
(1962) 03 AHC CK 0023

Allahabad High Court

Case No: Income-tax References No"s. 301, 302, 303 and 304 of 1959

COMMISSIONER OF
Income Tax, U.P.

APPELLANT

Vs

RAM RATAN GUPTA.

RESPONDENT

Date of Decision: March 13, 1962

Acts Referred:

- Income Tax Act, 1961 - Section 66

Citation: (1963) 48 ITR 531

Hon'ble Judges: Brijlal Gupta, J

Bench: Division Bench

Final Decision: Dismissed

Judgement

BRIJLAL GUPTA J. - These are four references u/s 66(1) of the Income Tax Act. Along with each reference there is an application u/s 66(4) also. The point involved in the references and the applications is the same. There is also only one statement of the case in respect of all the four references. Accordingly, we propose to dispose of all the four references and all the four applications u/s 66(4) by one consolidated judgment.

The question referred to us for opinion is :

"Whether, on the facts and in the circumstances of the case, the sum of Rs. 2,72,500 being the 1/4th share of Rs. 10,90,000 received by M/s. Beharilal Kailashpat on termination of their managing agency of Mills Company has correctly been treated as a receipt in the nature of a capital receipt ?"

The references were made at the instance of the Commissioner of Income Tax. The opposite parties in the references are four out of eight partners of firm, M/s. Beharilal Kailashpat (hereinafter called the firm) which was the managing agents of M/s. Laxmi Ratan Cotton Mills (hereinafter called the company). The applicant in the four applications is also the Commissioner of Income Tax and the opposite parties are the same four

partners of the managing agency firm as in the four references.

The facts giving rise to the references and the applications may be stated as follows :

There were two groups of partners who constituted the managing agency firm. The shares of the two groups in the managing agency firm were equal, namely, eight annas each. One group consisted of four members of the Singhanian family, two owning a share of annas 0-2-8 each and the other two, a share of annas 0-1-4 each. The other group consisted of four members of the Gupta family, each owning a share of two annas. The firm was appointed the managing agents under paragraph 6 of the memorandum of association which is :

"6. Messrs. Beharilal Kailashpat (hereinafter called the Agents firm) are appointed the Secretaries, Treasurers and Agents of the Company, upon the remunerations, terms and with powers and for the consideration set forth in the draft agreement annexed as Schedule A, which as also the provisions of this clause may be revised, modified or altered from time to time in such one or more or all the particulars as the Board of Directors and Agents may jointly agree to."

The matter was dealt with in the articles of association also. The relevant articles are articles 143 and 144. They are as follows :

"143. Appointment of Messrs. Beharilal Kailashpat as Agents of the Company - the members (or sole member as the case may be) for the time being of the firm of Beharilal Kailashpat shall be and they are appointed Agents of the Company, such appointment is hereby confirmed upon the terms, for the remuneration, and with powers in the Draft Agreement set forth in Schedule A hereto and the Board is hereby authorised to get the said agreement executed on behalf of the company and it is hereby expressly provided and declared that in consideration of the services rendered by them in promoting this Company, the appointment of the said firm of Beharilal Kailashpat to the Office of the Agents of the Company shall not be liable to be, at any time hereafter revoked or cancelled on any ground or for any reasons whatever, save and except their being found guilty of fraud in the management and discharge of their duties as such Agents of the Company.

144. If Messrs. Beharilal Kailashpat are removed for any other cause except that mentioned in the last article they are entitled to receive compensation - In the event of the said Company being wound up, the said firm of Messrs. Beharilal Kailashpat shall be entitled to receive and shall receive, out of the assets of the said Company and as compensation for the loss of such appointment of the Agents to the said Company as aforesaid a sum of money equal to the amount earned by the said firm during 5 years preceding the winding up of the said Company, if the Company shall have so long existed and if not then a sum of money equal to five times the average annual amount earned by the said firm, if the said Company shall have existed for more than a year and if not then a sum of money equal to sixty times the average monthly amount earned by the said firm

of Messrs. Beharilal Kailashpat."

The draft agreement is appended as schedule A to the memorandum and articles of association. Paragraph I of the draft agreement provides for the carrying on of the business of the company by the firm. Paragraph 2(a) provides for the tenure of the firm. Paragraph 2(b) provides for the remuneration of the managing agency firm while in office. Paragraphs 3(a) and 3(b) provide for the termination of the tenure of the firm as the managing agent of the company and for the compensation payable to the firm for loss of their appointment.

In pursuance of the memorandum and articles of association as well as of the draft agreement, an agreement was duly executed between the company and the firm on May 2, 1935.

The firm continued to function as the managing agents of the company till 1943, when disputes arose between the two groups of partners of the firm, namely, the Singhania group and the Gupta group. The disputes and differences were referred to the arbitration of Th.Kanhaiya Singh, who pronounced an award on January 18, 1944. The members of the Singhania group were not satisfied with the award and filed Suit No. 31 of 1944 for the setting aside of the award. The subject-matter of the civil suit was again referred to Th.Kanhaiya Singh for amending his award. Ultimately, the award was amended with the consent of the parties, and on January 11, 1945, a decree was passed by the civil court in terms of the amended award.

The dispute between the Singhania and Gupta groups related to several industrial concerns in which the two groups were jointly interested. The award appears to be in the nature of a partition or separation of the interests of the two groups in the various concerns. The only provision of the award with which we are concerned is that the company, the Laxmi Rattan Cotton Mills, was to be given over exclusively to the Gupta group. Provision was made for the purchase of the shares of the Singhanias by the Guptas at a certain valuation. After the interest of the Singhanias had ceased in the company, the managing agency was also to go to the Guptas exclusively. Before a decree could be passed in the civil suit, on January 27, 1944, a reconstituted firm in the name and style of M/s. Beharilal Ram Charan was brought into existence. The partners of this firm were the members of the Gupta group alone. On January 31, 1944, the company recognised this new firm as its managing agents by a resolution passed by it. As the recognition of the new firm as the managing agents of the company was prior to the settlement of all the disputes between the two groups and prior to the decree passed in the civil suit, the Singhanias entered into some correspondence with the company objecting to its recognition of the new firm as its managing agents. In due course by resolution dated September 1, 1944, the company overruled the objections of the Singhania group and terminated the managing agency of the firm, M/s. Beharilal Kailashpat, with effect from September 30, 1944.

Upon receiving information of the termination of the managing agency of firm, Beharilal Kailashpat, the Singhanias group required the company to pay damages and compensation for the alleged wrongful termination of the managing agency which was to last for a period of 99 years. The company replied to the Singhanias that their claim for compensation was misconceived as the managing agency was terminated due to quarrels between the two groups of partners themselves. Thereupon notices were given to the company both by the Singhanias group and by the Gupta group, claiming compensation. Ultimately, the dispute relating to the termination of the managing agency and compensation therefore was referred to the arbitration of Shri. K.M. Munshi. There was an agreement to refer dated October 19, 1944. The company as well as the rival groups, the Singhanias and the Guptas, were signatories to this agreement. Before, however, Sri Munshi could deliver his award, the two groups of partners settled their disputes inter se amicably. Under this settlement the Singhanias group was to receive compensation in the sum of rupees eight lakhs for the premature and wrongful termination of the managing agency. This amount of rupees eight lakhs, under the agreement between the two groups, was fixed quite irrespective of whatever amount may ultimately be awarded by the arbitrator as compensation for the wrongful termination of the managing agency. In pursuance of this agreement between the two groups, the Gupta group, on February 19, 1948, paid the sum of rupees eight lakhs to the Singhanias group. In due course, the arbitrator, Sri Munshi, delivered his award and awarded a sum of rupees 18,90,000 to the managing agency firm as compensation for the wrongful and premature termination of the managing agency. Rupees eight lakhs having already been paid to the Singhanias group in full settlement of their share of the compensation, the balance, namely, Rs. 10,90,000 fell to the share of the Gupta group. In these references we are not concerned with the amount of rupees eight lakhs paid to the . We are informed that this amount was treated by the department as a capital receipt and, therefore, not liable to tax in the hands of the members of the Singhanias group.

Out of the amount of Rs. 10,90,000 which fell to the share of the members of the Gupta Group, each one of the four members of that group got a sum of Rs. 2,72,500. The question which has arisen is as to the nature of this receipt. The contention of the four members of the Gupta group before the Income Tax department was that this receipt was in the nature of a capital receipt and was not liable to tax. The case of the Income Tax department on the other hand was that it was revenue receipt and, as such, liable to payment of Income Tax.

The Income Tax Officer without giving any reason treated the amount of Rs. 2,72,500 in the hands of each one of the four partners as a revenue receipt and subjected the same to tax. On appeal the Appellate Assistant Commissioner held that the receipt was not a revenue receipt but a capital receipt. The Appellate Assistant Commissioner seems to have been influenced only by the consideration that the similar amount of Rs. 8 lakhs in the hands of the Singhanias was not treated as a revenue receipt and was held to be exempt from tax. Thereafter, the department went up in appeal to the Income Tax

Appellate Tribunal where the matter appears to have been discussed and debated at some length. The Tribunal asked for a remand report setting out all the facts and circumstances on the basis of which a determination might ultimately be made as to the true nature of this receipt. In the remand report the Income Tax Officer recorded the findings that the actual work of management was done by Lala Ram Ratan Gupta in his capacity as an ex-officio director of the company and not as a partner of the managing agency firm; that the payment made to managing agents was for past services and did not represent compensation for depriving the managing agents of a source of income; that there was collusion between the company and the managing agents in making the payment; and that even if it is accepted that the managing agents rendered any service the payment represented remuneration in a commuted and consolidated form and was accordingly taxable as income.

The Tribunal heard the appeal a second time after the receipt of the remand report. It reversed the findings of the Income Tax Officer and came to the conclusion that Lala Ram Ratan Gupta worked on behalf of the managing agents of the company and not as a director of the company. He was the only adult male member of the Gupta group of partners in the managing agency firm and it was provided in the partnership deed itself that he would be in charge of the business of the firm. The Tribunal also held that the payment made to the firm was not for past services and that in view of the voluminous correspondence which passed between the company and the two groups of partners there was no collusion between the managing agents and the company. The Tribunal further held that there was no clause in the managing agency agreement for premature termination of the managing agency was wrongful as held in the award of Sri K. M. Munshi. In the result the Tribunal came to the conclusion that the amount received by the managing agency firm was a capital receipt not liable to tax.

The department being dissatisfied with the decision of the Tribunal applied for reference of the case to this court and the case has been referred to us as already stated above.

Three points have been raised before us by the learned counsel for the Income Tax department. The first point is that there was no material before the Tribunal for the finding that the payment to the firm by the company was not collusive and that the work which Sri Ram Ratan Gupta, one of the partners of the firm and a director of the company, did was not in his capacity as a director but as a partner. This point can be very shortly disposed of. It is well settled that the apparent state of affairs is to be presumed to be real until the contrary is shown. It is equally well settled that good faith and the genuineness of a transaction are also to be presumed until the contrary is proved. It follows that if the Income Tax department wanted to challenge the fact that the payment of compensation for the premature termination of the managing agency, which was based upon a resolution of the company terminating the tenure of the firm, and the amount of compensation, which was determined by the award of Sri K. M. Munshi, were not genuine but collusive transactions, it was for the Income Tax department to have materials before itself for those findings. Learned counsel has not been able to point to us any materials

on the basis of which the Income Tax Officer could come to the conclusion that the termination of the managing agency or the payment of compensation were collusive transactions. With regard to the other part of the learned counsels argument that the work done by Sri Ram Ratan Gupta was not in his capacity as a partner but as a director, the position is also the same. Under the memorandum and articles of association of the company as well as under the terms of the managing agency agreement the work of management of the company was to be done by the firm and not by the directors. The directors were only to exercise supervision in respect of the actual management of the company by the firm. Under the deed of partnership of the managing agency firm, Lala Ram Ratan Gupta was to do the work, as the other partners of the Gupta group were women and a minor. It follows that prima facie even though Sri Ram Ratan Gupta might also be a director of the company, whatever was done by him in the course of the management of the company, was done by him as a partner and not as a director. If the Income Tax department wanted to controvert this position, it was for the Income Tax department to have materials before it on the basis of which it could displace the prima facie case. Here also learned counsel has not been able to point to us any material on the basis of which it could be held that the work done by Sri Ram Ratan Gupta was not as a partner but as a director. The assessee could not be required to prove the negative. It follows that in the circumstances the Tribunal was fully justified in coming to the conclusion that the payment of compensation for the termination of the managing agency was not due to any collusion and that the managing agency firm did actually do management work of the company.

There is another answer to learned counsels argument. The proceeding before us is a reference u/s 66(1). The only question or questions which we have jurisdiction to decide are questions which have been actually referred to us. The point argued has not been referred to us, though it might be said to be implied in the question which has been actually referred to us. It follows that the questions, not having been actually referred, any argument on these questions is not open to learned counsel, and we are not called upon to decide the correctness or otherwise of the conclusions of the Tribunal on those questions. However, on the footing, as already stated above, that the questions might be implied in the question referred we have considered the same and we are satisfied that the conclusions reached by the Tribunal on those points are correct.

The second point raised by the learned counsel for the department is that the payment of compensation was in pursuance of the agreement between the parties. He has urged that where payment is made in pursuance of an agreement for termination of some agreement or contract of service, compensation partakes of the nature of a revenue and not a capital receipt. In support of this submission learned counsel has relied on two English decisions. The first of these is *Henry v. Foster*. That case related to three directors of a limited company. The articles of the company provided that in the event of any director, who had held office for not less than five years, dying or resigning or ceasing to hold office for any cause other than misconduct, bankruptcy, lunacy or incompetence,

the company should pay to him or his representatives by way of compensation for loss of office a sum equal to the total remuneration received by him in the preceding five years. All the three directors had held office for not less than five years. Two of the directors resigned office as directors and received from the company as compensation a payment calculated in accordance with the articles of the company. It was held that the payment to these two directors constituted a profit of the office of the director and was assessable to Income Tax. So far as the third director was concerned, he desired to retire from active management of the company, but as his co-director wished to be able to still consult him it was agreed that he should resign the office of chairman, receive as "compensation" a lump sum in lieu of the provision under the articles of the company, waiving any future claim under that article, and remain on the board of the company at a reduced rate of remuneration. In the case of this director, the House of Lords held that in the circumstances the sum received by him was not income assessable to Income Tax.

There is no difficulty in understanding this decision. So far as the first two directors were concerned, even though compensation paid to them was described as compensation for loss of office, the court was entitled to penetrate behind the form in which the transaction was couched and discover whether ultimately the payment was referable to rendition of service or not. It may be that the service may be a past service or a future service, but so long as the payment is referable to a service, it is in the nature of profit for holding an office and it was also a payment envisaged in the articles and, therefore, a revenue receipt assessable to Income Tax. In our case it has been shown above that there is nothing in the agreement providing for a premature termination of the managing agency agreement and for the payment of compensation for the term still remaining unexpired. The case of the third director in the English case has more relevance to the circumstances of our case. There the situation brought about by the resignation of the chairman and his continuing to remain a director on a reduced remuneration was a situation not contemplated by the articles of the company. In other words, the retirement of this director and payment of compensation to him was independent of the provision in the article. It was a termination of his employment and any compensation paid for releasing the company from liability to continue to employ him was in the nature of a capital payment not liable to tax. We are of the view that this decision is of no assistance to learned counsel.

Under the agreement in our case the termination of the managing agency is contemplated only in the case of the winding up of the company. No other case of premature termination is contemplated at all. The appointment as managing agents was to run for ninety-nine years and even beyond. After the expiry of the term, the managing agents were removable, if at all, only by a three-fourths majority of the shareholders. They were actually removed long before the expiry of ninety-nine years and it cannot be said that the termination of the managing agency was as contemplated by the agreement and compensation was to be determined or paid as provided in the agreement. Both the termination of the managing agency and the payment of compensation were wholly

outside the agreement and independent of it.

The other case relied on by the learned counsel is the case of *Dale v. de Soissons*. In this case the assessee was employed as assistant to the managing director of a company. His remuneration consisted of a fixed salary of pound 3,000 per annum and a commission calculated on profits under the terms of his service agreement. The assessee's appointment was to be for three years, but the company was entitled to terminate the agreement on the last date of any year on payment of pound 10,000 or pound 6,000 depending upon termination being at the end of the first year or the second year. The agreement was terminated at the end of the first year and a sum of pound 10,000 was paid to the assessee. In those circumstances it was held that the sum of pound 10,000 was not compensation for loss of office. It was in the nature of capitalised remuneration for the unexpired term for which the assessee was employed. This decision is also understandable. The termination was under the terms of the agreement of service itself and compensation was also paid as provided under the agreement. We have already pointed out when discussing the first case that where premature termination on payment of compensation is envisaged by the agreement the compensation paid is in the nature of capitalised remuneration liable to tax. That is not so in our case. Accordingly, this case also is of no help to learned counsel for the department.

The contract in the present case was an agency agreement. Such agreements have been distinguished from trading contracts. Agency agreements have been described as an apparatus making it possible to earn income. They have been treated as capital assets and termination of an agency agreement has been held to be destruction of a capital asset. Anything paid for destruction of such an asset partakes of the nature of capital gain and not income. By payment of compensation, the company took, in a sense, an assignment of the right of the managing agency which was to continue for a term of ninety-nine years. The termination of the agency agreement in lieu of payment of compensation was payment made to managing agency for the extinction of its capacity to make income so far as the business of this particular managing agency firm was concerned. This principle is enunciated by the Supreme Court in *Commissioner of Income Tax v. Vazir Sultan and Sons* and applies to this case.

The last point which has been realised by the learned counsel for the department is that the compensation paid by the company to the firm was compensation for past services and was not payment for the wrongful termination of the managing agency. By past services, learned counsel meant, services of the partners of the firm in promoting the company. He argued that the firm was appointed the managing agents for having promoted the company and the appointment was to last for a period of 99 years. For this learned counsel relied to paragraph 2 of the draft agreement. From a perusal of that paragraph, it is clear that the promotion of the company by the partners of the firm was consideration for the appointment of the firm and for its tenure. It was a duly executed consideration. The period of 99 years was a fixed period. The firm was to continue for the whole of that period, unless it resigned the managing agency. It was not removable

while the period of 99 years was still running. It could be removed only after the expiry of that period, and then also, only by a 3/4th majority of the shareholders of the company. It is clear that the situation in which the managing agency firm might resign or be removed prior to the expiry of the period of 99 years was not envisaged in the agreement at all. It follows that services rendered by the partners of the managing agency firm in promoting the company could not under the agreement form the basis of any compensation to be awarded to the firm for termination of the agreement either by its resignation or by its removal prior to the expiry of the period of 99 years. The compensation paid could not be consideration for past services.

It is paragraph 3 only of the agreement, which makes provision for the premature termination of the managing agency. That paragraph contemplates termination only in one contingency, that of the company being wound up. If the company itself was wound up, the managing agency would be discontinued. In that event only, compensation as provided in paragraph 3(a) was payable. Thus it is clear that the compensation paid on the termination of the managing agency was not compensation for past services and was quite independent of that agreement.

It may also be stated that the stand which the department took before the Tribunal was that the payment of compensation was collusive or something in the nature of an ex gratia payment and not payment rendered for something actually done. It was only as an alternative and only in passing that it seems to have been alleged that, if at all, the payment was referable only to past services for promoting the company. This argument stood overruled when the Tribunal came to the conclusion that the payment was not collusive but was genuine and bona fide and further when it held that services were actually rendered by the firm in pursuance of the managing agency agreement after the company came into existence. In the face of the finding that services were actually rendered by the firm, which is a finding of fact, the argument that if any service was at all rendered, it was only the past service for promoting the company, stood overruled.

In this connection a minor submission was also made by learned counsel for the department. That submission was that, if not the whole, at least part of the compensation must be referable to the past services rendered by the firm in promoting the company. This point was never raised by the department at any stage of the proceedings. If it had been raised, necessary facts might have been investigated, namely, how the total amount of compensation was worked out, how much, if at all, out of that total amount of compensation was referable to rendition of any service, past or present. By reason of the omission of the Income Tax department to take any such stand, all these facts remained uninvestigated. It is too late now for the learned counsel for the department to raise this point.

The result is that the compensation paid was receipt of a capital nature and the question referred to us must be and is answered in the affirmative. The assessee shall be entitled to the costs of these references, which we assess at Rs. 100 in each case.

The applications u/s 66(4) need not be dealt with separately. We are of the view that the question referred to us embraces all the various questions which are sought to be raised by these applications. We have also considered and dealt with such arguments on each of those questions as were raised before us. The applications are accordingly dismissed.

Question answered in the affirmative.