

(1973) 09 MAD CK 0017

In the Madras High Court

Case No : Tax Case No's. 87 of 1968 and 175 of 1969 (Reference No's. 18 of 1968 and 62 of 1969)

Commissioner of Income Tax

APPELLANT

Vs

Sarada Binding Works

RESPONDENT

Date of Decision : 21-09-1973

Acts Referred:

Income Tax Act, 1961 — Section 10

Citation : (1976) 102 ITR 187

Hon'ble Judges : V. Ramaswami, J;G. Ramanujam, J

Bench : Division Bench

Advocate : V. Balasubrahmanyam and J. Jayaraman, for the Appellant; Uttama Reddy, for the Respondent

Judgement

Ramanujam, J.—Both the above references are at the instance of the revenue and the assessee is the same in both the cases. The first case relates to the assessment year 1962-63 and the second relates to the subsequent assessment year 1963-64.

2. The assessee is a registered firm carrying on business as a book binder and publisher. It entered into an agreement dated November 15, 1958, with Shri B. Nagi Reddy under which it obtained the right to run the business of "Chandamama Publications" for a consideration of a fixed sum of Rs. 5,000 per annum plus a sum equivalent to 10 per cent. of the net profits of each year of business. By a settlement deed dated December 24, 1962, Shri B. Nagi Reddy settled his rights under the said agreement on his two grandsons. The two grandsons sold their rights to the assessee under a sale deed dated October 30, 1963, for a consideration of Rs. 1,50,000.

3. During the accounting period relevant to the assessment year 1962-63, the assessee paid a total sum of Rs. 15,497 to Shri B. Nagi Reddy as per the terms of the agreement dated November 15, 1958, and claimed the said amount as a business expenditure. The Income Tax Officer disallowed the claim, as in his

opinion the amount in question constituted consideration for the purchase of the business and was, therefore, in the nature of capital expenditure. The assessee preferred an appeal to the Appellate Assistant Commissioner who, however, confirmed the disallowance made by the Income Tax Officer. Aggrieved against the said decision the assessee went before the Appellate Tribunal. It was contended before the Tribunal by the assessee as follows :

(1) that there was no outright sale of the business of "Chandamama Publications" by Shri Nagi Reddy in favour of the assessee under the agreement dated November 15, 1958, but that it was only a lease of the business with the permission to use the goodwill and that the payment in question is only in the nature of a royalty for the use of the goodwill of the business; and

(2) that even if there was an outright sale of the business by Shri Nagi Reddy to the assessee, the consideration for the sale being in the nature of annual payment in perpetuity from and out of the profits of the business, it should be taken to be a revenue expenditure.

4. The Tribunal took the view that there was an outright sale of the business by Shri Nagi Reddy in favour of the assessee but that the payment of Rs. 15,497 was allowable as revenue expenditure in view of the decision in *Commissioners of Inland Revenue v. 36/49 Holdings Ltd.*, [1943] 25 TC 173(CA) and in *Travancore Sugars and Chemicals Ltd. Vs. Commissioner of Income Tax, Kerala*, . Aggrieved against the decision of the Tribunal the revenue sought a reference to this court. In that reference the assessee also wanted the question as to whether the Tribunal's view that there was an outright purchase of the business by the assessee under the agreement dated November 15, 1958, was right, to be referred. The Tribunal, therefore, referred the following two questions:

"(1) Whether, on the facts and circumstances of the case, and on the terms of the agreement of sale and purchase, the Appellate Tribunal was right in law in holding that the payment of Rs. 15,497 to Shri Nagi Reddy constituted revenue expenditure ?

(2) Whether the Appellate Tribunal was right in holding that there was an outright sale of the business by Shri Nagi Reddy as a result of the agreement dated 15th November, 1958 ?"

5. Likewise a sum of Rs. 20,598 was claimed by the assessee as a revenue expenditure in the assessment year 1963-64, which the Tribunal had upheld. Therefore, the revenue has sought and obtained a reference on the following question:

"Whether, on the facts and in the circumstances of the case, the Appellate Tribunal was right in law in holding that the payment of Rs. 20,598 constituted revenue expenditure ?"

6. The second question referred in T. C. No. 87 of 1968, as already stated, has been referred at the instance of the assessee in an application filed for reference

by the revenue. But it has been consistently held by this court that an assessee, who has not sought a reference himself, cannot have a question referred in an application filed for reference by the revenue. We have to, therefore, hold that the second question is not properly before us. We, therefore, refrain from answering that question.

7. The learned counsel for the assessee, however, submits that the first question referred in T. C. No. 87 of 1968 is wide enough to include the question as to whether there was a sale of the business by Shri Nagi Reddy to the assessee and that even if the reference on the second question is held to be incompetent, that question has to be considered while answering the first question. We are inclined to agree with the learned counsel for the assessee that the first question is wide enough to comprehend the question as to whether there was an outright purchase of business by the assessee. Thus, the first question referred in T. C. No. 87 of 1968 and the only question in T. C. No. 175 of 1969 relate to the nature of the annual payments made by the assessee to Shri Nagi Reddy during the assessment years 1962-63 and 1963-64, i.e., whether the expenditure is of a revenue or capital nature.

8. The contention of the assessee both before the Tribunal as well as before us is that there is no outright purchase of business by the assessee from Shri Nagi Reddy and that, in any event, the annual payment made in pursuance of the agreement dated November 15, 1958, can only be taken as a revenue expenditure. The Tribunal held that the transaction entered into by the assessee with Shri Nagi Reddy on November 15, 1958, will only amount to an outright purchase of business, but that the payment of a part of the consideration annually out of the profits without any time limit would only amount to a revenue expenditure. The learned counsel for the revenue contends that on the basis of the finding of the Tribunal that there is an outright purchase of the business by the assessee, the sums in question, which are paid as part of the consideration, can only be taken to be a capital expenditure and that the nature and character of the amounts have to be determined with reference to the payer and not with reference to the payee. But we are, however, inclined to accept the view of the Tribunal that even if the agreement dated November 15, 1958, amounted to an outright purchase of the business by the assessee, still the payment in question can only be treated as a revenue expenditure.

9. In *Travancore Sugars and Chemicals Ltd. v. Commissioner of Income Tax* their Lordships of the Supreme Court had to consider a somewhat similar question. In that case three undertakings run by the Government of Travancore were taken over by a company under an agreement where-under the assets of the three undertakings were agreed to be sold by the Government to the new company. Clause 7 of the agreement recited certain cash consideration for the sale of the assets of the three undertakings and also 20% of the annual net profit subject to a maximum of Rs. 40,000 being paid to the Government. The said 20% was later reduced to 10% by an amendment of the terms of the agreement. For the

previous year relevant to the assessment year 1958-59, the amount payable by the company to the Government under Clause 7 came to Rs. 42,480 and the question was whether the said payment was allowable u/s 10 of the Income Tax Act. The High Court held that the amount constituted a capital expenditure. The Supreme Court held that the payment in question was in the nature of a revenue expenditure, because: (1) the payment was for an indefinite period and had no limitation of time attached to it; (2) the payment was related to the annual profits which flowed from the trading activities of the assessee and had no relation to the capital value of the assets; and (3) the payment was not related to or tied up, in any way, to any fixed sum agreed between the parties as part of the purchase price of the three undertakings. The Supreme Court expressed that the agreement in that case is not one for payment of the price stipulated in instalments and that the real nature of the transaction has to be gathered not only from the concerned instruments but also from the surrounding circumstances; and the colour which the parties may give to a particular transaction which is the source of receipt and the characterisation of the receipt by themselves are of little consequence.

10. The Supreme Court again considered a similar question in *Devidas Vithaldas and Co. Vs. Commissioner of Income Tax , Bombay, .* In that case the Supreme Court expressed :

"In distinguishing between capital and revenue expenditure, the courts have applied in different cases different tests. None the less, it is recognized that none of them by itself is conclusive, and the determination one way or the other has to be made on the facts and circumstances of each case."

11. Dealing with the acquisition of a running business it expressed the view that the acquisition of the goodwill of a business will amount to an acquisition of a capital asset and, therefore, its purchase price would be a capital expenditure and that it will not make any difference whether the consideration is paid in a lump sum at one time or in instalments distributed over a definite period. Where, however, the transaction is not one for acquisition of the goodwill, but for the right to use it, the expenditure would be a revenue expenditure. In that case a chartered accountant carrying on his profession in the name and style of *Devidas Vithaldas & Co.,* entered into a partnership with another reserving to himself all the rights and interests in the goodwill of that business. Under a deed of dissolution he agreed to sell the goodwill to the other partner on payment of certain share out of the net profits of the business to himself or his wife or to his son for and during the terms of the respective lives. On the question whether the payment made to his wife after his death in pursuance of the said agreement under which the goodwill was transferred is a revenue expenditure, the court held that the transaction was in the nature of a licence and not a sale of the goodwill, that the payments in question, therefore, being in the nature of royalty are to be treated as revenue expenditure. The main reason for holding that the transaction did not amount to the sale of the goodwill is that the duration of the

payment as also the amount of the consideration was indefinite as they depended on the rise and fall in the profits of the business. The above decision fully supports the claim for deduction put forward by the assessee in this case.

12. But the learned counsel for the revenue seeks to get support from the decision in Commissioner of Income Tax, West Bengal II, Calcutta Vs. Coal Shipment (P) Ltd., , M.K. Brothers (P) Ltd. Vs. Commissioner of Income Tax, Kanpur, and the minority judgment of Sikri C.J. in Devidas Vithaldas & Co. v. Commissioner of Income Tax.

13. In Commissioner of Income Tax v. Coal Shipments P. Ltd., the question was whether the payment made to a competitor in business to ward off competition in business would constitute capital expenditure. It was held that the object of making that payment is to derive an advantage by eliminating competition for a certain period and that the payment having been made for the enduring benefit of the assessee's business it was of a capital nature, even if the enduring benefit may not be of a permanent and everlasting character. In M.K. Brothers Private Ltd. v. Commissioner of Income Tax the assessee purchased the sole selling agency rights from another in consideration of the assessee adjusting the commission it earned towards certain debts due by him. The question arose was whether the amounts so adjusted was a revenue or capital expenditure. The Supreme Court held that the payment amounted to a capital expenditure as it was a case of application of income to discharge a liability incurred not in the course of running the business, but undertaken for the purpose of acquiring the sole selling agency right which was an asset of a capital nature. Both the above decisions do not touch the aspect which we have to consider here. In those cases it was definitely found that the amounts in question were spent for acquiring either capital assets or an advantage of an enduring nature and there was no question of the payment depending on the profits earned.

14. The view taken by Sikri C.J. in his dissenting judgment in Devidas Vithaldas & Co. v. Commissioner of Income Tax of course supports the stand taken by the revenue. The learned Chief Justice said at page 292 :

"I am unable to see how a mode of payment of purchase price of any capital asset can convert a capital payment into a revenue payment in the hands of the vendee. It may be that the mode of payment may affect the character of the receipt in the hands of the vendor but, as far as the vendee is concerned, I am unable to agree that the mode of payment can convert what is obviously a capital payment or expenditure into a revenue payment or expenditure. Reliance was placed on the three grounds adopted by this court in Travancore Sugars and Chemicals Ltd. v. Commissioner of Income Tax, viz., indefinite period, absence of any expressed lump sum, and payment relating to profits and not being tied up with any fixed sum agreed to as the purchase price of a capital asset. I am unable to regard these grounds as conclusive in a case where there can be no doubt that the capital asset has been sold."

15. But the majority has not accepted this view and they have held that the transaction does not amount to a sale and that the payment of consideration for the use of the goodwill of the business, which is indefinite and depends on the profits earned by the company each year, can only be a revenue expenditure.

16. The learned counsel for the revenue, however, points out that the majority view in the above case proceeds on the basis that the transaction in that case does not amount to a sale and that if the transaction were to be held to be a sale then the view expressed by Sikri C.J. has to be the true legal position. It is true, the majority has taken the view that the transaction in that case did not amount to a sale but amounted to a licence for the use of the goodwill and the consideration paid for such user can only be a revenue expenditure. But in this case though the Tribunal has held that the transaction under the agreement is one of sale, none the less that part of the consideration which is indefinite depending on the profit earned by the assessee each year will only be a revenue expenditure. We are of the view that even if the transaction in question amounts to a purchase of the business on which we express no opinion, the consideration which consists of partly a fixed annual sum and partly a periodical payment on a certain percentage of the profits earned by the assessee from the said business cannot, in entirety, be treated as a capital payment. The fixed annual sum paid towards part of the consideration will obviously be a capital payment. The periodical payments of sums which are indefinite depending upon the future profits earned cannot be treated as of capital nature. The purchase consideration should, therefore, be taken to consist of two elements, one of a capital nature and another of an income nature. The fact that some of the elements of sale consideration are of a capital nature does not in the least bit point to the periodical payments which are indefinite depending on the profits of the company being also of a capital nature. Wheatcroft in his treatise, *The Law of Income Tax, Sur Tax and Profits Tax*, at page 1152, sets out the following three types of cases where the purchase price may be paid periodically or in instalments and the points of distinction between them :

"First, there are cases where all the payments must be treated as income of the recipient and the payer is entitled to deduct tax on payment and to a deduction in computing his total income. Secondly, there are cases where the payments are all treated as capital and are neither taxable to the recipient nor deductible in computing the payer's total income. Thirdly, there are cases where the payments must be dissected into an income content and a capital content so that the former part is taxable and deductible whilst the latter is not."

17. We are of the view that the case before us will come under the third type pointed out above. The question whether the payment is capital or revenue has to be considered in relation to the facts of each case and the true nature of the payment has to be ascertained from the documents and all the surrounding circumstances, the important features to consider being the nature of the original obligation, the period of time during which the payments are to continue,

whether or not they are expressed in the form of instalments of some capital sum and what provisions, if any, are made for commutation. The same author points out the following four tests in deciding the question as to whether a particular expenditure is allowable or not:

"In general, however, in order to decide whether some particular expenditure of a trader should be brought into account, four tests, similar to those considered in relation to receipts, should be applied. First, is the expenditure wholly and exclusively laid out for the purposes, of the trade ? If not, it will be excluded. Secondly, is the expenditure of a revenue, and not of a capital nature ? Unless it is of a revenue nature it will be excluded. Thirdly, may tax be deducted and retained on payment ? If so, it will be excluded. Finally, is there some other special provision of the Income Tax Act which permits, or requires, the payment to be brought in, or left out of account ?"

18. He has also pointed out that in considering whether a particular item is deductible for tax purposes the problem should be looked at from the point of view of the payer, not of the payee relying on the following passage of Lord Denning in *Ralli Estates Ltd. v. Commissioner of Income Tax*, [1961] 1 WLR 329 (PC):

"Their Lordships...consider that the cases about income receipts have no relevance here. Payments which are income receipts in the hands of the recipient are not necessarily revenue expenditure in the hands of the payer."

19. On the facts of this case it is clear that under the agreement the assessee had undertaken to pay a sum of Rs. 5,000 per annum plus a sum equivalent to 10 per cent. of the profits of the business each year so long as the business is carried on by the assessee. The said payments are not limited to any particular and definite duration so that it could be said that it is a mode of payment of the purchase price by instalments. Further, it is seen that the payments are related to the future profits of the business run by the assessee, and it is not tied up or related in any way to any special sum whatsoever. The payments calculated at a certain percentage of profit of business for an indefinite period cannot be treated as payments by instalments of a capital sum. The very character and nature of the said payments suggest that no idea of connecting these payments with any specified capital sum was ever present in the minds of the contracting parties. In these circumstances, we find no difficulty in holding that the payments are of revenue character and that there are no elements present which would justify us in attributing to these payments a capital character. The payments are to be made for an indefinite period until they were commuted by mutual agreement. Though the payments are fixed with reference to the profits, they are indirectly related to the turnover. The payments were not related to any specified sum which was agreed upon by the parties as purchase price of the business. Such circumstances were taken to indicate that the payments are of revenue nature in *Commissioners of Inland Revenue v. 36/49 Holdings Ltd.* In that case certain periodical payments were taken to be revenue expenditure for the following

reasons:

- (1) The payments were to be made in perpetuity until the right to commute is exercised;
- (2) the payments were related to the turnover which were the trading activity, and the sums paid were in that respect not dissimilar from royalties;
- (3) the sums payable under the second category were not tied in any way or related in any way to any special sum whatsoever.

20. We, therefore, answer the first question in T.C. No. 87 of 1968 and the only question in T.C. No. 175 of 1969 in the affirmative and against the revenue. The assessee will have his costs in T.C. No. 87 of 1968 alone. Counsel's fee Rs. 250. There will be no order as to costs in T.C. No. 175 of 1969.