

Commissioner of Income-Tax, Kerala

Vs

Alagappa Textiles (Cochin) Ltd.

Civil Appeals Nos. 2001 and 2002 of 1972

(V.D. Tulzapurkar, R.S. Pathak JJ)

19.09.1979

JUDGMENT

TULZAPURKAR J. -

These appeals by special leave raise a common question whether on proper construction of the agreement dated November 10, 1955, entered into by the assessee with Kamala Mills Ltd., the latter was the "manager" of the assessee within the meaning of s. 384 read with s. 2(24) of the Companies Act, 1956, and if so whether the remuneration paid by the assessee to the latter in the two calendar years 1957 and 1958 relevant to the assessment years 1958-59 and 1959-60 cannot be allowed as business expenditure under s. 10(2)(xv) of the Indian I.T. Act, 1922 ?

The facts giving rise to the question may briefly be stated as follows :

The assessee (M/s. Alagappa Textiles (Cochin) Ltd.) is a public limited company carrying on business of manufacture and sale of yarn and has its registered office at Alagappa Nagar in Kerala State. It entered into an agreement dated November 10, 1955, with Kamala Mills Ltd., Coimbatore, for financing and managing the assessee-mills at Alagappa Nagar for a period of five years. Clause 8 of the agreement provided that Kamala Mills Ltd., shall be paid, for the services rendered by it by way of purchases, sales and management, remuneration at the rate of 1% on all purchases made by it for the assessee-mills and at half a per cent. on all sales of yarn, yarn waste and cotton waste and other products of the mill. Pursuant to the aforesaid term, Kamala Mills Ltd. drew remuneration to the tune of Rs. 1,03,547 and Rs. 18,294 respectively, for the calendar years 1957 and 1958 corresponding to the assessment years 1958-59 and 1959-60. These amounts were assessed to tax in the hands of Kamala Mills Ltd. The assessee in its assessment proceedings for the said two assessment years claimed deduction in respect of the said two amounts as business expenditure under s. 10(2)(xv) of the Act. The claim was disallowed by the ITO on the ground that under s. 384 of the new Companies Act, 1956, which had come into force on April 1, 1956, the continuation of a body corporate as manager was prohibited for the period beyond six months from the coming into force of the Act, that remuneration paid to Kamala Mills Ltd., subsequent to October 1, 1956, was illegal being in violation of s. 384 and, therefore, the deduction claimed in respect of such payment for the calendar years 1957 and 1958 could not be allowed. In the appeals preferred by the assessee against the decision of the ITO, it was contended that though the payment of remuneration to a body corporate as manager after October 1, 1956, was illegal under s. 384, the payments were for services rendered

and were fully justified by commercial expediency and as such the same should be allowed under s. 10(2)(xv) of the Act. It was also urged that even if the expenses incurred were in violation of the statute such expenses should be allowed since in computing the profits even of illegal business only the net profit was taxed after allowing all the expenses. The AAC was not impressed by these arguments, but he disallowed the deduction mainly on the ground that the assessee by its own conduct had disputed its liability to pay any remuneration to Kamala Mills Ltd. after October 1, 1956, and in that behalf he relied on an admitted fact that the assessee had filed a suit against Kamala Mills Ltd. to recover back such remuneration which had been paid to it in contravention of s. 384 on the basis that, since the payment was illegal, Kamala Mills Ltd. was holding such amounts of remuneration in trust for and on behalf of the assessee and in such a situation the deduction could not be allowed. The assessee carried the matter in further appeals to the Tribunal, but the Tribunal confirmed the view of the taxing authorities that under s. 384 of the Companies Act, 1956, it was not legal for the assessee to have permitted Kamala Mills Ltd. to continue to work as its manager after October 1, 1956, and that the payment of remuneration after the said date was illegal and could not be considered as valid expenditure for the purpose of the I.T. Act. In this behalf, the Tribunal relied on two decisions in CIT v. Haji Aziz and Abdul Shakoor Bros. [1955] 28 ITR 266 (Bom) and Raj Woollen Industries v. CIT [1961] 43 ITR 36 (Punj). An argument was raised before the Tribunal that Kamala Mills Ltd. was not only a manager but also a financier and that the remuneration should be treated as having been paid to the financier. While observing that it was a new case put forward by the assessee, the Tribunal negated the contention holding, on construction of the agreement, that it was by virtue of its position as manager that Kamala Mills Ltd. was allowed to carry on the financial affairs of the assessee and the remuneration was payable to it as manager and in no other capacity. The Tribunal also held that the claim for deduction was in respect of a disputed liability inasmuch as the assessee had not merely filed a suit to recover the amount but had in the meantime obtained a decree against Kamala Mills Ltd., and, therefore, the amounts could not be lawfully claimed as permissible deduction.

At the instance of the assessee, the following question was referred to the High Court for its opinion :

"Whether, on the facts and in the circumstances of the case, the Tribunal was justified in law in disallowing the claim of the assessee for deduction of Rs. 1,03,547 and Rs. 18,294 from the income of the assessment years 1958-59 and 1959-60 as not an admissible business expenditure under sec. 10(2)(xv) of the Indian Income-tax Act, 1922 ?"

The High court answered the question in the negative, in favour of assessee and against the department. The High Court, on construction of the agreement dated November 10, 1955, took the view that since in the matter of the exercise of its powers and the discharge of its functions thereunder, Kamala Mills Ltd. could not be said to be "subject to the superintendence, control and direction of the board of directors" of the assessee, Kamala Mills Ltd. was not a "manager" of the assessee within the definition given in s. 2(24) of the companies Act, 1956, and therefore, the illegality under s. 384 was not attracted and as such the remuneration paid by the assessee to Kamala Mills Ltd. for services rendered during the calendar years 1957 and 1958, was allowable as

a business expenditure under s. 10(2)(xv) of the Act. As regards the decree that had been obtained by the assessee against Kamala Mills Ltd., the High Court observed that the appeal filed by Kamala Mills Ltd. against the said decree was still pending in the High Court and if ultimately the appeal was dismissed and the amounts were recovered back from Kamala Mills Ltd., the assessee could be taxed on those amounts under s. 41(1) of the Act, but that could not be a valid ground for disallowing the deduction claimed by the assessee. The revenue has challenged in these appeals the view of the High Court that Kamala Mills Ltd. was not the manager of the assessee within the meaning of s. 384 read with s. 2(24) of the Companies Act, 1956, and the further view that the remuneration paid to Kamala Mills Ltd., during the calendar years 1957 and 1958, was deductible as business expenditure under s. 10(2)(xv) of the Act.

Before we consider the principal question relating to the proper construction of the agreement dated November 10, 1955, it will be desirable to note the relevant provisions of the Indian Companies Act, 1913, as also the new Companies Act, 1956, which have a bearing on the question at issue. Since the agreement between the assessee on the one hand and the Kamala Mills Ltd. on the other was entered into at a time when the Indian Companies Act, 1913, was in force it will be proper first to refer to the definition of "manager" given in s. 2(9) of the said Act. Section 2(9) ran thus :

"2 (9) 'manager' means a person who subject to the control and direction of the directors has the management of the whole affairs of a company, and includes a director or any other person occupying the position of a manager by whatever name called and whether under a contract of service or not."

It will be clear that to satisfy the aforesaid definition a person, which could include a firm, body corporate or an association of persons, apart from being in management of the whole affairs of a company had to be "subject to the control and direction of the directors". This definition has undergone a substantial change under the Companies Act, 1956. Under this Act, s. 2(24) defines the expression "manager" thus :

"2. (24) 'manager' means an individual (not being the managing agent) who, subject to the superintendence, control and direction of the board of directors, has the management of the whole, or substantially the whole, of the affairs of a company, and includes a director or any other person occupying the position of a manager, by whatever name called, and whether under a contract of service or not."

In this definition three conditions are required to be satisfied : (a) the manager must be an individual, which means that a firm or a body corporate or an association is excluded and cannot be a manager (a fact which is expressly made clear in s. 384). (b) he should have the management of the whole, or substantially the whole, of the affairs of the company, and (c) he should be subject to the superintendence, control and directions of the board of directors in the matter of managing the affairs of the company. Subject to the changes made in the aspects covered by (a) and (b), in both the definitions the aspect that a manager has to work or exercise his powers under the control and directions of the board of directors is common and essential. In fact it is this aspect which distinguishes "manager" from "managing agent". If the definition of "manager" as given in s. 2(24) is compared with that of "managing agent" as given in s. 2(25) it will appear clear that though there is an overlapping of the functions of the manager as well as the managing agent of the company the essential distinction seems to be that whereas the manager has to be subject to the superintendence, control and direction of the board of directors the managing agent is not so subject.

Section 384 of the companies Act, 1956, in express terms prohibits, after the commencement of the Act, the appointment of a firm or a body corporate or an association of persons as a manager as also the continuation of such employment after expiry of six months from such commencement It runs thus :

"384. No company shall, after the commencement of this Act, appoint or employ, or after the expiry of six months from such commencement, continue the appointment or employment of, any firm, body corporate or association as its manager."

The aforesaid provision positively disqualifies a firm, body corporate or association from being appointed as manager of a company or from continuing the employment of a firm, body corporate or association as manager after the expiry of six months from the commencement of the Act. Obviously, to attract the prohibition or disqualification contained in s. 384, a firm, body corporate or association must be a "manager" within the meaning of s. 2(24), that is to say, it should be in management of the whole or substantially the whole of the affairs of a company, and should be under superintendence, control and direction of the board of directors of the company. It was not seriously disputed that under the terms and condition contained in the agreement dated November 10, 1979, Kamala Mills Ltd. could be said to be in management of substantially the whole of the affairs of the assessee-mills but the question is whether it was working under the superintendence, control and direction of the board of directors of the assessee so as to be its "manager" within s. 2(24) of the Act ?

Turning now to the agreement in question it may be stated that at the commencement of the deed the parties thereto have been described in a particular manner, namely, the assessee has been described and referred to as the "company" while Kamala Mills Ltd. has been described and referred to as the "managers" throughout the document. Then follow two recitals which make very clear the object or purpose with which the agreement was entered into, according to these recitals the assessee was not having sufficient finance to carry on its business of manufacture and sale of yarn and the board of director thought it proper to find out a financier who was agreeable to help the assessee monetarily and take active interest in its business and that since Kamala Mills Ltd. agreed to assist the assessee with sufficient finance and to manage the assessee's mill on certain terms and conditions which the board of directors had approved the agreement was executed between the parties. Then follow the operative parts of the deed setting out the terms and conditions on which Kamala Mills Ltd. agreed to provide sufficient finance as also to manage the business of the assessee. Clause 1 enlisted in sub-clauses (a) to (m) the powers and functions which were to be exercised and performed by Kamala Mills Ltd. during the period of five years for which the agreement was to operate; such powers were conferred and functions entrusted for the purpose of "managing and running the mill" of the assessee; inter alia, Kamala Mills Ltd. was to make purchase of all cotton, staple fibre or any other raw material for the manufacture of the yarn and to enter into contracts in that behalf at such rates and prices as it may deem fair and proper and make payments for all such purchases and incur all expenses incidental thereto; it was also to make purchases of all stores and spares and other materials necessary for the manufacture of yarn; it was to appoint all staff, technical or non-technical and workers skilled and unskilled as also clerks and other staff necessary for the working of the mill and fix their terms and remuneration and could discharge or dismiss or take disciplinary action against them; it had to sell and make contracts for sale for immediate or future delivery of yarn, yarn waste or cotton waste or any other material or products of the mill at such rates or prices and on such terms and conditions as it may think fit; it could decide, lay down and change from time to time the programme of manufacture of yarn and other products of the mill and to insure against fire and other risks all cotton, yarn, material, stock-in-trade and incur and pay all premia

necessary in that behalf; it could pledge, secure and hypothecate all stocks and stores and stock-in-trade with such bank or banks where arrangements for overdrafts shall have been completed by the board of directors, and it could claim, demand, realise and sue for all goods, materials and amounts due to the assessee in the exercise and carrying out of any or all of the powers conferred under sub-cl. (a) to (k). Clause 2 of the agreement stipulated that Kamala Mills Ltd. shall provide funds or arrange for finance necessary for exercising the powers of purchase of cotton, stores and other materials and for payment of wages, salaries, commissions and allowances and for meeting all expenses incidental to manufacture and sale of yarn and other products of the mill. Under cl. 3 the assessee was to open a separate current account and an overdraft account for a limit not exceeding Rs. 30,00,000 with such bankers as Kamala Mills may require with power to Kamala Mills to operate on the said accounts exclusively by itself and in the name of the assessee and it was to have power to receive, endorse, sign transfer and negotiate all bills, cheques, drafts, etc., that may be received in the name of the assessee in the course of the management of the mill and it was specifically agreed that no one except Kamala Mills shall have power to operate on the said accounts. Clause 4 entitled Kamala Mills Ltd. to charge the assessee interest at the rate of 7 1/2% per annum with half-yearly rests on all advances made by it and funds for the purposes set out in cl. 2. Clause 5 gave Kamala Mills Ltd. a first and prior charge on all the stocks and stores and stock-in-trade for all the moneys and amounts that may be advanced by it to the assessee except to the extent of any charge or security of such stocks and stores and stock-in-trade that may be created in favour of the banks for the overdraft account and such charge in favour of Kamala Mills was to be a possessory charge. Clause 8 quantified the remuneration payable to Kamala Mills Ltd. for services rendered by way of the purchases, sales, and the management of the mill at the rate of 1% on all purchases made by it for the assessee-mill and at 1/2% on all sales of products effected for and on behalf of the assessee. Clause 10 required Kamala Mills Ltd. to maintain proper accounts in respect of all purchases, sales and expenses, commissions and remunerations due to it, etc., and submit to the assessee monthly statements of accounts. Clause 11 put the outer limit of Rs. 15,00,000 at any one point of time on the advances and financial assistance to be given by Kamala Mills Ltd. to the assessee and it was provided that if and when sums over and above the said limits become necessary to be advanced, Kamala Mills would be entitled to appropriate and take for itself as owners such quantity of yarn as may be in stock as in value would be equivalent, at cost or market value, whichever was lower, to the sum that it may be obliged to advance over and above Rs. 15,00,000. Clause 13 of the agreement is very important having a crucial bearing on the question at issue and may be set out verbatim. It ran thus :

"13. The company (assessee) either represented by its managing agent or board of directors shall not exercise the powers delegated to the managers (Kamala Mills Ltd.) under the foregoing clauses, except by way of general supervision and advice, nor interfere with the discretion of the managers in the exercise of their functions and powers vested in them by virtue of this agreement."

Under cl. 14 it was provided that the manager's (Kamala Mills Ltd.) powers were limited in the manner aforesaid and they were not and shall not be deemed to be managers in charge of the whole affairs of the company within the meaning of s. 2(9) of the Indian Companies Act. A significant provision showing the intention of the parties that Kamala Mills Ltd. was not to be regarded as a "manager" under the Indian Companies Act, 1913. Clause 16 is significant and it provided that the agreement shall be in force for a period of five years commencing from the date thereof and that "this agreement for management being an agency coupled with interest", it could be revoked before the expiry of the said period of five years by 12 months' notice in writing being given by one party to the other but if the assessee were to revoke it, the assessee shall be liable to compensate Kamala

Mills for the loss of remuneration for the unexpired period of the agreement at the average rate at which Kamala Mills Ltd. had been earning by way of remuneration under the agreement till the date of such notice of termination. A modification by introducing one additional term is not material for our purposes.

On a perusal of the aforesaid clauses of the agreement in question two or three things stand out very clearly. It is true that at the commencement of the deed, Kamala Mills Ltd. has been described and referred to as the "managers" of the assessee throughout the document but mere label or nomenclature given to a party in the document will not be decisive. It is also true that the several powers and functions were entrusted to Kamala Mills Ltd., under cl. 1 of the agreement to enable it "to manage or run the mill" of the assessee. But simply because powers and functions were given to Kamala Mills Ltd. for the purpose of "managing and running the mills" of the assessee, it would not follow that Kamala Mills Ltd. was in truth and substance a "manager" of the assessee within the meaning of s. 2(24) of the 1956 Act. For this purpose the agreement will have to be read as a whole and the court will have to decide what was the true intention of the parties in entering into such agreement. The two recitals clearly indicate the object with which and the purpose for which the agreement was entered into. It does appear that the assessee was in financially straitened circumstances and on that account was utterly unable to carry on its business of manufacture and sale of yarn and, therefore, the board of directors were in search of a financier who would make available the necessary finances for the running of the mill as also to take active interest in the business of the assessee and when Kamala Mills Ltd. agreed "to assist the company (assessee) with sufficient finance and manage the mill" belonging to the assessee on terms and conditions that were approved by the board of directors of the assessee that the agreement was entered into between the parties; in other words, it is clear that the dominant object with which the agreement was entered into was that Kamala Mills Ltd. should really act as a financier so that the assessee-mill could run and since heavy finances were to be procured by Kamala Mills Ltd. large powers and functions connected with the working of the mill were entrusted to it. This aspect becomes abundantly clear from cl. 16 of the agreement wherein the parties expressly provided that this agreement for management was by way of and amounted to an agency coupled with interest so far as Kamala Mills Ltd. was concerned and, therefore, revocation of the agreement before the expiry of the five years' period was made dependent upon 12 months' notice in writing being given by one party to the other and further if such revocation was done by the assessee suitable compensation was made payable to Kamala Mills Ltd. In other words managerial functions were incidental and had to be entrusted to Kamala Mills because of the financier's role undertaken by it. The large powers and functions entrusted to Kamala Mills Ltd. under the several sub-clauses of cl. 1 of the agreement do show that management of substantially the whole, if not the whole, of the affairs of the assessee-company had been made over to Kamala Mills Ltd. But the crucial question is whether such management was to be done by Kamala Mills Ltd. under "the superintendence, control and direction of the board of directors" of the assessee and in that behalf cl. 13 of the agreement which we have quoted above is very eloquent. In terms it provided that so far as the powers conferred and the functions entrusted to Kamala Mills Ltd. were concerned, the board of directors shall not exercise or perform the same except by way of general supervision and advice and it was further made clear that the board of directors shall not interfere with the discretion of Kamala Mills Ltd. in the exercise of their functions and powers vested in it by virtue of the agreement. In other words, the general supervision or advice of the board of directors was of such character that the board had no say whatsoever nor could it interfere with the discretion of Kamala Mills Ltd. in the matter of the exercise of the powers and the discharge of the functions entrusted to Kamala Mills Ltd. under the agreement. It is thus clear to us that the dominant object of the agreement was that Kamala Mills Ltd. should act as

financiers of the assessee-mill and in the matter of the exercise of its powers and discharge of its functions Kamala Mills Ltd. was never "subject to the superintendence, control or direction" of the board of directors of the assessee. If this position clearly emerges on the true construction of the agreement in question then it is obvious that Kamala Mills was not acting or working as the "manager" of the assessee within the meaning of s. 2(24) of the Companies Act, 1956, and as such the illegality of s. 384 of the Act was not attracted. In this view of the matter, the remuneration paid by the assessee to Kamala Mills Ltd. for the two calendar years 1957 and 1958, relevant to the assessment years 384 of the Companies Act, 1956, and as such the expenditure incurred by way of paying such remuneration would be deductible as business expenditure under s. 10(2)(xv) of the Indian I.T. Act, 1922.

In view of our aforesaid conclusion the aspects whether the assessee had disputed its liability to pay such remuneration to Kamala Mills Ltd, or had filed a suit at the instance of the Company Law Board to recover it back from Kamala Mills Ltd. or had obtained a decree in that behalf against Kamala Mills Ltd. become irrelevant. However, we would like to place on record the fact that the decree obtained by the assessee against Kamala Mills Ltd. has been reversed or set aside in appeal by the Kerala High Court - a fact which was brought to out notice by the Advocate on Record for the assessee communicated to him by his client in a letter dated 22nd August, 1979. However, even if in further appeal the trial court's decree was restored and the assessee were to recover back the remuneration, the assessee can be taxed on the two amounts under s. 41(1) of the 1961 Act.

In our view, therefore, the High Court was right in answering the question in favour of the assessee. The appeals are, therefore, dismissed with costs.

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