

Commissioner of Income-tax, Gujarat Iii Vs. Ambika Mills Ltd.

LegalCrystal Citation : legalcrystal.com/733334

Court : Gujarat

Decided On : Dec-26-1975

Reported in : [1976]104ITR669(Guj)

Judge : B.J. Diwan, C.J. and; T.U. Mehta, J.

Acts : [Income Tax Act, 1961](#) - Sections 37 and 37(1)

Appeal No. : Income-tax Reference No. 94 of 1974

Appellant : Commissioner of Income-tax, Gujarat Iii

Respondent : Ambika Mills Ltd.

Advocate for Def. : J.M. Thakore, Adv.

Advocate for Pet/Ap. : K.H. Kaji, Adv.

Judgement :

Divan, C.J.

1. In this matter at the instance of the revenue the following question had been referred to us for our opinion :

'Whether, on the facts and in the circumstance of the case, the conclusion reached by the Tribunal that the sum of Rs. 92,308 being legal expenses incurred by the assessee was admissible as a revenue deduction is correct in law ?'

2. The facts leading to this reference are as follows. We are concerned with assessment year 1960-61. The assessee is public limited company. It owns three textile mills known as Mills Nos. 1,2 and 3. Mill No. 3 is situated at Board and is known as 'Jagdish Mills'. The relevant previous year was calendar year 1959. In the course of the assessment proceedings the assessee-company claimed a deduction of the sum of Rs. 92,308 being expenditure incurred but the assessee towards court expenses and other expenses in connection with liquidation proceedings which the assessee-company had initiated against Lalbhai Trikamlal Mills Ltd. (hereinafter referred to as 'the Lal Mills'). This amount of Rs. 92,308 represented court expenses incurred during the year out of provision made in calendar year 1958. So far as the income in calendar year 1958 was concerned, the amount of Rs. 92,308 was disallowed in that year and was left for consideration in the assessment year 1960-61. The major portion of the expenses was incurred towards liquidation proceedings of the Lal Mills. At this stage it is necessary to set out some facts which have been found by the Tribunal and which are now established by the two additional documents

brought on the record of the proceedings before us. The Lal Mills was incorporated on July 9, 1929. The managing agents of the Lal Mills were Ramachandra Lalbhai, Jasubhai Lalbhai and one Chinubhai Lalbhai. After the death of Chinubhai, his son, Bharatkumar, seems to have been taken up as one of the managing agents. In the year 1953, the Lal Mills was in financial difficulties and a winding-up petition was filed by one of the creditors against the Lal Mills in the District Court at Ahmedabad. That petition was pending when an arrangement was arrived at between the assessee and the Lal Mills. This arrangement was ultimately recorded in the form of an agreement dated August 20, 1953, between the Lal Mills and the managing agents on the one hand and the assessee-company on the other. Under this financial agreement, the assessee agreed to advance Rs. 25 lakhs against first mortgage debentures. The assessee-company also agreed to advance a further sum of Rs. 10 lakhs which was to be secured by charge subject to the first mortgage over the plant, machinery, etc., of the Lal Mills. On December 3, 1953, the debenture trust deed for Rs. 25 lakhs was executed and subsequently a further sum of Rs. 31 lakhs was advanced against the second mortgage. The second mortgage was executed on May 14, 1954, and the limit of the advance under the second mortgage was Rs. 41 lakhs. It appears that as on December 9, 1954, the assessee-company was a creditor of Lal Mills to the extent of Rs. 67 lakhs and out of this amount, an amount of Rs. 65 lakhs was secured by the first and the second mortgages above. It may also be pointed out that under the financial agreement of August 20, 1953, the assessee-company became entitled to be in the sole management of Lal Mills for a period of seven years, that being the period for which the debentures were to remain in force and it also became entitled to a share of seven annas in the rupee in the managing agency commission that the managing agents of Lal Mills were to receive under their managing agency agreement with Lal Mills. It appears from the record that the managing agents of Lal Mills were entitled to receive a commission of 14 1/2 annas and out of this managing agency commission seven annas share was to be paid to the assessee-company. Various other terms to secure the sole management of the company to the assessee were also incorporated in this agreement of August 20, 1953. It appears from the order of the Appellate Assistant Commissioner in these assessment proceedings that after the agreement was entered into, a litigation had to be undergone by the assessee-company against the Lal Mills and Chinubhai Lalbhai and others who were the managing agents for prevention of interference by the previous managing agents of Lal Mills in the day to day management by the assessee-company and its nominees. An amount of Rs. 11,750 had to be spent by the assessee-company towards litigation expenses in connection with that dispute and ultimately the matter had gone to the High Court at Bombay in appeal in respect of those proceedings. That sum of Rs. 11,750 by way of expenditure by the assessee so far as assessment year 1956-57 was concerned. The income-tax Officer had disallowed that amount of Rs. 11,750 by way of expenditure but the matter was taken in appeal and the Appellate Assistant Commissioner allowed the claim as revenue expenditure.

3. On December 10, 1954, the assessee-company sent a notice of demand to Lal Mills claiming repayment of Rs. 31 lakhs and unsecured amount of Rs. 2 lakhs and it also claimed interest on the debentures of Rs. 25 lakhs since the interest was not paid. A reply to this notice was sent by the Lal Mills on December 7, 1954, and ultimately, on January 15, 1955, the assessee-company presented a winding-up petition in the District Court at Ahmedabad since that court had jurisdiction under the Indian Companies Act, 1913. After the passing of the Indian Companies Act, 1956, the winding-up proceedings were transferred to the High Court of Bombay. Ultimately, an order was passed by Mody J. of the Bombay High Court, on April 20, 1958, granting

permission to withdraw the winding-up petition. From the judgment of Mody J., which is brought on the record by the consent of the parties as exhibit 2, it appears that the matter was contested quite a good deal. The proceedings had gone on before the learned judge for four to five days and a lot of contest had developed. Ultimately, it was agreed between what was been referred to by Mody J. as the Lalbhai Trikamalal group, to sell 12,525 shares of Lal Mills to what is known as Harivallabh family who were the majority shareholders in the assessee-company before us. The total number of ordinary shares of Lal Mills was 17,500 and it was agreed that the shares of Lalbhai group should be sold to the members of Harivallabh group or their nominees. Ultimately, as mentioned above, the winding-up proceedings came to an end after the shares were brought over or agreed to be brought over in the above manner and that order was passed on April 25, 1958. In connection with these proceedings an aggregate sum of Rs. 92,308 was spent by the assessee-company as legal expenses and the question which has been canvassed before the departmental authorities, before the Tribunal and also before us is whether amount was revenue expenditure or capital expenditure. The Income-tax Officer held that this amount was spent as capital expenditure as in his view the liquidation proceedings had been initiated with a view to acquire control over the Lal Mills. Against this decision of the Income-tax Officer, the assessee-company took the matter in appeal. The Appellate Assistant Commissioner remanded the matter and after the remand report was submitted by the income-tax Officer, the Appellate Assistant Commissioner considered the matter and held that this expenditure was revenue expenditure. According to the Appellate Assistant Commissioner the winding-up proceedings were resorted to by the assessee in order to safeguard the outstanding amount of loan which had been advanced by the assessee-company to Lal Mills. Against this decision of the Appellate Assistant Commissioner and dismissed the appeal so far as that aspect was concerned. Thereafter, at the instance to us for our opinion.

4. We may also point out that the relevant portion of the remand report called for by the Appellate Assistant Commissioner has been produced and by the consent of the parties marked as exhibit 1 on the record of this reference. The agreement dated August 20, 1953, is annexure 'D' on the record of this reference and it sets out how the entire arrangement for the assessee-company at advance money to Lal Mills was arrived at and what were the terms and conditions of that arrangement. One of the recitals in the agreement is as follows :

'Whether Lalbhai Mills having come into financial difficulties, a petition for winding up of Lalbhai Mills was presented at the instance of one of the creditors to the District Court at Ahmednagar, for winding up of Lalbhai Mills, which petition is still pending in the said District Court AND WHEREAS by their order dated 24th July, 1953, the Central Government, under the powers vested in them have caused an investigation to be made into the affairs of Lalbhai Mills under the provisions of the Industries (Development and Regulation) Act, 1951, and whereas the managing agents, with the consent and privity of the confirming parties requested Ambica Mills to take over the sole charge and management of the business of Lalbhai Mills including manufacture, sale and distribution of its products and also including purchase of cotton, stores, spare parts, etc., which Ambica Mills has agreed to do upon the terms and conditions hereinafter contained.'

5. It may be mentioned that the Ambica Mills is the assessee before us. Clause 1 of the operative part of the agreement sets out the arrangement regarding the sole charge and management of the business of Lal Mills including the manufacture, sale

and distribution of its products and also including the purchase of cotton, stores, spare part etc., being taken over by Ambica Mills. The Ambica Mills became as entitled to conduct and manage the business of Lal Mills as the constituted attorneys of the managing agents and they were to conduct and manage the business as a prudent man would conduct his own business under the supervision and control of the board of directors of Lal Mills. Under clause 5 of the agreement the assessee-company agreed to advance a sum of Rs. 25 lakhs secured by first debentures of the face value of Rs. 25 lakhs and the interest was to run at six per cent. per annum payable every half year. It was also provided that during the continuance of the agreement Ambica Mills were to advance sum or sums of money not exceeding in all a sum if Rs. 10 lakhs to Lal Mills for the purpose of discharging, if and when necessary, the existing liabilities of Lal Mills. This amount of Rs. 10 lakhs was to be advanced over and above the sum of Rs. 25 lakhs and this amount not exceeding Rs. 10 lakhs was to be secured by a charge on the land, buildings, plant and machinery subject to the first mortgage deed was to be created. This amount not exceeding of Rs. 10 lakhs was to carry interest and to be secured by a charge on the land, buildings, plant and machinery, etc., The agreement also mentions that Lal Mills had borrowed a sum of Rs. 20,75,000 from the Bank of Baroda Ltd. on the hypothecation or pledge of its liquid assets and this was under a cash credit arrangement which Lal Mills had with the Bank of Boroda Ltd. The period of the agreement was to be seven years from the date the assessee-company took over the charge or management of the business of Lal Mills and if at the end of seven years Lal Mills had not paid back in full the mortgage debentures of Rs. 25 lakhs or other advance or advances made by Ambica Mills to Lal Mills for carrying on its business, then the agreement was to continue for such further perios until the whole of the amount due under the said debentures and also the advance of advances which might have been made by Ambica Mills to Lal Mills had been paid off in full. It was also agreed that the period of seven years could be extended by a further period of two years at the option of Lal Mills. The assessee-company became entitled under the terms of the agreement, clause 13, to appoint four directors, one of whom was to be the chairman of Lal Mills, the managing agents between themselves, that is, the Lalbhai group were to appoint three directors on the board of directors including the ex-officio directors and the Lalbhai group were to the exercise their voting strength in any general meeting of the Lal Mills in favour of the appointment of the said four directors to be appointed by Ambica Mills and an irrevocable power of attorney was also to be executed in favour of Ambica Mills authorizing Ambica Mills to exercise all or any of the powers and authorities vested in the managing agents. The agreement also provided for payment of seven annas in the rupee out of the 14 12 annas managing agency commission in connection with the management of the affairs of Lal Mills which the managing agents of Lal Mills were entitled to and it was also agreed that the managing agents who are the confirming parties belonging to the Lalbhai group were to sell 1,000 ordinary shares of Lal Mills at par to seessee-company or their nominees and the relevant share certificates in respect of the said 1,000 shares were to be handed over to the assessee-company or their nominee or nominees on payment of the price thereof. Clause 22 indicates the dire straits in which Lal Mills had landed itself. The arrangement set out in the agreement dated August 20, 1953, was conditional and was not to take effect unless and until the following conditions were complied with :

- (a) The petition for winding up of Lal Mills pending in the District Court at Ahmedabad had been withdrawn or dismissed;
- (b) The order of the Central Government for investigation into the a fairs of Lal Mills

was vacated; and

(c) Release of the charge of land, buildings, plant and machinery of Lal Mill in favour of Government for income-tax dues was obtained.

6. This was the arrangement in pursuance of which the debenture trust deed for Rs. 25 Lakhs was executed on December 3, 1953. Apparently, by that time the three conditions mentioned in the agreement of August 20, 1953, were satisfied and, thereafter, the assessee-company entered into the management of Lal Mills. From what was averred in the winding-up petition, as appears from the copy of the judgment of Mody J., exhibit 2 on the record of this case, the allegation in the winding-up petition was that it was filed by the assessee-company as creditors of the Lal Mills and the grounds urged in support of the order for winding up were that the Lal Mills was unable to pay its debts, that the substratum of the company had gone and that Lal Mills was commercially insolvent because the Lal Mills had, in the years 1952, 1953 and for the period up to 29th November, 1954, incurred heavy losses and, therefore, it was not possible for Lal Mills to carry on its business at a profit. As pointed out above, the proceedings before Mody J. were contested bitterly and during the pendency of those proceedings, it appears that it was agreed between Lalbhai group on the one hand and Harivallabh group on the other that the Harivallabh group should buy from the Lalbhai group majority shareholding so as to enable the Harivallabh group to have complete majority shareholding in Lal Mills and after that arrangement was arrived at, the winding-up petition was withdrawn and no other creditor of the Lal Mills had come forward to support the winding-up proceedings.

7. It was urged by Mr. Kaji, on behalf of the revenue before us, that the assessee-company was properly secured so far as its advances to the extent of Rs. 65 lakhs were concerned by the debenture mortgage deed to the extent of Rs. 25 lakhs and by the second mortgage deed to the extent of the remaining amount out of Rs. 65 lakhs and it has security over the entire assets of the Lal Mills. It was urged that the assessee-company could have filed a civil suit to recover its outstanding if it was entitled on law to do so and instead it adopted liquidation proceedings with a view to obtain ultimate control over the Lal Mills. It was urged in this connection that liquidation proceedings are not intended for the recovery of loans by creditors and since the assessee-company was in full management of Lal Mills, it was not possible for the Lalbhai group to interfere with the day to day management of the mills and yet the secured creditors who were in full management of Lal Mills applied for winding up of Lal Mills with a view to obtain complete control as distinguished from partial control over the affairs of Lal Mills. It was further emphasised by Mr. Kaji that the winding-up petition was withdrawn after the purchase of majority of the ordinary share of Lal Mills and so far as the loans advanced by the assessee-company to Lal Mills were concerned, decided no benefit was secured by it when the winding-up petition was ultimately withdrawn as recorded in the order of the Bombay High Court dated April 25, 1958. Even at that stage the assessee-company did not make any effort at realising security. On these facts, Mr. Kaji, for the revenue, submitted that on the balance of probabilities, the main aim and object of the assessee-company in initiating liquidation proceedings was to obtain complete control over the Lal Mills and those proceedings were not initiated with a view to safeguard the loans advanced by the assessee-company to Lal Mills.

8. In our opinion, it is not possible for us to accept any one of these contentions of Mr. Kaji. In the first place as the record of the case shows, even after the management of

Lal Mills was taken over by the assessee-company, the assessee-company had no smooth sailing. As a matter of fact, an amount of Rs. 11,750 had to be spent to prevent members of the Lalbhai group from interfering with the day to day management of Lal Mills by the assessee-company. Further, the very fact that there was a bitter contest in winding-up proceedings as noted in exhibit 2 indicates that the winding-up petition was not a collusive proceeding and the proceedings were started because the Lal Mills was alleged to be commercially insolvent. The question that we have to consider is not what a reasonable and prudent man would decided on when placed in a situation similar to the assessee-company when it initiated the liquidation proceedings but whether the company resorted to liquidation proceedings with a view to safeguard its loans advanced to the Lal Mills. It appears from the record before us, so far as the facts are concerned, that even after the assessee-company had entered into the management under the terms of agreement of August 20, 1953, it had to fight a litigation to ensure its complete management over the affairs of Lal Mills. Even after the period of management of one year by Lal Mills and even after nearly Rs. 67 lakhs were secured by one or the other mortgage and Rs. 2 lakhs unsecured had been sunk by the assessee-company in the Lal Mills, that company was still in financial difficulties and the financial difficulties were such that it is alleged by the assessee-company in the winding-up petition that Lal Mills was not even in a position to pay recurring interest on the amount of Rs. 25 lakhs secured by the debentures. The learned Advocate-General appearing for the assessee-company is right when he contends that no secured creditor would take a risk of initiating winding-up proceeding unless he felt that the situation was so hopeless that winding-up proceeding was the only way out for him to safeguard his own security. In the scheme of winding-up proceeding under the Companies Act, 1956, as envisaged, it is open to a secured creditor to insist on the security even in winding-up proceeding or to surrender his security and come in as unsecured creditor or to insist on security to the extent that the assets are sufficient to meet the secured amount and to come as an unsecured creditor for the balance but it is always a speculative matter in winding-up proceeding as to what will be the ultimate result in proceeding and whether, if ultimately the company is wound up by the court and the assets are sold, the sale proceeds realised would be sufficient to meet the claim even of the secured creditor. Under these circumstances the contention urged on behalf of the revenue by Mr. Kaji that a secured creditor does not ordinarily apply for winding - up of the company over the assets of which he is holding a security, much less a secured creditor who is in sole management of the business of the company in financial difficulties, loses its force in the light of the facts of this particular case.

9. The correct test to be followed by the court in matters like the present has been laid down by the Supreme Court in *Sree Meenakshi Mills Ltd. v. Commissioner of Income-tax*. The Supreme Court there held that the deductibility of expenditure incurred in prosecuting a civil proceeding depends upon the nature and purpose of the legal proceeding the assessee's business and cannot be affected by the final outcome of that proceeding. However, wrong-headed, ill-adviced, unduly optimistic or over-confident decision, expenditure in starting and prosecuting a civil proceeding cannot be denied as a permissible deduction in computing the taxable income merely because the had failed if otherwise the expenditure was laid out for the purpose of the business wholly and exclusively, that is reasonable and honestly incurred to promote the interest of the business. Persistence of the assessee in launching the proceeding and carrying it form court and incurring expenditure for that purpose is not a ground for disallowing the claim. It was also held by the Supreme Court that in order that an expenditure may be admissible as a deduction under section 10(2)(xv)

of the Indian Income-tax Act, 1922, equivalent to section 37(1) of the Income-tax Act, 1961, it is not necessary that the primary motive in incurring it must be directly to earn income thereby.

10. In the present case it cannot be dispute that if the litigation expenditure is incurred by the assessee-company in order to safeguard the loan advanced by it, it would be revenue expenditure. In the instant case nobody could have predicated in advance when the winding-up petition was started in the District Court at Ahmedabad on January 15, 1955, that ultimately the Lalbhai group of shareholder would be prepared to surrender their shareholding to the Harivallabh group, that is, the group controlling and holding the majority in the assessee-company, What was the original object with which the financial arrangement was entered into and the sub-sequent winding-up proceeding were launched by the assessee-company In view of the litigation which required an expenditure of Rs. 11,750 and in view of the bitter fight has been noticed by Mody J., in exhibit 2, it is not possible for us to say that the winding-up petition was a collusive proceeding between the two group and that this was a part of the pre-arranged plan or a pre-arranged scheme so that through the machinery of the winding-up petition the complete control including the control over the shareholder of Lal Mills might pass to the assessee-company. Under these circumstances, the test that has to be applied is whether the expenditure was voluntarily incurred by the assessee-company and with a view to preserved the money advanced, that is to preserve its assets. It view of the various factors which we have pointed out above and particular the fact that even after entering into the management of Lal Mills the assessee-company had no smooth sailing. It cannot be said that the winding-up proceeeding was initiated by the assessee-company in order to obtain complete control over the Lal Mills. The question that we must ask ourselves in : 'What must have been the aim and object Lal Mills ?' If on the balance of probabilities it can be said that the aim and object in initiating the winding-up proceeding was to obtain complete control over the Lal Mills, the question that we have posed to ourselves must be answered in favour of the assessee, that is it must be held that it cannot be predicated that when the company initiated winding-up proceeding on January 15, 1955, its aim and object was to obtain complete control over the Lal Mills. What ultimately happened in those winding-up proceeding by way of compromise between the rival group is no indication of why the winding-up proceeding were initiated.

11. In view of this conclusion it must be held that the Tribunal was right that on the facts and in the circumstance of the case and law the amount of Rs. 91,308 spent by the assessee was admissible as a revenue deduction and that was the correct conclusion in law. We, therefore, answer the question referred to us in the affirmative, that is, in favour of the assessee and against the revenue. The Commissioner will pay the cost of this reference to the assessee.