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EY Tax Alert

Delhi High Court rules amount paid for out-of-court settlement of patent infringement dispute in the US is deductible expenditure



Executive summary

This Tax Alert summarizes a recent decision of the Delhi High Court (Delhi HC) in the case of Desiccant Rotors International Pvt. Ltd. (Taxpayer) [ITA No. 572 of 2011] on the issue of whether an amount paid for an out-of-court settlement of patent infringement dispute is allowable as deduction in view of Explanation 1 to Section 37 (Explanation) of the Indian Tax Laws (ITL). The Explanation specifically denies deduction of expenditure incurred by a taxpayer for any purpose which is an offence or which is prohibited by law. The Delhi HC held that the out-of-court settlement, prior to the final outcome of the litigation, was primarily to avoid expenses and uncertainty of long-drawn litigation. It further held that the payment was in the nature of damages to compensate the patent-holder for losses incurred and not a penalty for infraction of law. Hence, the payment was not covered within the scope of the Explanation and was allowable as deduction.

Background and facts

- ▶ Section 37 of the ITL grants deduction of revenue expenditure incurred wholly and exclusively for business purposes. However, the Explanation denies deduction of expenses incurred for any purpose considered to be an offense or which is prohibited by law. The Explanation was inserted by the Finance (No. 2) Act, 1998, with retrospective effect from 1 April 1962 (i.e., from the inception of the current ITL). The object of the Explanation, as explained in the Explanatory

Memorandum to the Finance Bill and Circular¹ issued by the Central Board of Direct Taxes, is to deny deduction of unlawful expenses.

- ▶ The Taxpayer is engaged in the business of manufacturing environmental control systems and was exporting its products to the US and other countries.
- ▶ A US company (US Co) instituted a suit against the Taxpayer, alleging that the sale of the Taxpayer's products in the US was an infringement of the US Co's patents and demanded compensation from the Taxpayer. The litigation continued for three years. Finally, the Taxpayer entered into an out-of-court settlement with the US Co to resolve the dispute and paid compensation in INR in settlement of the dispute. The Taxpayer claimed the said payment as deduction from its business income.
- ▶ The Tax Authority denied the deduction by invoking the Explanation, which was confirmed by the first appellate authority.
- ▶ On further appeal by the Taxpayer, the Tribunal ruled in favour of the Taxpayer and allowed the deduction by holding that the Explanation was not applicable in the Taxpayer's facts.
- ▶ The Tax Authority preferred further appeal before the Delhi HC.

^[1] Circular No. 772 dated 23 December 1998

Tax Authority's contentions

- ▶ The payment made by the Taxpayer to the US Co, towards settlement of patent infringement claim, is covered by the Explanation, since it is in the nature of penalty for violation of patent law. The settlement represented admission by the Taxpayer of violation of the US Co's patents. The amount was paid for avoiding conviction by the US Court and the penal consequences arising from such a conviction.
- ▶ The facts that that the payment was made before the pronouncement of the judgment by the US Court and that the violation was that of US, and not, Indian law, did not make any difference to the applicability of the Explanation.
- ▶ To attract the Explanation, a competent authority's or Court's finding that an offense was committed or law was infringed, is not necessary.

Taxpayer's contentions

- ▶ The payment made to the US Co is not hit by the Explanation since it is in the nature of compensation paid for settlement of patent dispute and not a penalty for infraction of law.
- ▶ There was no infringement of any law, much less, an Indian law, since no such findings were recorded by the Court. The payment was made

after obtaining legal advice, with a view to put an end to costly litigation.

- ▶ Alternatively, even assuming the payment was made for infringement of patents, such payment amounted to civil damages which are compensatory in nature and cannot be termed as penalty. It is well-settled that compensatory payments are allowable as deduction. Reliance was placed on the decisions of the Supreme Court in the cases of *Prakash Cotton Mills v CIT*² and *Mrs. Rajalakshmi Narayanan v Mrs. Margret Kathleen Gandhi and others*³.
- ▶ As another alternative contention, the Taxpayer argued that the references to 'offence' and 'prohibited by law' in the Explanation must be restricted to law as applicable in India. Reliance was placed on decisions of the Calcutta HC⁴ and the Allahabad HC⁵ in the context of the General Clauses Act and the Indian Contract Act, where the courts held that the term 'law' used in the expressions 'any law for the time being in force' and 'forbidden by law' in the respective statutes, referred to Indian law. In the present case, the violation, if at all, was of US law and, for this reason also, the Explanation was not attracted.

Delhi HC's Ruling

The Delhi HC held that the payment was not covered by the Explanation and was allowable as deduction for the following reasons:

- ▶ A specific recital in the settlement agreement supported that the paramount consideration for

coming to the settlement was to avoid expenses and uncertainty of future litigation. The settlement agreement also mentions that payment made by the Taxpayer to the US Co is for 'loss of goodwill', damages to its capital and termination of the case in a US Court. Mere acceptance of the US Co's patent in the settlement agreement does not represent acknowledgement of infringement by the Taxpayer.

- ▶ The Delhi HC also noted that a consent judgment passed by a Court, in terms of a settlement agreement between the litigants, is not a decision of the Court but merely represents acceptance by the Court of the agreement between the parties. Thus, the consent judgment passed by the US Court in the Taxpayer's case on settlement of the patent dispute cannot be regarded as the Court's finding on the Taxpayer's violation of patent law.
- ▶ The settlement agreement permits the Taxpayer to continue to manufacture and sell the same goods all over the world (including India), except for certain specified countries. Thus, it cannot be inferred that the Taxpayer was violating the patent laws or the payment was made for an objective prohibited by law.
- ▶ Moreover, the US Co, in its suit, had sought civil and not criminal damages in the suit filed against the Taxpayer. The Delhi HC also referred to relevant provisions of the US patent law to note that the remedy for infringement of patent in the US involves civil action and damages which are calculated for compensating the owner of the patent rights for the loss of profit/royalty. There

was no element of penalty in the award of damages under such law. For these reasons, the Delhi HC held that the payment made by the Taxpayer was compensatory in nature which, as per settled law, is an allowable deduction.

- ▶ The payment was motivated purely by commercial purposes and, hence, allowable as deduction.

Since the Delhi HC ruled in favor of the Taxpayer, on the basis of the above reasoning, it specifically did not deal with the Taxpayer's alternative argument that the Explanation is restricted in its application to Indian law and left the issue open.

Comments

Even prior to the insertion of the Explanation, it was well-settled by the decisions of the Supreme Court that a payment which is compensatory in nature is an allowable deduction whereas payment made as a consequence of infraction of law is not allowable. The present Delhi HC ruling supports that the said principle continues even after the insertion of the Explanation. However, the characterization of a payment, whether compensatory or penalty, is a fact-based exercise and requires consideration of the circumstances and the relevant legal provisions, pursuant to which the payment is made. In the present case, it was noted that, even if there is infringement of patent in the US, the consequence is payment of civil damages. This ruling provides guidance that, in such circumstances, the Explanation is not attracted.

[2] [201 ITR 684]

[3] [211 ITR 244]

[4] *Susanta Mukherjee v UOI* [(1975)(94 CWN 412)]

[5] *Abdul Hameed v Mohd. Ishaq* [AIR 1975 All. 166]

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