IN THE HIGH COURT OF JUDICATURE AT MADRAS

DATED: 10.09.2012

CORAM:

THE HONOURABLE MRS.JUSTICE CHITRA VENKATARAMAN

and

THE HONOURABLE MR.JUSTICE K.RAVICHANDRABAABU

Tax Case (Appeal) No.244 of 2006

M/s.Carborandum Universal Limited

"Tiam House",

28, Rajaji Salai

Chennai-600 001. .. Appellant

versus

The Joint Commissioner of Income Tax

Special Range-I

Chennai-600 034. .. Respondent

PRAYER: Tax Case Appeal filed under Section 260A of the Income Tax Act, against the order of the Income Tax Appellate Tribunal, Madras 'A' Bench dated 17.08.2005 made in ITA No.568/(Mds)/01.

For appellant : Mr.C.V.Rajan

For respondent : Mr.T.Ravikumar

Standing Counsel for Income Tax

JUDGMENT

(Judgment of the Court was delivered by CHITRA VENKATARAMAN,J.)

The following are the substantial questions of law raised in this Tax Case relating to the assessment year 1997-98:

1. Whether on the facts and in the circumstances of the case, the Tribunal was right in holding that scrap sales should be included in the total turnover while computing deduction under Section 80HHC?

2. Whether on the facts and circumstances of the case, the Tribunal was right in holding that 90% of gross interest without deducting expenses incurred in earning the interest income has to be excluded from the business profits while computing deduction under Section 80HHC?

3. Whether on the facts and circumstances of the case, the Tribunal was right in holding that non-compete fee paid to Sri.U.Mohan Rao was capital expenditure without appreciating that such expenditure has not resulted in an enduring benefit?

4. Whether on the facts and circumstances of the case, the Tribunal was right in confirming the disallowance of depreciation claimed under Section 32 by relying on the decision of Supreme Court in the case of M/s.Escorts Vs. UOI (199 ITR 43), when the appellant has not claimed doubt deduction under Section 35AB and 32 on technical knowhow?

The assessee is on appeal before this Court. The assessee is engaged in the manufacture of abrasives, industrial ceramics and electro minerals.

2. As far as the first and second questions raised before this Court are concerned, both these questions are covered by the decisions of this Court. The first question regarding the includability of scrap sales in total turnover is covered by the decision reported in [2007] 293 ITR 108 (Commissioner of Income Tax Vs. Shiva Distilleries Limited) and [2008] 297 ITR 107 (CIT Vs. Ashok Leyland Ltd.) in favour of the assessee. Consequently, the question has to be held against the revenue and the order of the Tribunal, to that extent, is incorrect.

3. As far as the second question regarding the includability of the gross interest or the net interest as per Explanation (baa) to Section 80HHC is concerned, the same has to be answered in favour of the assessee, following the decision reported in [2012] 343 ITR 89 (ACG Associates Capsules Pvt. Ltd. Vs.

CIT) that only after netting, the interest for the 90% includability has to be considered for the purpose of computing the deduction under Section 80HHC.

4. As far as the fourth question as to whether the assessee was entitled to depreciation or deduction under Section 35AB is concerned, it is seen from the documents placed before this Court that the expenditure incurred by the assessee was for the purpose of getting the technical knowhow by the assessee on manufacturing and processing of goods. Going by the provisions of Section 35AB and the Explanation on technical knowhow, we have no hesitation in holding that the assessee is entitled to the relief under Section 35AB only, and not to the claim of depreciation under Section 32. Consequently, the decision of the Tribunal to that extent, stands confirmed.

5. This leaves us with the third question as regards the nature of expenditure on the non-compete fee paid to U.Mohanrao. It is seen from the facts narrated in the order dated 17.07.1998 that this Court granted the scheme of amalgamation of the following companies with M/s.Carborandum universal Limited (CUMI), the assessee company:

(i) M/s.Cutfast Abrasives

(ii) M/s.Cutfast Polymers

(iii) M/s.Eastern Abrasives Ltd. (previously a subsidiary of the assessee) and

(iv) M/s.Carborandum Universal Investments Ltd.

6. The scheme of amalgamation was effective from 01.04.1997. Consequent on the amalgamation, the assessee entered into a non-compete agreement with U.Mohanrao, formerly Chairman and Managing Director of Cutfast Abrasive Tools Limited and who also happened to be the Chairman and Managing Director of M/s.Cutfast Polymers Private Limited. The non-compete agreement dated 29.04.1996 stated that the said U.Mohanrao, associated with M/s.Cutfast Polymers Private Limited (hereinafter called as CPPL), had access to all information on process, knowhow, clientele of the products dealt with by CPPL and pricing and marketing of all the products relating to CPPL and was in a position to influence the business of manufacture, sale and distribution of the products held by the said company. In the circumstances, in order that the said Mohanrao's expertise in that field did not, in any manner, prejudice the good prospects of the business of the assessee company in future, the parties agreed that in respect of the products, namely, phenol formaldehyde resin (in liquid and powder forms), saturated polyester resin, unsaturated polyester resin, modified alkalyd and any other resin, all having application in coated and bonded abrasives manufacture, shall not be dealt with by the said U.Mohanrao. In consideration of the same, the said U.Mohanrao would be paid a sum of Rs.50,00,000/- as a non-compete fee. The agreement laid down the restrictive covenants that the said U.Mohanrao shall not manufacture directly or indirectly any of the products mentioned above and shall not deal with the said products in any manner or advise, assist, aid, either directly or indirectly, any competitor or any other person in either establishing, managing, promoting or developing the business of the said products or any product similar thereto; he shall not act as a Consultant or use any knowhow, design or drawings directly or

indirectly and refrain from disclosing or divulging any information relating to the knowhow, trade practices, etc. The agreement was to be effective for a period of five years from the date of the agreement.

7. On 29.04.1996, yet another agreement was entered into between the assessee and the said U.Mohanrao, former Chairman and Managing Director of Cutfast Abrasive Tools Limited, as by way of a non-compete agreement that the said U.Mohanrao shall not, in any manner, assist any third party, or sell or render advise or act as a Consultant in respect of the products, namely, coated and bonded abrasives, current range of products of the Electrominerals Division of CATL and cloth processing for coated abrasives. In consideration of the said agreement, the said U.Mohanrao was paid a sum of Rs.1,75,00,000/- towards non-compete fee. On 14.10.1996, there was a supplementary agreement between the assessee and the said U.Mohanrao, which contemplated inclusion of other products, namely, coated and bonded abrasives, current range of products of the Electrominerals Division of CATL and also all other electromineral products, used or capable of being used in the manufacture of abrasive products (both bonded and coated), and cloth processing for coated abrasives. The agreement was to be effective for a period of five years and a further sum of Rs.35,00,000/- was agreed to be paid to the said U.Mohanrao. Thus, in all, the assessee had paid a sum of Rs.2.6 crores to the said U.Mohanrao as by way of non-compete fee. The assessee claimed this amount as a revenue expenditure. It is a fact that the assessee did not write off this amount in the books of accounts. However, placing reliance on the decision reported in [1987] 165 ITR 63 (Commissioner of Income Tax Vs. Late G.D.Naidu and others) (Mad.) and 87 ITD 541 (Sri Annapurna Gowri Shankar Hotel Pvt. Ltd. Vs. CIT), the assessee contended that it was entitled to deduction. The claim of the assessee was rejected by the Assessing Officer on the ground that the said U.Mohanrao was the erstwhile Chairman and Managing Director of the company and such non-compete agreement had increased the assessee's market presence and improved its potential to have better results in the market; the payment made over a period of more than five years once was for procuring an enduring benefit to the business. Consequently, the Officer held that the expenditure was in the capital field and not as revenue.

8. Aggrieved by this, the assessee went on appeal before the Commissioner of Income Tax (Appeals), who upheld the decision of the Assessing Authority. Aggrieved by this, the assessee went on further appeal before the Income Tax Appellate Tribunal. Referring to the decision reported in [1991] 191 ITR 249 (Chelpark Company Ltd. Vs. Commissioner of Income Tax) and [1999] 239 ITR 142 (Tamilnadu Dairy Development Corpn. Ltd. Vs. Commissioner Of Income-Tax), the Tribunal, by a cryptic order, rejected the assessee's claim. There is hardly any discussion in the order, particularly with reference to the non-compete fee agreements, referred to above. Aggrieved by this, the assessee is on appeal before this Court.

9. Learned counsel appearing for the assessee placed reliance on the decision of the Apex Court reported in [1971] 82 ITR 902 (CIT Vs. Coal Shipments P. Ltd (S.C.)), [1980] 124 ITR 1 (Empire Jute Co. Ltd. Vs. Commissioner of Income Tax (S.C.)) and [1989] 177 ITR 377 (Alembic Chemical Works Co. Ltd.) and pointed out to the guiding factor in the matter of considering the claim as to whether the expenditure would fall under the capital or revenue head. Making particular emphasis on the fact that the expenditure incurred was more in the field of indefinite income earning operation and not in the context of strengthening the income earning structure, he submitted that the Tribunal and the Authorities below committed a serious error in looking at the enduring benefit concept for the purpose of rejecting the assessee's case.

10. Referring to the decision reported in [1980] 124 ITR 1 (Empire Jute Co. Ltd. Vs. Commissioner of Income Tax (S.C.)), he submitted that the expenditure incurred was for the exploitation of a commercial asset; hence was revenue in character. Even where an expenditure is incurred by obtaining an advantage of enduring benefit, it may, nonetheless, be on revenue account and the test of enduring benefit may break down. He further submitted that what is material herein is to consider the nature of advantage in a commercial sense. If the advantage is in the field of facilitating the assessee's business operation more effectively or more profitably leaving the fixed capital untouched, the expenditure would be on revenue account.

11. Referring to the decision reported in [1991] 191 ITR 249 (Chelpark Company Ltd. Vs. Commissioner of Income Tax), learned counsel pointed out that the decision has to be understood in the light of the facts found herein. So too [1987] 165 ITR 63 (Commissioner of Income Tax Vs. Late G.D.Naidu and others) (Mad.). Thus, reiterating the principles laid down in [1980] 124 ITR 1 (Empire Jute Co. Ltd. Vs. Commissioner of Income Tax (S.C.)) and [1989] 177 ITR 377 (Alembic Chemical Works Co. Ltd.), learned counsel further made reference to [1999] 239 ITR 142 (Tamilnadu Dairy Development Corpn. Ltd. Vs. Commissioner Of Income-Tax) and [2008] 302 ITR 249 (CIT Vs. Eicher Ltd. (Delhi)) to submit that the agreement entered into between the assessee company with U.Mohanrao would clearly show that the expenditure was only on the revenue account.

12. Countering the claim of the assessee, learned Standing Counsel appearing for the Revenue supported the order of the Tribunal and placed reliance on the decision reported in [1971] 82 ITR 902 (CIT Vs. Coal Shipments P. Ltd (S.C.)) and [1991] 191 ITR 249 (Chelpark Company Ltd. Vs. Commissioner of Income Tax) that when the assessee had not written off the said expenditure in its accounts and the amount paid was to ward off any competition in the business of the assessee, the expenditure made was only a capital expenditure; hence, not entitled to deduction.

13. Heard learned counsel appearing for both sides and perused the materials placed on record.

14. As far as the question as to whether an expenditure could be a capital expenditure or revenue expenditure is concerned, the concept that the expenditure yielding an advantage of an enduring nature would be only a capital expenditure, has been fine-tuned, that even when expenditure was incurred for obtaining advantage of enduring benefit, nonetheless, the same can be taken as one of revenue account. In the decision reported in [1980] 124 ITR 1 (Empire Jute Co. Ltd. Vs. Commissioner of Income Tax (S.C.)), the Apex Court pointed out that the test of enduring benefit is not a certain or conclusive test and it cannot be applied blindly and mechanically without regard to the particular facts and circumstances of a given case. In a transaction of transfer of allotment of loom hours, on the question as to whether it is a revenue expenditure or a capital expenditure, the Apex Court pointed out that a payment may be a revenue payment from the point of view of the payer and a capital payment from the point of view of the receiver and vice versa. Thus whether an expenditure is capital or revenue has to be determined with regard to the nature of the transaction and other relevant factors. Referring to the decision reported in [1965] 58 ITR 241 (PC) (Commissioner of Taxes v. Nchanga Consolidated Copper Mines Ltd.), the Apex Court pointed out that "there may be cases where expenditure, even if incurred for obtaining advantage of enduring benefit, may, nonetheless, be on revenue account and the test of enduring benefit may break down. ... What is material to consider is the nature of the advantage in a commercial sense and it is only where the advantage is in the capital field that the expenditure would be disallowable on an application of this test. If the advantage consists merely in facilitating the assessee's trading operations or enabling the management and conduct of the assessee's business to be carried on more efficiently or more

profitably while leaving the fixed capital untouched, the expenditure would be on revenue account, even though the advantage may endure for an indefinite future."

15. Referring to the decision reported in [1965] 56 ITR 52 (SC) (Bombay Steam Navigation Co. [1953] P. Ltd. v. CIT) as well as [1924] 8 TC 671 at 676, (Robert Addie and Sons' Collieries Ltd. v. IRC), the Apex Court referred to the words of Lord Sumner, which may usefully be extracted herein too:

> "If the outgoing expenditure is so related to the carrying on or the conduct of the business that it may be regarded as an integral part of the profit-earning process and not for acquisition of an asset or a right of a permanent character, the possession of which is a condition of the carrying on of the business, the expenditure may be regarded as revenue expenditure. See Bombay Steam Navigation Co. (1953) P. Ltd. v. CIT [1965] 56 ITR 52 (SC). The same test was formulated by Lord Clyde in Robert Addie and Sons' Collieries Ltd. v. IRC [1924] 8 TC 671, 676 (C Sess) in these words: "Is it a part of the company's working expenses?-- is it expenditure laid out as part of the process of profit earning?-- or, on the other hand, is it a capital outlay?-- is it expenditure necessary for the acquisition of property or of rights of a permanent character, the possession of which is a condition of carrying on its trade at all?" It is clear from the above discussion that the payment made by the assessee for purchase of loom hours was expenditure laid out as part of the process of profit earning. It was, to use Lord Sumner's words, an outlay of a business "in order to carry it on and to earn a profit out of this expense as an expense of carrying it on". [John Smith and Son v. Moore [1921] 12 TC 266, 296 (HL)]. It was part of the cost of operating the profit-earning apparatus and was clearly in the nature of revenue expenditure. "

16. Thus the question as to whether an expenditure is revenue or not has to be seen from the context of an expenditure forming "part of the cost of the income-earning machine or structure" as opposed to part of "the cost of performing the income-earning operations". -- [1971] 82 ITR 902 (CIT Vs. Coal Shipments P. Ltd. (S.C.).

17. Thus, the consistent guiding principles in matters of understanding an expenditure as a capital or revenue, as held by the Apex Court, is to find out the aim and object of the expenditure and the commercial necessities of making such an expenditure. The question has to be considered in the background of the facts of each case, that "the idea of "once for all" payment and "enduring benefit" are not to be treated as something akin to statutory conditions; nor are the notions of "capital" or "revenue" a judicial fetish. " -- [1989] 177 ITR 377 (Alembic Chemical Works Co. Ltd.).

18. Going by the above-said principle, if one looks at the decision reported in [1991] 191 ITR 249 (Chelpark Company Ltd. Vs. Commissioner of Income Tax), one may find that the decision that the expenditure was a capital expenditure and hence not deductible, rested in the context of the peculiar facts of the case; the partnership with which the assessee had the non-compete agreement got dissolved immediately after the payment of the non-compete fee and the potential competitor had vanished. On these facts, this Court observed that, whatever the assessee had paid for was of permanent or enduring quality, in the sense that competition had been totally eliminated and protection had been acquired for the business of the assessee as a whole. We do not find that the Revenue could draw any support from the said decision of this Court, it being one based on the facts of the said decision. The question herein as to whether non-compete fee paid to the ex-Managing

Director was a revenue or a capital expenditure, has to be seen in the context of the facts of this case and the circumstances in which the payments were made.

19. It is not denied by the Revenue that U.Mohanrao was the Chairman and Managing Director of some of the companies which got merged with the assessee company. The said U.Mohanrao had access to all information starting from manufacturing process, knowhow to the clientele and the products, including the pricing of the products. By a process of amalgamation, the assessee had acquired the business of the amalgamating companies. However, for the fruitful exercise of its business as a business proposition, the assessee thought it fit to enter into a non-compete agreement with a person who had the knowledge of the entire operations, so as to get the full yield of the amalgamated company's business. In that context, rightly, the assessee took a commercial decision to pay non-compete fee to U.Mohanrao and going by the decision of the Apex Court, particularly the decision reported in [1971] 82 ITR 902 (CIT Vs. Coal Shipments P. Ltd (S.C.)), that the payment was in respect of the performing of the business of the assessee, we have no hesitation in holding that the expenditure is only on revenue account and not on capital account. In the circumstances, we accept the case of the assessee, set aside the order of the Tribunal and allow the Tax Case.

20. It may be pointed out that in the assessee's own case relating to the assessment years 1998-99, 1999-2000 in T.C.Nos.97 and 98 of 2008, by order dated 06.04.2011, Question Nos.2 and 4 herein were raised before this Court. The first question relating to scrap sales was considered and answered against the assessee, referring to the decision of the Tribunal reported in 97 ITD 306 (JCIT Vs. Virudhunagar Textiles Limited). The second question also was answered against the assessee, following the decision of this Court reported in [2006] 282 ITR 389 (Mad.) (CIT Vs. Chinnapandi) and the third question was also decided against the assessee following the decision reported in [1993] 199 ITR 43 (Escorts Ltd Vs. Union of India).

21. As far as the first question is concerned, we have referred to the decision of the Apex Court to grant relief to the assessee. As far as the second question is concerned, again, we have referred to the decision reported in [2012] 343 ITR 89 (SC) (ACG Associated Capsules Pvt. Ltd. Vs. Commissioner of Income-Tax (SC)) to grant relief to the assessee. In the circumstances, we have considered the said questions in favour of the assessee and had not followed the decision of this Court rendered in the assessee's own case. As far as the third question on the question of depreciation under Section 35 AB is concerned, on facts, we have held against the assessee and the same is different from the assessee's own decided case, although on a different ground.

In the result, the Tax Case Appeal stands disposed of accordingly. No costs.

Index: Yes / No (C.V.,J.) (K.R.C.B.,J.)

Internet: Yes / No 10.09.2012

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To

1. The Income Tax Appellate Tribunal, Madras 'A' Bench.

2. The Commissioner of Income Tax (Appeals)-V, Chennai-600 034.

3. The Joint Commissioner of Income Tax, Special Range-I, Chennai-34.

CHITRA VENKATARAMAN,J.

and

K.RAVICHANDRABAABU,J.

Tax Case (Appeal) No.244 of 2006

Dated: 10.09.2012