

Madhowji Dharamshi Mfg. Co. Ltd. vs The Commissioner Of Income-Tax, Bombay on 29 April, 1970

Equivalent citations: AIR1970SC1811, [1970]78ITR62(SC), (1970)2SCC229, AIR 1970 SUPREME COURT 1811

Author: J.C. Shah

Bench: A.N. Grover, J.C. Shah, K.S. Hegde

JUDGMENT

J.C. Shah, J.

1. Madhowji Dharamshi Mfg. Co. Ltd.-hereinafter called 'the assessee' - was carrying on the business of manufacturing and selling textiles. The assessee was a flourishing concern; the annual profits earned by the assessee before October 1946 ranged between Rs. 15 to 20 lakhs and it had very large reserves.

Till October 7, 1946, the assessee was managed by the Provident Investment Co. Ltd. which owned a majority of the shares of the assessee. On October 7, 1946 the entire share capital of the assessee was purchased by Dalmia Investment Company Ltd. and the Provident Investment Co. Ltd. resigned their office as managing agents of the assessee.

2. Dalmia Cement and Paper Marketing Company Ltd. hereinafter called 'the D. C. P. M.' - were incorporated on October 21, 1937 with the object, inter alia, of carrying on the business of and to work as selling agents or managing agents of any person, firm or company. By an agreement dated October 29, 1948, the D. C. P. M. were appointed selling agents of cotton goods manufactured by the assessee for a period of 10 years commencing from November 1, 1948 upon the terms and conditions mentioned in the selling agency agreement. Under the agreement it was provided that in the event of the assessee being at any time during the continuance of the agreement wound up for the purpose and with the object of transferring its business to another company, the transferee shall appoint the D. C. P. M. and their successors and assigns to be selling agents for the residue of the term under the selling agency agreement on the same terms and conditions as to remuneration, emoluments or otherwise. Pursuant to the agreement dated October 29, 1948, the D. C. P. M. acted as the selling agents of the assessee.

3. A company called "Vastra Vyavasaya Ltd."-hereinafter called "V. V." - was a private limited company incorporated on May 27, 1948 with the object, inter alia, of carrying on the business of managing agents, manager, secretaries or agents of any person, firm or company. V. V. was

appointed managing agent of the assessee for 20 years with effect from July 1, 1950 under a resolution of the assessee dated July 5, 1950. A formal agreement was executed on August 30, 1950, setting out the terms and conditions of the managing agency agreement.

4. The assessee claimed in the proceeding for assessment for the year 1951-52 corresponding to the account year ending December 31, 1950, allowance under Section 10(2) (xv) of the Income-tax Act, 1922 in respect of Rs. 17,80,000/- and Rs. 46,80,00 /- expended under an agreement dated February 21, 1951 and confirmed by the directors on February 28, 1951, as compensation for breach of contracts respectively to the selling agents and the managing agent. The Income-tax Officer rejected the claim for allowance, and the Appellate Assistant Commissioner confirmed the order of the Income-tax Officer. In Second appeal the Income-tax Appellate Tribunal observed:

...we are satisfied upon the facts and circumstances of this case that the selling agency and the managing agency agreements in both the appeals were merely a make-believe, or sham or colourable transaction and that the claim for compensation and the payments are equally fraudulent. They were part of a scheme x x x to withdraw a tax-free sum from the appellants before their liquidation.

5. The assessee then applied under Section 66(1) of the Indian Income-tax Act to draw up a statement of the case and refer the following question to the High Court of Bombay for opinion:

1. Whether on the facts and in the circumstances of the case the Tribunal was right in disallowing the compensation amount of Rs. 17,80,000/-paid by the applicant company to its selling agents on the breach of the selling agency agreement?

2. Whether the Tribunal had any material before it to come to the conclusion that there was a scheme from the very beginning of the appointment of the selling agents to withdraw a tax free sum from the applicant company before its liquidation?

3. Whether the Tribunal was justified to hold that the selling agency agreement was merely a make-believe or sham or colourable transaction and that the claim for compensation and the payment thereof was fraudulent?

4. Whether on the facts and in the circumstances of the case the Tribunal was right in holding that the nature of compensation payment of Rs. 17,80,000/- made to the selling agents was the same as that of the payment in English case of Godden v. A. Wilson's Stores (Holding) Ltd. reported in (1962) 40 Tax Cas 161?

5. Whether on the facts and in the circumstances of the case the Tribunal was right in disallowing the compensation amount of Rs. 46,80,000/-paid by the applicant company to its managing agents on the breach of the managing agency agreement?

6. Whether the Tribunal had any material before it to come to the conclusion that there was a scheme on the appointment of the managing agents to withdraw a tax

free sum from the applicant company before its liquidation?

7. Whether the Tribunal was justified to hold that the managing agency agreement was merely a make-believe or sham or colourable transaction and that the claim for compensation and the payment thereof was fraudulent?

8. Whether on the facts and in the circumstances of the case the Tribunal was right in holding that the nature of compensation payment of Rs. 46,80,000/- made to the managing agents was the same as that of the payment in English case of (1962) 40 Tax Cas 161?

9. Whether on the facts and in circumstances of the case Tribunal was justified in ignoring the awards of the arbitrators and the decrees of the High Court in arriving at its conclusion that the selling agency agreement and the managing agency agreement were colourable transactions?

The Tribunal rejected the application, and a petition under Section 66(2) to the High Court of Bombay requesting that a statement of the case be called on the questions submitted was summarily rejected. With special leave, the assessee has appealed to this Court.

6. Under the Indian Income-tax Act, 1922, compensation paid by a trader to an agent or employee for premature termination of the agreement of agency or employment for a fixed duration was regarded as an admissible allowance under Section 10(2)(xv) of the Act: *Anglo-Persian Oil Co. (India) Ltd. v. Commr. of Income-tax*. In the hands of the agent or employee the amount was ordinarily regarded as a capital receipt: *Commr. of Income-tax v. Shaw Wallace and Co.*, *Kettle-well Bullen and Co. Ltd. v. Commr. of Income-tax*, *Calcutta*, *Godrej & Co. v. Commr. of Income-tax*, *Bombay City*; *Commissioner of Income-tax, Hyderabad-Deccan v. Vazir Sultan & Sons*. Relying upon this state of the law certain tax-payers resorted to ingenious devices by terminating the contracts with their employees and agents and agreeing to pay large amounts of compensation free from tax liability: *Lakshmiratan Cotton Mills Co. Ltd. v. Commr. of Income-tax*, *U. P.* and *Juggilal Kamlatpat v. Commr. of Income-tax*, *U. P.*. The Legislature became wise to the devices adopted, to secure for themselves large sums of money free of income-tax. The Legislature by the Finance Act of 1955 amended Section 7, and added Explanation 2(i) and also incorporated Section 10(5A).

7. To the present case the amendment made by the Finance Act of 1955 does not apply. The Revenue authorities and the Tribunal have however come to the conclusion that the appointments of the selling agents and the managing agent, and the agreements to pay compensation for determining their contracts formed a chain of sham or colourable transactions designed to ensure withdrawal of large sums tax free from the profits of the assessee before it was liquidated.

8. The facts found by the Tribunal may be briefly set out. The share-holding of the assessee was controlled directly or indirectly "through inter-connected companies" wholly owned or controlled by Seth R. Dalmia. Till October 7, 1946, the assessee was managed by the Provident Investment Company Ltd. The share-holding of the Provident Investment Company Ltd, was taken over by the

Dalmia Investment Company Ltd. which is wholly owned by Seth R. Dalmia. The Provident Investment Company Ltd., then resigned their office. Under an agreement dated October 29, 1948, the D. C. P. M., another company controlled by Seth R. Dalmia were appointed selling agents with effect from November 1, 1948 for 10 years on generous terms. Under the agreement it was stipulated that even the purchaser of the assets of the assessee was bound to continue the D. C. P. M. as selling agents. On May 27, 1948 V. V. was incorporated with a paid-up capital of Rs. 20,000/-. Till it was appointed managing agent on July 5, 1950, V. V. had done no business. The shareholding of V. V. was almost exclusively with Seth R. Dalmia and his other concerns.

9. The circumstances in which V. V. was appointed managing agent and the events which took place in quick succession thereafter leave no room for doubt that the chain of events was a part of a design to withdraw large sums of money tax free from the assessee's profits. A general meeting was held on July 5, 1950 and a resolution was passed appointing V. V. as managing agents for 20 years with effect from July 1, 1950. On July 25, 1950, a notice was issued calling an extraordinary general meeting seeking authority of the Board of Directors "to sell the mills if a suitable occasion arose". On August 16, 1950 a resolution was unanimously passed authorising the directors to sell the mills if "an opportunity arose". On October 26, 1950, the managing agency agreement between the assessee and V. V. was executed and on October 27, 1950 the assessee agreed to sell for Rupees 36,50,000/- all its assets including stock-in-trade (except certain woollen goods, stock, stores, etc.) to M/s. Ram Sahai Mal More Ltd. of Calcutta. On October 31, 1950 the purchasers took charge of the mills. On January 10, 1951 a deed of conveyance for the properties was executed. On February 14, 1951 the D. C. P. M. and V. V. called upon the assessee to pay compensation for breach of their agreements, alleging that the assessee had failed to stipulate for their appointment as selling agents and managing agent respectively of the purchasers. On February 21, 1951 the directors of the assessee informally agreed to pay compensation for the unexpired portion of the agency agreements. On February 28, 1951 the assessee intimated that they agreed to pay compensation amounting to Rs. 17,80,000/- and Rs. 46,80,000/- to , the selling and managing agents respectively. On March 31, 1951 a portion of the amounts was actually paid. On December 31, 1951, it was resolved to wind up the assessee. At an extraordinary general meeting held on April 26, 1952, two liquidators were appointed and on May 15, 1952, the liquidators addressed separate letters to the selling agents and the managing agent disputing the agreements for payment of compensation and offering to re-examine the question of payment of compensation and the validity of the claim relating to payment of compensation. On August 16, 1952, the liquidators of the assessee and the selling agents and the managing agent agreed to refer the "disputes" between them to arbitration upon the terms set out in two separate agreements of reference. On November 24, 1952, the arbitrators made and published two separate awards to the effect that there was a breach of contract by the assessee and that the selling agents and managing agent were entitled to compensation and that all the settlements were valid and binding between the parties. A decree was obtained from the High Court of Bombay on April 16, 1953 confirming the awards made by the arbitrators declaring, inter alia, that the liquidators of the assessee were liable to pay to the selling agents and the managing agent the sums of Rs. 17,80,000/- and Rs. 46,80,000/- respectively as and by way of compensation together with costs.

10. On a review of these facts, the Tribunal reached the conclusion that the transactions entered into and the agreements made by the assessee with the selling agents and the managing agent and the resolutions passed were "all sham and colourable transactions with a view to appropriate the funds of a flourishing concern to their own use by those who controlled the assessee company and the managing agents and selling agents". That finding is amply borne out by the evidence.

11. The High Court was therefore right in refusing to call for a statement of the case.

12. The appeal fails and is dismissed with costs.