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Court : Income Tax Appellate Tribunal ITAT Delhi

Decided On : Aug-31-2004

Reported in : (2005)1SOT59(Delhi)

Appellant : Hcl Ltd.

Respondent : Asstt. Cit

Judgement :

The assessee, hereinafter known as HCL, entered into an agreement styled "manufacturing and software license agreement" on 1-9-1987 with an American company which at that time was known as Tolerant, which name was changed later to Veritas. The agreement was for the supply of technology relating to the manufacture of computers in India and related software. Under clause 2.1 of the agreement, HCL was to be granted a license and technology transfer for the technology, including all items listed in Exhibit B, subject to the payment of the "manufacturing license payment stipulated in clauses 5.1 and 5.2 of the agreement. Under this clause, HCL agreed to pay Tolerant a "one time charge of five hundred thousand US dollars (\$500,000)" and the same had to be paid in the following manner: (a) \$ 200,000 to be paid as initial payment within ten days after the effective date of the agreement. (b) \$200,000 after the delivery of the source materials as described in Exhibit B and the completion of the initial assistance conducted for HCL by Tolerant, whichever is earlier, unless the source materials have not been delivered by such date, in which case the payment will be made immediately upon delivery of the source material; and (c) the final payment of \$

100,000 shall be due to Tolerant on 30-6-1987 and payable to Tolerant by certain dates with which we are not concerned in this appeal. Clause 7 of the agreement provided for limitation of the liability of Tolerant. Clause 8.3.1 provided for the execution of a "Deposit Agreement" concurrently with the execution of the manufacturing and software license agreement in the form prescribed in Exhibit G, pursuant to which certain "deposit materials" as defined in the deposit agreement shall be deposited by Tolerant in escrow on the terms and conditions stated in the deposit agreement. In the event of release pursuant to the deposit agreement, the deposit materials may be used by HCL only for support of the software and may not be transferred or licensed to any other party. Clause 10. 10 provided for an arbitration between the parties in case of disputes or controversy relating to the manufacturing and software license agreement.

The agreement was approved by the Government of India, Ministry of Industry by a letter dated 18-5-1987, subject to the following modifications. First, it stated that the lump sum know-how fee of US \$ 500,000 was to be net of taxes and the tax liability will have to be borne by HCL. Second, the know-how fee was to be paid in three instalments as under : (a) First 1/3 after the agreement is filed with the RBI and the capital goods clearance, if any, obtained.

(c) Third and final 1/3 on the commencement of commercial production or four years after the agreement is filed with the RBI. The other contents of the approval letter are not relevant for our purpose.

The first instalment of \$ 1,66,666 was remitted by HCL on 29-6-1988 after deducting the tax of Rs. 9,74,475. The second instalment of a like amount was remitted on 18-11-1988, on receipt of documentation. No tax was deducted at source from this remittance, but a guarantee was given.

It would appear that after the second remittance, there arose disputes between HCL and Tolerant regarding the obligations arising under the agreement. From the letter written on 24-3-1989 by HCL to Tolerant, a copy of which is placed at page 59 of the paper book, it appears that Tolerant made a demand for the final payment by letter dated 17-2-1989, in response to which HCL raised the following issues: (i) That the processor supplied for the system by Tolerant was not fast

enough for the Indian market. The agreement dated 1-9-1987 was accordingly amended by an amendment letter dated 23-1-1989 to the effect that a faster processor based technology may be supplied, but even this system was found insufficient to meet the expectations of the Indian market as compared to other indigenously available products.

(ii) It was therefore essential that the system based on 32532 processor be introduced so that the assessee can effectively compete in India.

(iii) No updates were received from Tolerant though there was an obligation to do so under clause 2.4.3 of the agreement.

(iv) The boards in kit form, agreed to be provided by Tolerant as per the amendment letter dated 23-2-1989, were to be provided immediately.

(v) Most importantly, in accordance with clause 8.3. 1.1 of the agreement, Tolerant and HCL were to execute a deposit agreement for the fully commented source code which was to be deposited by Telerant in escrow. This has not been done. It was requested that the formalities in this behalf may be completed at the earliest.

It was stated by HCL that Tolerant may give its reaction to the above, so that HCL can plan its manufacturing and also come up with a schedule for Clearance of the final payment".

After this letter, it appears that the disputes were referred to arbitration as per the arbitration clause in the agreement on 8-8-1990.

Pursuant to the award, which was signed by Tolerant (which had become Viritas by that time) on 1-11-1990 and by HCL on 15-11-1990. According to the award, which is styled as "general release and settlement agreement" HCL was to pay Tolerant a sum of US \$ 17,500 on receipt of which Tolerant would deliver to counsel for HCL one complete copy of the "fully commented source code from which the software was compiled in machine readable form on magnetic tape media in ASCII format, and on paper, along with any documentation as is reasonably necessary to understand and compile such source code". On delivery, counsel for HCL would deliver to counsel for Tolerant the amount of US \$ 17,500.

When intimation is received about the clearance of the L/C under which the sum was paid, counsel for HCL may release the source code to HCL. HCL was to pay royalty for the use of the source code, which was a fixed royalty of US \$ 400 for each SBB (system building block) manufactured or sold by HCL. These are the two important terms of the arbitration award; the other terms are not relevant for the present appeal.

In the return filed by HCL, the assessee herein, as agent of Tolerant (now Veritas) treated as such under section 163 of the Income Tax Act, in response to the notice issued under section 148 of the Act, it claimed that the amounts remitted are not liable to tax in the hands of the non-resident company, vz . z., Tolerant (Veritas) and in the note submitted along with the return the reasons for such a claim were given. Briefly, the claim was that because of the disputes between the parties concerning their obligations under the agreement no income accrued to the non-resident company (Tolerant) during the relevant accounting year which is the year ended 31-3-1989, that the income can be said to have accrued to Tolerant only when the disputes were settled by the arbitration award (styled as "general release and settlement agreement") which was only in October or November 1990 relevant of the assessment year 1991-92 and that therefore no income was taxable for the year under appeal. The claim was rejected by the income-tax authorities and hence the present appeal.

The case put forward on behalf of the assessee is like this: (a) section 9(1)(vi) of the Act relied on by the income-tax authorities does not determine the point of time when the income accrues, nor does it say that the income is to be taxed on receipt basis; (d) no income was received in India under section 5(2), it was received by Tolerant outside India; (c) Tolerant did not get any right to receive the income in the year of account; (a) the remittances made in June and November, 1988 were only in the nature of advance payments, without any right in favour of Tolerant to treat them as having accrued as income and (e) the fact that the assessee did not put forth the claim under section 195(2) that no income element was embedded in the remittances cannot affect the claim now made that the amounts are not taxable. Several authorities were cited in support of the above points a few of which we shall advert to later. With reference to the specific disputes between the

assessee and Tolerant which arose under the agreement, and their effect on the accrual of income, the following points were made on behalf of the assessee: (1) Delivery of the "deposit material" to an escrow agent was of the essence of the agreement.

(2) The technology-provider (Tolerant) having defaulted in this, there was no compliance on its part with the terms of the agreement.

(3) Amounts remitted were only in the nature of advance, which Tolerant had no right to appropriate as its income.

(4) There was neither a debt owed by HCL, nor was a corresponding right to receive income vested in Tolerant.

(5) In the case of a contractual liability, where disputes arise between parties to the contract, income accrues to the parties only at the point of time when the disputes are finally settled.

(6) Therefore, there was no accrual of income in the relevant previous year.

On behalf of the department, the following arguments were raised: (1) The source material has been supplied by Tolerant as per the agreement and it was only the enhancement thereof that was not supplied as undertaken. (2) The dispute between the parties could have been only with reference to the final remittance, which means that the original source code had been given to the assessee. Only the enhanced code was not supplied for which the final payment was disputed (withheld). (3) "Deposit agreement" in Exhibit G is only for the support services and not for the source code. (4) In any case the arbitration proceedings started only on 8-8-1990 and not during the relevant previous year and hence it cannot be argued that the disputes prevented the income from accruing, even during the relevant previous year. (5) The remittances already made were not under dispute, (6) The assessee-company (HCL) has credited the foreign company (Tolerant) in its books with the amounts remitted and (7) Once the amounts were received by Tolerant, no argument could be raised that they did not accrue, because accrual can never be subsequent to the receipt.

In support of the above arguments, the judgment of the Supreme Court in the case of Standard Triumph Motor Co. Ltd. v. CIT (1993) 201 ITR 391 (SC) and that of the Honble Delhi High Court in Saraswati Insurance Co.

Ltd. v. CIT (2001) 252 ITR 430 (Del.) were strongly relied upon.

In his reply, the learned counsel for the assessee submitted that the argument that the dispute was only with reference to the enhancement of the source materials and not with reference to the materials referred to in the Deposit Agreement is erroneous in point of fact, that HCL did not merely dispute the final payment but claimed that Tolerant did not perform its obligations under the agreement properly and in the manner expected of it under the agreement, that the very fact that HCL wrote a letter pointing out to the failure on the part of Tolerant to perform its obligations under the agreement on 24-3-1989, which date fell in the relevant previous year, itself would show that the disputes started in the said year itself and that therefore it was wrong to contend that any income accrued to Tolerant in the relevant accounting year. He also submitted that the judgments cited on behalf of the department laid down propositions which were not relevant to the controversy in the present appeal.

The question for consideration is whether the disputes between HCL, the assessee herein, and Tolerant (now Veritas) were such that they postponed the accrual of income in favour of the later till they were finally settled by arbitration. In the case of CITv. swadeshi Cotton & Flour Mills P Ltd (1964) 53 ITR 134 (SC), the Supreme Court held that income under a contract which gave rise to disputes between the parties thereto, can be said to have accrued only when the disputes were finally settled. In contrast, in the case of a statutory liability, the position is different. In that case the liability arises the moment the conditions necessary for attracting the statute have been fulfilled and the fact that the person subject to the statute disputes the liability does not postpone the same. It is on this principle that excise and customs duty liabilities can be deducted for purposes of assessment to income-tax the moment goods are manufactured or imported and the fact that a person manufacturing or importing the goods disputes the liability does not detract from the efficacy of the liability. Herein we are not concerned with a statutory

liability. We are concerned with a contractual liability, the contract being the agreement styled "Manufacturing and software licensing agreement". Under the agreement, certain technology is to be provided by Tolerant to the assessee, which is engaged in the manufacture of computers in India. The agreement has been approved by the Government of India. A payment schedule for remitting the US \$ 500,000 has also been prescribed. The amount has to be remitted in instalments, which we have already noted, at different stages of fulfilment of the obligations under the agreement by Tolerant. Disputes arose between the parties with HCL claiming that the technology supplied by Tolerant was out-dated and placed handicaps on it in competing with other manufacturers of computers. In particular, HCL claimed that Tolerant did not comply with the formalities relating to "Deposit Agreement" in accordance with clause 8.3.1.1 of the licensing agreement. The "deposit agreement" was to be executed concurrently with the licensing agreement and the "deposit materials" had to be placed under escrow by Tolerant. According to clause 1 of the deposit agreement, the "deposit materials" shall consist solely of one complete copy of the fully commented source code from which the software was compiled, in machine-readable form on disk of magnetic tape media in ASC 11 format, and such documentation as is necessary to understand and compile such source code." Tolerant was under an obligation to deposit the deposit materials under escrow in a sealed package within 30 days after the execution of the deposit agreement (clause 2 of the deposit agreement). HCL, through its employees, had the right to inspect the deposit material "for the purpose of determining their completeness prior to their delivery to the Deposit Agent and an HCL employee will have the option to accompany Tolerant's delivery of the Deposit Materials to the Deposit Agent". Under clause 2.1 of the deposit agreement it was Tolerant's obligation to deliver even the updates to the deposit materials until they are released to HCL. The deposit agreement made detailed provisions relating to the receipt of the deposit materials by the deposit agent, storage inspection, maintenance of records, events causing release of the materials, obligations of the deposit agent, delivery site, time and mode of delivery to HCL, discharge of the deposit agent, compensation payable to the agent, indemnity and so on and so forth. The fact that the deposit agreement had to be executed concurrently with the licensing agreement and the further fact that the

former was attached to the licensing agreement as Exhibit "G" are pointers to the importance thereof. Though it is a technical subject, it is not difficult to appreciate or infer that the fully commented source code, which is the deposit material subject to the elaborate terms and conditions prescribed in the deposit agreement, is of vital importance for the successful implementation of the licensing agreement, so far as HCL is concerned. We are inclined to agree with the submission of the learned counsel for the assessee that the execution of the deposit agreement concurrently with the licensing agreement and the delivery of the fully commented source code to the deposit agent were of the essence of the licensing agreement, the non-fulfilment of which would render the very licensing agreement useless to the assessee. Therefore, when Tolerant did not fulfil its obligations vis-a-vis the deposit agreement, the assessee (HCL) raised a dispute and withheld the final payment. The argument of the revenue that the earlier two payments, which are the subject-matter of the appeal, were made only because Tolerant had fulfilled its obligations with regard to the basic source materials and that the assessee withheld the final payment only because Tolerant had failed to supply the updates does not appear to have any factual basis. The schedule of payments is not related to the accrual of income, in the sense that it can be said that the income to the extent of US \$ 1,66,667 accrued on 29-6-1988 and income to the extent of US \$ 1,66,667 accrued on 18-11-1988, when such payments were remitted. These dates and the events are only landmarks, on the happening of which the remittances had to be made and have no bearing on the question of accrual of income. The timeframe stipulated in the licensing agreement for remitting the license fees is a convenient arrangement between the parties merely linked with the performance of certain obligations. In fact it would appear that the timeframe was modified by the Government of India while approving the agreement. It is somewhat difficult to imagine that a third party to the agreement, such as the Government of India, would have a say in the matter of when and how much income accrued to the foreign company. For instance, the last instalment of the licensing fee had to be remitted, as per the modification made by the Government of India while granting approval, on the commencement of commercial production or four years after the agreement is filed with the RBI. Once commercial production has been commenced, the liability to remit the amount will arise and

irrespective of the fact that the amount was not actually remitted, the income would accrue to the non-resident company as it would get a right to the amount. The actual remittance of the licensing fee, therefore, has nothing to do with the question of accrual of income. The question can be determined only by finding out at what point of time Tolerant would get the right to receive the income, as against the remittance.

The answer to this question would depend upon the nature of the agreement and the rights and obligations of the parties thereto. A perusal of the various terms and conditions of the licensing agreement shows that the deposit agreement has a crucial role to play in facilitating the successful manufacture and marketing of the computers by HCL in India. Unless the fully commented source code is delivered to the deposit agent, for being transmitted to HCL on the fulfilment of certain conditions it cannot be said that Tolerant had fulfilled all its obligations under the licensing agreement so that it can be said to have obtained a right to the income (contrasted with remittance). It is not in dispute that Tolerant defaulted in this, which created difficulties for HCL in successfully manufacturing and selling the computers in India. So it withheld the final payment. Disputes arose between the parties which were referred to arbitration as envisaged by the licensing agreement itself. They were resolved by the arbitration committee and HCL was asked to pay US \$ 17,500 for obtaining the fully commented source code and a further sum of US \$ 400 as royalty for use thereof. The disputes were referred to arbitration on 8-8-1990 and the award was given in October 1990 and signed by both the parties later in that year. In our opinion, Tolerant gets a right to receive the income only when the disputes were resolved by the arbitration award and not before. Only on performance of the conditions prescribed in the deposit agreement do the obligations of the parties under the licensing agreement get fulfilled and only then does the non-resident company get a right to the income under the licensing agreement. The amounts remitted till then are merely in the nature of monies applied in connection with the working of the licensing agreement. We do not think that any intention on the part of the parties to the licensing agreement was expressed or could be inferred to the effect that the agreement could be broken up into three different stags depending upon the time-frame stipulated for remitting the monies payable by HCL. It was a single licensing agreement, subject to

various conditions including, most crucially, the concurrent execution of the deposit agreement and the performance of the obligations thereunder and when there is a default in performing the obligations under the deposit agreement it cannot be said that Tolerant had any right to claim any income under the licensing agreement. The monies received by it till the arbitration award was given and the subsequent performance of the obligations under the deposit agreement relating to the delivery of the fully commented source code remained mere receipts, which could not be rightfully appropriated by it as its income.

As already noted several authorities were cited on behalf of the assessee to show that applying the tests laid down therein, no income had accrued to the non-resident company in the case before us. A distinction was drawn between the earning of the income and the accrual or arising thereof. Suffice to notice the judgment of the Supreme Court in *ED. Sassoon & Co. v. CIT* (1954) 26 ITR 27 (SC), which was applied by the Hon'ble Delhi High Court in *Amar Nath Khandelwal v. CIT* (1980) 126 ITR 322 (Del.). The principle laid down in these judgments is that income can be said to have accrued to the assessee, not merely because he has rendered services or contributed to the accrual but only when he has created a debt in his favour or a right to receive the payments.

Till such right or debt is created, any amounts received will remain merely as monies collected without any right on the person receiving those monies to appropriate them as his income. A proper construction of the licensing agreement, the deposit agreement, the correspondence relating to the disputes between the HCL and Tolerant and the arbitration award shows that only when the award was made and was accepted by both the parties by affixing their signature thereto did any income accrue to Tolerant and not before.

The authorities cited on behalf of the revenue relate to the question of waiver of income after it had accrued, a situation with which we are not concerned.

In the result, we hold that the technical know how fees received by Tolerant in the amount of Rs. 48,38,314 is not assessable in the year under appeal. It accrued only when the arbitration award was made and was accepted by HCL and Tolerant (now Veritas). Ground No. 5 is allowed.

Ground Nos. 1 to 4 challenging the jurisdiction of the assessing officer to make a reassessment are dismissed as "not pressed".

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