(1969) 09 AHC CK 0015

Allahabad High Court

Case No: Income-tax Reference No. 420 of 1963

J.K. Cotton Manufacturers Ltd. — APPELLANT

Vs

Commissioner of Income Tax — RESPONDENT

Date of Decision: Sept. 26, 1969

Acts Referred:

- Income Tax Act, 1922 - Section 10(2), 66(2)

Citation: (1970) 75 ITR 592

Hon'ble Judges: V.G. Oak, C.J; T.P. Mukerjee, J

Bench: Division Bench

Advocate: C.S.P. Singh, for the Appellant; Shanti Bhushan, General and R.R. Misra, for the Respondent

Final Decision: Disposed Of

Judgement

V.G. Oak, C.J.

This is a reference u/s 66 of the Indian Income Tax Act, 1922 (hereinafter referred to as " the Act"). The assessee is a public limited company, Messrs. J.K. Cotton Manufacturers Ltd., Kanpur. The assessment year is 1944-45. Formerly, a firm "Juggilal Kamlapat" was the managing agent of the assessee-company. Under an agreement dated August 8, 1941, the managing agents were entitled to work for the assessee-company for a period of 20 years. The managing agents were to charge commission on sales at the rate of 21/2 per cent. The assessee decided to terminate the managing agency of firm Juggilal Kamlapat, and to employ Messrs. J. K. Commercial Corporation as new managing agents, who were to receive commission at the reduced rate of 2 per cent. In order to compensate the firm, Messrs. Juggilal Kamlapat, the assessee-company paid the former managing agents Rs. 2,50,000 as compensation. The assessee-company claimed this payment of Rs. 2,50,000 as permissible deduction u/s 10(2)(xv) of the Act. This claim of the assessee was rejected by the Income Tax Officer on the ground that the payment amounted to capital expenditure. This view was upheld in appeal by the Appellate Assistant

Commissioner. The ultimate decision of the taxing authorities was upheld by the Appellate Tribunal, but on another ground. The Tribunal held that the expenditure was not incurred for the purpose of business, but for extra commercial reasons. The assessee applied for a reference to this court u/s 66(1) of the Act. That application was rejected. Upon an application u/s 66(2) of the Act, this court directed the Tribunal to refer certain questions of law to this court. Accordingly, the Appellate Tribunal, Allahabad, has referred four questions, of law to this court.

2. Mr. C. S. P. Singh, appearing for the assessee, did not press questions. Nos. 1,2 and 3. It is not, therefore, necessary to reproduce those questions or answer them. Question No. 4 runs thus :

" Whether a sum of Rs. 2,50,000 paid by the assessee to the managing, agents for the termination of their managing agency is an expenditure admissible u/s 10(2)(xv) of the Income Tax Act ? "

3. The assessee claimed deduction under Clause (xv) of Section 10(2) of the Act. Clause (xv) is :

" any expenditure..... (not being in the nature of capital expenditure or personal expenses of the assessee) laid out or expended wholly and exclusively for the purpose of such business, profession or vocation."

4. There was no suggestion that the payment in question was in the nature of personal expenses of the assessee. So, in order to decide whether the payment is covered by Clause (xv) or not, two questions have to be considered. The first question is whether the expenditure was wholly and exclusively for the purpose of the business. The second question is whether the payment was in the nature of capital expenditure. These two questions will have to be discussed separately.

5. The nature of the transaction was discussed by the Appellate Tribunal in paragraph 8 of its judgment, dated January 23, 1953. The Tribunal at first observed that from the evidence on the record there can be no doubt that the expenditure was not at all incurred for the purpose of business. Ultimately, the Tribunal concluded that the huge amount of Rs. 2,50,000 paid to the first managing agents was obviously spent for extra commercial reasons. It is not clear what the Tribunal meant by the expression " extra commercial reasons". It may be that the Tribunal thought that the transaction was not of prudent nature. Or, it may be that the Tribunal thought that the assessee was actuated by some improper or oblique motive.

6. The "Tribunal was not called upon to decide whether the transaction was prudent or not. That was a matter for the discretion of the management. In paragraph 8 of the judgment of the Appellate Tribunal dated January 23, 1953, there is no clear indication that the transaction was of fraudulent nature. On going through the orders of the Income Tax Officer and the Appellate Assistant Commissioner we find

no suggestion on the part of the department at that stage that this transaction was fraudulent. It appears that some such suggestion came before the Tribunal for the first time when the appeal was taken up by the Tribunal. A transaction should be presumed to be fair and in good faith, unless fraud is alleged and proved. It was not fair to the assessee to suggest a case of fraud at such a late stage of the proceeding. In view of the history of the litigation, it is not possible to charge the assessee with some improper or oblique motive.

7. The Tribunal enumerated various circumstances for reaching the conclusion that the payment was for extra-commercial reasons. The Tribunal noticed that both the managing agents (old and new) had constitutions in which Singhania family had major interests. The only benefit from the change was the small reduction in the rate of commission from 2^- per cent to 2 per cent. There was no indication on the record that the first managing agents were ever approached by the assessee to reduce the rate of commission from 21/2 per cent. to 2 per cent. The assessee was obliged to hypothecate its goods with the second managing agents, who charged interest at 3 per cent. on the advances made to the assessee.

8. The circumstances enumerated by the Tribunal may lead to the inference that the transaction was not of prudent nature. But, as explained above, the Tribunal was not called upon to judge the wisdom of the transaction. All the authorities were satisfied that the assessee did pay the amount of Rs. 2,50,000 to the first firm of managing agents. We are not dealing with any sham transaction. On the facts found by the Tribunal it must be held that the transaction was of commercial expediency. The expenditure in question was wholly and exclusively for the purpose of the assessee''s business. So, the test laid down by Section 10(2)(xv) of the Act has been satisfied by the assessee.

9. Now we proceed to consider whether the payment by the assessee was in the nature of capital expenditure.

10. There was some discussion before us whether the payment to the managing agents amounted to capital receipt or revenue receipt. But, in the present case, we are mainly concerned with the question whether the payment by the assessee-company constituted revenue expenditure or capital expenditure.. In ANGLO-PERSIAN OIL CO. (INDIA), LTD. Vs. COMMISSIONER OF Income Tax., it was explained by the Calcutta High-Court that the principle that capital receipt spells capital expenditure or vice versa is simple ; but it is not necessarily sound.

11. In P. Orr and Sons Vs. Commissioner of Income Tax, Madras, a sum of Rs. 1,25,000 was paid to the managing agents for terminating the managing agency. It was not intended to bring in any capital assets. It was held that the transaction did not result in the acquisition of any capital assets. The payment was not in the nature of capital expenditure for purposes of Section 10(2)(xv) of the Act.

12. In Race course Betting Control Board v. Wild [1938] 22 TC 182 it was observed on page 188 that a payment may be revenue payment from the point of view of the payer and capital from the point of view of the receiver and vice versa.

13. In Atherton v. British Insulated and Helsby Cables Ltd. [1925] 10 T.C. 155 (H.L.) Viscount Cave L. C. observed on page 192 :

"... When an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think that there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital."

14. In Indian Copper Corporation Ltd. Vs. Commissioner of Income Tax, it was held by the Patna High Court that it is not necessary for expenditure to be allowable u/s 10(2)(xv) of the Act that there should be any direct correlation in point of time between the expenditure and the earning of any profits.

15. In Kettlewell Bullen and Co. Vs. Commissioner of Income Tax, Calcutta, it was. explained by the Supreme Court that it cannot be said as a general rule that what is determinative of the nature of a receipt on the cancellation of a contract of agency or office is extinction or compulsory cessation of the agency or office. Where payment is made to compensate a person for compilation of a contract which does not affect the trading structure of his business or deprive him of what in substance is his source of income, termination of the contract being a normal incident of the business, and such cancellation leaves him free to carry on his trade, the receipt is revenue. Where by the cancellation of an agency the trading structure of assessee is impaired, or such cancellation results in loss of what may be regarded as the source of the assessee''s income, the payment made to compensate for cancellation of the agency agreement is normally a capital receipt.

16. In Gillanders Arbuthnot and Co.,Ltd. Vs. The Commissioner of Income Tax, Calcutta, it was held by the Supreme Court that there is no immutable principle that compensation received on cancellation of an agency must always be regarded as capital.

17. In Assam Bengal Cement Co. Ltd. Vs. The Commissioner of Income Tax, West Bengal, the facts were these. The appellant-company acquired from the Government of Assam, for the purpose of carrying on the manufacture of cement, a lease of certain lime-stone quarries for a period of 20 years for certain half-yearly rents and royalties. In addition to the rents and royalties the appellant agreed to pay the lessor annually a sum of Rs. 5,000 during the whole period of the lease as a protection fee and in consideration of that payment the lessor undertook not to grant to any person any lease, permit or prospecting licence. It was held by the Supreme Court that payment of Rs. 40,000 was capital expenditure and had to be disallowed u/s 10(2) (xv) of the Act.

18. In Godrej and Co. Vs. Commissioner of Income Tax, Bombay City, the facts were these. The assessee-firm was appointed managing agents of a company for a period of 30 years under an agreement executed in 1933. The assessee-firm was entitled to receive commission at the rate of 20 per cent. on the net profits of the company. Subsequently, parties decided to alter the terms of the managing agency. The rate of commission was reduced from 20 per cent. to 10 per cent. By a special resolution dated October 22, 1946, it was decided that a sum of Rs. 7,50,000 should be paid to the assessee-firm as compensation. The question arose whether the amount received by the assessee-firm was revenue receipt or capital receipt. In this connection, their Lordships of the Supreme Court discussed the nature of expenditure incurred by the managed company. On page 385 it was observed :

"There can be no doubt that by paying this sum of Rs. 7,50,000 the managed company has secured for itself a release from the obligation to pay a higher remuneration to the assessee-firm for the rest of the period of managing agency covered by the principal agreement. Prima facie, this, release from liability to pay a higher remuneration for over 17 years must be an advantage gained by the managed company for the benefit of its business and the immunity thus obtained by the managed company may well be regarded as the acquisition of an asset of enduring value of means of a capital outlay which will be a capital expenditure ..."

19. After considering the circumstances of the case, their Lordships concluded on page 387 that, so far as the managed company was concerned, money was paid for securing immunity from the liability to pay higher remuneration to the assessee-firm for the rest of the period of the managing agency. Consequently, it was capital expenditure.

20. The facts of the present case are similar to those in the case of Godrej & Co., In the present case the assessee-company employed the firm "Juggilal Kamlapat" as managing agents under an agreement dated August 8, 1941. The term of the agreement was 20 years. After the expiry of about 3 years out of 20 years the assessee-company decided to terminate that contract of managing agency. The managing agents were paid a sum of Rs. 2,50,000 as compensation.

21. It is true that in the case of Godrej & Co. the court was primarily concerned with the question of the nature of the receipt in the hands of the managing agents. The court was not directly concerned with the nature of expenditure incurred by the managed company. But the court realised the close connection between the expenditure incurred by the managed company and the compensation received by the managing agents. The court, therefore, considered it convenient to ascertain the nature of expenditure incurred by the managed company. The observations of the Supreme Court as regards the expenditure incurred by the managed company cannot be dismissed as obiter dicta.

22. Mr. C. S. P. Singh urged before us that this question does not arise in the present reference. It was pointed out that the Tribunal did not decide the question whether the expenditure incurred by the assessee was revenue expenditure or capital expenditure. But the broad question before the Tribunal was whether the assessee was entitled to deduction u/s 10(2)(xv) of the Act. For answering that question, the Tribunal took up the subsidiary question whether the expenditure was wholly and exclusively for business purposes. Having answered that subsidiary question against the assessee, the Tribunal ha d no difficulty in answering the broad question also against the assessee. The question referred to us is whether the expenditure is admissible u/s 10(2)(xv) of the Act. For disposing of this broad question, we must consider the subsidiary question which arises u/s 10(2)xv) of the Act. It is not, therefore, correct to say that the nature of expenditure (revenue or capital) is outside the scope of the reference.

23. Following the decision of the Supreme Court in Godrej & Co. v. Commissioner of Income Tax, we hold that payment of the sum of Rs. 2,50,000 by the assessee to the former managing agents amounted to capital expenditure.

24. The net result is this. On the one hand, the expenditure was wholly and exclusively for the purpose of the assessee''s business. On the other hand, the payment amounted to capital expenditure. Consequently, the expenditure is not covered by Section 10(2)(xv) of the Act. Question No. 4 has to be answered against the assessee.

25. We consider it unnecessary to record any answers on questions Nos. 1, 2 and 3. We answer question No. 4 in the negative, and against the the assessee. The assessee shall pay the Commissioner of Income Tax, U. P., Rs. 200 as costs of the reference.