

**Ericsson Communication Ltd. Vs. Dy. Cit**

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**Court :** Delhi

**Decided On :** Dec-14-2001

**Reported in :** (2002)74TTJ(Del)337

**Appellant :** Ericsson Communication Ltd.

**Respondent :** Dy. Cit

**Advocate for Pet/Ap. :** M.S. Syali,;Rajiv Anand; & Shyamal Mukherjee, for the assessed;

**Judgement :**

ORDER

K.C. Singhal, J.M.

Both the appeals were heard together and are being disposed of by the common order for the sake of convenience. ITA No. 4494 is against the order of the Commissioner (Appeals) confirming the action of assessing officer under section 201(1) of the Income Tax Act, 1961 (hereinafter referred to as the Act) demanding the tax which ought to have been deducted at source by the assessed under section 195. ITA No. 4495 is against the order of the Commissioner (Appeals) confirming the levy of interest under section 201(1A) of the Act.

2. The brief facts giving rise to these appeals are these. The assessed is a 100 per cent subsidiary company of M/s. Telefonaktiebolaget L.M. Ericsson, Sweden (hereinafter referred to as LME') which was incorporated in India in pursuance of

the approval dated 5-2-1996, granted by Ministry of Industry, Government of India. It is engaged in the business of setting up/installation and commissioning of telecom projects and setting up of information technology system relating thereto. It entered into a Corporate Visual Identity Agreement with LME on 1-1-1997, for the use of their trademark 'Ericsson'. As per the terms of the aforesaid agreement, the assessed was required to pay royalty @1 per cent of total net sales to LME for the use of the trademark 'Ericsson' on all its product. On 30-12-1997, the assessed made a provision for royalty in its books of accounts as follows:

Royalty a/c

Debit

Rs. 2,24,96,669

Accrued expenses a/c

Credit

Rs. 2,24,96,669

No tax was deducted by ECPL at the time of passing these entries. On 18-8-1989, ECPL passed the following entries :

Accrued expenses a/c

Debit

Rs. 2,24,96,669

LM Ericsson a/c

Credit

Rs. 2,24,96,669

3. A survey under section 133A of the Act was conducted at the premises of the assessed on 9-10-1998, in the course of which it was discovered that the

assessed had not deducted the tax while making the above-mentioned entries.

Subsequently on 17-12-1998, the assessed reversed the above entries by passing the following entries :

LM Ericsson a/c

Debit

Rs. 2,24,96,669

Royalty a/c

Credit

Rs. 2,24,96,669

According to the assessing officer, the assessed should have deducted the tax at source under section 195 in respect of the sum attributable to royalty. The Explanationn of the assessed was that under the industrial policy of the government, royalty payment by a 100 per cent subsidiary company to its overseas holding company was not permissible. Hence, no income had accrued to LME and, thereforee, it could not be said that royalty sum was chargeable to tax under the Act and consequently, assessed was not required to deduct the tax at source. This Explanationn was not accepted by the assessing officer since in his view, the payment of royalty was clearly an income chargeable to tax under the Act. It was further observed by him that there was no restriction in the approval granted by FIPB. According to him, RBI would have allowed the remittance of this amount on the basis of the above approval. Hence, it was held by him that income had accrued in the hands of foreign company and the assessed was in default by not deducting the tax at source under section 195. Consequently, the demand of Rs. 1,07,98,401 was created under section 201(1) which was subsequently reduced to Rs. 44,99,334 under section 154.

4. As a result of the order under section 201(1), the assessing officer also levied interest under section 201(1A) amounting to Rs. 39,14,480 vide order dated 7-3-2000, which was later on rectified under section 154 and the interest was reduced

to Rs. 16,31,009.

5. The matter was carried before the Commissioner (Appeals), who has upheld the order of assessing officer under section 201(1) by holding as under :

'(1) Income from royalty accrued to the parent foreign company by virtue of the Corporate Visual Identity Agreement. This agreement has neither been abrogated nor modified so as to remove the consideration clause in para 17. The foreign company also did not waive its right to receive the royalty. therefore, as per the terms of the agreement, the income from royalty accrued to the foreign company the moment sale was made by the Indian company, i.e., assessed. therefore, a legally enforceable right to earn the royalty arose from the agreement and consequently, the income by way of royalty was chargeable to tax. Reliance was placed on the Supreme Court judgment in the case of Tuticorin Alkali Chemicals & Fertilisers Ltd. v. CIT : [1997]227ITR172(SC) .

(2) The 'New Industrial Policy' of the Government of India was tabled in Parliament on 24-7-1991. As per this policy, the government decided to take a series of initiative in respect of foreign investment and other matters. The policy clarifies that there shall be no bottleneck for giving approval to foreign investment. Consequent to the new policy, any number of multinationals have been doing business in India through their wholly-owned subsidiaries and are making remissions including royalty remissions to the non-resident parent company.

(3) Under the provisions of section 195 the liability to deduct tax at source arises at the time of credit of income to the non-resident.

The appellant was accordingly liable for deduction of tax at source at the time it credited the sum of Rs. 2,24,96,669 to the royalty account. Subsequent events or problems in the actual remission of the royalty cannot justify the failure of the appellant to discharge her statutory obligation.

In view of the above findings, the Commissioner (Appeals) upheld the action of assessing officer under section 201(1) as well as levy of interest under section 201(1A). Aggrieved by the same, the assessed is in appeal before the Tribunal

against both the orders.

6. The learned counsel for the assessed has seriously assailed the orders of the Commissioner (Appeals) by contending that no income accrued to the non-resident parent company inasmuch as the agreement itself between assessed and LME was opposed to the industrial policy by the Government of India. According to him, such agreement was void by virtue of the provisions of the Contract Act, 1872, and, therefore, no enforceable right accrued from such agreement. He also drew our attention to para 6(ii) of the industrial policy appearing at page 5 of the paper book which prohibits payment of royalty by 100 per cent subsidiaries to non-resident parent company. He then drew our attention to the letter of the assessed dated 28-6-2000, addressed to the Under Secretary, Foreign Investment Promotion Board, New Delhi, seeking clarification as to whether royalty payment could be made by the assessed to its parent company. This letter appears at page 15 of the paper book. He then drew our attention to the reply by the Ministry of Commerce and Industry dated 11-7-2000, wherein it has been clarified that royalty payment could not be made by the assessed to the parent foreign company. He also drew our attention to Press Note No. 9 (2000 series) dated 8-9-2000, appearing at per page 111 and 112 of the paper book which permitted the payment of royalty by subsidiary company to its non-resident parent company. In view of these materials, it was submitted by him that payment of royalty by 100 per cent subsidiary company to its holding company was permitted by the Government of India only with effect from 8-9-2000, and prior to that there was absolute prohibition for paying the same. Further, the agreement between the parties for payment of royalty against the use of trademark was never approved by the Government of India and, therefore, such agreement was void in the eye of law and consequently, no enforceable right or liability accrued to either party under the said agreement. In support of his contention, he relied on the decision of the Delhi High Court in the case of Universal Plast Ltd. v. Santosh Kumar : AIR1985 Delhi383 . therefore, it was strongly argued by him that no enforceable debt was created in favor of the non-resident parent company and consequently, no income accrued to LME. Hence, assessed was not liable to deduct tax at source under section 195. Consequently, assessed could not be deemed as assessed-in-default under section 201 of the Act. Regarding the decision of Supreme Court in the case

of Tuticorin Alkali Chemicals & Fertilizers Ltd. (supra), it was submitted by him that the said decision is distinguishable inasmuch as the accrual of income itself is challenged in the present case. Regarding the entries in the books of accounts, it was submitted by him that these are not determinative of the accrual of income. Regarding the finding No. 2 of the Commissioner (Appeals) as noted by us in earlier paragraph, it was submitted by him that the same is unwarranted since it is not supported by any material or evidence. Accordingly, it was prayed by him that order of Commissioner (Appeals) be quashed since there was no liability on the assessed to deduct the tax at source as there was no accrual of income in the hands of non-resident foreign company.

7. On the other hand, the learned Senior Departmental Representative has strongly supported the order of the Commissioner (Appeals) by reiterating the reasonings given by the assessing officer as well as Commissioner (Appeals) and, therefore, the same need not be repeated. In addition, it was argued by him that accrual of income is not affected by void or voidable agreement. According to her, even the income from illegal contract or business is taxable in view of Supreme Court decision in the case of CIT v. Pyara Singh : [1980]124ITR40(SC) . Proceeding further, it was submitted that a contract can be said to be void only if it is prohibited by a statute and, therefore, the agreement in the present case cannot be said to be void inasmuch as there is no provision of a statute prohibiting the payment of royalty by the assessed to non-resident foreign company. According to her, the policy of the government cannot be equated with the provision of a statute. In this connection, she relied on the decision of Supreme Court in the case of CIT v. S.C. Kothari : [1971]82ITR794(SC) . Particular attention was drawn to the observation of their Lordships at page 799 wherein it is ruled that contracts which are prohibited by statute would be illegal. Further reliance was placed on the decision of Karnataka High Court in the case of United Breweries Ltd. v. Assistant Commissioner : [1995]211ITR256(KAR) . She also relied on the decision of Calcutta High Court in the case of Satyanarayan Rungta v. CIT : [1978]115ITR382(Cal) for the proposition that the agreement is not void even though it may be against government policy. She further relied on the decision of Allahabad High Court in the case of Harinder Singh v. Income Tax Officer : [1987]166ITR763(All) for the proposition that under the Act, the authorities are not

concerned with whether the activities of the assessed are legal or illegal. Lastly, she placed reliance on the Supreme Court decision in the case of CIT v. Shiv Prakash Janak Raj & Co. : [1996]222ITR583(SC) for the proposition that the concept of real income cannot be employed so as to defeat the provisions of the Act and rules and, therefore, there is no room nor it would be permissible for the court to import the concept of real income so as to whittle down, qualify or defeat the provisions of the statute. It was further argued by her that both the parties entered into the agreement with the intention to act upon the same and in furtherance thereof, the necessary entries were made by the assessed which itself shows that income accrued from the contract. The reversal of entries were made only after the survey. therefore, it cannot be said that income did not accrue to the non-resident company. It was also submitted by her that only the guidelines have been issued by the Government which are in the nature of administrative guidelines and could be changed at any time by the government and consequently, such guidelines could not be considered as law. therefore, it could not be said that agreement between the parties was prohibited by law.

8. In reply, the learned counsel for the assessed relied on the decision of the Supreme Court in the case of Maddi Venkataraman & Co. (P) Ltd. v. CIT : [1998]229ITR534(SC) wherein illegal business has been distinguished from illegal act in the course of regular business. It was further submitted by him that the issue regarding accrual of income was never before the court in the cases relied upon by the learned Senior Departmental Representative. He did not dispute the submissions of learned Senior Departmental Representative that terms of the policy could be changed at any time but submitted that no payment could legally be made till such policy was changed. He pointed out that the policy was, in fact, changed with effect from 8-9-2000 when payment of royalty was permitted by 100 per cent subsidiary company to non-resident parent company. therefore, prior to 8-9-2000, no income accrued to LME. Consequently, income can be said to accrue only after 8-9-2000. He also relied on the decision of Supreme Court in the case of Non Such Tea Estate Ltd. v. CIT : [1975]98ITR189(SC) wherein it has been ruled that the expenditure, which required approval of Central Government could not be allowed as deduction in the absence of such approval. On the same reasoning, it was submitted by him that no income can be said to accrue if the

payment of any sum is prohibited by the policy of the government. Proceeding further, it was submitted that policy of the government has the backing of Art. 73 of Constitution of India and, therefore, Senior Departmental Representative is not right in contending that agreement can be said to be void only if it is prohibited by statute. Lastly, it was stated by him that the case law relied upon by the Senior Departmental Representative are distinguishable on facts.

9. The rival submissions of the parties, the material placed before us and the case law referred to by the parties have been considered carefully. The moot question for our consideration is whether the assessed can be said to be an assessed-in-default under section 201(1). According to this section, a person is deemed to be an assessed-in-default if he or it does not deduct or after deducting fails to pay the tax as required by or under the Act. According to the assessing officer, the assessed failed to deduct the tax under section 195 in respect of royalty payable under the agreement dated 1-1-1997, to the non-resident parent company. According to section 195, every person responsible for paying any interest (not being interest on securities) or any other sum chargeable under the provisions of this Act (not being income chargeable under the head 'salaries') is under obligation to deduct the tax at source at the time of credit of such income to the account of the payee or at the time of payment thereof. So the condition precedent for invoking section 195 is that the sum being paid or credited must be chargeable to tax under the Act. Section 4 of the Act is a charging section according to which, the total income of every person is chargeable to tax. The total income of a non-resident, as per section 5(2), includes all income which is either received in India, or accrues or arises or is deemed to accrue or arise in India. The income which is deemed to accrue or arise in India is defined in section 9 with which we are not concerned in the present case since the case of the assessing officer is that income by way of royalty accrued to the assessed in India as per the terms of agreement between the assessed and LME.

10. Admittedly, in the present case, there is no dispute that LME is a non-resident company. It is also not in dispute that there is no actual payment of royalty by the assessed to LME as is apparent from the finding of assessing officer to the effect. Hence, the transaction was complete except that the physical payment had to be

made to the foreign party'. Reference can be made to reason No. 3 given by assessing officer for rejecting the contentions of the assessed. thereforee, the only question to be considered is whether any income by way of royalty accrued to the LME in terms of the agreement dated 1-1-1997. It is a settled legal position that income accrues only when an enforceable debt is created in favor of the recipient. Reference can be made to the well known judgment of the Hon'ble Supreme Court in the case of E.D. Sassoon & Co. Ltd. & Ors. v. CIT : [1954]26ITR27(SC) . An enforceable debt is created only for an enforceable agreement, i.e., a valid contract. An agreement which is not enforceable is void in the eye of law and, thereforee, no enforceable debt can be said to have been created by virtue of such agreement. In order to decide the validity of the agreement between assessed and LME, let us have a look at the relevant provisions of the Contract Act, 1872.

11. According to section 2(g) of the Contract Act, an agreement not enforceable by law is said to be void. According to clause (h) of this section, an agreement enforceable by law is a contract. Further as per clause (j) of this section, a contract which ceases to be enforceable in law becomes void when it ceases to be enforceable. According to section 23, the consideration or object of an agreement is lawful unless (i) it is forbidden by law; (ii) it is of such a nature that if permitted would defeat the provisions of any law; (iii) it is fraudulent; (iv) it involves or implies injury to the person or property of another; (v) the court regards it as immoral or opposed to public policy. It further provides that every agreement, of which the object or consideration is unlawful, is void. The perusal of the aforesaid provisions reveals that an agreement would be void if inter alia, it is forbidden by law or opposed to public policy or if it defeats the provisions of any law. A void agreement is considered as non est in the eye of law. thereforee, in case of void agreement, it cannot be said that any right or liability accrues or arises to either of the parties of such agreement.

12. The aforesaid legal position is fortified by the decision of the Hon'ble Delhi High Court in the case of Universal Plast Ltd. v. Santosh Kumar Gupta (supra). In that case the plaintiff agreed to sell 4,200 spindles with motor and accessories to the defendant against consideration of Rs. 1,02,440. The defendant agreed to pay Rs. 10,000 in advance and balance amount by 3-9-1973. The agreement was by

virtue of letter, dated 5-7-1973, which recorded a fact that possession of spindles had already been delivered to defendant. Since, the defendant did not make the balance payment, the plaintiff filed a suit for recovery of the same along with interest. The defendant inter alia, raised a contention that agreement was void since the spindles could not be disposed of in view of the absolute prohibition by the provisions of Woollen Textiles (Production and Distribution) Control Order, 1962, issued under the Essential Commodities Act, 1955. Consequently, the suit could not be decreed in favor of the plaintiff. After referring to various decisions of Hon'ble Supreme Court, the High Court held that the agreement between the parties was void and therefore, the claim of plaintiff could not be allowed. The relevant observations of the Hon'ble Delhi High Court (as per headnote) were as under :

'The prohibition in law to the transfer of spindles is absolute. The law is so strict that no one could even change the location of the spindles. Transfer could be effected only with the prior permission in writing of the Textile Commissioner. Permission of the Textile Commissioner is not, therefore, an idle formality.

Where an agreement to sell spindles was entered into without prior permission of the Textile Commissioner in spite of prohibition against sale of spindles without such permission contained in a Control Order issued under the Essential Commodities Act, the agreement being illegal, could not be enforced. For similar reasons, the buyer who had paid advance in pursuance of the agreement, would not be able to recover it. In such a case, it could not be said that as penalty and prosecution is provided if there is contravention of the provisions of clause 3 of the Control Order, the agreement for sale of spindles which was without any prior written permission of the Textile Commissioner, could be given effect.'

The only other aspect of the issue remains to be considered is whether the prohibition by any policy of Government of India would render the agreement void. After giving our deep thoughts to the issue, we are of the view that the word 'law' not only includes the provisions of an enactment or rules made there under but also the policies of the Government of India which the government can declare in conformity with the provisions of the Constitution of India. The policies of

Government of India have the backing of article 73 of the Constitution of India which provides that powers of the executives of Union of India shall extend to the matters with respect to which Parliament has power to make laws. The Hon'ble Supreme Court in the case of *Ram Jawaya v. State of Punjab* : [1955]2SCR225 has held that functions of executives are not confined to the executions of laws made by the legislature but are co-extensive with legislative powers of Union of India. thereforee, the policies declared by Government of India are enforceable at law and consequently, any agreement opposed to such policy would be void. Even otherwise, section 23 of the Contract Act itself declares the agreement void if it is opposed to public policy. thereforee, the contention of the learned Senior Departmental Representative that only the prohibition by the provisions of a statute would render the agreement void, cannot be accepted.

13. Having held as above, let us now examine as to whether the agreement between the assessed and the non-resident company 'LME' can be said to be void. Para 6(ii) of the industrial policy declared by Ministry of Industry for the consideration of Foreign Direct Investment (FDI) proposals by the Foreign Investment Promotion Board (FIPB) reads as under :

'6. The Board should examine the following while considering the proposals submitted to it for consideration : (ii) whether the proposal involves technical collaboration and if so (a) the source and nature of technology sought to be transferred, (b) the terms of payment (payment of royalty by 100 per cent subsidiaries is not permitted).'

The assessed vide letter dated 28-6-2000, sought clarification as to whether the assessed could pay the royalty to its foreign parent company by virtue of the approval letter of the government dated 5-2-1996. The Government of India, Ministry of Commerce and Industry, Department of Industrial Policy and Promotion vide letter dated 11-7-2000, addressed to the assessed clarified as under :

'I am directed to refer to your letter dated 28-6-2000, on the above mentioned subject and to clarify that neither the FC approval dated 5-2-1996 permits payment of royalty to the foreign collaborator nor does the extant policy provide for royalty payment to the parent foreign collaborator by the Indian wholly owned subsidiary.'

The material placed before us further shows that Government of India, Ministry of Commerce and Industry, Department of Industrial Policy and Promotion (FC Division) vide Press Note No. 9 (2000 series) dated 8-9-2000 declared as under :

In pursuance of government's commitment to liberalising the FDI regime, government on review of the policy on FDI, has decided to bring about the following changes in the FDI policy :

(I) .....

(II) .....

(III) Payment of royalty up to 2 per cent for exports and (per cent for domestic sales is allowed under automatic route on use of trademarks and brand name of the foreign collaborator without technology transfer.

(IV) Payment of royalty up to 8 per cent on exports and 5 per cent on domestic sales by wholly owned subsidiaries to offshore parent companies is allowed under the automatic route without any restriction on the duration of royalty payments.

(V) Offshore Venture Capital Funds/Companies are allowed to invest in domestic venture capital undertaking as well as other companies through the automatic route, subject only to SEBI regulations and sector specific caps on FDI.'

The assessed, again vide letter dated 5-4-2001, sought clarification from the Foreign Investment Promotion Board, Ministry of Commerce and Industry by writing as under :

'Our company is a 100 per cent subsidiary of Telefonaktiebolaget L.M. Ericsson, Sweden. We had entered into an agreement without overseas parent company effective from 1-1-1997, for the payment of royalty for use of trademark. The Government of India, vide Press Note No. 3 (1997 series) dated 17-1-1997 published guidelines for the consideration of proposals by the Government (FIPB) which prohibited the payment of royalty by 100 per cent Indian subsidiaries to their overseas parent companies.

We would be grateful if you could kindly clarify whether royalty payment by 100 per cent Indian subsidiaries to their foreign parent companies for use of trademark was permissible under law prior to 17-1-1997, when these guidelines were published.'

The Government of India vide letter dated 12-4-2001, replied as under :

'I am directed to refer to your letter dated 5-4-2001 on the above-mentioned subject with reference to this Ministry's letter referred to above and to clarify that prior to the issue of Press Note No. 3, dated 17-1-1997, royalty on sale or use of trademarks was prohibited to 100 per cent subsidiaries. Royalty for sale or use of trademarks has been permitted only with prospective effect from 8-9-2000, in accordance with the provisions of Press Note No. 9 (2000).'

The above material clearly shows that payment of royalty by 100 per cent subsidiary company to its non-resident parent company was absolutely prohibited under the policy of the Government of India till 8-9-2000. The payment of royalty was only permitted by the government by virtue of Press Note No. 9 of 2000 series dated 8-9-2000. thereforee, at the time when agreement was entered into, there was absolute prohibition for payment of royalty by 100 per cent subsidiary company to its non-resident parent company. Admittedly, the assessed is 100 per cent subsidiary company of the non-resident foreign company 'LME'. Further, undisputedly the agreement was entered into on 1-1-1997, when there was absolute prohibition for payment of royalty. thereforee, it is held that the agreement between the assessed and 'LME' was opposed to the industrial policy declared by the Government of India and, thereforee, the agreement was void by virtue of section 23 of the Contract Act.

14. Regarding entries in the books of account of the assessed, we are of the view that such entries are not determinative of the nature of income. Reference can be made to the decision of Hon'ble Supreme Court in the case of Tuticorin Alkali Chemicals & Fertilisers Ltd. (supra) wherein it has been held that accounting system, even though recognised by Institute of Chartered Accountant, cannot override the legal position. thereforee, if the income does not accrue to the assessed, then he cannot be charged to tax merely because certain entries are

made in the books of account under mistaken view of law. As far as, second finding of Commissioner (Appeals) as noted by us is concerned, it is not supported by any material or evidence and therefore, is vacated.

15. In view of the above discussion, it is held that agreement being void was unenforceable in law and consequently, no enforceable debt was created in favor of 'LME'. As a result thereof, it is further held that no income accrued under the Act with reference to any royalty amount by virtue of section 5(2). Hence, assessed was under no obligation to deduct tax at source under section 195. therefore, the assessed could not be deemed to be an assessed-in default under section 201(1). Consequently, no interest under section 201(1A) could be charged. Accordingly, both the orders of Commissioner (Appeals) are set aside and the demand of tax under section 201(1) and interest levied under section 201(1A) are hereby deleted.

16. In the result, both the appeals are allowed.