Supreme Court of India
The Commissioner Of Income-Tax, ... vs Sri Meenakshi Mills Ltd. & Ors on 25 October, 1966
Equivalent citations: 1967 AIR 819, 1967 SCR (1) 934
Author: V Ramaswami
Bench: Ramaswami, V.

PETITIONER:
THE COMMISSIONER OF INCOME-TAX, MADRAS

Vs.

RESPONDENT:
SRI MEENAKSHI MILLS LTD. & ORS.

DATE OF JUDGMENT:
25/10/1966

BENCH:
RAMASWAMI, V.
BENCH:
RAMASWAMI, V.
SHAH, J.C.
BHARGAVA, VISHISHTHA

CITATION:
1967 AIR 819 1967 SCR (1) 934
CITATOR INFO :
E 1969 SC1160 (5)
R 1986 SC 1 (4)
RF 1986 SC1370 (90)
R 1986 SC1483 (4)

ACT:
Indian Income-tax Act (11 of 1922), s. 42-Scope--Finding of fact by Tribunal-Interference by High Court, validity,-Corporate entity, if Court can lift veil--

HEADNOTE:
The assessee-companies, carried on business in Madurai and each had a branch at Pudukottai, a former native State. They hold majority share in a Bank which, too, had its head office at Madurai and branch at Pudukottai. T, who was a shareholder of the Bank, was the moving figure in the assessee-companies. The assessees borrowed moneys from the Madurai head office of the Bank on the security of fixed deposits made by the assessees' branches with the Pudukottai branch of the Bank. The loans were far in excess of the available profits at Pudukottai. The Income-tax Officer held that the borrowings in British India on the security of the fixed deposits made at Pudukottai amounted to

constructive remittance of the profits by the branches of the assessee-companies to their Head Office in India within the meaning of s. 4 of the Income-tax Act, and this view the Appellate Assistant Commissioner upheld. The assessees appealed to the Trbunal which took note that the branch whether of the assessee of the Bank constituted only one unit, and the establishment of the branch of the Bank at Pudukottai was intended to help the financial operations of T in the concerns in which he was interested., and the Pudukottai branch of the Bank had transmitted funds deposited by the assessees for enabling the Madurai branch to advance loans at interest to the assessees and the transmission of the funds was made with the knowledge of assessees. The Tribunal held that the assessees were rightly assessed. In reference the High Court answered the question in favour of the assessees holding it was not established that there was any arrangement between the assessees and the Bank whether at Pudukottai or at Madurai for transference of moneys from Pudukottai branch to Madurai and the facts on record did not establish that there was any transfer of funds between Pudukottai and Madurai for the purpose of advancing moneys to the assessees, and the transactions represented ordinary banking transactions and there was nothing to show that the amounts placed in fixed deposits in the branch were intended to and were in fact transferred to head office for the purpose of lending them out to the depositor himself. In appeals by the Commis-sioner, this Court,

HELD: The appeals must be allowed

The High Court erred in law in interfering with the findings of the appellate Tribunal. In a reference the High Court must accept the findings of fact reached by the appellate Tribunal and it is for the party who applied for a reference to challenge those findings of fact first by an application under s. 66(1). If the party failed to file an application, under s. 66(1) expressly raising the question about the validity of the findings of fact, he is not entitled to urge before the High Court that the findings are vitiated for any reason. [938 H-939 B]

India Cements Ltd. v. Commissioner of Income-tax, Madras, 60, I.T.R. 52, relied on.

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In the context of the facts as found by the Tribunal, the entire transactions formed part of a basic arrangement or scheme between the creditor and the debtor that the money should be brought into British India after it was taken by the borrower outside the taxable territory. [940 B-C]

Section 42 requires, in the first place, that money should have been lent at interest outside the taxable territory, in the second place, income, profits or gains should accrue or arise directly or indirectly from such money so lent at interest, and in the third place, that the money should be brought into the taxable territories in cash or in kind. If

all these conditions are fulfilled, then the section lays down that the interest shall be deemed to be interest accruing or arising within the taxable territories. [939 D]
The provision in s. 42(1), which brings within the scope of the charging section interest earned out of money lent outside, but brought into British India, was not ultra vires the Indian Legislature on the ground that it was extra-territorial in operation. [939 F]
The section contemplates the bringing of money into British India with the knowledge of the lender and borrower and this gives rise to a real territorial connection. This knowledge must be an integral part of the transaction. [940 A]
A. H. Wadia v. Commissioner of Income-tax, Bombay 17 I.T.R. 63, approved.
In certain exceptional cases the Court is entitled to lift the veil of corporate entity and pay regard to the economic realities behind the legal facade. For example, the Court has power to disregard the corporate entity if it is used for tax evasion or to circumvent tax obligation. [941 E]
Devid Payne & Co. Ltd. in re, Young v. David Payne & Co., Ltd. [1904] 2 Ch. D. 608. distinguished.
Case law referred to.

JUDGMENT:

CIVIL APPELLATE JURISDICTION : Civil Appeals Nos. 1084 to 1097 of 1965.

Appeals by special leave from the judgment and order dated January 8, 1963 of the Madras High Court in Tax Case No. 108 of 1960.

B. Sen, A. N. Kirpal, S. P. Nayyar and R. N. Sachthey, for the appellant (in all the appeals).

R. Venkataraman and R. Ganapathy Iyer, for the respondent (in all the appeals).

The Judgment of the Court was delivered by Ramaswami, J. These appeals are brought, by special leave, from the judgment of the High Court of Madras dated January 8, 1963 in Tax Case No. 108 of 1960.

All the three respondents (hereinafter called the aassessee- companies') are public limited companies engaged in the manufacture and sale of yam at Madurai. Each of the assessee-companies had a branch at Pudukottai engaged in the production and sale of cotton yarn. The sale-proceeds of the branches were periodically deposited in the branch of Madurai Bank Ltd. (hereinafter referred to as the 'Bank') at Pudukottai a former native State either in the current accounts or fixed deposits which earned interest for the various assessment years as follows:

Assessment years MeenakshiRajendra Saroja Mills millsmills Rs. Rs. Rs.

1946-47 1,08,902 25,511 1947-48 1,18,791 24,953 30,620 1948-49 1,50,017 33,632 36,890 1949-50 42,36941,393 195-0-51 1,27,314 41,957 42,092 The Bank aforesaid was incorporated on February 8, 1943 with Thyagaraja Chettiar as founder Director, the Head Office being at Madurai. Out of 15,000 shares of this bank issued 14,766 were held by Thyagaraja Chettiar, his two sons and the three assessee-companies as shown below:

Share holding

1. Thyagaraja Chettiar 1,008

2. Manickavasagam 250

3. Sundaram 250

4. Meenakshi Mills 5,972

5. Rajendra Mills 3,009

6. Saroja Mills 4,177 All the three assessee companies borrowed moneys from the Madurai branch of the bank and on the security of the fixed deposits made by their branches with the Pudukottai branch of the Bank. It is the admitted case that the loans granted to the assessee-companies were far in excess of the available profits at Pudukottai. In the assessment proceedings of the assessee-companies for the various years under dispute, the Income-tax Officer was of the view that the borrowings in British India on the security of the fixed deposits made at Pudukottai amounted to constructive remittances of the profits by the branches of the assessee-

companies to their Head Offices in India within the meaning of s. 4 of the Indian Income-tax Act, 1922 (hereinafter called the 'Act'). Accordingly he included the entire profits of the assessee-companies including the interest receipts from the Pudukottai branches in the assessment of the assessee-companies, since the overdrafts availed of by the assessee-companies in British India far exceeded the available profits. The assessee-companies appealed to the Appellate Assistant Commissioner of Income-tax. After examining the constitu-

tion of the assessee-companies and the Bank and the figures of deposits and overdrafts, the Appellate Assistant Commissioner found that the deposits made by the assessee- companies and other companies closely allied to them formed a substantial part of the total deposits received by the Bank. He was also of the view that the Pudukottai branch of the Bank had transmitted the funds so deposited for enabling the Madurai branch to advance loans at interest to the assessee-companies and that the transmissions of the funds were made with the knowledge of the assessee-companies

who were major shareholders of the Bank. The Appellate Assistant Commissioner also considered that the Pudukottai branch of the Bank had no other appreciable transactions except the collection of funds and on the facts found S. 42(1) of the Act applied to the case. The assessee- companies took the matter in appeal to the appellate Tribunal -which took note of the position that the head office and the branch-whether of the assessee-companies or of the Bank-constituted only one unit and that Thyagraja Chettiar occupied a special position in both the concerns and the establishment of the branch of the Bank at Pudukottai was intended to help the financial operations of Thyagaraja Chettiar in the concerns in which he was interested. After detailed consideration of the deposits and overdrafts and the inter-branch transactions of the Bank the appellate Tribunal held that s. 42(1) of the Act was applicable to the facts of the case and that the assessee- companies must be attributed with the knowledge of the activity of their branches at Pudukottai and of the remittances made by the Pudukottai branch of the Bank to Madurai head office, and that the entire transactions formed part of an arrangement or scheme.

In the course of its judgment, the appellate Tribunal observed as follows:

> "Even so, it seems to us, we cannot escape the fact that Thyagaraja Chettiar, his two sons and the three Mills had a preponderant, if not the whole, voice in the creation, running and management of the Bank. We cannot also forget that Pudukottai is neither a cotton producing area nor has a market for cotton; except that it was a non-taxable territory, there was nothing else to recommend the carrying on of the business in cotton spinning or weaving there. There is yet another aspect to which our attention was drawn by the learned counsel for the assessee. That being, a non-taxable area, there were many very rich men there with an influx of funds to invest in banks and industries. By the same token, it appears to us it was not necessary for the Madurai Bank which was after all a creation of certain people which started with a small capital of Rs. 32,800 to have gone to Pudukottai for opening a branch. If there was an influx of money in Pudukottai Sup.C.I./66-14 because of the finances, nobody would have agreed to borrow money from it. At any rate, it is clear it would have had no field for investment in Pudukottai the only source of investment being outside Pudukottai." The appellate Tribunal further stated: "But having regard to the special position of Thyagaraja Chettiar and the balance sheets of the bank referred to above and the lack of investments in Pudukottai itself of' the moneys borrowed there, it seems more reasonable to conclude that the bank itself was started at Madurai and a branch of it was opened at Pudukottai only with a view to help the financial operations of Thyagaraja Chettiar and the mills in which he was vitally interested."
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> At the instance of the assessee-companies the appellate Tribunal referred the following question of law for the determination of the High Court:
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> "Whether on the facts and in the circumstances of the case, the taxing of the entire interest earned on the fixed deposits made out of the profits earned in Pudukottai by the assessee's branches in the Pudukottai branch of the Bank of Madurai is correct?"

> The High Court answered the question in favour of the assessee-companies holding that it was not established that there was any arrangement between the assessee-companies and the Bank whether at Pudukottai or at Madurai for transference of moneys from Pudukottai branch to Madurai and the facts on record did not establish that there was any transfer of funds between Pudukottai and Madurai for the purpose of advancing moneys to the assessee-companies. The High Court further took the view that the transactions represented ordinary banking transactions and there was nothing to show that the amounts placed in fixed deposits in the branch were intended to, and were in fact transferred to head office for the purpose of lending them out to the depositor himself.

On behalf of the appellant Mr. Sen submitted at the outset that the High Court was not legally justified in interfering with the findings of fact reached by the appellate Tribunal and in concluding that there was no arrangement or scheme between the lender and the borrower for the transference of funds from Pudukottai to Madurai. In our opinion, there is justification for the argument put forward on behalf of the appellant and the High Court erred in law in interfering with the findings of the appellate Tribunal in this case. In India Cements Ltd., v. Commissioner of Income-tax, Madras(1) it was pointed out by this Court that in a reference the High Court must accept the findings of fact reached by the appellate Tribunal and it is for the party who. applied for a reference to challenge those findings of fact first by an application under s. 66(1). If the party concerned has failed to file an application under s. 66(1) expressly raising the question about the validity of the findings of fact, he is not entitled to urge before the High Court that the findings are vitiated for any reason. We therefore proceed to decide the question of law raised in these appeals upon the findings of fact reached by the appellate Tribunal.

Section 42 of the Act states as follows:

> "All income, profits or gains accruing or arising whether directly or indirectly through or from any money lent at interest and brought into the taxable territories in cash or in kind shall be deemed to be income accruing or arising within the taxable territories This section accordingly requires, in the first place, that any money should have been lent at interest outside the taxable territory. In the second place, income, profits or gains should accrue or arise directly or indirectly from such money so lent at interest, and, in the third place, that the money should be brought into the taxable territories in cash or in kind. If all these conditions are fulfilled, then the section lays it down that the interest shall be deemed to be income accruing or arising within the taxable territories. This section was the subject-matter of interpretation by the Federal Court in A. H. Wadia v.

Commissioner of Income-tax, Bombay(2) It was held by the majority of the Judges in that case that the provision in s. 42(1) of the Act, which brings within the scope of the charging section interest earned out of money lent outside, but brought into, British India was not ultra vires the Indian Legislature on the ground that it was extra- territorial in operation. It was pointed out that the section contemplated the bringing of money into British India with the knowledge of the lender and

borrower and this gave rise to a real territorial connection. The learned Chief Justice took the view that the nexus was the knowledge to be attributed to the lender that the borrower had borrowed money for the purpose of taking it into British India and earning income on that money. Mukherjea and Mahajan, JJ. took a somewhat different view. Mahajan, J. considered that there must be an arrangement between the lender and the borrower to bring the loan into British India, and Mukherjea, J. further emphasised the point by stating that it must be the basic arrangement underlying the transaction that the money should be brought into British India after it is taken by the borrower outside his territory. But all (1) 60 I.T.R. 52.

(2) 17 I.T.R. 63.

the learned Judges agreed that the knowledge of the lender and the borrower that the money is to be taken into British India must be an integral part of the transaction. That is the ratio of the decision of the Federal Court with regard to the construction of s. 42(1) of the Act. Having examined the findings of the appellate Tribunal in the present case we are satisfied that the test prescribed by the Federal Court in Wadia's case(1) is fulfilled and the appellate Tribunal was right in its conclusion that there was a basic arrangement or scheme between the assessee- companies and the Bank that the money should be brought into British India after it was taken by the borrower outside the taxable territory. The appellate Tribunal has pointed out that the assessee-companies had a preponderant, if not the whole, voice in the creation, running and management of the Bank and that Pudukottai was neither a cotton producing area nor had it a market for cotton and except that it was a non- taxable territory there was nothing else to recommend the carrying on of the cotton spinning or weaving business there. The Tribunal further remarked that having regard to the special position of Thyagaraja Chettiar and the balance sheets of the Bank and lack of investments in Pudukottai, it was reasonable to conclude that the Bank itself was started at Madurai and a branch was opened at Pudukottai only with a view to helping the financial operations of Thyagaraja Chettiar and the mills in which he was vitally interested. The Tribunal found that Pudukottai branch of the Bank had transmitted funds deposited by the assessee-companies for enabling the Madurai branch to advance loans at interest to the assessee,companies and the transmission of the funds was made with the knowledge of the assessee-companies who were the major shareholders of the Bank. In the context of these facts it must be held that the entire transactions formed part of a basic arrangement or scheme between the creditor and the debtor that the money should be brought into British India after it was taken by the borrower outside the taxable territory. We are accordingly of the opinion that the principle laid down in Wadia's(1) case is satisfied in this case and that the Income-tax authorities were right in holding that the entire interest earned on fixed deposits was taxable.

In the course of argument Mr. Venkataraman contended that even if Thyagaraja Chettiar, a Director of the assessee- companies, knew in his capacity as Director of the Madurai Bank that money placed in fixed deposit by the assessee- companies would be transferred to the taxable territory, that knowledge cannot be imputed to the assessee-companies and so it cannot be said that the transfer was part of an integral arrangement of the loan transaction. In support of this argument learned Counsel referred to the decision. of the Court of Appeal in David Payne & Co. Ltd., In re. Young v.

(1) 17 I.T.R. 63.

David Payne & Co. Ltd.,(1) We are unable to accept the argument of the respondents as correct. The decision in David Payne & Co's (1) case, has no bearing on the question presented for determination in the present case. In David Payne & Co's (1) case, supra, the question at issue related to the powers and duties of Directors and it was held that because the same person is a common director of two companies, the one company has not necessarily notice of everything that is within the knowledge of the common director, which knowledge he has acquired as director of the other company. In the present case the question at issue is entirely different. The appellate Tribunal has, upon examination of the evidence, found that the transference of funds from Pudukottai to Madurai was made as part of the basic arrangement between the Bank and the assessee- companies and that Thyagaraja Chettiar who was the moving figure both in the Bank and in each of the assessee- companies had knowledge of this arrangement. It is well established that in a matter of this description the Income-tax authorities are entitled to pierce the veil of corporate entity and to look at the reality of the transaction. It is true that from the juristic point of view the company is a legal personality entirely distinct from its members and the company is capable of enjoying rights and being subjected to duties which are not the same as those enjoyed or borne by its members. But in certain exceptional cases the Court is entitled to lift the veil of corporate entity and to pay regard to the economic realities behind the legal facade. For example, the Court has power to disregard the corporate entity if it is used for tax evasion or to circumvent tax obligation. For instance, in Apthorpe v. Peter Schoenhofen Brewing Co.(2) the Income Tax Commissioners had found as a fact that all the property of the New York company, except its land, had been transferred to an English company, and that the New York company had only been kept in being to hold the land, since aliens were not allowed to do so under New York law. All but three of the New York company's shares were held by the English company, and as the Com- missioners also found, if the business was technically that of the New York company, the latter was merely the agent of the English company. In the light of these findings the Court of Appeal, despite the argument based on Salomon'S(3) case, held that the New York business was that of the English company which was liable for English income tax accordingly. In another case-Firestone Tyre and Rubber Co. v. Llewellin(4)--an American company had an arrangement with its distributors on the Continent of Europe -whereby they obtained supplies from the English manufacturers, its wholly owned subsidiary. The English company credited the American with the price received after deducting the costs plus 5 (1) [1904] 2 Ch. D. 608.

(3) [1897] A.C. 22.

(2) 4 T.C. 41.

(4) [1957] 1 W.L.R. 464.

per cent. It was conceded that the subsidiary was a separate legal entity and not a mere emanation of the American parent, and that it was selling its own goods as principal and not its parent's goods as agent. Nevertheless, these sales were a means whereby the American company carried on its European business, and it was held that the substance of the arrangement was that the American company traded in England through the agency of its subsidiary. We, therefore, reject the argument of Mr. Venkataraman on this aspect of the case.

For the reasons expressed we hold that the question referred to the High Court by the appellate Tribunal must be answered in favour of the Income-tax Department and against the respective assessee-companies and these appeals must be allowed with costs.

Y.P.

Appeals allowed.