Indian Patent Act. It is for this reason that the respondent/assessee still continues to manufacture and sell the impugned energy recovery wheel desiccant in India.

15. Without prejudice to the above, her alternate submission was that there was no infringement of even US laws and on the facts of this case, no such finding was recorded by any Court. The payment was made as a result of settlement which

payment was compensatory in character. The reason for settlement was explained to the authorities below, viz., in order to buy peace and not to face litigations in US Courts, which is costly. She argued that no damages had been paid under the Indian Patent Act or under the US Patent Laws and there was no evidence to show the infringement. She also argued that in absence of any violation of the provisions of Indian Patent Act, the payment under settlement with SEMCO does not fall within the meaning and scope of expression 'offence' and 'prohibited by law' used in Explanation to Section 37(1) of the Act. The assessee still manufactures the energy saving wheel using the impugned desiccant and sells it in India as well as exports it to other countries without any restrictions and no suit has been filed by SEMCO for infringement of its patent in India. However, exports to USA and Canada, past settlement is as per the Settlement Agreement.

16. Ms. Kapila further submitted that even if it is presumed that the payment was made for infringement of patent, that entails only civil damages, which are compensatory in nature and it cannot be said that the payment made was in the nature of penalty. She pointed out that the averments in the plaint filed by SEMCO as per which the only civil damages were claimed and criminal suit was scored out in the plaint. Once the payment is treated as purely compensatory in nature, the same could not

be disallowed as per the law settled by the Supreme Court in the case of ***Prakash Cotton Mills (supra)*** which principle was reaffirmed by the Apex Court in the case of ***Mrs. Rajalakshmi Narayanan v. Mrs. Margret Kathleen Gandhi and others [211 ITR 244]***.

17. After giving our thoughtful consideration to the respective submissions, we are of the view that the order of the Tribunal does not call for any interference and both the questions of law set out above need to be answered in negative, i.e., in favour of the assessee and against the Revenue.
18. At the outset, we are inclined to accept the submission of the assessee that the paramount and governing consideration behind such a settlement/agreement can be to avoid the expenses and uncertainty of further litigation. It is a matter of common knowledge that litigation can turn out to be quite expensive and it cannot be even possible, what to talk of feasible, for a small time/middle level company in India like the assessee to litigate in US Court. Furthermore, the settlement agreement contains a specific recital to this effect inasmuch as it records “whereas, in order to avoid the expenses or uncertainty or further litigation, the parties desired to settle and adjust all differences and controversies among themselves subject to the terms of this Agreement.” No doubt in the Agreement, the assessee accepted the patent of SEMCO. That

by itself would not mean that the assessee also accepted that it was infringing the said patent. Secondly, payment is made by the assessee to SEMCO for “loss of goodwill and damages to its capital and for terminating of case US Courts” as is clearly mentioned in Clause (3) of the Agreement. No finding is given by any Court that the assessee had violated the patent right of SEMCO. With the aforesaid payment, the “Covenants to Release” recorded in Clause (2) is as under:

**“2. COVENANTS TO RELEASE**

2.1 SEMCO hereby releases, remises and forever discharges the Settling Entities and their agents, attorneys, consultants, offices, employees, representatives, heirs, successors and assigns and their Customers from any and all claims, demands, or causes of action that arise out of or relate to the Action, and any and all obligations, actions, causes of action, suits, debts, contracts, controversies, agreements, promises, damages, judgments, awards, executions, claims and demands whatsoever in law or in equity, and any and all claims for damages (and attorneys’ fees and costs) based upon the violation of a federal, state or other statute, regulation or law or arising out of any conduct, contract, employments, action, event or circumstance, under the law of any and all nations, whether known or unknown, which occurred at any time up to and including the date of the execution of this Agreement, except obligations created by this Agreement, any associated licence Agreement and/or by the Consent Judgment to be filed in accordance with this Agreement.”

19. It would be pertinent to highlight that the Agreement is applicable within the area defined as “territory”. This territory mentions some specific countries in Europe as well as Japan, Australia and Korea. There is no mention of ‘India’ at all. That clearly implies that SEMCO has no objection if the assessee continues to manufacture the goods in the same manner using

same patent which it has been using and marketing it in India or any other countries, which are not stipulated in the 'territory' with respect to which only restraint is provided in the agreement. It is for this reason the assessee even today continues to manufacture those goods and is selling the products in this country. Once we find that the settlement has arrived at under the aforesaid circumstances, there is no room to hold that it was because of the reason that the assessee was violating the patent laws or the payment was made for an objective prohibited by law. This is our view even when we presume that the expression 'prohibited by law' would include US laws and would not be confined to law in India.

20. Moreover, we also agree with the contention of the learned counsel for the assessee that the payment under the settlement is compensatory in nature. The remedy for infringement of patent involves civil action for compensating the damage to private properties. It may be noted that in the plaint filed by it, SEMCO has sought civil damages under Sections 284 and 285 of the US Patent Code (US 35). Criminal Suit is scored out in the plaint. The relevant provisions of US 35 (Patent Code) read as follows:

**“Section 284. Damages**

Upon finding for the claimant the Court shall award the claimant damages adequate to compensate for the infringement, but in no event less than a reasonable royalty



for the sue made of the invention by the infringer, together with interest and costs as fixed by the Court.

**Section 285. Attorney fees**

The Court in exceptional cases may award reasonable attorney fees to the prevailing party.”

21. It will be seen from the above that the damages are calculated for compensating the owner of the patent rights for the loss of profit/royalty even under the laws of USA. There is no element of penalty even in USA. Even the Indian Patents Act, 1970 (as amended by the Act of 2005) does not prescribe any penalty or fine for infringement of a patent registered under that Act. This is clear from the Section 108 of the Indian Patent Act, which reads as under:

**“Sec. 108 Reliefs in suit for infringement**

The reliefs which a Court may grant in any suit for infringement include an injunction (subject to such terms, if any, as the Court things fit) and, at the option of the plaintiff, either damages or an account of profits.”

22. Therefore, any payment for infringement of patent, being purely compensatory in nature, cannot be disallowed as per the law settled by the Supreme Court in the case of **Prakash Cotton Mills (supra)**, where the Apex Court observed as under:

“... Therefore, whenever any statutory impost paid by an assessee by way of damages or penalty or interest is claimed as an allowable expenditure under Section 37(1) of the Income-tax Act, the assessing authority is required to examine the scheme of the provisions of the relevant statute providing for payment of such impost notwithstanding the nomenclature of the impost as given

by the statute, to find whether it is compensatory or penal in nature. The authority has to allow deduction under section 37(1) of the Income-tax act, wherever such examination reveals the concerned impost to be purely compensatory in nature. Wherever such impost is found to be of a composite nature, that is, partly of compensatory nature and partly of penal nature, the authorities are obligated to bifurcate the two components of the impost and give deduction to that component which is compensatory in nature and refuse to give deduction to that component which is penal in nature.”

23. It was an expenditure which was motivated purely by commercial purpose and would be allowable under Section 37(1) of the Act as held by the Apex Court in the case of ***Sri Venkata Satya Narayana Rice Mill Contractor Co. Vs. Commissioner of Income Tax [223 ITR 101]***.

24. As regards consent judgment passed by the US District Court in accordance with Clause 2 read with Clause 3 of the Settlement Agreement, the law is well-settled by the Supreme Court in the case of ***Pulavathi Venkata Subba Rao Vs. Valluri [AIR 1967 SC 591]***, wherein the Court held that:

“A compromise decree is not a decision of the Court. It is the acceptance by the Court of something to which the parties had agreed. A compromise decree merely sets the seal of the Court on the agreement of the parties.”

25. Since questions formulated are answered on the aforesaid reasoning, it is not necessary to go into the issue as to whether the expression ‘prohibited by law’ would confine to law in force in Indian only. We leave that question open.

26. We, thus, do not find any merit in this appeal, which is dismissed with costs.

**(A.K. SIKRI)**  
**JUDGE**

**(M.L. MEHTA)**  
**JUDGE**

**JULY 11, 2011**  
pmc