

## PAYMENT FOR KNOW-HOW: WHETHER CAPITAL EXPENDITURE

THE DISTINCTION between capital expenditure and expenditure for revenue in income-tax has always been a difficult one to apply. The income tax law does not offer a statutory definition of what is capital and what is revenue. Consequently, the matter has to be decided on the basis of various propositions laid down from time to time in case law. However, case law cannot be expected to present a mathematical formula, or even a reasonably precise criterion. Each case will concentrate on its own facts. It cannot project itself beyond its own ambit. A recent case<sup>1</sup> illustrates how the distinction between capital and revenue expenditure requires the greatest amount of circumspection in its application. The Alembic Chemical Works Co. which was already manufacturing penicillin, desired to improve the output and, for that purpose, decided to obtain technical know-how from a Japanese company, namely, Meiji Seika Kisha Ltd. In 1963, Alembic and Meiji entered into an agreement. It was agreed that Meiji shall supply to Alembic the sub-cultures of the most suitable penicillin-producing strains of Meiji, along with the technical information etc. for fermentation of penicillin, flow sheet of the process on a pilot plant and design and specifications of the main equipment in the pilot plant. Meiji also undertook to arrange for the visit of technical personnel of Alembic to the plants of Meiji at Japan for acquiring familiarity. A lump sum payment of 50,000 US dollars was to be paid to Meiji by Alembic, as the consideration for the supply of technology. The information transmitted was to be kept secret.

### Test of enduring benefit not decisive

The question arose whether the above sum, paid by Alembic to Meiji, was "capital" expenditure or "revenue" expenditure for the purpose of Indian income-tax law. It may be recalled that section 37 of the Income Tax Act, 1961 allows deduction of any expenditure, not being capital expenditure, laid out or expended wholly and exclusively for the purpose of the business or profession. The income-tax department argued that the purchase of the technology conferred a lasting benefit on Alembic and therefore it was capital expenditure. But the argument was not accepted by the Supreme Court, and the judgment of the High Court of Gujarat, which had answered the question in favour of the revenue on a reference by the Tribunal, was set aside. The Supreme Court pointed out, *inter alia*, that Alembic had already been producing penicillin since 1961, and what the agreement facilitated was improvement of the existing production, rather than the creation of a new line of production. The Supreme Court further held that the fact that the benefit conferred by the acquisition may be lasting, did not necessarily mean

---

1. *Alembic Chemical Works Co. Ltd. v. C.I.T., Gujarat*, J.T. 1989(2) S.C. 122, 130, 131, 132, paragraphs 11, 13 and 14.

that it was a capital expenditure. The so-called test of "once for all" payment (as constituting capital expenditure) would not be conclusive. What is relevant is the purpose of the outlay and its intended object and effect, considered in a common sense way, having regard to business realities. As had been held earlier,<sup>2</sup> there may be cases where expenditure, even if incurred for obtaining an advantage of an enduring character, may nonetheless be on revenue account, and the test of enduring benefit may break down on the facts of the case.

### The common sense test

Thus, the court adopted a pragmatic approach and arrived at a solution that harmonises with business reality. The aspect of common sense, in distinguishing between capital and revenue, has been emphasised by Lord Pearce also in *D.P. Australia v. Commissioner of Taxation*,<sup>3</sup> in these words:

The solution to the problem is not to be found by any rigid test or description. It has to be derived from many aspects of the whole set of circumstances some of which may point in one direction, some in the other. One consideration may point so clearly, that it dominates other and vaguer indications in the contrary direction. It is a common sense appreciation of all the guiding features which must provide the ultimate answer. . . .

### Secrecy clause

One aspect of interest in the above case was the fact that in deciding that the expenditure was revenue expenditure, the Supreme Court placed some emphasis on the secrecy clause contained in the agreement between Alembic and Meiji. This is usually inserted in agreements for the transfer of technology and relying on this clause, the Supreme Court observed:

The circumstance that the agreement, insofar as it placed limitations on the right of the assessee in dealing with a know-how and the conditions as to non-partibility, confidentiality and secrecy of the know-how, inclined towards the inference that the right pertained more to use of the know-how than to its exclusive acquisition.

In the above case, clause (2) of the agreement provided for the main objective, namely, transfer of technology, in these words:

(2) For and in consideration of the sub-cultures, design, flow sheet

---

2 *C.I.T., Bombay v. Associated Cement Co. Ltd.*, J.T. 1988(2) S.C. 287, 290 and *Empire Jute Co. Ltd. v. C.I.T.*, (1980) 124 I.T.R. 1 (SC).

3. (1966) A.C. 224 (P.C.).

and written description to be furnished by Meiji to Alembic pursuant to paragraph (1) hereof, Alembic shall pay to Meiji in advance and in lump sum, such an amount as Meiji is able to collect fifty thousand U.S. dollars (\$ 50,000) net in Tokyo after deducting any taxes and charges to be imposed in India upon Meiji with respect to the said payment to Meiji.

Clause (4) of the agreement provided as under:

(4) Meiji will give advice, to the extent considered necessary by Meiji, on any difficulty Alembic may encounter in applying the sub-cultures and information obtained by Alembic from Meiji to the large scale manufacture. The above provision shall be in force after Meiji's receipt of the amount set forth in paragraph (2) hereof until the end of two (2) years from the effective date of this agreement.

Clause (6) of the agreement provided as under regarding secrecy:

(6) Any of the sub-cultures and informations obtained by Alembic from Meiji shall be regarded as strictly confidential by Alembic and its personnel and shall be used by Alembic only on its Penicillin G plant in India, and shall not be disclosed to any other person, firm or agency, governmental or private. Alembic shall take all reasonable steps to ensure that such sub-cultures and information will not be communicated. Alembic shall take all possible precautions against the escape from its premises of the strain obtained from Meiji or propagated therefrom. Alembic shall not apply for any patent to any country in relation to any of the sub-cultures and information obtained by Alembic from Meiji.

It was this obligation of secrecy which weighed with the Supreme Court in determining that the expenditure was to be classified as "revenue" expenditure.

*P.M. Bakshi\**

---

\* Honorary Member, Law Commission of India