

IN THE SUPREME COURT OF INDIA
CIVIL APPELLATE JURISDICTION
CIVIL APPEAL NO.1667 OF 2010
(Arising out of S.L.P. (C) No.18545 of 2009)

Commissioner of Income Tax, Ahmedabad

...Appellant(s)

Versus

M/s. Mastek Limited

...Respondent(s)

W I T H

Civil Appeal No.1668 of 2010
(Arising out of S.L.P. (C) No.16713 of 2009)

O R D E R

Delay condoned.

Leave granted.

Heard learned advocates on both sides.

These two civil appeals are filed by the Department against the order dated 2nd September, 2008, of the Gujarat High Court refusing to formulate, inter alia, the following question of law:

"Whether the Income Tax Appellate Tribunal, in the facts and circumstances of this case, was right in confirming the order passed by the Commissioner of Income Tax (Appeals) deleting the additions made by the Assessing Officer on account of royalty expenses?"

...2/-

In the lead matter, which is civil appeal arising out of S.L.P. (C) No.18545 of 2009, the facts are as under: Assessee carries on the business of development of Software Package and Packaged Software Products divisible into four groups, namely, (i) Customized Software; (ii) Packaged Software Products; (iii) Agency Products; and (iv) Exports. In the lead matter, we are concerned with Assessment Year 1996-1997 and with the Agency Products. In that year, assessee claimed deduction under Section 37 of the Income Tax Act, 1961 ['Act', for short] in respect of royalty expenses of Rs.3,23,28,158/-. The Assessing Officer held that, only one-sixth of the amount was allowable in view of Section 35AB of the Act and, accordingly, after allowing the benefit under Section 35AB of the Act, the Assessing Officer made a disallowance of Rs.1,12,12,352/-, which was added back to the income of the assessee. On appeal filed by the assessee, the Commissioner of Income Tax (Appeals) deleted the additions made by the Assessing Officer, which view was confirmed by the Income Tax Appellate Tribunal ['Tribunal', for short] following its earlier decision in the assessee's own case in I.T.A. No.4968/1995 and others dated 25th November, 1999. Being aggrieved by the decision of the Tribunal, the Department instituted Tax Appeal No.606 of 2008 in the High Court which, as stated hereinabove, refused to formulate the above proposed question, hence, these civil appeals.

During the year under consideration, the assessee claimed that it had paid royalty as below:

...3/-

Ingress Corporation	Rs.27969750
Comshare	Rs.2727591
LMB	Rs.1639817
	Rs.32328158

In respect of the said payments, the assessee claimed deduction under Section 37 of the Act on the ground that the assessee had made the said payments towards royalty for “duplicating” the software by the name ‘Ingres’ in India and supplying the same to the end-users. According to the assessee, the ownership of the said software was retained by Ingres Corporation [which is an American based Multi-National Company in United States]; that for each copy, which stood duplicated and sold to the customers in India, the assessee had paid royalty to the Corporation based on its sale value and, thus, such payment towards royalty formed part of the expenditure incurred by the assessee in making the sales. Before us, it was argued on behalf of the assessee that the payment of royalty was for duplicating the software ‘Ingres’ in India and for supplying the same to the end-users. In this connection, it was pointed out that there is a vital difference between payment of consideration for acquisition of a software and payment for acquisition of the right to use the said software. According to the assessee, in the former case, the payment would constitute capital expenditure whereas, in the latter case, it would constitute an expenditure under Section 37 of the Act.

...4/-

At the outset, we may reiterate what we have stated earlier in so many judgements, namely, that the Department has to analyse the process undertaken by the assessee(s), analyse the contracts and the price structure to ascertain the nature of payment. Depending upon the analysis of the process of "duplication" in the context of the contracts signed by the assessee with the American Corporation, one has to find out whether the expense incurred is a Revenue expenditure or a capital expenditure. Moreover, one cannot proceed to decide such cases merely on the basis of the labels affixed to a given process. In this case, the assessee contends that it makes payment to the American Corporation in the United States for "duplicating" the software. Before coming to the dictionary meaning of the word "Duplication", we may state that 'Ingres', according to the Department, is a software which is a 'Back-end System', which, in turn, is used to develop other softwares therefrom depending on the needs of the customers. In the present case, the customers of the assessee are Reliance Industries Limited, Anand Bazar Patrika, Air India, etc. One more aspect needs to be highlighted. The contract/arrangement between the assessee and the American Corporation in this case consists of two parts, namely, commercial and manufacture. From the said contract/ arrangement, it, prima facie, appears that the above customers are given direct access to the software 'Ingres' and, according to the Department, this is one reason why royalty is shared between the assessee and the American Corporation in the ratio of 60 : 40. According to the Department, such high ratio itself suggests that the impugned payment is not for "duplication", simpliciter.

According to the Dictionary of Computer by W.R. Spencer, a "Database System" [which is also called as 'Database Management System'] is an integrated software system that facilitates accessing, entering and deletion of data. According to the Dictionary of Computer by Prentice Halls, 'Database Management System' is a collection of software programmes designed to manage and maintain a collection of records [Database] by providing facilities for storing, organizing and retrieving related information, as and when required. According to the same Dictionary, 'Duplicating' is a process of copying from a source data medium to a destination data medium, which has the same physical form: for example, to copy a file from one magnetic tape to another magnetic tape is "duplication". According to Microsoft's Computer Dictionary, a "Back-end processor" is a processor that manipulates data sent to it from another processor: for example, a high speed graphic processor dedicated to painting images of a video display operates in response to commands passed "back" to it by the main processor. According to the same Dictionary, the part of a compiler that transforms the source code into object code is called "Back-end". A Back-end processor is a slave processor that performs a specialized task, such as providing rapid access to a database, freeing the main processor for other work. Such function is called 'Back-end' because it is supporting to the computer's main function.

Keeping in mind the fact that none of the above-mentioned aspects has been considered by the High Court, we are of the view that the High Court should have framed, on the facts and circumstances of these cases, the following question of law for determination:

"Whether allowance of royalty expenses, as claimed by the assessee, are to be allowed in its entirety under Section 37 of the Income Tax Act, 1961, or only one-sixth thereof, as mandated by Section 35AB(1) of the Income Tax Act, 1961, are allowable during the relevant Assessment Years?"

Accordingly, we hereby remit these cases to the High Court for answering the above question.

Before concluding, we may clarify that we have highlighted some technical and legal aspects mentioned hereinabove only for the purpose of pointing out that applicability of Section 37 vis-a-vis Section 35AB of the Act can be decided if there is a proper factual foundation on those aspects. Our reasons, mentioned above, should not be treated as conclusive. We are of the view that an in-depth exercise needs to be carried out to understand the actual process undertaken by the assessee to be examined in the light of the contract/arrangement with the American Corporation [including the purchase order and the position of the royalty shared by the assessee and the said Corporation]. Therefore, we have not examined the case on merits. Our reasons given herein are only to support this Order remanding the case to the High Court. We leave contentions on both sides expressly open. If the High Court comes to the conclusion that further foundational facts are required to be examined, it may remit the case to the Authorities below, if it deems fit.

...7/-

Subject to what is stated above, civil appeals filed by the Department are allowed and the matter stands remitted to the High Court for deciding the question framed by us hereinabove.

No order as to costs.

.....J.
[S.H. KAPADIA]

.....J.
[AFTAB ALAM]

New Delhi,
February 10, 2010.

