

(1988) 02 MAD CK 0032

In the Madras High Court

Case No : Tax Case No's. 600 of 1978 and 395 and 396 of 1979

Commissioner of Income Tax

APPELLANT

Vs

Pioneer Engineering Syndicate

RESPONDENT

Date of Decision : 11-02-1988

Acts Referred:

Income Tax Act, 1961 — Section 263, 37

Citation : (1989) 175 ITR 93

Hon'ble Judges : M.N. Chandurkar, C.J;M. Srinivasan, J

Bench : Division Bench

Advocate : J. Jayaraman, for the Appellant; K.C. Rajappa, for the Respondent

Judgement

M.N. Chandurkar, C.J.—In these three tax cases which are being disposed of by this common judgment, three questions fall for

consideration. These are as follows :

1. Whether, on the facts and in the circumstances of the case, the Appellate Tribunal was right in holding that the payment of Rs. 50,000 made by

the assessee to Pioneer Construction Company, Vijayawada, under the ""Dissolution deed"" dated January 1, 1966, was allowable as deduction in

computing the income of the assessee for the assessment year 1969-70 ?

2. Whether, on the facts and in the circumstances of the case, the Appellate Tribunal was right in cancelling the order of the Commissioner of

Income Tax u/s 263 of the Income Tax Act, 1961f, for the assessment year 1967-68 ?

3. Whether, on the facts and in the circumstances of the case, the Appellate Tribunal was right in holding that the payment of Rs. 50,000 made by

the assessee to Pioneer Construction Company, Vijayawada, under the

""dissolution deed"" dated January 1, 1966, was allowable as deduction in computing the income of the assessee for the assessment year 1968-69 ?

4. The first question arises out of the assessment proceedings for the assessment year 1969-70 and the second and third questions arise in respect of the assessment years 1967-68 and 1968-69. It is common ground that the answer to the second and third questions will depend upon what

view we take to answer question No. 1. All these three questions arise out of a payment of Rs. 50,000 made by the assessee-company, Pioneer

Engineering Syndicate, to Pioneer Construction Company, Vijayawada, hereinafter referred to as ""the company"", in terms of the same deed dated

January, 1, 1966, which is described as a deed of dissolution.

5. All these questions have been referred in accordance with the directions of this court u/s 256(2) of the Income Tax Act, 1961.

6. The assessee is a partnership firm which was originally constituted under an instrument of partnership deed dated April 1, 1962. The

construction company which has been referred to by the Tribunal as the Vijayawada firm was closely associated with the assessee-firm and had

two common partners. The Vijayawada firm was rendering financial aid to the assessee-firm as well as technical help and assistance to the

assessee-firm in executing contracts. The assessee-firm was reconstituted with effect from February 1, 1964. One partner had died, four partners

had retired and seven new partners joined the firm with the result there were 17 partners and two minors admitted to the benefits of the

partnership. The instrument of partnership dated February 1, 1964, contained certain clauses with regard to the assistance to be taken from the

Vijayawada firm and the payments to be made to them. Clauses 14 and 15 which are the only relevant clauses read as follows :

14. If, in addition to the finance provided by the partners, more finance is required, the same shall be obtained from the Pioneer Construction

Company, Vijayawada-2, and the Associated Engineering Syndicate, Madras-14, only on the following terms :

1. Interest at 12 per cent. per annum shall be paid on the 31st March every year.

2. A commission of 2 1/2 per cent. of the value of the works executed payable on the 31st March every year to the above two firms in proportion

to the average amounts borrowed from them.

It is agreed to make the following payments on the 31st March of every year for technical services to be rendered to the company.

15. (a) 3 per cent. of the value of the work executed to the Pioneer construction company, Vijayawada-2.

(b) 1 1/2 per cent. of the value of the work executed to the Associated Engineering Syndicated, 80, Lloyds Road, Royapettah, Madras-14.

(c) 1/2 per cent. of the value of the work executed to Sri P. V. Raj & Company, Gaganmahal Colony, Domalguda, Hyderabad-2.

(d) Rs. 1,000 per mensem to Sri P. V. Raj & Company, Gaganmahal Colony, Domalguda, Hyderabad.

7. The assessee-firm was reconstituted with effect from January 1, 1966. Seven partners withdrew from the partnership. The Vijayawada firm was

also reconstituted. As a result of the reconstitution of both the firms, there were no common partners between the assessee-firm and the

Vijayawada firm. The new agreement of reconstitution dated January 1, 1966, was, however, styled as "agreement of dissolution". The clause

relevant for the purpose of these references in the agreement dated on January 1, 1966, reads as follows :

5. The continuing partners shall have the right to execute and exploit the pending contracts and the commitments or acceptances so far made in the matter of execution of contracts or on matters connected therewith.

The continuing partners agree to pay the Pioneer Construction Company, Vijayawada, a sum of rupees fifty thousand only every year for the

calendar years 1966, 1967 and 1968 in consideration of the existing agreement between the two firms regarding finance and technical services.

This amount is payable in two equal installments on the 30th June and 31st December every year. The Pioneer Construction Company shall not be entitled to any other payment other than the payment mentioned above.

8. In terms of clause 5 reproduced above, the assessee-firm paid Rs. 50,000 to the Vijayawada firm for the financial years 1966-67 to 1968-69.

For each of these years, the assessee-firm claimed the said payments as deductions. This claim was allowed by the Income Tax Officer for the

assessment years 1967-68 and 1968-69, However, for the assessment year 1969-70, the Income Tax Officer disallowed the deduction treating

the payment as capital expenditure. In respect of the order of the Income Tax

Officer for the assesment years 1967-68 and 1968-69, the

Commissioner exercised his revisional jurisdiction u/s 263 of the Income Tax Act, 1961, and set aside the deduction.

9. In respect of the assessment year 1969-70, in the appeal filed by the assessee, its contention that the payment of Rs. 50,000 was revenue in

character was accepted by the Appellate Assistant Commissioner. The Revenue then filed an appeal before the Tribunal. On behalf of the

Revenue, figures were quoted to show the amount which would have been actually payable to the Vijayawada firm in accordance with the original

agreement. These figures were as follows :

Assessment year Amount

Rs.

1967-68 ... 2,20,000

1968-69 ... 1,68,410

1969-70 ... 1,56,475

1970-71 ... 4,12,830

1971-72 ... 3,95,670

10. Pointing out these figures, it was argued before the Tribunal that the assessee had got rid of the obligation to pay the above amounts by paying

a lump sum of Rs. 1,50,000 and had thus obtained an enduring advantage. The Tribunal took the view that perhaps due to the experience which

the assessee-firm had secured in its line of business, it was no longer considered necessary to pay large sums to the Vijayawada firm. Therefore,

the previous contract was replaced by a less onerous contract. The Tribunal summed up the position by saying that in the course of carrying on of

the assessee's business and in consideration of the financial and technical assistance rendered by the Vijayawada firm, the assessee was paying a

sum of Rs. 50,000 per annum as against a larger commission paid earlier and this was substitution of a less onerous contract for the earlier one.

The case, according to the Tribunal, was one of modification in terms of a trading

contract incidental to the carrying on of one of the assessee's

businesses. The Tribunal further observed that the case could be treated as one whereby, making a consolidated or lump sum payment, the

assessee has relieved itself of an onerous recurring liability and the payment could not, therefore, be construed as capital in nature. The Tribunal

followed the decision of the Supreme Court in Commissioner of Income Tax, Madras Vs. Ashok Leyland Ltd., . The Tribunal having confirmed

the order of the Appellate Assistant Commissioner, the Revenue had asked for the first question to be referred.

11. Having regard to the decision of the Tribunal for the assessment year 1968-69, the Tribunal also allowed the appeal filed by the assessee

against the revisional order of the Commissioner of Income Tax. That is how questions Nos. 2 and 3 have been referred for consideration.

12. Learned counsel appearing on behalf of the Revenue has contended before us that the payment of Rs. 50,000 per year for the three years in

question was made for getting rid of huge payments which was a liability recurring every year and for reorganisation of the assessee's business.

The argument was that consequent upon the fresh agreement of reconstitution of the partnership when two persons who were partners of the

Vijayawada firm ceased to be partners of the assessee-firm, the assessee-firm had got itself rid of the control exercised by the Vijayawada firm

and, consequently, the assessee-firm must be considered as having obtained an enduring advantage by payment of the lump sums in question.

When it was pointed out to learned counsel for the Revenue that it was not the case of the Revenue before the Tribunal that the payment was made

as part of the reorganisation of the assessee's business with a view to get rid of the control of the Vijayawada firm, learned counsel wanted to

argue that the question whether the payment was made for getting rid of the control by the Vijayawada firm depended upon the construction of the

documents and it was open to the Revenue to argue on the basis of the documents in the assessment proceedings that the payment was made to

enable the assessee-firm to get rid of the control by the Vijayawada firm.

13. It is well settled that so far as reference proceedings are concerned, this court has to proceed on the basis of the finding recorded by the

Tribunal, as it was not even an argument before the Tribunal and there is no

finding recorded by the Tribunal, and rightly so with regard to the alleged purpose of making a lump sum payment, as now contended by learned counsel. We have, therefore, declined to hear the learned counsel for the Revenue on the question whether the payment of Rs. 50,000 per year can be considered as having been paid for getting rid of the control by the Vijayawada firm and whether this has resulted in any enduring advantage.

14. On the questions framed and directed to be referred to this court, the controversy appears to us to be simple and is within a narrow compass.

The controversy is whether these payments made for three years at the rate of Rs. 50,000 per year in order to get rid of a liability which was to the tune of about Rs. 15,00,000 for the five years referred to earlier can be considered as payment of a capital nature.

15. Learned counsel appearing on behalf of the Revenue has relied on that line of cases which dealt with compensation paid in connection with the

remuneration payable under managing agency agreements. In *Godrej and Co. Vs. Commissioner of Income Tax, Bombay City*, , the Supreme

Court took the view that a sum of Rs. 7,50,000 in that case was paid and received not to make up the difference between the higher remuneration

and the reduced remuneration, but in reality, it was compensation for releasing the company from the onerous terms as to remuneration as it was, in

terms expressed to be. In that case, it was found that the amount was paid for securing immunity from the liability to pay higher remuneration to the

assessee-firm for the rest of the term of the managing agency and, therefore, it was a capital expenditure, and so far as the assessee-firm was

concerned, it was received as compensation for the deterioration and injury to the injury to the managing agency by virtue of the release of its rights

to get higher remuneration and, therefore, a capital receipt. It will be noticed from that judgment that the amount of remuneration originally agreed

to be paid was reduced and the amount was paid by way of compensation during the subsistence of the managing agency and, therefore, it was

considered to be capital expenditure in character. The other case, *J.K. Cotton Manufacturers Ltd. Vs. Commissioner of Income Tax, Lucknow*, ,

was a case in which the termination of the managing agency was not found to be in *terrorem* but was voluntary so as to obtain an enduring or

recurring benefit and payment of the compensation was not dictated by

commercial expediency since there was absolutely no necessity to terminate the managing agency and the appellant wanted to benefit both the firms in which the family had major interest. The compensation paid to the outgoing agents was, therefore, found to be capital expenditure. It is, however, important to point out that in that decision, the Supreme Court considered the earlier decision in CIT v. Ashok Leyland Ltd. [1972] 88 ITR 549. In Ashok Leyland Ltd.'s case, it was found that the managing agency was terminated on business considerations and as matter of commercial expediency and on facts it was found that by terminating the managing agency, the company had not acquired any enduring benefit or any income-yielding asset. It was then observed in this case as follows (p. 554) :

It is true that by terminating the services of the managing agents, the company not only saved the expense that it would have had to incur in the relevant previous year but also for a few more years to come. It will not be correct to say that by avoiding certain business expenditure, the company can be said to have acquired enduring benefit or acquired any income-yielding asset.

16. Referring to this decision in J.K. Cotton Manufacturers Ltd. Vs. Commissioner of Income Tax, Lucknow, , the Supreme Court pointed out

that in Commissioner of Income Tax, Madras Vs. Ashok Leyland Ltd., , there was finding of fact that the termination of the managing agency was

purely on business considerations and as a matter of commercial expediency and that no enduring benefit was acquired by the company. It is also

important to point out that while holding, on the facts of the case in J.K. Cotton Manufacturers Ltd. Vs. Commissioner of Income Tax, Lucknow, ,

that the payment was of a capital nature, the Supreme court reiterated the approach which had to be adopted while determining whether an

outgoing amount is of a capital nature or of a revenue nature as indicated in M. K. Brothers (P.) Ltd.'s case, the Supreme Court had observed as

follows (P. 42) :

The answer to the question as to whether the money paid is a revenue expenditure or capital expenditure depends not so much upon the fact as to

whether the amount paid is large or small or whether it has been paid in lump sum or by instalments, as it does upon the purpose for which the

payment has been made and expenditure incurred. It is the real nature and quality of the payment and not the quantum or the manner of the

payment which would prove decisive. If the object of making the payment is to acquire a capital asset, the payment would partake of the character

of a capital payment even though it is made not in lump sum but by instalments over a period of time.

17. The Supreme Court further reiterated the classic test laid down by viscount Cave L.C. in Atherton's case [1925] 10 TC 155 , where the Lord

Chancellor had observed as follows (at p. 231 of 101 ITR) :

But when an expenditure is made, not only once and for all, but with a view to bringing into existence as 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 a n opposite conclusion) for treating

such an expenditure as properly attributable not to revenue but to capital.

18. Therefore, even according to the decision cited on behalf of the Revenue, if there is a payment made on the ground of commercial expediency

and if such payment does not result in the acquisition of any capital asset or an enduring benefit, merely because such payment is made to get rid of

the liability which is much larger, the outgoing amount cannot be considered as capital in nature. Ultimately, the conclusion as to whether a

particular outgoing is capital or revenue in character must be decided with reference to the facts of each particular case. Learned counsel also

brought to our notice a decision of the Punjab and Haryana High Court in Dalmia Dadri Cement Ltd. Vs. Commissioner of Income Tax, . That

was a case of termination of a managing agency which was to continue till May 25, 1968. The managing agency was, however, terminated in

December 1952, and the assessee paid to the managing agent a sum of Rs. 6,00,000 as compensation for premature termination of the managing

agency. Though the Income Tax Officer held that the payment was not a revenue expenditure, the Appellate Assistant Commissioner had taken a

different view. The Tribunal, however, held that the advantage which the company had gained was of such an enduring nature that it amounted to a

capital expenditure. The Division Bench took the view that the assessee had derived an enduring benefit from an economic point of view. On the

terms of the agreement which was terminated, it was found that there was

brought into existence a clear advantage of an enduring nature, an advantage indistinguishable from a material or fixed asset for the assessee-company. It appears to us that the circumstances which weighed with the learned judges for reaching the conclusion that the advantage was of an enduring nature were that the assessee had taken the deliberate decision as part of a planned policy for laying the foundation or the basis of future economic prosperity of the company. It was found that the assessee-company was not faced with an immediate danger to be averted, no financial problem confronted the board of directors for terminating the managing agency agreement nor was any economic difficulty to be surmounted by adopting this course of payment of lump sum. The decision cited *supra* must, in our view, be restricted to the facts of that case. We may point out that the question of capital or revenue expenditure was considered by the Supreme Court in *Empire Jute Co. Ltd. Vs. Commissioner of Income Tax*, . The Supreme Court, in that case, pointed out that the test of acquisition of enduring benefit or advantage cannot be applied mechanically or blindly. After referring to the test laid down by Lord Cave in *Atherton v. British Insulated and Helsby Cables Ltd.* [1925] 10 TC 155 , and the decision of the Privy Council in *Commissioner of Taxes v. Nchanga Consolidated Copper Mines Ltd.* [1965] 58 ITR 241 , the Supreme Court observed as follows (head-note) :

There may be cases where expenditure, even if incurred for obtaining an advantage of enduring benefit, may, none the less, be on revenue account and the test of enduring benefit may break down. It is not every advantage of enduring nature acquired by an assessee that brings the case within the principle laid down in this test. What is material to consider is the nature of the advantage in a commercial sense and it is only where the advantage is in the capital field that the expenditure would be disallowable on an application of this test. If the advantage consists merely in facilitating the assessee's trading operations or enabling the management and conduct of the assessee's business to be carried on more efficiently or more profitably while leaving the fixed capital untouched, the expenditure would be on revenue account, even though the advantage may endure for an indefinite future. The test of enduring benefit is, therefore, not a certain or conclusive test and it cannot be applied blindly and mechanically

without regard to the particular facts and circumstances of a given case.

19. The approach indicated by the Supreme Court in *Empire Jute Co. Ltd. Vs. Commissioner of Income Tax*, , must now be the approach and it

would not, therefore, be enough to merely ascertain whether a particular expenditure has resulted in any advantage of an enduring character. The

advantage, as pointed out by the Supreme Court, must be in a commercial sense and further must be in the capital field. Only if the advantage is in

the capital field, the expenditure will partake of the nature of capital expenditure. Now, so far as the present case is concerned, it is difficult for us

to see that benefit of an enduring character has been secured by the assessee. The extensive liability has undoubtedly been got rid of, but getting rid

of a liability by paying a lesser sum cannot be said to secure an enduring benefit, though it may be a benefit in the limited sense and much less can

be said to be a benefit in the capital field.

20. Our attention has been invited by learned counsel for the assessee to the decision of the Bombay High Court in *Life Insurance Corporation of*

India Vs. Commissioner of Income Tax, Bombay City-II, . That was a case in which the Life Insurance Corporation, in whom the assets and

liabilities of all the insurers had vested statutorily by the Life Insurance Corporation Act, 1956, was required by the statute to make payments of

compensation annually for a period of 10 years in the case of chief agents and by a lump sum in the case of special agents. The chief agents and the

special agents were appointed by the insurers whose business had vested in the Corporation. The payments of such compensation were claimed as

permissible deductions in the assessment proceedings. The Income Tax Appellate Tribunal had held that the compensation was a price for the

taking over of the business of the insurers and was not deductible. The Bombay High Court, relying on *Commissioner of Income Tax, Madras Vs.*

Ashok Leyland Ltd., , observed that the ratio of that decision was that if services were terminated by payment of compensation with the result that

the recurring liability is got rid of, the amount paid by way of compensation was in the nature of revenue expenditure and that such compensation

does not result in the acquisition of any enduring benefit or income-yielding asset. Applying this ratio, it was held that the payment of compensation

to the chief agents and the special agents partook of the nature of revenue

expenditure and not capital expenditure. The same reasoning, in our view, would be applicable in the instant case. In order to get rid of a liability much larger in quantum, a lesser payment is made. It may be advantageous to refer to the very pertinent observations made by Rowlatt J. in *B.W. Noble Ltd. v. Mitchell* [1927] 11 TC 372 , and quoted with approval by the Supreme Court in *Commissioner of Income Tax, Madras Vs. Ashok Leyland Ltd.*, , that in the ordinary case, a payment to get rid of a servant when it is not expedient to keep him in the interest of trade would be a deductible expenditure and a payment made to remove the possibility of a recurring disadvantage cannot be considered as a payment made to acquire an enduring advantage.

21. The payment in the instant case clearly appears to us to be made on grounds of commercial expediency and to facilitate the carrying on of the business and must, therefore, be treated as having been incurred fully and exclusively for the purposes of the trade. As we have already pointed out, there was no benefit of any enduring character in the capital field which accrued to the assessee. In our view, the Tribunal was justified in treating the payment of Rs. 50,000 as being revenue in character. Consequently, question No. 1 has to be answered in the affirmative and against the Revenue. Consequent upon the view which we have taken on question No. 1 questions Nos. 2 and 3 have also to be answered in the affirmative and against the Revenue and, accordingly, all the questions are answered against the Revenue. The Revenue to pay costs, Rs. 1,000, one set.