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(1987) 34 TAXMAN 274

Calcutta High Court

Case No: IT Reference No. 129 of 1983

M.V. Philips	APPELLANT
Vs	
Commissioner of Income Tax	RESPONDENT

Date of Decision: May 6, 1987

Acts Referred:
Income Tax Act, 1961 â€" Section 256(1), 263, 9, 9(1), 9(1)(vi)#Patents Act, 1970 â€" Section 48, 5

Citation: (1987) 34 TAXMAN 274

Hon'ble Judges: Shyamal Kumar Sen, J; Dipak Kumar Sen, J

Bench: Division Bench

Judgement

Dipak Kumar Sen, J.
N.V. Philips" Gloeilempenfabrieken Bindhhoven, Holland, the assessee, is a non-resident company incorporated in

the Netherlands. On 8-7-1964, the assessee entered into an agreement with one Crookes Interfran Ltd., an Indian company, under which the

assessee agreed to furnish to the Indian company technical information relating to vitamin D and its manufacture, use and sale on, inter alia, the

following- terms and conditions:

(a) The assessee would render to the Indian company all assistance and furnish information from time to time in respect of the working methods,

manufacturing processes and methods of application relating; to vitamin D.

(b) The assessee would provide the Indian company with following data, assistance and information:

(i) Drawings with detailed instructions and directions for a plant to be set up in the territory specified in the agreement of a capacity of 1,000 kg.

per annum producing vitamin D.

(ii) Data regarding working methods and manufacturing processes (including indications, instructions, specifications, standards and formulas),

methods of analysis and quality control and other particulars to enable the Indian company to start and carry on the manufacture of vitamin D.

(iii) Medical and other information relating to the pharmacological and pharmaceutical properties of vitamin D.

(iv) The training of one or more technicians of the Indian company in the factory of the assessee in the Netherlands for setting up the plant as

aforesaid and/or the placing at the disposal of the Indian company of a technical expert for the erection and initial working of the plant as also the

training of an agreed number of qualified staff of the Indian company in the factory of the assessee in the Netherlands.

(v) Assistance to the Indian company in the initial costings of production and advice on problems in respect of establishment, installation, running

and administration of the said plant.

(vi)Analysing in the laboratory of the assessee in the Netherlands samples produced by the Indian company free of charge of each batch of vitamin

D manufactured by the Indian company.

(c) Any information disclosed by the assessee to the Indian company under the agreement would be solely for the use of the Indian company,

would be considered as having been disclosed in confidence and would not become the property of the Indian company until such time and to the

extent that such information would become public by application and user.

(d) The Indian company would take all reasonable care to keep such information confidential and not disclose the same to third parties except as

may be necessary in the actual and normal course of use thereof. The Indian company would obtain corresponding under takings of secrecy from

its employees in suitable form.

(e) The Indian company would undertake during the continuance "of the agreement and thereafter not to copy the equipment, tools and instruments

supplied by the assessee to the Indian company nor to cause or permit the same to be copied and not to prepare or permit the drawings thereof.

(f) The Indian company would pay to the assessee in consideration of the technical assistance and information supplied 5 per cent of the net selling

price of vitamin D manufactured and sold by the Indian company subject to Indian income tax.

(g) The agreement would take effect from the start of the manufacture of vitamin D by the Indian company and would remain in force for ten

consecutive years and would continue thereafter for the period of one year, unless terminated by either party giving to the other six months"

previous notice in writing before the end of the original or the extended period.

In the assessment year 1973-74, the corresponding accounting year ending on 31-12-1972, the assessee received a sum of Rs. 31,080 from

Dupher Interfran Ltd., the successor-in-interest of Crooks Interfran Ltd., under the said agreement dated 8-7-1984. In its assessment to income

tax in the said assessment year, the assessee contended before the ITO that the said amounts had been received from the Indian company as and

by way of technical assistance fees. The ITO in the first instance accepted the contention of the assessee and held that only 10 per cent of the

receipts of the assessee from Dupher Interfran Ltd., would be treated as taxable income of the assessee as the same were technical assistance

fees. The Commissioner subsequently set aside the said assessment u/s 263 of the income tax Act, 1961 ("the Act"), as he was of the opinion that

the payments received by the assessee from the Indian company were more in the nature of royalty than technical assistance fees. The assessee

preferred an appeal before the Tribunal against the order of the Commissioner u/s 263. The appeal was unsuccessful.

2. The ITO in the reassessment after construing the agreement in the background of Explanation II to clause (vi) of sub-section (1) of section 9

held that it was obvious that technical assistance, know-how and information furnished by the assessee to the Indian company were nothing else

than royalty. He made a distinction between technical assistance fee and technical services fee. He held that technical assistance fee was paid for

passing on technical information and services rendered in connection therewith whereas technical services fee was paid for rendering actual

technical services. He held that the assessee had received the payments from the Indian company in consideration of passing on of certain technical

know-how and information and even if certain services have been rendered in connection therewith the entire receipt would be taxed as royalty.

The ITO noted that in the tax deduction certificates issued by the Indian company to the assessee the said payments had been described as

royalty. It was not in dispute that if the said amounts are treated as technical services fees only 10 per cent of the amount paid would be taxable in

the hands of the assessee, whereas if the said amounts were treated as royalty, 80 per cent of the same would be taxable in the hands of the

assessee.

The ITO in making the assessment relied upon the order passed by the Commissioner u/s 263, where it was noted that the agreement was for a

period of ten years and that the Indian company would not require technical assistance after the formative stage. The payment under the said

agreement would continue during the entire term of the agreement. It was also noted that the payment was to be made on the basis of a fixed

percentage of the turnover of the Indian company. This indicated that the payment was in the nature of royalty.

3. In the assessment year 1974-75 the payment received by the assessee from the Indian company being Rs. 26,475 was also treated as payment

received by the assessee on account of royalty by the ITO and taxed as such.

4. The assessee preferred an appeal from the said order of assessment before the Commissioner (Appeals), who set aside the order of the ITO

with a direction to make the assessment in terms of the directions contained in the order passed u/s 263 in respect of the assessment year 1973-

74.

In the subsequent assessment made on remand the ITO following the assessment of the assessee for the earlier assessment year 1973-74, held that

the payment received by the assessee from the Indian company was a payment in the nature of royalty and taxable as such.

5. Being aggrieved, the assessee preferred appeals from the said two orders of assessment before the Commissioner (Appeals).

In construing the agreement between the assessee and the Indian company, the Commissioner (Appeals) noted that in the agreement there was no

separate provision for payment on account of any patent licence to be granted by the assessee. He held that payments were received for the entire

services by the assessee which included supply of data, assistance and information and supply of technique for manufacture of products of the

assessee in India on a fixed percentage of the net selling price of the manufactured products. He held that this payment had an element of royalty as

also the element of fees. He came to the conclusion that 50 per cent of the payments received by the assessee from Dupher Interfran Ltd., was in

the nature of fees for technical assistance and information and should be taxed as such and the balance 50 per cent should be treated as royalty

and taxed in the hands of the assessee accordingly.

6. Being aggrieved, both the revenue and the assessee preferred appeals from the order of the Commissioner (Appeals) before the Tribunal.

7. Before the Tribunal it was contended on behalf of the assessee that at the material time the word "royalty" had not been defined in the Act, and,

therefore, the general meaning of the said word had to be obtained from dictionaries. The assessee cited the Random House Dictionary and the

Webster"s New World Dictionary, where the word "royalty" was defined, inter alia, as (a) payment by lessee to the owner of the land for privilege

of working mine; (6) the amount paid to a patentee for the use of his patent; (c) payment made to author for books, etc., sold.

It was contended that the payments by the Indian company to the assessee did not fall in any of the aforesaid [categories as the assessee had not

given any patent right or copy rights or any trade name or the right to use trade name of the products of the assessee. No licence had been granted

to the Indian company by the assessee for manufacture of any item patented by the assessee. The definition of the word "royalty" in Explanation II

to clause (vi) of sub-section (1) of section 9 was incorporated with effect from 1-6-1976. In the assessment years 1973-74 and 1974-75, the

artificial meaning given to the word "royalty" could not be ascribed.

8. It was contended on behalf of the revenue before the Tribunal that Explanation II to section 9(1)(vi) merely stated the position at law, as it

always stood and, therefore, the same should be accepted in determining the nature of the payment made by the Indian company to the assessee in

the assessment years involved.

9. The Tribunal held that clauses (v), (vi) and (vii) of section 9(1) incorporated by the Finance Act, 1976, with effect from 1-6-1976 were new

pieces of legislation prospective in operation and the same could not be taken into account for resolving the controversy involved. The Tribunal

construed the meaning of the word "royalty" from the dictionaries cited on behalf of the assessee and held that royalty was compensation or

portion of the proceeds paid to the owners of a right for the use of it. Payments made against patents or oil or mineral rights were illustrations of

such payments. It was held that in the instant case payments had been made by the Indian company to the assessee for use of rights in the nature of

patent.

The Tribunal considered the definition of the word "patent" in the Patents Act, 1970 and the Indian Patents and Designs Act, 1911, and also the

provisions therein for the grant and user of patents and held that a patent was a right recognised by law for exclusive use of an invention by the

inventor who had obtained patent, therefore, or by Ms nominees or licensees against payment in lump or a periodic payment related to the

turnover or in any other manner as agreed upon. Such payment would be a payment of royalty.

The Tribunal held further that an inventor could utilise his invention without obtaining a patent and it was not legally necessary for the inventor to

obtain a patent. The inventor could exploit the invention being information or knowledge of the secret processes without getting it patented by

sharing it with others against payment who would keep such information or knowledge secret and such payments would be payments for royalty.

The Tribunal held that in the instant case it was open to the assessee to obtain patents in respect of the manufacturing processes of its products.

The assessee agreed to impart to the Indian company the knowledge and information of the process of manufacturing itself for which the Indian

company was required to make payment of a fixed percentage of the turnover and to keep the information received secret. The Tribunal held that

payment made by the Indian company to the assessee on account of the aforesaid would be royalty.

The Tribunal held further that some of the information to be imparted by the assessee under the agreement, viz., providing data, assistance and

information with regard to drawings and detailed instructions and directions of a plant to be set up in India by the Indian company as also general

information with regard to the properties of the products to be manufactured would amount rendering of a technical service and the payment

received in respect of the same would not be a royalty.

The Tribunal held that the Commissioner (Appeals) was justified in estimating a part of the payment as royalty and the balance as fees for technical

services. In the facts, the Tribunal declined to interfere with the estimate made by the Commissioner (Appeals).

10. On applications of the assessee u/s 256(1) of the Act, the Tribunal has referred the following question as a question of law arising out of its

order for the opinion of this Court:

Whether, on the facts and in the circumstances of the case, and on proper interpretation of the agreement dated 8th July 1964, between N.V.

Philips'' Gloeilampenfabrieken and Crookes Interfran Ltd. (now known as Duphar Interfran Ltd.) the Tribunal was right in holding that so much of

the payment made under clause 5 of the said agreement as was referable to the provision of such data, assistance and information as have been

referred to in clauses 2(ii) and 2(iii) thereof was to be regarded as ''royalty'' and not as technical service fees for the purpose of the income tax

assessment of N.V. philips'' Gloeilampenfabrieken for the assessment years 1973-74 and 1974-75?

11. At the hearing before us, the learned advocate for the assessee contended that at the material time the word ''royalty'' had not been defied in

the Act and as such the said word had to be construed from the commercial point of view. He submitted that any nomenclature given by the parties

in the agreement would not be conclusive or decisive. He drew our attention to the following for the meaning and definition of the word ''royalty'':

(a) Jowitt''s Dictionary of English Law, 1977 edn. ""Royalty, a payment reserved by the grantor of a patent, lease of a mine or similar right, and

payable proportionately to the use made of the right of the grantee. It is usually a payment of money, but may be payment in kind, that is, of part of

the produce of the exercise of the right.

(b) Encyclopaedia Britannica, 1972 edn., Volume 19, page 676. In this treatise ""royalty has been described as the payment made to the owners of

certain types of rights by those who are permitted by the owners to exercise the rights. The rights concerned are literary, musical and artistic

copyright, rights in inventions and designs, and rights in mineral deposits including oil and natural gas. As to inventions, a royalty may be said to be

a compensation paid under a licence granted by the owner of a patent (the licensor) to another person (the licensee) who wishes to make use of

the invention, the subject of the patent. The patent remains the property of the licensor. A licence may be exclusive, in which case the patent owner

precludes himself from granting licences to third parties, or non-exclusive, in which case the patent owner may grant licences to as many persons as

he wishes.

(c) Wharton"s Law Lexicon: In this book "royalty" has been denned as a payment to a patentee by agreement on every article made according to

the patent; or to an author by a publisher on every copy of the book sold; or to the owner of minerals for the right of working the same on every

tonne or other weight raised.

(d) Law Lexicon by Ramanatha Aiyer: In this book "royalty has been denned to meanÃ¯Â¿Â½(a) percentages or dues payable to land-owners for

mining rights; (6) suras paid for the use of a patent; (c) percentages paid to an author by a publisher on the sales of a book".

12. The learned advocate for the assessee drew our attention to the relevant provisions of the Patent Act, 1970. u/s 48 of the Patent Act, a patent

granted would confer upon the patentee the exclusive right to make, use, exercise, sell or distribute the invention in India by himself or by his agents

or licensees. Under the said section a patent can be granted for a method or processes of manufacturing of any article. u/s 5 of the Patent Act a

patent can be granted not for products prepared or produced by chemical processes but for the methods or processes of manufacture.

13. Relying on the aforesaid, the learned advocate for the assessee contended that in the instant case under the agreement between the assessee

and the Indian company, the assessee had made available to the Indian company technical information and know-how. Such information and

know-how as contemplated in the agreement do not stand in the same footing as protected rights under a registered patent. It was contended that

there was no property right on such technical information and know-how until such special knowledge and skill exclusive to the person concerned

could form the subject-matter of a patent. In such a case, the special knowledge and skill would come to constitute a property in the hands of the

person who acquired or obtained such special knowledge or skill. Otherwise, mere imparting know-how for reward cannot be held to be

conferring of any property right as such as in the case of a teacher who imparts his knowledge or skill to his pupils. Technical knowledge and

advice cannot be treated as capital assets.

The learned advocate for the assessee next contended that the Tribunal itself had held that some of the information to be imparted by the assessee

to the Indian company under the agreement would be of the nature of technical assistance and payment received, therefore, would be in the nature

of fees for such assistance. In that view, there was no reason why other technical information and knowledge to be made available by the assessee

to the Indian company should be treated differently and payment made, therefore, should be held to be a royalty. The learned advocate for the

assessee contended last that the fact that payment was being made to the assessee by the Indian company of a fixed percentage of the net selling

price of the products manufactured and sold by the Indian company would not make any difference to the quality and character of payment. The

measure or method of payment cannot determine the nature of the transaction involved.

14. The learned advocate for the revenue contended on the other hand that on a proper construction of the agreement between the assessee and

the Indian company it would appear clearly that the assessee had at its disposal information regarding working methods and manufacturing

processes of its various products which was being made available by the assessee to the Indian company. It would appear from clause (4) of the

agreement that the information disclosed by the assessee to the Indian company under the agreement was meant solely for the use of the Indian

company. The said clause further recorded that such information was being disclosed by the assessee in confidence to the Indian company and

would not become the property of the Indian company till such information would become public. The Indian company was obliged to obtain

similar undertakings of secrecy in respect of the information imparted by the assessee from its employees to the extent the latter would come to

know of the same.

The learned advocate for the revenue contended that it was apparent that such information made available to the assessee regarding methods and

manufacturing processes were exclusive to the assessee and not available to the public in general. The assessee treated such information as its own

property and made it clear that such information to the extent made available to the Indian company would not become the property of the latter.

The same was not meant to be disclosed to third party.

It was contended that, under the agreement, the Indian company was permitted to utilise such information to be imparted by the assessee for the

period of the agreement and the Indian company would pay for the use thereof at an agreed rate. If such information was not meant to become the

property of the Indian company, the same necessarily remained the property of the assessee of which the Indian company had limited use for the

specified period against periodical payment. It was contended in the aforesaid facts that part of the payment made by the Indian company to the

assessee referable for user of such exclusive information would have the character of a royalty though the assessee did not have a registered patent

in respect of such methods and manufacturing processes.

15. In support of the respective contentions of the parties, a number of decisions were cited at the bar which are considered hereafter:

(a) Mills v. Jones (Inspector of Taxes) 14 TC 769:In this case, the taxpayer had made certain improvements on a handgrenade and had obtained a

number of patents in respect of such improvements. During the great war, British Government used the said invention and a large number of

handgrenades were manufactured. After the end of the war, a Royal Commission was set up to deal with the question, inter alia, of payment to be

made to inventors whose patent had been utilised by the Government during the war. The taxpayer received substantial payment from the

Government in respect of the user, past, present and future for his patented improvements. The amount received by the taxpayer in the award was

brought to tax. It was contended by the taxpayer that as the payment was being made, inter alia, for right to use the invention in the future a part of

the said amount was capital receipt in his hands and could not be taxed. The matter was finally disposed of in the House of Lords. The facts found

by the General Commissioners that large stocks of grenades were still in existence after manufacture and that the amount of the award attributable

to future use was negligible were accepted and it was held that the taxpayer had been correctly charged to income tax.

This decision was cited for the following observations made by Bomer, LJ. in the Court of Appeal which were relied on by the revenue.

A patentee has, of course, a monopoly, and that monopoly, which is a right of preventing other people utilising his invention, is a capital asset in his

hands. He may exploit that capital asset in either or both of the following ways: he can himself exercise his invention for profit, or he can grant

licences to others to do so on payment of royalty. The profit he derives by exercising the invention himself or the profit he derives from the royalty

are profits and gains within the meaning of Schedule D, notwithstanding the fact that every year his capital asset is diminishing in value. The owner

of a secret process, such as was possessed by Mr. Handley Page, stands in a very analogous position; he has not a monopoly at law, but he has a

monopoly in factÃ¯Â¿Â½a monopoly in fact arising from the possession by Mm of the secret knowledge of the process that he is carrying: on. That

secret knowledge is as much his capital asset as is the patent monopoly the capital asset of the patentee, and, like the patent, he can use that capital

asset in either or both of the following ways; he can himself carry on the secret process or he mayÃ¯Â¿Â½it is very seldom done owing to the obvious

danger involved-grant a licence to a third person to carry on the secret process, securing himself against Ms secret process being divulged by that

third party to others. In both these cases the profits he derives from carrying on the secret process himself and the royalty he might derive from the

licensee would be annual profits or gains, within the meaning of Schedule D.

(b) Musker (H.M. Inspector of Taxes) v. English Electric Co. Ltd. [1964] 41 TC 556 (HL): In this case, the taxpayer a manufacturer of

engineering products acquired specialised information and technique in engineering processes which it kept with itself. At the request of the British

Admiralty, the taxpayer entered into an agreement with the former whereby it agreed to design and develop a marine turbine and to licence the

manufacture of turbines to other companies in the United Kingdom, Australia and Canada.

Later, the taxpayer at the request of the Ministry of Supply of the British Government entered into agreements with the Government of Australia

and an American Corporation under which the taxpayer granted licences to the latter to manufacture a bomber plane which the taxpayer had

designed and developed. Under all the aforesaid agreements the taxpayer agreed to impart manufacturing technique to the licensees in

consideration of which the taxpayer received specified lump sum payment. On these facts it was held by the House of Lords that the payments

received by the taxpayer were trading and not capital receipts. The following observations in the judgment of Viscount Redcliffe were relied on by

the assessee:

There is no property right in "know-how" that can be transferred, even in the limited sense that there is a legally protected property interest in a

secret process, special knowledge or skill can indeed ripen into a form of property in the fields of commerce and industry, as in copyright,

trademarks and designs and patents, and where such property is parted with for money what is received can be, but will not necessarily be, a

receipt on capital account. But imparting "know-how" for reward is not like this, any more than a teacher sells his knowledge or skill to his pupil....

The other point is that "know-how", though very naturally looked upon as part of the capital equipment of a trade, is a fixed asset only by analogy

and, as it were, by metaphor. The nature of receipts from it depends essentially, I think, upon the transaction out of which they arise and the

context in which they are received.

(c) P.H. Divecha and Another Vs. Commissioner of Income Tax, Bombay I, : This decision of the Supreme Court was cited for the proposition

laid down as follows:

...It may also be stated as a general rule that the fact that the amount involved was large or that it was periodic in character have no decisive

bearing upon the matter. A payment may even be described as "pay", "remuneration", etc., but that does not determine its quality, though the name

by which it has been called may be relevant in determining its true nature, because this gives an indication of how the person who paid the money

and the person who received it viewed it in the first instance. The periodicity of the payment does not make the payment a recurring income

because periodicity may be the result of convenience and not necessarily the result of the establishment of a source expected to be productive over

a certain period. These general principles have been settled firmly by this Court in a large number of cases...."" (p. 232)

(d) CIT v. Cilag Ltd. [1968] 70 ITB 760 (Bom.): In this case a foreign company entered into an agreement with it a 60 per cent Indian subsidiary

under which the Indian company was appointed the sole importer, distributor, processors and manufacturers of the products of the foreign

company in India. The agreement further provided that the foreign company would provide the Indian subsidiary the know-how for manufacture of

the active substances required for the conditioning of the products of the foreign company and also of the products in consideration of payment of

5 per cent of the actual cost to be computed on an agreed basis by way of compensation fee or royalty. On these facts it was held by a Division

Bench of the Bombay High Court that the royalties received by the assessee were income from business. The observation of Romer, LJ. in the

case of Handley Page v. Butterworth (Inspector of Taxes) [1935] 19 TC 328 noted earlier was quoted in the judgment of Desai, J.

(e) Commissioner of Income Tax (Central) Vs. Hindusthan General Electrical Corporation Ltd., : In this case one of the questions which arose

before a Division Bench of this Court was whether know-how made available and utilised for a long period by the person to whom it was made

available would constitute a permanent benefit and the consideration received for such know-how would be capital or revenue receipt. Following

the decision of the House of Lords in the case of Musker (supra), it was held that by obtaining know-how no capital asset would be acquired.

The Division Bench observed as follows:

...Royalties, usually, are periodical payments for continuous enjoyment of certain benefits under a contract. In every case payment of royalty is not

a capital expenditure. In our case the various types of payments that the assessee has to make seem to be closely related to the assessee''s

manufacturing processes of ''Simple'' products. In other words, these payments are intimately linked up with the manufacturing activities of the

assessee and not with the capital values of the assets that the assessee would require. They cannot, strictly speaking, be said to be the purchase

price of these assets. It is true that the assessee''s foreign principals would be imparting their ''know-how'' to the assessee for a reward : but that is

assessee''s foreign principals were merely supplying technical information to enable the assessee to carry on business in terms of the agreement.

(p. 257)

(f) Commissioner of Income Tax, Bombay City-I Vs. Gilbert and Barker Manufacturing Co., U.S.A., : In this case, it was held by a Division

Bench of the Bombay High Court on facts that it was possible to make available know-how by one person to another on the basis of a licence and

the same would be a method of carrying on a business by the person who has the know-how. The Court quoted with approval the observation of

Romer, LJ., in the case of Handley Page (supra) which has been noted earlier.

(g) COMMISSIONER OF Income Tax, GUJARAT-I Vs. AHMEDABAD MANUFACTURING and CALICO PRINTING CO., : In this

case, the assessee, an Indian company, entered into an agreement with an English company under which the foreign company granted to the

assessee sole and exclusive right and licence to manufacture, sell, distribute and exploit the products of the English company with improvements

and modifications in India and the use of any Indian patent owned by the English company in respect of the said products. The English company

also agreed to make available to the assessee or its authorised agents know-how within the knowledge of the English company for use by the

assessee for manufacture of the products of the English company in India. The English company also agreed to make available to the assessee

benefits or results of future research and development by the English company relating to its products and to furnish to the Indian company at the

execution of the agreement secret or patent formulations used by the English company for the manufacture of its products. The assessee undertook

to maintain secrecy of the formulation, methods and processing of products of the English company and all improvements or modifications thereof

and further agreed not to disclose or give any other person in India the benefits of such research, invention or patents relating to the said know-

how. Under the agreement, the assessee was required to pay 1 per cent of the net sale proceeds of the products manufactured by the assessee in

India to the English company. Such payment was described as research contribution. No further fee or remuneration was payable by the assessee

to the English company.

The assessee contended that what it had paid to the English company under the head "Research contribution" were, in fact, payments of royalty

and liable to deduction of tax at source at a lower rate. The revenue contended to the contrary. On these facts, it was held by a Division Bench of

the Gujarat High Court that the agreement between the assessee and the English company was only for a period of 10 years and provided for

exploitation of secret formulation, patent and various other rights of the English company by the assessee in India exclusively. The payment was a

payment of royalty. The High Court considered the meaning of the expression "royalty" as appearing in various dictionaries as also in foreign law

on international commercial agreements.

(h) CIT v. Dunlop Rubber Co. Ltd., (1983) 142 ITR 493 (Delhi) : In this case the assessee was a non-resident English company and had a

network of subsidiaries and associate companies all over the world. The assessee maintained technical research establishments in the U.K. from

which latest information, processes and invention relating to goods manufactured by the assessee were communicated to its subsidiaries and

associate companies. Under an agreement entered into by and between the assessee and its Indian subsidiary, the latter agreed to pay to the

assessee a proportionate part of the cost and expenses including salaries and research and development expenditure incurred by the assessee for

acquisition, discovery and development of information, processes and invention. The Government of India permitted the Indian subsidiary to pay to

the assessee research contribution to be paid on the volume of sales by the Indian company subject to a ceiling. The question arose whether the

amounts paid by the Indian subsidiary to the assessee were payments of or in the nature of royalty or the same were merely being reimbursement

of expenses. It was held by a Division Bench of this Court on the facts as found that payment was made by the Indian subsidiary to the assessee

for sharing of expenses of research. It was noted that the agreement did not provide as to ultimately what would happen to the information

furnished by the assessee to the Indian subsidiary and it was observed that if the agreement provided that the information would belong either to

the assessee or to the subsidiary on payment then it could have been contended that the payments were either royalty or hiring charges for such

information and as such taxable income.

(i) Commissioner of Income Tax Vs. Stanton and Stavely (Overseas) Ltd., : In this case, the assessee a non-resident company incorporated in the

U.K. entered into an agreement with the Indian Iron & Steel Co. Ltd. under which the assessee authorised the Indian company to use during the

continuance of the agreement the information to he communicated to the Indian company for manufacture of the products of the assessee in a

specified territory. The agreement further provided that the assessee would act as consultants of the Indian company on the manufacture of

products of the assessee and would advise the Indian company on problems of technical nature and impart to the Indian company particulars of all

improvements in the manufacturing technique of such product which would result from research carried out by the assessee during the continuance

of the agreement. The assessee also agreed to provide to the Indian company during the continuance of the agreement a licence and authority to

use its patents in respect of products manufactured by it. In consideration of the aforesaid, the Indian company agreed to pay to the assessee-

commission at a specified date to be calculated on the net selling price of the products of the assessee manufactured and sold by the Indian

company during the continuance of the agreement. The question which arose was whether the amounts paid by the Indian company to the assessee

by way of commission were in the nature of royalty and fees within the meaning of rule 1(ix) and rule 1(x) of the First Schedule to the Companies

(Profits) Surtax Act, 1964, and were required to be excluded from the total income of the assessee in computing its chargeable profits. A Division

Bench of this Court affirmed the finding of the Tribunal on these facts and held that the amounts described as commission in the agreement between

the assessee and the Indian company were in the nature of royalties and fees and were entitled to the exemption provided by the said rules of the

said Act. This Court considered the dictionary meaning of the terms "royalty" and "fee". It was observed that the "nomenclature" used by the

parties which were not defined in the statute were required to be construed on the basis of commercial principles and concepts as understood

generally by people in trade or commerce. The nomenclature given by the parties would not be conclusive or decisive of the matter.

(j) Citizen Watch Company Ltd. Vs. Inspecting Asst. Commr. of I.T., Range-V, Bangalore and Others, : This judgment is that of a learned Judge

of the Karnataka High Court delivered in a writ petition. In this case the assessee, a non-resident company, incorporated in Japan entered into a

collaboration agreement with the Government of India under which the assessee agreed to supply technical know-how to the Government for

establishment of a modern watch factory in India. The Government set up a company known as Hindusthan Machine Tools Ltd. wholly owned by

the Government and transferred its rights, obligations and responsibilities under the agreement with the assessee to the Indian company. The

agreement provided for payment of various amounts to the assessee for services and the technical know-how to be provided by the assessee to

the Government or the Indian company. The said payments were respectively for supply of drawings and other information, a fee for technical and

other assistance as agreed as also a royalty at a specified rate to be calculated on the price of the watches to be manufactured by the Indian

company. It was held by the learned Judge that the amounts paid to the assessee by the Indian company on account of documentation and

technical assistance fees were separate and were not payments of royalty or in the nature of royalty within the meaning of the double taxation

agreement entered into by and between the Government of India and Japan. The Court considered the meaning of the term "royalty" from the

English and legal dictionaries and held that royalty is a payment made for the use of patents, etc., but did not include a fee payable for supply of

document and information.

16. In the instant case, in the agreement dated 8-7-1964, the assessee agreed, inter alia, to furnish information to the Indian company from time to

time in respect of the following:

(a) working methods,

(b) manufacturing processes including indications, instructions, specifications, standards and formulas,

(c) methods of analysis, and

(d) quality control.

The agreement provided that any information disclosed by the assessee to the Indian company would be solely for the use of the Indian company.

The same would be considered as having been disclosed in confidence and would not become the property of the Indian company till such

information would otherwise before public by application and user.

The agreement further provided that the Indian company would take all reasonable care to keep such information supplied by the assessee as

confidential and would not disclose the same to the third party.

17. It appears to us from the aforesaid provisions of the agreement that the assessee considered the information to be supplied to the Indian

company by the assessee under the said agreement as exclusive and not generally available. The fact that the agreement required the Indian

company not to treat the information furnished by the assessee as its own property indicates further that the assessee intended and treated the

information to be supplied by it as its own property. Under the agreement the assessee would be entitled to utilise and use such information for the

period of the agreement.

18. From the dictionary meaning of the term "royalty", it appears that the said term connotes payments periodic or at a time for user by one person

of certain exclusive rights belonging to another person. The examples of such exclusive rights are rights in the nature of a patent, mineral rights or

right in respect of publications. It appears to us that the person who grants the user of the exclusive right might have the sanction of law which

guarantees the exclusiveness. Such sanction may be obtained by taking out a patent in respect of an invention. In other cases, such exclusive right

would arise from the ownership of mineral rights, protected by the laws relating to property. In respect of books and publication the exclusive right

of the author is protected and sanctioned by the laws of copyright.

19. It is possible that a person who invents may not take out a patent for his invention but unless some other inventor independently and by his own

efforts come to duplicate the invention the original invention remains exclusive to the inventor and it is conceivable that such an inventor might

exploit his invention permitting some other person to have the user thereof against payment. Similarly, it is possible for a person carrying out

operations of manufacture and production of a particular produce to acquire specialised knowledge in respect of such manufacture and production

which is not generally available. A person having such specialised knowledge can claim exclusive right to the same as long as he chooses not to

make such specialised knowledge public. It is also conceivable that such a person can exploit and utilise such specialised knowledge in the same

way as a person holding a patent or owning a mineral right or having the copyright of a publication to allow a limited user of such specialised

knowledge to others in confidence against payment.

20. There is no reason why payment for the user of such specialised knowledge, though not protected by a patent, should not be treated as royalty

or in the nature of royalty.

The analogy of a teacher imparting his knowledge to his students upon payment which has been cited on behalf of the assessee cannot apply in all

force in the facts before us. A teacher may have specialised knowledge but such knowledge is not exclusive. Such knowledge might be obtained

from any other teacher who professes to teach the same subject. It is the exclusiveness of the specialised knowledge which can be utilised for the

purpose of business which, in our view, would determine the issue. We agree respectfully with the observations of Romer, LJ. in Handley Page"s

case (supra) which have been quoted with approval by our High Courts.

21. From the decisions cited before us, it appears that the nomenclature used by the parties in respect of a particular service would not be decisive

of the matter but such nomenclature has to be construed on the basis of commercial principles. In the case before us, the assessee was entitled to

receive from the Indian company 5 per cent of the net selling price of the manufacturing product as a consideration for supply of both technical

assistance information. It is significant that a distinction had been made in the agreement between technical assistance and information. Technical

assistance may be rendered also by supply of information although, in our view, such information by way of technical assistance would be

information of general nature. But supply of exclusive and specialised information on the basis of which production and manufacture is possible, in

our view, goes beyond the concept of assistance and falls into the category of a right of user of an exclusive property right.

22. For the reasons as aforesaid, we accept the conclusion of the Tribunal and hold that the information agreed to be supplied by the assessee in

respect of working methods and manufacturing processes of the product under clause 2(ii)/(iii) are exclusive information and knowledge available

to the assessee and not generally disseminated and payment in respect thereof would bear the character of royalty.

23. For the reasons as aforesaid, we answer the question referred in the affirmative and in favour of the revenue. The reference is disposed of

accordingly without any order as to costs.

Shyamal Kumar Sen, J.

24. While agreeing with my learned Brother I wish to add the following:

25. The facts that the company would keep all information received from the assessee solely for the purpose of its use in the factory and would

treat the same, as having been disclosed in confidence and that it shall not become the property of the company until such time as and to the extent

of that such information or any part thereof becomes public. As a result of user or disclosure really show that the assessee treated the said

processes and information as its own exclusive property and did not part with the same except on the above restriction. The analogy of a teacher in

parting with his knowledge to the pupil cannot have any application because the teacher does not impose such restriction. It has been expressly

provided In that agreement that the company agreed that it would take all reasonable care to keep such information confidential and not to disclose

the same to the third parties only show that this is in the nature of an exclusive right or property of the nonresident assessee and only permission

was granted to utilise the same for its own specific use in a particular manner by the Indian company. It was further provided that the Indian

company would not copy the equipment, tools and instruments or any part thereof supplied by the assessee to the company nor would cause or

permit the same to be copied. Although no licence has been granted by owner of a patent in this case but this is analogous to the position of a

patent owner granting a licence because this is really a permission granted to use the secret process exclusively in a particular manner meant only

for Indian company and not to be disclosed the same to the third parties. Therefore, it is clear that the non-resident assessee itself treated the

method of manufacturing process carried on by it as its exclusive secret process over which it had exclusive domain and wanted the same to be

kept secret and not meant for the public and granted the company right to utilise the same only in the aforesaid restricted manner. This secret

knowledge in this case is as much its capital asset as is a patent, a monopoly and a capital asset of the patentee as observed by Romer, LJ. in the

case of Handley Page (supra) at page 328 of the said report. This secret process which the non-resident assessee-company is parting with in this

case is analogous to the parting of a monopoly right of the patentee and, therefore, the remuneration received by the assessee for the same should

be treated as royalty and for the reasons as aforesaid the answer to the question referred should be in the affirmative and in favour of the revenue.