

**IN THE INCOME TAX APPELLATE TRIBUNAL
DELHI BENCH 'B', NEW DELHI**

Before Sh. Kul Bharat, Judicial Member

Dr. B. R. R. Kumar, Accountant Member

ITA No. 7575/Del/2018 : Asstt. Year : 2014-15

Choice Hospitality (India) Pvt. Ltd., B-92, 9 th Floor, Himalaya House, 23, Kasturba Gandhi Marg, New Delhi-110001	Vs.	ACIT, Circle-6(1), New Delhi-110002
(APPELLANT)		(RESPONDENT)
PAN No. AABCC4755C		

Assessee by : None

Revenue by : Sh. Vivek Kr. Upadhyay, Sr. DR

Date of Hearing: 11.03.2024

Date of Pronouncement: 15.05.2024

ORDER

Per Dr. B. R. R. Kumar, Accountant Member:

The present appeal has been filed by the assessee against the order of Id. CIT(A)-33, New Delhi dated 26.07.2018.

2. Following grounds have been raised by the assessee:

"1. That the Hon'ble CIT(A) had erred in disallowing on ad-hoc basis 50% royalty expense of Rs. 13,43,087 paid by appellant to 'Choice Hotels Licensing BV' for grant of franchisee rights and use of brand name and erroneously holding the same as capital expenditure without properly appreciating the facts of the case, cases as relied upon & provisions of the Act.

2. That the Hon'ble CIT(A) had erred in disallowing entertainment expenses of Rs.27,83,582 claimed under section 37(1) of the Act on erroneous reasoning and without properly appreciating the facts of the case and provisions of the Act."

3. Brief facts of the case are that the Assessee claimed deduction in respect of royalty expenses amounting to Rs.26,86,175/- in the profit & loss account. The expenses were paid to M/s Choice Hotels Licensing B.V. The Assessing Officer examined the claim as to whether the expenses were in the nature of revenue or capital. Before the Assessing Officer, it was submitted that M/s Choice Hotels Licensing B.V. has granted license to Assessee to franchise, to operate the franchise and to develop and expand the system in the territory and use the brands in India like quality, comfort, sleep inn, cambria suites & ascend collection to the hotel properties. M/s Choice B.V. and the Assessee entered into an agreement to franchise and to establish and operate hotels.

Royalty Expenses - Rs.13,43,087/-:

4. Out of the above expenditure of Rs.26,86,175/- royalty was payable as per the following:

- Fixed royalty of Rs.3,46,294/- @ US \$ 500 per quarter for each franchised hotel that enters the system on or before April 1, 2015.
- Variable royalty of Rs.23,39,880/- for each franchised hotel that entered the system after April 1, 2015.

5. Before the AO, it was claimed that the royalty expense did not provide any enduring benefit to the Assessee. It was submitted that the fixed / variable royalty paid was for separate hotels. It was not a case where fixed lump sum royalty is paid once and, thereafter, regular royalty payments are made.

6. The Assessing Officer held that royalty has been paid by the Assessee basically for the use of the brand name. The Assessing Officer referred to decisions of the Hon'ble Supreme Court in the cases of Southern Switch Gear Ltd. vs. CIT, 232 ITR 359 and Janas Woodhead & Sons (India) Ltd. vs. CIT, 224 ITR 342. The Assessing Officer has quoted the relevant part of the above decisions in the Assessment Order. The summary of the above decisions is that if the expenditure of payment makes an accretion to the capital asset, then it has to be held to be a capital expenditure.

7. The Assessing Officer was of the view that granting exclusive right to operate in the territory is a right giving enduring benefits to the Assessee and allowed depreciation @ 25% on the claim of Rs.26,86,175/-.

8. The Id. CIT(A) held that in the paragraph meant for Choice's obligations, it is provided that the Choice shall lend operation manuals, rules & regulations. The Choice shall also permit consultation at the offices or through other means of communication, at reasonable times in the respective fields of hotels, lodging and restaurants operations. The Choice was also under obligation to provide experienced personnel in the respective fields. The relevant part of agreement is reproduced below:

"5.1 Choice shall lend the Master Franchisee such number of Operations Manuals and Rules and Regulations as the Master Franchisee requires in order to lend each Franchisee and Franchised Hotel one copy immediately prior to their entering into the Franchise Agreement, subject to availability.

5.2 Choice shall permit consultation with CHI at the Master Franchisee's request and expense at CHI's office at Silver Spring, Maryland, USA or by telephone or other means of communication, at reasonable times and when available, with CHI's personnel in their respective fields of hotel, lodging and restaurant operations.

5.3 Choice shall provide, at the Master Franchisee's written request and expense, at CHI's registered office or at the Franchised Hotels, personnel experienced in their respective fields of hotel operations, subject to their availability and at reasonable times. The expenses for such personnel shall include, without limitation, the expenses of travel and accommodation incurred in the performance of such services, and a per diem of US\$300.00 paid pro rata according to the time spent by such personnel; all payments for the said services shall be made in U.S. currency within 30 days of billing.

5.4 Choice shall utilize the International Marketing Fees to provide international sales offices, representation of hotel trade shows, advertising in international consumer and trade media, and for group promotional campaigns and to provide such marketing, merchandising, advertising, research data and advice as may from time to time be developed by Choice and is considered by Choice to be helpful or necessary to the operation of the Business or as requested by the Master Franchisee.

5.5 Choice shall list the Franchised Hotels in such relevant directories of Choice hotels as it may publish from time to time, subject, however, to payment of a fee for each hotel so listed as the parties may agree from time to time.

5.6 Choice shall provide, to the extent and in such locations as Choice may determine to be reasonable and appropriate, international marketing and advertising of the Franchised Hotels located in the Territory and to spend for such purposes within or outside of the Territory, as Choice may determine in its sole discretion, the International Marketing Fee.

5.7 Choice shall include in the Reservation System each Franchised Hotel that is in good standing, such that the Franchised Hotels can be booked world-wide through the Reservation System (including CDS that are connected to the Reservation System).

5.8 Choice shall inspect each Franchised Hotel approximately once each year, and provide initial training and additional training (which training shall total seven days per year), of the Master Franchisee's personnel and personnel employed at the Franchised Hotels as Master Franchisee and Choice may determine to be appropriate. Any such inspections or further additional training provided at the request of the Master Franchisee shall be paid for according to Clause 5.3 above."

9. From the above clauses, the Id. CIT(A) held that it can be seen that Choice B.V., under the agreement, had to provide the operation manual and rules. The operation manuals and rules are, in fact, technical knowhow for running the business of the hotel. It is obvious that the knowledge acquired by the franchisee can be used not only for one year but also after the expiry of the agreement. The Id. CIT(A) held that the technical knowhow is secured by the franchisee, that can be applied to the business process, even without using the brand name of Choice. Such transfer of knowledge can no doubt be treated in the nature of enduring benefit. It is also relevant to note that the Assessee has been stated to have been providing the franchisees a complete spectrum of hotel operating and technical services like hotel development, project planning, technical & pre opening services, reservation systems, sales & marketing support, human resources support, quality assurance inspections and financial planning. In so far as, the project planning, hotel development, technical & pre operating services are concerned, being 100% subsidiary of Choice B.V., the

knowledge is acquired by the Assessee from Choice B.V. There is no proof that such technical knowhow or expertise is developed by the Assessee Company.

10. The Id. CIT(A) relied on the submission of the assessee is as under:

"The Appellant provides the Franchisee to individual hotel properties for use of the above said brands. It also provides a complete spectrum of Hotel operating and technical services like Hotel Development, Project Planning, Technical and Pre-opening Services, Reservations System, Sales and Marketing Support, Human Resources Support, Quality Assurance Inspections, Financial Planning. The Appellant receives fees from Hotel properties in the name of franchisee fees, marketing fees, management operation fees etc."

11. Based on the above, the Id. CIT(A) held that the Assessee is not engaged in manufacturing business, the business of the Assessee is running the hotel. Hence, the technical know-how, project planning etc. are related to the knowhow of the running the hotel business and building it. The Id. CIT(A) held that the technical know-how acquired by the Assessee cannot be limited to its use for one financial year only. The Id. CIT(A) held that the assessee has got enduring benefit to the recipient of the technical know-how.

12. The Id. CIT(A) held that where the transfer of technical know-how etc. is mixed with the brand name to be used by the franchisee, entire expenditure cannot be claimed either as a revenue expenditure or capital expenditure.

13. To conclude, the Id. CIT(A) held that *"a fair proportion is to be assessed having regard to the facts of the case. Though there is no*

definite criterion available in the agreement to decide the nature of benefits, I assess that 50% of royalty expenses were towards enduring benefits and remaining 50% towards the running of the business during the year under consideration. In this way, I hold that expenses to the extent of Rs. 13,43,087/- were in the nature of capital expenditure and remaining 50% towards revenue expenses. The Assessee is entitled to depreciation @ 25% on the capitalized expenditure. Thus the Assessee is allowed depreciation at Rs.3,35,771/-.

Consequently, the addition of Rs. 10,07,316/- is confirmed."

14. We have gone through the entire record. The assessee paid royalty at fixed cost and at variable cost. The royalty is paid for use of brand name and also for technical know-how. The assessee has been provided complete spectrum of Hotel operating and technical services like Hotel Development, Project Planning, Technical and Pre-opening Services, Reservations System, Sales and Marketing Support, Human Resources Support, Quality Assurance Inspections, Financial Planning. The payment of royalty is on annual basis and it is paid for the purpose of "franchise to operate and maintain hotels in an assigned territory and use its brands such as Quality, Comfort, Sleep inn, Cambria suits." It is a fact that payment of royalty to Choice B.V. was for the use of brand name or trademark. The Assessee accepted non-exclusive right and obligation to operate the franchise and to maintain the franchised hotel in the territory, subject to the terms & conditions mentioned in the agreement.

15. In the case of Janas Woodhead & Sons (India) Ltd., the High Court had come to the conclusion that the business setup by the Assessee was a new business and the foreign firm had

not only furnished information and the technical knowhow but also rendered valuable services in setting up of the factory itself. Even after the expiry of the agreement, there was no embargo on the Assessee to continue to manufacture the product in question. However, the Hon'ble High Court observed that the entire payment could not be held as to be revenue expenditure merely because the same was to be made at a certain percentages of the rate of the gross turnover. The Hon'ble Supreme Court held the decision of the Hon'ble High Court justified. In the case of Southern Switch Gear Ltd., the Hon'ble Supreme Court held that technical knowledge obtained from the foreign company provided enduring advantage. Benefits in that were available to the Assessee for its manufacturing and industrial processes even after the termination of the agreement. The transfer of designs, procedures, experience and technical knowhow, which can be used even after the expiry of the agreement provides benefits of enduring nature. The court held that the entire technical fees cannot be allowed as revenue expenditure.

16. The Hon'ble Delhi High Court in the case of CIT vs. Hero Honda Motors Ltd. (2015), 55 taxmann.com 230 wherein it was held that the payment of royalty for right to use or access to technical know-how and information is revenue expenditure.

17. The Id. CIT(A) has valiantly tried to bifurcate the annual royalty paid into "onetime benefit" as one part and "recurring benefit" on the other part as some manuals and SOPs are provided. The royalty paid was meant for the standardization of operations and utilization of brand name. The assessee is

precluded from using the brand unless the royalty is paid. Simply by the virtue of provisions of some manuals and SOPs, the amount paid cannot be treated as capital expenditure in nature unless it results in acquiring of a capital receipt. The Id. CIT(A) though tried to be logical, erred in treating the SOPs provided as capital in nature and allowing depreciation when the SOPs themselves do not constitute or given rise any capital asset. Hence, the royalty payment made by the assessee which is recurring in nature is hereby directed to be treated as revenue expenditure. The appeal of the assessee on this ground is allowed.

Entertainment Expenses - Rs.27,83,582/-:

18. The Assessee has taken this ground to oppose disallowance of entertainment expenses amounting to Rs.27,83,582/-. In this respect the Assessing Officer observed that payments were made to individuals and through credit cards. Exact nature of expenses and nexus with the business were not discernable. The Assessee submitted sample bills and copy of the ledger account. The Assessing Officer found that the bills were mostly related to food without the proof of business expediency. Having not been satisfied with the submission of the Assessee, the Assessing Officer disallowed Rs.27,83,582/- claimed as deduction.

19. The Assessee has submitted before the Ld. CIT(A) that it is operating in hospitality sector and the expenses claimed include meals, dinners etc. for entertainment of its clientele in order to enhance its customer base in India. The Assessee has furnished additional documents in the form of ledger account, summary sheets, bills/invoices etc. but the Id. CIT(A) refused to admit

the additional evidences. The assessee is directed to furnish the reasons before the Id. CIT(A) for not producing the same before the AO and the Id. CIT(A) shall examine the reasons and adjudicate the matter accordingly. The appeal of the assessee on this ground is allowed for statistical purpose.

20. In the result, the appeal of the assessee is partly allowed for statistical purpose.

Order Pronounced in the Open Court on 15/05/2024.

Sd/-

(Kul Bharat)
Judicial Member

Dated: 15/05/2024

Subodh Kumar, Sr. PS

Copy forwarded to:

1. Appellant
2. Respondent
3. CIT
4. CIT(Appeals)
5. DR: ITAT

Sd/-

(Dr. B. R. R. Kumar)
Accountant Member

ASSISTANT REGISTRAR