

# ALLAHABAD HIGH COURT

J.K. Commercial Corporation Ltd.

Vs.

Commissioner of Income-Tax

I.T. Ref. No. 714 of 1963  
(V.G. Oak, C.J. and T.P. Mukerjee , J.)

24.10.1968

## JUDGMENT

**T.P. Mukerjee , J.**

1. This is a case stated under Section 66(1) of the Income-tax Act, 1922, by the Allahabad Bench of the Appellate Tribunal. The material facts are these:-

2. The Muir Mills Ltd. is a public limited company, having a share capital of Rs. 60,00,000 divided into 30,000 ordinary shares of Rs. 100 each and 30,000 preference shares of Rs. 100 each. Previously, one Mr. K.J.D. Price and Mr. T. I. Smith were the managing directors of this company and they, along with the members of their family and friends, held the largest single block of shares in the company. Towards the end of the year 1945, they decided to leave India and sell away their shares. Their shares were purchased by Major General Mahabir Shamsher Jung Bahadur Rana, Major General Madan Shamsher Jung Bahadur Rana and Sri Hanuman Prasad Dhanuka. They also purchased some more shares in the open market and by May, 1947, they possessed 5,085 ordinary shares and 19,540 preference shares of the said company. Thereafter, they floated two private companies, viz., the Indian Textile Syndicate Ltd. and the Cotton Textile Corporation Ltd. The Indian Textile Syndicate Ltd. was appointed as the managing agents and the Cotton Textile Corporation Ltd. as the selling agents of the Muir Mills. Subsequently, there were differences between them and the entire lot of shares, which had been pledged with M/s. Hongkong and Shanghai Banking Corporation Ltd., as security for certain advances taken from that bank, were sold in auction on April 18, 1950. The bidders at the auction were M/s. Bengal and Assam Investors Ltd., represented by their director, Sri Lakshmipat Singhania, and one Sri Hari Shankar Bagla. Ultimately, the highest bid of Sri Lakshmipat Singhania for Rs. 87,05,000 was accepted and thereupon M/s. Bengal and Assam Investors Ltd. came to be the owners of those 5,085 ordinary shares and 19,540 preference shares of the Muir Mills Ltd.

3. Although by the purchase at the auction M/s. Bengal and Assam Investors Ltd. became owners of the largest single block of shares in the Muir Mills Ltd., the Singhania failed to gain

control of that company. The Baglas, on the other hand, having failed to purchase the shares in the public auction, devised ways and means to seize control and management of the Muir Mills Ltd. They purchased 2/3rds share of the Ranas in the Indian Textile Syndicate Ltd. and the Cotton Textile Corporation Ltd., which were, respectively, the managing and sole selling agents of the Muir Mills Ltd., and having acquired the dominating voting power in the managing agency, the Baglas came into actual control of the said mills. The Singhanias, though they were holding the largest single block of shares, were reduced to non-entities in view of the tactics adopted by the Baglas. The Baglas saw to it that no meeting of the general body of the shareholders of the said mills was called for for six years from 1950 to 1955 and they also did not allow the registration of the shares purchased by the Singhanias. The Singhanias, therefore, continued to hold the shares in blank transfers.

4. In February, 1955, M/s. Bengal and Assam Investors Ltd. sold out of their own shareholding a block of 750 ordinary shares and 3,625 six per cent. cumulative preference shares of the Muir Mills Ltd. to the assessee-company for Rs. 15,01,250. The assessee-company was under the management and control of the Singhanias who held more than 70% of its shares.

5. When the Singhanias failed to secure registration of the shares purchased by them and gain control of the Muir Mills Ltd., they filed an application in this court under Sections 397 and 398 of the Companies Act, 1956, which was registered as Company Case No. 32 of 1956. In this case there were six applicants :

- (1) M/s. J. K. Investment Trust Ltd.;
- (2) Lala Lakshmipat Singhania;
- (3) Major General Sham Sher Jung Bahadur, through his duly constituted attorney, Sri Lakshmipat Singhania;
- (4) Rani Jagadamba Kumari Devi, widow of the late Madan Sham Sher Jung Bahadur Rana, through her duly constituted attorney, Sri Lakshmipat Singhania;
- (5) M/s. Bengal and Assam Investors Ltd., through its director, Sri Lakshmipat Singhania;
- and
- (6) Sri Hanuman Prasad Dhanuka.

6. Various reliefs were asked for by the applicants, one of which was that the respondent-company be directed to rectify the register of members by registration of the transfer of the preference and ordinary shares held by M/s, Bengal and Assam Investors Ltd. Another relief prayed for was that the managing agency agreement entered into by M/s. Muir Mills Ltd. with M/s. Indian Textile Syndicate (Private) Ltd. and the sole selling agency agreement with M/s. Kanpur Agencies (Private) Ltd. be terminated. An ad interim order was passed by the court whereby the existing board of directors was suspended and a committee of management was appointed with the late Dr. N.P. Asthana, as the chairman. The court also directed the suspension of the existing managing agents for a period of six months and the assessee-company was

ordered to run the Muir Mills Ltd. under the supervision of the committee of management. These interim orders were made by the court on March 1, 1957, and October 27, 1957.

7. Before the orders aforesaid had been made by this court, the directors of the assessee-company held a meeting on August 30, 1955. In that meeting the report of the financial adviser submitted to the directors was considered. The financial adviser pointed out that the assessee-company had a substantial stake in the Muir Mills Ltd., and that the existing directors and managing agents were misappropriating the funds and assets of the company. He further reported that the company had been showing loss from 1950 to 1954 and the loss aggregating to Rs. 72 lakhs exceeded the paid-up capital of the Muir Mills Ltd. In these circumstances, the financial adviser advised that it would be in the best interest of the assessee-company if it took such steps as to protect the interest of the company against the reported misappropriation and mismanagement made by the existing directors and managing agents of M/s. Muir Mills Ltd. in collaboration with the shareholders who had already filed the application under Sections 397 and 398 of the Companies Act, 1956. At the meeting of the board of directors held on August 30, 1956, referred to above, it was resolved, inter alia, that the assessee-company should " bear the cost of such proceedings and reimburse such expenses as the applicant or applicants may incur ". In these circumstances, the assessee-company incurred total sum of Rs. 77,158 on account of legal charges and Rs. 11,891 on account of travelling expenses in the prosecution of the said case (Company Case No. 32 of 1956). The fact that the assessee-company did, in fact, spend these amounts is not disputed.

8. In the assessment for the year 1958-59 the assessee-company claimed deductions of the sums of Rs. 77,158 and Rs. 11,891 from its total income on the ground that the expenditures were incurred wholly and exclusively for the protection of its shareholding and were, therefore, allowable under Section 10(2)(xv) of the Income-tax Act, 1922. Alternatively, it was claimed that the expenditures were allowable under Section 12(2) of the said Act as having been incurred solely for the purpose of earning dividends from the shares held by the assessee. The Income-tax Officer, however, disallowed the entire claim.

9. On appeal, the Appellate Assistant Commissioner of Income-tax upheld the disallowance. He held that the real purpose of the assessee-company in financing the litigation was to acquire the managing agency of the Muir Mills Ltd. He observed :

"The reason advanced in the resolution of the board of directors for bearing the cost of litigation, viz., to protect the company's interest as a shareholder in the Muir Mills is rather far-fetched. The real purpose behind the litigation was to oust the Baglas from the management of the Muir Mills and acquire control over the Muir Mills Ltd. by the Singhania. As such, the expenses were of capital nature. Accordingly, I agree with the Income-tax Officer that the expenses were not allowable either under Section 10(2)(xv) or Section 12(2) of the Income-tax Act."

10. In second appeal, the Appellate Tribunal took a different view. The Tribunal found that the expenses in question were incurred by the assessee-company for the purpose of protecting its shares in the Muir Mills Co. Ltd. and to ensure its prospective dividend earning capacity. The Tribunal, therefore, held that the expenditure was admissible under Section 12(2) of the Income-tax Act. As regards the quantum of allowance, the Tribunal took the view that the whole of the expenditure was not a permissible deduction. The Tribunal took into consideration the fact that the investment of M/s. Bengal and Assam Investors Ltd. in M/s. Muir Mills Ltd. amounted to Rs. 87,05,000 out of which the assessee-company had purchased from it only 750 ordinary shares and 3,625 preference shares for a sum of Rs. 15,01,250. The Tribunal, therefore, held that, roughly 1/6th of the total litigation expenses could be allowed as having been incurred wholly and exclusively for the protection of the assessee-company's investment in the shares in question. Accordingly, the Tribunal directed that a sum of Rs. 15,000 be allowed as expenditure under Section 12(2) of the Income-tax Act, 1922.

11. Against the decision of the Tribunal, both the department as well as the assessee-company sought a reference to this court on the question of the allow ability of the expenses or a part thereof. The Tribunal allowed the applications in reference and referred the following question on behalf of the department for the opinion of this court :

" Whether, on the facts and in the circumstances of the case, any part of the legal expenses of Rs. 77,158 and travelling expenses of Rs. 11,891 were allowable under Section 12(2) of the Act ?"

12. On behalf of the assessee-company, the Tribunal has referred the following question :

" On the facts and in the circumstances of the case, whether the whole of the expenses referred to in question No. (1) should have been allowed or only a proportionate part thereof? "

13. On' behalf of the assessee-company Sri Singh contends that the Tribunal erred in allowing Rs. 15,000 out of the total expenses incurred by it in connection with the litigation relating to M/s. Muir Mills Ltd. Sri Singh argues that the whole of the expenditure was incurred by the assessee-company for the purpose of protection of its investments with a view to earn dividends and, therefore, the entire amount was allowable as expenses incurred solely for the purpose of earning such income under Section 12(2) of the Indian Income-tax Act, 1922.

14. Sri Shanti Bhushan, appearing for the department, on the other hand, resisted the claim of the assessec-company, and contended that no part of the litigation expenses should have been allowed by the Tribunal. He contended that, in the first place, the expenses were in the nature of capital expenditure. It was submitted that when the shares were purchased they had not been registered in the name of the assessee and they had very little earning capacity. By means of the

litigation, the assessee-company wanted to change the managing agents of M/s. Muir Mills Ltd. and to improve the management so that the new management might allow registration of the shares and declare better dividends. It was, therefore, not a case of mere protection or maintenance of the investments but it was a case in which the investments were sought to be improved. The expenditure incurred in that connection, it was argued, cannot be regarded as an expenditure of revenue nature but it should be regarded as a capital expenditure. If the expenses were regarded as capital in nature they were, clearly, excluded from the purview of Section 12(2). Sri Shanti Bhushan also pointed out that the assessee-company was itself not a party to the company case and, at all events, its shareholding was much less than that of M/s. Bengal and Assam Investors Ltd., which was the party to the company case. It was, therefore, incumbent on the part of M/s. Bengal and Assam Investors Ltd. to bear the major part of the legal expenses. Considered from this point of view, it must be held that the expenditure incurred by the assessee cannot be regarded as having been expended solely for the purpose of earning dividend. Finally, the learned standing counsel contended that even if the expenditure is regarded as having been incurred for the purpose of protection of the shares in question, it would not be allowable under Section 12(2) of the Act.

15. The question which arises for our consideration is whether the whole or any part of the legal and travelling expenses is a permissible deduction against the assessable income of the assessee. Section 12 of the Income-tax Act, 1922, as it stood at the relevant time, excluding the immaterial portions, ran as follows :

" 12. Other sources.--(1) The tax shall be payable by an assessee under the head 'Income from other sources' in respect of income, profits and gains of every kind which may be included in his total income (if not included under any of the preceding heads).

(1A) Income from other sources shall include dividends.

(2) Such income, profits and gains shall be computed after making allowance for any expenditure (not being in the nature of capital expenditure) incurred solely for the purpose of making or earning such income, profits or gains."

16. The two essential conditions which must be satisfied for the allowance of an expenditure against income from dividends under Section 12(2) are that (i) it must not be capital in nature, and (ii) it must be incurred solely for the purpose of making or earning such income. Before proceeding further, it must be noted that there appears to have been no dispute at any stage of the assessment proceedings that the shares in question were purchased by the assessee-company for the purpose of investment. The Tribunal no doubt noticed that there were circumstances in the case which gave rise to the suspicion that the assessee-company did not purchase the shares bona fide for the purpose of investment and the Tribunal observed that it was doubtful whether the assessee as a prudent investor would purchase shares which did not pay any dividend for about five years, particularly, when the vendor, namely, M/s. Bengal and Assam Investors, had not been registered in respect thereof. The Tribunal, however, found that there was no evidence to

support the view that there was no bona fide sale by M/s. Bengal and Assam Investors Ltd., and the transaction was merely a re-distribution of the shares held by the latter between its sister concerns including the assessee. The Tribunal, therefore, rightly, concluded that the questions in issue had to be dealt with on the footing that the assessee-company acquired the shares bona fide by way of investments.

17. As regards the object or the purpose for which the assessee bore the entire legal expenses, the Tribunal said as follows in paragraph 14 of its order :

" In the light of the above finding, we must uphold the contention of the assessee that the expenditure was incurred for the purpose of protecting its shares in the Muir Mills Co. Ltd., and to ensure its prospective dividend earning capacity. As such, the expenditure would be admissible under Section 12(2) of the Income-tax Act."

18. Thus, according to the Tribunal, the objectives which induced the assessee to finance the litigation were two-fold, namely, to protect the shares, and, secondly, to insure the prospective dividend earning capacity of the shares. In either case, the expenditure would be an allowable deduction.

19. Sri Shanti Bhushan's contention that the litigation was financed by the assessee-company with a view to improve the quality of its shares and, therefore; it is capital in character has to be considered in the background of contemporaneous events. The assessee had invested a sum of Rs. 15 lakhs in the purchase of the shares and it had to safeguard the investment and ensure realisation of dividends therefrom. The Baglas were frittering away the assets of the Muir Mills Ltd. and showing losses year after year. The financial adviser of the assessee-company pointed out to its board of directors that during the six years from 1950 to 1955 the Muir Mills Ltd. had shown a total loss of Rs. 72 lakhs. The Baglas did not call for any meeting of the general body of shareholders with a view to avoid confrontation with them and they had even refused to accord registration of the shares purchased by the assessee and other concerns of the Singhanian group. There was patently gross mismanagement by the Baglas and the investment of the assessee was in jeopardy. The learned company judge felt necessary to supersede the management of the Baglas and impose a new board of management under the stewardship of the late Dr. N. P. Asthana. In the light of these patent and established facts, it is obvious that if the applicants had lost the company case (No. 32 of 1956) and the management continued to remain in the hands of the Baglas their shares worth more than Rs. 15 lakhs would have been reduced to mere scraps of paper. It was, therefore, necessary for the assessee to finance the case not for improvement of the quality of its investment but for the very preservation thereof.

20. It is well settled that an expenditure incurred for preservation or protection of a capital asset is revenue in nature and not a capital expenditure. The leading authority in point is the decision of the King's Bench Division in the case of *Southern (H.M. Inspector of Taxes) v. Borax*

*Consolidated Ltd*<sup>1</sup>., In that case an English company acquired land in America for the purpose of its business. Subsequently, an action was brought in the American courts against the company claiming that the company's title to the land and building erected thereon was invalid, and in defending that action the company incurred costs amounting to 6,249. It was held that the sum of 6,249 was wholly and exclusively laid out by the company for the purposes of its trade and was an allowable deduction in computing the profits of the company for income-tax purposes. It was also observed that the legal expenses incurred by the company did not create any new asset at all, but were expenses incurred in the ordinary course of maintaining the assets of the company and the fact that it was maintaining the title, and not the value, of the company's business did not make any difference. This decision has been cited with approval by the House of Lords in *Morgan v. Tate and Lyle Ltd*<sup>2</sup>., and also by the Supreme Court in *Commissioner of Income-tax v. Finlay Mills Ltd*<sup>3</sup>., and in *Assam Bengal Cement Co. Ltd. v. Commissioner of Income-tax, West Bengal*<sup>4</sup>. In the case of *Finlay Mills*, the Supreme Court, referring to the decision in *Southern (H. M. Inspector of Taxes) v. Borax Consolidated Ltd.*, said that where a sum of money is laid out for the acquisition or the improvement of a fixed capital asset, it is attributable to capital, but if no alteration is made in the fixed capital asset by the payment, then it is properly attributable to revenue, being in substance a matter of maintenance, the maintenance of the capital structure or the capital asset of the company.

In the present case, we have found that the expenses were incurred by the assessee not for

<sup>1</sup>(1940) 4 All. ER 412: (1941) 1 KB 111: 110 LJ KB 705 : 23 Tax Cases 597 : (1942) 10 ITR (Supp) 1

<sup>2</sup> (1954) 26 ITR 195: (1954) 3 WLR 85 : (1954) 2 All. ER 413 : (1955) AC 21 : 35 Tax Cases 367

<sup>3</sup>(1951) SCJ 739: (1952) SCR 11 : 54 Bom. LR 6 : (1951) 2 MLJ 638 : (1951) 20 ITR 475 : AIR 1951 SC 464

<sup>4</sup>(1955) SCJ 205: (1955) 1 SCR 972 : (1955) 1 MLJ (SC) 118 : AIR 1955 SC 89 : (1955) 27 ITR 34

any improvement of the investments but for protection and preservation of the shares. The fact that as a result of such expenses the assessee expected to earn better dividends is an additional argument for their allowance under Section 12(2) of the Income-tax Act, 1922.

21. The learned standing counsel then contended that the expenses were not incurred by the assessee solely for the purpose of earning the dividend income and as such they were not allowable under Section 12(2). In this connection be pointed out that the assessee held but a fractional part of the total shareholding in *Muir Mills Ltd.*, and a prudent businessman in the position of the assessee would not bear the entire cost of the litigation. It was submitted that the expenditure was incurred with an oblique motive, namely, to benefit the *Singhanias* and its sister concerns. There is, however, nothing in the statement of facts submitted by the Tribunal to show that the assessee had incurred the expenses with a view to foster the business of the other concerns in which the *Singhanias* were interested. Moreover, the test of allowability is not what a prudent man would do in similar circumstances. An assessee might be an imprudent businessman; yet, if he incurs an expenditure voluntarily for the purposes of its own business, it would be allowable as a proper deduction. In *Eastern Investments Ltd. v. Commissioner of Income-tax*<sup>5</sup>, the assessee, an investment company, under an agreement with its principal shareholder, reduced its share capital and issued debentures carrying interest to that shareholder.

The transaction was entered into by the company voluntarily on the ground of commercial expediency and in order indirectly to facilitate the carrying on of the company's activities. The transaction was not challenged on the ground of fraud. The question before the Supreme Court was whether the interest on debentures paid to the principal shareholder was an allowable deduction against the assessee's income from dividends. The Supreme Court held that the interest was allowable under Section 12(2) as expenditure incurred solely for the purpose of earning the company's income. The Supreme Court observed that the fact that the transaction resulted in considerable benefit to the principal shareholder was inconsequential. The Supreme Court further laid down that, in the absence of fraud, the question whether it was a prudent or wise transaction and whether it was necessary for the assessee to enter into that transaction was irrelevant. A similar view had been taken by the House of Lords in the case of *Usher's Wiltshire Brewery Ltd. v. Bruce (Surveyor of Taxes)*<sup>6</sup>. In that case, a brewery company were the owners of a number of premises which they had acquired solely for the purpose of their business as brewers. These premises were let out to tenants who were " tied " to purchase the beer manufactured by the assessee-company. The assessee claimed, inter alia, that in computation of their profits for assessment under Schedule D the following expenses should be allowed : (i) expenses for repairs to the tied houses incurred by the assessee; (ii) fire and licence insurance premiums; (iii) rates and taxes, and (iv) legal and other costs. The tenants of the tied houses were bound to pay some of these moneys themselves in terms of their leases. The House of Lords held that the entire expenditure was a proper debit in the computation of the assessable income of the brewery company notwithstanding the fact that "it enures also to the benefit of the tenant's separate trade in the tied house".

22. In the present case, as in the case of *Eastern Investments Ltd*<sup>7</sup>, there is no allegation

<sup>5</sup>(1951) SCJ 420 : (1951) 21 Comp. Cas. 194 : (1951) SCR 594 : AIR 1951 SC 278 : (1951) 20 ITR 1

<sup>6</sup>(1915) AC 433: 84 LJ KB 417 : 31 TLR 104 : 6 Tax Cases 399

<sup>7</sup>(1951) SCJ 420 : (1951) 21 Comp. Cas. 194: (1951) SCR 594 : AIR 1951 SC 278

of fraud and the expenses were incurred voluntarily by the assessee on grounds of commercial expediency. The fact that it was not necessary for the assessee to bear the entire expenditure or that the expenditure also enured to the benefit of the other concerns of the Singhanias or that the assessee did not act like a prudent businessman is entirely irrelevant in view of the decisions of the Supreme Court and of the House of Lords in the cases referred to above.

23. The next contention of the standing counsel is that it was competent on the part of the Tribunal under Section 12(5), read with Section 10(4A), of the Income-tax Act, 1922, to allow only 1/6th of the total litigation expenses if in its opinion the claim for entire expenses was excessive and unreasonable. This contention does not survive after what we have stated above. Moreover, Section 12(5) read with Section 10(4A), permits disallowance of an expenditure which results, directly or indirectly, in the provision of any remuneration or benefit or amenity to a director or a person who has a substantial interest in the company if in the opinion of the

Income-Lax Officer such expenditure is excessive or unreasonable " having regard to the legitimate business needs of the company and the benefit derived by or accruing to it therefrom ". There is no evidence as to who were the directors of the assessee-company. The Singhania had, no doubt, substantial interest in the company but it does not, appear how they were personally benefited by the expenditure to the exclusion of other shareholders. If as a result of the litigation the investments of the assessee-company were placed on a better footing and the company started earning better dividends, the Singhania would be benefited as much as other shareholders. Moreover, we have already held that the expenditure was incurred for the legitimate needs of the assessee-company and it has substantially benefited thereby. In the circumstances, Section 12(5), read with Section 10(4A), has no application here. Further, as already noticed, the Tribunal held in paragraph 14 of its order that " the expenditure was incurred for the purpose of protecting its shares in the Muir Mills Co. Ltd., and to ensure its prospective dividend earning capacity". There is no finding that only a part of such expenditure was incurred for the purposes stated. That being so, the entire expenditure is allowable and any dichotomy thereof is not permissible.

24. All the contentions put forward by the learned standing counsel must, therefore, fail. In the result, our opinion is that the entire legal and travelling expenses incurred by the assessee, amounting to Rs. 77,158 and Rs. 11,891, respectively, were allowable under Section 12(2) of the Income-tax Act, 1922. The Tribunal was not justified in disallowing a substantial portion thereof,

25. We, therefore, answer the two questions referred to this court by the Tribunal as follows. The whole of the legal expenses of Rs. 77,158 and travelling expenses of Rs. 11,891 were allowable under Section 12(2) of the Act, and no part thereof should have been disallowed. The assessee would get a consolidated cost of Rs. 300 from the department.

Answered accordingly.