

**IN THE INCOME TAX APPELLATE TRIBUNAL
BENCH 'C' NEW DELHI**

**ITA Nos.2534 & 2535/Del/2011
Assessment Years: 2005-06 & 2006-07**

**GATES INDIA LTD
C-434, DEFENCE COLONY
NEW DELHI
PAN NO:AAACA8125F**

Vs

**DEPUTY COMMISSIONER OF INCOME TAX
CIRCLE-12(1), NEW DELHI**

C L Sethi, JM and K G Bansal, AM

Dated: July 29, 2011

Appellant Rep by: Shri K L Chandak, FCA
Respondent Rep by: Shri Salil Mishra Sr. DR

Income tax – Section 37 – Capital or Revenue – Whether the expenses incurred on purchase of backup software is an expenditure on intangible asset particularly when the assessee cannot provide any details regarding its life span, nature and utility – Whether the royalty payment for which no new asset is acquired by the assessee and there is no residual value after the agreement is allowable as revenue expenditure.

A) Assessee is engaged in the business of manufacturing and trading in rubber hoses. Assessee claimed deduction of software expenses. It was submitted by the assessee that the expenses were revenue in nature on account of high obsolescence of the softwares. AO considered that software packages are intangible assets as they are used in the process of business and included in fixed assets. The issue of obsolescence is taken care of by providing a high rate of depreciation @60%. Thus, the expenditure was held to be capital expenditure. CIT (A) confirmed the view taken by the AO stating that the purchase of software had granted benefit of enduring nature to the assessee. No evidence exists on record that the softwares purchased by the assessee have a short span of life.

Assessee contended that the assessee purchased softwares of the value of Rs.16.61 lacs out of which Rs. 10.86 lacs were in respect of Corporate Data Link (Cards), business card scanner, and software and had been capitalized. Thus, the assessee had applied mind to the useful life of various softwares and treated the expenses to be revenue in nature only in cases where useful life was short due to obsolescence.

B) Assessee paid royalty to Gates Corporation, USA as per technical assistance agreement entered into with it. The royalty is paid for the license granted to manufacture and sell the licensed products using the industrial property right and technical information furnished to the assessee in pursuance of a non-exclusive right to sell the products throughout the world. Assessee contended that the assessee did not acquire any tangible or intangible

property and the royalty is paid on the basis of a fixed percentage of the turn over. Accordingly, the expenditure was revenue in nature.

AO found that the assessee had been given indivisible non-transferable and exclusive license to assemble and manufacture products and parts in the territory of India and to sell the products so assembled or manufactured. Therefore, the expenditure was capitalized and the depreciation allowance was deducted @25%. CIT (A) confirmed the order of the AO stating that the agreement was valid for a period of 10 years and was further extendable, which showed that the benefit was not restricted only to 10 years. The assessee had obtained benefit of enduring nature in respect of its manufacturing and industrial process. Thus, it was capital in nature.

After hearing both the parties, the ITAT held that,

A) ++ the major claim is in respect of back up software amounting to Rs.3.50 lacs. The other softwares are TDS software, anti virus and expenses incurred for support and installation. The expenditure incurred in respect of support charges is obviously revenue in nature. The TDS software is not used in the process of manufacture. Therefore, it can be said on functional basis that the expenditure is revenue in nature. Further, anti software virus is purchased to protect other softwares and, therefore, the expenditure is of revenue nature. In respect of backup software no detail or explanation has been filed about the nature and utility of the software. No evidence exists on record about the useful life span of the software. The burden to prove that expenditure is revenue in nature, is on the assessee, which has to be discharged by filing relevant facts. Such facts are absent in this case. In absence of facts, it cannot be said that the expenditure is revenue in nature. Accordingly, it is held that expenditure of Rs.3.50 lacs only is capital in nature;

B) ++ as per the agreement, "technical information" has been defined to mean and include the existing patented and un-patented technological knowledge and inventions, trade secrets, formulae manufacturing process and methods for the manufacture of licensed products such as designs, assembly data and drawings; models; methods; process specifications; product engineering; material specifications; operational, engineering and manufacturing data; norms of productivity and scrap; and quality parameters at all stages of production. The assessee has been granted sole right to manufacture and sell the licensed products using industrial property rights and technical information in the contract territory and has also been granted right to sub-license the rights but only on prior approval of the Gates Corporation. The services include drawings for designing, manufacturing and assembling; specifications; material list; general calculation sheet; data for inspection and trial operation, fabrication and assembly procedures, operating and instruction manuals, and any other necessary technical data and know-how generally used by the Gates Corporation. Royalty is to be paid at a percentage of the net selling price for each sale of the licensed product. The assessee has also been granted license on an exclusive, non-assignable basis to use licensed trademark relating to licensed products during the subsistence of the agreement;

++ the gross block of the assets at the beginning of the year amounted to about Rs.88 crores. After depreciation, the value of net block was about Rs.45.47 crores. This clearly establishes that no new business has been set up by the assessee in this year. Accordingly, the agreement with Gates Corporation is not for setting up a new business. The technical knowledge which was being provided under the old agreement will be provided under the instant agreement albeit including assistance in the areas newly discovered by the Gates Corporation. Such up gradation is inherently necessary in view of rapid innovation in every field of technology. This by itself does not lead to benefit of enduring nature as expenses

like product innovations etc. in the existing business are revenue in nature. The exclusive license to manufacture in India without such exclusivity in sale territory by itself does not lead to benefit of enduring nature. The agreement does not contain any article regarding reversion of drawings and design etc. after the expiry of agreement. The assessee has been prohibited to use trade mark and brand name after the expiry of the period of agreement. In any case, the drawings and designs are bound to become obsolete after the expiry of the period of 10 years, which is a very long period of time in present era of fast changing technologies. Therefore, the assessee has not acquired any new fixed asset. The assessee does not retain any residual right under the agreement. Therefore, exclusive right to manufacture goods in India for 10 years does not lead to inference of benefit of enduring nature in the capital field. Thus, the expenditure incurred as royalty is revenue in nature.

Assessee's appeal partly allowed

ORDER

Per: K G Bansal:

These two appeals of the assessee for two different years were argued in a consolidated manner by the learned counsel for the assessee and the learned Sr. DR. Therefore, we find it convenient to pass a consolidated order.

Assessment year 2005-06

1.1 The assessee has taken up only one ground in this appeal in respect of capitalization of the expenditure incurred on purchase of softwares. The ground contains averment of facts and the cases sought to be relied upon. Thus, the ground is narrative and argumentative in nature. When the learned counsel was confronted with this fact, it has been stated that the ground may be read as overleaf: -

"That on the facts and in the circumstances of the case, the learned CIT(A) erred in confirming the addition of Rs.2,29,870/- in respect of software expenses."

2. The facts of the case are that the assessee-company filed nil return on 31.10.2005. The return was processed u/s 143(1) on 15.02.2007. Thereafter, statutory notices u/s 143(2) and 142(1) were issued on 17.08.2006 and 15.06.2007 respectively for scrutinizing the return. It was found that the assessee is engaged in the business of manufacturing and trading in rubber hoses. Coming to the point of dispute, it is mentioned that the assessee claimed deduction of software expenses amounting to Rs.5,74,674/-. The assessee was required to justify the claim. In response, the details of expenses were filed and it was submitted that the expenses are revenue in nature on account of high obsolescence of the softwares. The Assessing Officer considered the facts. It has been mentioned that software packages are intangible assets as they are used in the process of business and included in fixed assets. The issue of obsolescence is taken care of by providing a high rate of depreciation @60%. Thus, the expenditure of Rs.5,74,674/- has been held to be capital expenditure. After deducting depreciation of Rs.3,44,804/-, addition of Rs.2,29,870/- has been made to the total income.

2.1 Before the learned CIT(A), the submissions made before the Assessing Officer were reiterated. He also considered the decision of Special Bench of the Tribunal in the case of *Amway India Enterprises, 114 TTJ 476 = (2008-TIOL-97-ITAT-DEL-SB)*. According to him, it has

been held in its case that when an assessee acquires a computer software or gets the license to use the software, he acquires an intangible asset. However, the softwares become obsolete rapidly with technical innovations, therefore, if the life of the software is less than two years, the expenditure may be taken as revenue expenditure. If the utility period is more than two years, then it can be said that a benefit of enduring nature accrues to the assessee. That by itself will not make the expenditure to be capital expenditure. In such a case functional test has to be applied. On the basis of this decision and the decision in the case of *Maruti Udyog Limited Vs. DCIT, 1922 ITD 119 = (2004-TIOL-106-ITAT-DEL)*, it has been held that software is a capital asset of intangible nature. The purchase of software has granted benefit of enduring nature to the assessee. No evidence exists on record that the softwares purchased by the assessee have a short span of life. Therefore, the findings of the Assessing Officer have been confirmed.

2.2 Before us, the learned counsel submitted that the assessee purchased softwares of the value of Rs.16,61,402/- in this year. The expenditure of Rs.10,86,782/- in respect of Corporate Data Link (Cards), business card scanner, and software of the value of Rs.10,72,528/-, Rs.6,500/- and Rs.7,700/- respectively has been capitalized. The aggregate value of these softwares amounts to Rs.10,86,728/-. Thus, only the balance amount of 5,74,674/- has been claimed as revenue expenditure. This shows that the assessee has applied mind to the useful life of various softwares and treated the expenses to be revenue in nature only in cases where useful life was short due to obsolescence. The details of these expenses have been placed on page No.36 of the paper book, which are reproduced below: -

Particulars	Date of purchase	Amounts (Rs.)
Software purchases during the year		
Corporate Data Link (Card Scanner)	31st July, 2004	1,072,528/-
Business Card Scanner	28th Aug., 2004	6,500/-
Business Card Scanner	30th April, 2004	3,50,000/-
Back up Software	11th May, 2004	575/-
TDS software	7th June, 2004	575/-
Mcafee anti virus	29th October, 2004	178,524/-
Support charges & installation for Anti Virus		45,000/-
Software purchased	27th October, 2004	7,700/-
Total Software purchases		1,661,402/-
Less: Capitalized during the year		1,086,728/-
Closing Balance as 31st March, 2005		574,674/-

2.3 Coming to the findings of the lower authorities, it has been mentioned that functional test has not been considered by them and the addition has been upheld because no evidence could be brought on record to show that useful life was less than two years. In view of the fact that the substantial expenditure had been capitalized by the assessee itself, it is argued that the claim in respect of revenue expenditure should be allowed.

2.4 In reply, the learned DR submitted that a software package is intangible asset, as held in the case of *Maruti Udyog Limited (supra)*. The Act or the Rules do not make any

distinction between a capital asset or revenue expenditure in so far as intangible assets are concerned. The assessee has not placed any evidence on record that the life of softwares was less than two years. The details show that backup software was purchased for a consideration of Rs.3,50,000/-. This software is in the nature of application software, which has to be categorized as capital expenditure only.

2.5 We have considered the facts of the case and submissions made before us. The facts are that the assessee incurred total expenditure of Rs.16,61,402/- for purchase of various softwares. Out of this expenditure, a sum of Rs.10,86,728/- was capitalized and the balance expenditure of Rs.5,74,674/- was claimed as revenue expenditure. The major claim is in respect of back up software amounting to Rs.3,50,000/-. The other softwares are TDS software, anti virus and expenses incurred for support and installation. The expenditure incurred in respect of support charges is obviously revenue in nature. The TDS software is not used in the process of manufacture. Therefore, it can be said on functional basis that the expenditure is revenue in nature. Further, anti software virus is purchased to protect other softwares and, therefore, the expenditure is of revenue nature. This leaves us with backup software purchased at the cost of Rs.3,50,000/-. No detail or explanation has been filed about the nature and utility of the software. No evidence exists on record about the useful life span of the software. From the narration, it appears that this software is used to provide necessary support to all other softwares. The burden to prove that expenditure is revenue in nature, is on the assessee, which has to be discharged by filing relevant facts. Such facts are absent in this case. The question of application of decided cases comes only thereafter. In other words, in absence of facts, it cannot be said that the expenditure is revenue in nature. Accordingly, it is held that expenditure of Rs.3,50,000/- only and not Rs.5,74,674/- is capital in nature. The Assessing Officer is directed to revise the order by taking Rs.3,50,000/- only as capital expenditure. The calculation regarding depreciation shall also be revised accordingly. Thus, this appeal is partly allowed.

Assessment Year : 2006-07

3. The position of first ground in this appeal is similar to the ground taken in the appeal for assessment year 2005-06 (supra). The Assessing Officer had capitalized a sum of Rs.37,130/-, being the expenditure incurred for purchase of various softwares like Card Scanner novell netware and group software, MS Project 2003, Autocad, Microsoft Visal Professional, Leap Software, Microsoft Office etc. The submissions of the assessee are similar to the submissions made in the proceedings for assessment year 2005-06. The Assessing Officer capitalized the expenditure and allowed depreciation @60%, leading to net addition of Rs.14,855/-. The learned CIT(A) upheld the decision as in earlier assessment year 2005-06. The submissions of the learned counsel and the learned DR before us are also the same as in assessment year 2005-06. We find that no data whatsoever has been furnished in respect of useful life of the softwares and the purpose for which they are used. In assessment year 2005-06, the assessee had capitalized the expenditure in respect of card scanner software. This has been claimed as revenue expenditure in this year. In absence of the details above the nature, use and useful life of the softwares, it is held that the lower authorities were right in capitalizing the expenditure, as the burden cast on assessee u/s 37 has not been discharged. Thus, this ground is dismissed.

3.1 Ground No.2 is against capitalization of royalty payment of Rs.29,77,118/- to Gates Corporation, USA under technical collaboration agreement. It is mentioned that similar expenses had been allowed in past while there is no change in the facts. In this connection, it is mentioned in the assessment order that the assessee incurred expenditure by way of royalty and training amounting to Rs.29,77,118/- and Rs.1,98,936/- respectively. It was

submitted that the assessee is carrying on the business of manufacturing and trading in rubber hoses since its formation in September 1999. In financial year 2005-06, it has paid royalty to Gates Corporation, USA as per technical assistance agreement entered into with it. The royalty is paid for the license granted to manufacture and sell the licensed products using the industrial property right and technical information furnished to the assessee in pursuance of a non-exclusive right to sell the products throughout the world. Under the agreement, the Gates Corporation has supplied technical services, an exclusive non-transferable licence, authority, permission to use the licensed trademarks in respect of the licensed products. It has been argued that the assessee did not acquire any tangible or intangible property and the royalty is paid on the basis of a fixed percentage of the turn over. Accordingly, it is argued that the expenditure is revenue in nature. A number of cases were cited before him. The Assessing Officer also found out the cases, which support the view that the expenses of royalty are partly capital in nature. He referred to the decision in the case of *CIT Vs. Ciba India Ltd.*, 69 ITR 692, *Sriram Pistons & Rings Ltd. Vs. CIT* 171 Taxman 81 = (2008-TIOL-309-HC-DEL-IT); *CIT Vs. Gujarat Carbon Ltd.*, 254 ITR 294; and *CIT Vs. Jyoti Electric Motors Ltd.*, 255 ITR 345, relied upon by the assessee. He also considered the decision in the case of *CIT Vs. British India Corporation Limited* 165 ITR 51; *CIT Vs. Indian Oxygen Ltd.*, 218 ITR 337; *CIT Vs. IAEC (Pumps) Ltd.*, 232 ITR 316; *CIT Vs. Wavin India Limited*, 236 ITR 314. On the basis of these decisions, he culled out various propositions, which lead to the conclusion that the expenditure is revenue in nature. These are as under: -

- i) the right is non exclusive and non transferable;
- ii) no benefit of enduring nature is derived; or
- iii) right of usage is only during pendency of agreement;
- iv) agreement is of short tenure;
- v) on expiry of agreement no residual right remains with the assessee.

3.2 He also considered the decision in the case of *Jonas Woodhead & Sons (India) Ltd. Vs. CIT*, 224 ITR 342 = (2002-TIOL-832-SC-IT) and *Southern Switch Gear limited Vs. CIT and Others*, 232 ITR 359. On the basis of these decisions, he culled out the proposition, which support the view that the expenditure is capital in nature. These are as overleaf: -

- i) the technical assistance covers establishment of factory and operation of thereof;
- ii) even after termination of agreement the assessee is entitled to continue manufacture if goods;
- iii) the right to make or manufacture certain goods exclusively in India itself is an independent right secured by assessee from foreign company.

3.3 Finally, it has been held that the terms of agreement are quite comprehensive and the whole technical know-how to set up the business has been provided by the Gates Corporation, USA. The assessee has been given indivisible non-transferable and exclusive license to assemble and manufacture products and parts in the territory of India and to sell the products so assembled or manufactured. Comprehensive technical know-how has been provided because of which the assessee is a market leader. Therefore, the expenditure of Rs.23,82,041/- has been capitalized. The depreciation allowance has been deducted @25%,

thus, leading to net addition of Rs.23,82,041/-. The findings of the Assessing Officer in respect of royalty expenditure have been upheld by the learned CIT(A) on the grounds inter alia that the agreement is valid for a period of 10 years and is further extendable, which shows that the benefit is not restricted only to 10 years. The assessee has obtained benefit of enduring nature in respect of its manufacturing and industrial process. There is no provision regarding reversion of rights obtained by the assessee to the Gates Corporation, USA. However, the expenditure in respect of training has been held to be revenue in nature.

3.4 The learned counsel took up through the royalty agreement dated 24.08.2004, a copy of which has been placed on record. It is argued that on the facts, various cases relied upon by him before the lower authorities support the contention that the expenditure is revenue in nature. In reply, the learned DR drew our attention to the findings of the Assessing Officer and the learned CIT(A). In particular, it is submitted that the agreement is extendable beyond 10 years. The agreement provides the comprehensive technical know-how to the assessee. Therefore, it is argued that the learned CIT(A) was right in holding that the expenditure is capital in nature.

3.5 In rejoinder, the learned counsel submitted that although the revenue has relied on the decision in the case of Southern Switch Gears Limited (supra), the whole of the expenditure has been held to be capital in nature. At best, only a part of the expenditure could have been taken as capital expenditure.

4. We have considered the facts of the case and submissions made before us. The question as to whether an expenditure is capital or revenue in nature is always a vexed question, which has to be decided on the basis of the facts of each case. When the expenditure leads to acquisition of an asset of fixed nature, it constitutes capital expenditure. Another test is that when an expenditure leads to a benefit of enduring nature to the assessee, it is capital expenditure. However, it has to be seen whether the benefit is in capital field or in revenue field.

4.1 With this preliminary remark, we examine the contents of the agreement dated 24.08.2004. The recital to the agreement shows that there was a pre existing agreement dated 03.02.1996, which expired on 14.05.2003. The instant agreement is stated to be made substantially on the same terms for granting right or license to manufacture, use and sell the licensed products. In article 1, various terms used in this agreement have been defined. In particular, "technical information" has been defined to mean and include the existing patented and un-patented technological knowledge and inventions, trade secrets, formulae manufacturing process and methods for the manufacture of licensed products such as designs, assembly data and drawings; models; methods; process specifications; product engineering; material specifications; operational, engineering and manufacturing data; norms of productivity and scrap; and quality parameters at all stages of production. Under article 2, the assessee has been granted sole right to manufacture and sell the licensed products using industrial property rights and technical information in the contract territory. The assessee has also been granted right to sub-license the rights but only on prior approval of the Gates Corporation. Under article 4, the Gates Corporation shall provide technical services so that the assessee may manufacture licensed products to the best advantage. The services include drawings for designing, manufacturing and assembling; specifications; material list; general calculation sheet; data for inspection and trial operation, fabrication and assembly procedures, operating and instruction manuals, and any other necessary technical data and know-how generally used by the Gates Corporation. Provision has also been made for deputing technical personnel at the request of the assessee for which cost of round trip, lodging and other associated expenses and taxes shall

be paid by the assessee. Under article 5, royalty is to be paid at a percentage of the net selling price for each sale of the licensed product as set fourth in the appendix to the agreement. The percentage is 1%. The formula for computing net selling price has been specified. Under article 10, the assessee has also been granted license on an exclusive, non-assignable basis to use licensed trademark relating to licensed products during the subsistence of the agreement. The agreement is to remain in force for an initial period of 10 years. It may be mentioned by us at this stage that gross block of fixed assets amounted to about Rs.88 crores and addition of work in progress of about Rs.4.26 crores was made in this year. With these facts, we proceed to examine as to whether the expenditure created any fixed asset are led to a benefit of enduring nature to the assessee in the capital field.

4.2 We have already mentioned that the assessee had been carrying on the business of manufacturing industrial hoses. The gross block of the assets at the beginning of the year amounted to about Rs.88 crores. After depreciation, the value of net block was about Rs.45.47 crores. This clearly establishes that no new business has been set up by the assessee in this year. Accordingly, it is held that the agreement with Gates Corporation is not for setting up a new business. The recital to the agreement states that it is in continuation of the pre existing agreement dated 03.02.1996, which expired on 14.05.2003 and that the instant agreement is drawn substantially on the same terms as agreed upon in the earlier agreement dated 03.02.1996. In view thereof, it can also be concluded that the technical knowledge which was being provided under the old agreement will be provided under the instant agreement albeit including assistance in the areas newly discovered by the Gates Corporation. Such up gradation is inherently necessary in view of rapid innovation in every field of technology. But for such innovations the business will not survive. This by itself does not lead to benefit of enduring nature as expenses like product innovations etc. in the existing business are revenue in nature. The agreement is exclusive in terms of manufacturing in the territories of India but non-exclusive in terms of sale all over the world. The exclusive license to manufacture in India without such exclusivity in sale territory by itself does not lead to benefit of enduring nature. The learned DR was specifically requested to point towards any article in the agreement which grants benefit to the assessee to continue to use technical information, trade mark or brand name after expiry of the agreement. He was not able to do so. The agreement does not contain any article regarding reversion of drawings and design etc. after the expiry of agreement. The assessee has been prohibited to use trade mark and brand name after the expiry of the period of agreement. In any case, the drawings and designs are bound to become obsolete after the expiry of the period of 10 years, which is a very long period of time in present era of fast changing technologies. Therefore, it is clear that the assessee has not acquired any new fixed asset. Assuming that the exclusive right to manufacture in India may grant some benefit of enduring nature, it is clear that it does not affect the capital structure of the assessee-company. Therefore, in the light of various decisions in the matter including in the case of *Empire Jute Company Limited Vs. CIT, (1980) 124 ITR 1 = (2002-TIOL-238-SC-IT)*; no advantage in capital field has been obtained by the assessee. From all the five points listed by the Assessing Officer for royalty to be revenue expenditure, the only point surviving against the assessee is that the agreement subsists over a long period of 10 years. According to us, this point by itself does not lead to inference of capital expenditure because no advantage has been received in the capital field. On the other hand, the expenditure or any part thereof has not been incurred for setting up the business. The assessee does not retain any residual right under the agreement. Therefore, exclusive right to manufacture goods in India for 10 years does not lead to inference of benefit of enduring nature in the capital field. At the same time it is seen that the license fee is paid on the basis of net turn over and it has a direct relationship with an item in the revenue field. Therefore, we are of the view that the expenditure is of revenue in nature. Accordingly, ground No.2 of the

appeal is allowed. Since the expenditure has been held to be revenue in nature, there will be no question of grant of depreciation thereon.

5. The result of aforesaid is that both the appeals are partly allowed.

(This order was pronounced in open court on 29.7.2011.)