
Fees for availing technical know-how to bring a new business into existence in the form of a JV company treated as a capital expenditure

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In brief

In a recent decision, the Supreme Court (SC) has held that the expenditure incurred for availing technical know-how and technical information was capital expenditure as it was incurred for the formation of a new business.

In detail

Facts of the case

- The taxpayer¹ was an Indian company incorporated pursuant to a joint venture (JV) agreement between an Indian company and a foreign company. The foreign company was engaged in the business of development, manufacture and sale of automobiles and parts.
- The taxpayer entered into a technical collaboration agreement (TCA) with the foreign company for availing technical know-how and technical information for a lump sum fee to be paid in five equal instalments commencing from the third year of commercial production along with a royalty of 4% on its sales. The taxpayer treated these payments as revenue expenditure.
- Simultaneously certain other agreements were entered between the taxpayer and the foreign company for providing technicians and engineers for necessary guidance for setting up of plant, supply of parts for manufacture of cars and supply of manufacturing facilities (the agreement *inter-alia* stipulated specifications for manufacturing facilities to be sold by the foreign company to the taxpayer). The taxpayer treated the payments made under these agreements as capital expenditure.
- The tax officer in the reassessment proceedings, treated the amount towards technical know-how and

royalty payable under the TCA as capital expenditure and disallowed the claim of the taxpayer. The matter was carried by the taxpayer to the SC.

Issue before the SC

Whether the amount paid for availing technical know-how and technical information should have been treated as revenue expenditure or capital expenditure?

Taxpayer's contention

- The technical know-how and technical information was not for formation of a plant but to manufacture products in India.
- The ownership rights continued with the foreign company and the taxpayer had limited right to use and exploit the know-how.

¹ TS-218-SC-2017

- On a similar issue, the Delhi High Court (HC) in the taxpayer's own case² held that the payment for know-how fee and royalty was in the nature of revenue expenditure.

Revenue's contention

The technical know-how and technical information aided in formation of a new asset in the form of a new manufacturing facility/ plant for manufacturing of cars and therefore, was of enduring nature and the expenditure in question should qualify as capital expenditure.

Supreme Court's decision

- There is no single rule of thumb, principle or test which is paramount and each case needs to be probed in the light of circumstances of that particular case. The solution 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. It is a common sense appreciation of all guiding features which must provide the ultimate answer.
- The distinction between capital and revenue expenditure with reference to acquisition of technical information and know-how has also been spelt out by the SC³ and HCs in many cases. Where there was transfer of ownership in the intellectual property rights or in licenses, it would clearly be capital expenditure. However, where no such rights had been transferred but an

arrangement facilitates the grant of license to use those rights for a limited purpose, it would be in the nature of revenue expenditure as no enduring benefit was acquired thereby.

- Where the technical know-how availed was for improvising the existing business, the expenditure would be treated as revenue expenditure. This case, thus, indicates that if such technical know-how was for the purpose of setting up a new business, the position may be different.
- The very purpose of entering into the JV agreement was to set up a JV company with an aim and objective to establish a unit for manufacture of automobiles and part thereof. As a result of the JV agreement, the taxpayer was incorporated which entered into TCA in question for technical collaboration. This technical collaboration included not only transfer of technical information, but also complete assistance, actual, factual and on the spot, for establishment of plant, machinery etc. to create a manufacturing unit for the products. Thus, a new business was set up with the technical know-how provided by the foreign company.
- In case of termination of the TCA, the JV itself would end and there may not have been any further manufacturing using the technical know-how of the foreign collaborator.

- The TCA was crucial for setting up of the plant project in question for manufacturing of the goods. Thus, the question of improvising the existing technical know-how by borrowing the technical know-how from foreign company did not arise and accordingly, the expenditure in the form of fees paid would be in the nature of capital expenditure and not revenue expenditure.
- Distinguishing the decision of the Delhi HC², the SC held that the technical know-how therein was obtained for improvising the scooter segment, which was already in existence, as against the TCA, which was meant for setting up a new plant to manufacture cars.

The takeaways

The SC has reiterated the long standing position that the expenditure incurred on formation of a new business is capital in nature. However, as noted by the SC, whether a particular expenditure is capital or revenue in nature depends on specific circumstances and facts of the case, a detailed investigation needs to be undertaken to determine whether a particular expenditure of this nature has been incurred on capital field or revenue field.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor

² [(2015) 327 ITR 481 (Delhi)]

³ [(1968) 69 ITR 692 (SC)]

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