GUJARAT HIGH COURT

Commissioner of Income-Tax

Vs.

Tarun Commercial Mills Co. Ltd

ITR No. 198 of 1974

(B.J. Divan, C.J. and B.K. Mehta, J.)

01.04.1976

JUDGMENT

B.K. Mehta, J.

1. The assessment year under reference is 1968-69, the corresponding previous year being the calendar year 1967. The assessee is a public limited company having a textile mill at Ahmedabad. It debited cloth kharajat account in its trading books with an amount of ₹ 18,247 with a view to make provision for payment to the Textile Commissioner for non-fulfilment of export obligations undertaken for the use of "sanforized" trade mark. The Income-tax Officer held that the said payment was by way of penalty and, therefore, could not be considered as incidental to carrying on of the business. He, therefore, disallowed the said expenditure by his assessment order of February 25, 1970. There were other claims and contention advanced on behalf of the assessee before the Income-tax Officer with which we are not concerned in this reference. The assessee being dissatisfied with the order of the Income-tax Officer carried the matter in appeal before the Appellate Assistant Commissioner. The Appellate Assistant Commissioner was of the opinion that the amount provided was, in the facts and circumstances of the case, an expenditure incurred wholly and exclusively for the purpose of the assessee's business. He, therefore, allowed the appeal to the extent to which it related to the claim of ₹ 18,247 on account of the amount paid for non-fulfillment of the export obligations. The revenue, therefore, went in appeal before the Tribunal, which following its decision in Income-tax Appeal No. 976 (Ahd.) of 1970-71 between *Income-tax Officer v. Rustam Jehangir Vakil Mills Ltd*[1]*.,* held that the payment of ₹ 18,247 must be regarded as revenue expenditure laid out wholly and exclusively for the purpose of the assessee's business. At the instance of the revenue, therefore, the following question has been referred to us for our opinion :

"Whether, on the facts and in the circumstances of the case, penalty of ₹ 18,247 paid to the Textile Commissioner for non-fulfilment of the assessee's export obligation was business expenditure incurred wholly and exclusively for the purpose of the assessee's business ?"

[1] by its order of April 27, 1973, (1977) 2 Comp LJ 13 (Guj)]

2. Before the attempt to answers the question, it would be profitable to set out shortly the broad features of the scheme under which the assessee had undertaken the obligation to export for the use of sanforized" trade mark.

3. The assessee-company was recognized as a registered user of trade mark No.100387 (sanforized) of M/s. Cluett Peabody & Co. with the Trade Mark Registry of the Government of India. One of the conditions under which the assessee-company was recognised and registered as a user of he trade mark "sanforized" was that it would export such percentage of fabrics labeled "sanforized" as the Government of India may from time to time determine and in case in case of failure to attain such export target, the registration of the user was liable to be withdrawn. It appears that in accordance with the above stipulation for the use of the trade mark in question, the Government of India determined that during the period July, 1963, to November, 1965, the respective mills recognized and registered as users of the said trade mark had to export 5% of the value of production of Sanforized cloth produced by them during that period. It further appears that when this trade mark registration was revalidated for a further period of seven years, it was decided to increase the export obligation of the Government of India was conveyed to the assessee-company by the Government of India in the Ministry of Commerce : vide letter No. 27(1) /66-MP, dated April 30, 1966. The entire question of export obligation and its enforcement was reviewed when it was found that many mills which were recognized and registered as users or the trade mark "Sanforized" failed to fulfill their export obligation during the period ending 1965. As a result of the review it was decided to enforce the export obligations strictly and, therefore, a new scheme was evolved which had broadly the following features :

(1) For the sake of convenience of the exporting units the period commencing from January 1, 1963, to November 30, 1965, was allowed to be expired in December, 1965, instead of November, 1965, as originally agreed and the new commitments of export to the extent of 10% of the value of sanforized cloth produced were agreed to commence from January 1, 1966.

(2) The quantity of export was to be determined with reference to liner yards instead of the value of the goods.

(3) The defaulting mill-companies which failed to fulfil their export targets in the period 1963-1965 were allowed to carry forward the shortfall in the export obligations which were agreed to be achieved and fulfilled in the ensuing period of January, 1966, to November, 1972.

(4) In order to fulfil the export obligations the registered users of the trade mark in

question were required to execute a bond undertaking to export sanforized cloth of not than 10% of the production during 1966-1972 as also shortfalls in the export of sanforized cloth during June, 1963, to December, 1965.

(5) Mill-companies failing to fulfil the export obligation were to pay 10 paise per linear yard to the extent of the annual shortfall, and the performance of each mill-company was to be reviewed annually and the amount covering the shortfall in the annual export obligation was to be deposited with the Government by the defaulting mill by way of penalty and at the end of seven years period, i.e., 1966-72, a final review was to be made of the cumulative performance of the mill review was to be made of the cumulative performance of the mill against the total obligation and a refund of deposit was to be made to those mills which were entitled to such refund.

4. In pursuance of this scheme a bond was executed by the assessee-company in favour of the President of India. It is common ground between the parties that the bound similar to the one executed by Arvind Mills Ltd., on June 21, 1971, in favour of the President of India agreeing and undertaking to export 10% of Sanforized cloth for the use of trade mark "Sanforized" was executed between the assessee-company and the President of India though the bond in question has not been produced in the paperbook before us. Since it is the admitted position that the bond executed by the assessee-company before us was similar to the one executed by M/s. Arvind Mills Ltd., on June 26, 1971, we set out the important provisions from the bond executed by the Arvind Mills Ltd., in favour of the President of India, as under :

> "Whereas in consideration of the Government having permitted the mill to use the trade mark 'sanforized' on the cloth sanforized by it during the period form July 1, 1963, to December 31, 1972, the mill had agreed to :
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> (1) export to the foreign countries excluding Nepal, Sikkim, Bhutan and exports to Afghanistan also (except where payments are made in free foreign exchange and not under the special arrangement with Afghanistan) either in the form of cloth itself or in the form of ready-made garments and made-up articles to the extent of 5 per cent. of its production of Sanforized cloth for the period from July 1, 1963, to December 31, 1965, 1965, and to the extent of 10 per cent. of its production of sanforized cloth for the period from January 1, 1966, to December 31, 1969;
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> (2) to pay such sum to the Government as may be determined after being calculated at the rate of 10 paise per linear year on the quantity of sanforized cloth including readymade garments and made-up articles falling short of the quantity of such cloth undertaken to be exported by the mill in terms of sub-clause (1) above for the period from July 1, 1963, to December 31, 1965, and from January 1, 1966, to December 31, 1969;
>
> I. .....
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> III. AND WHEREAS with full knowledge of the conditions governing the use of the trade mark 'sanforized' and at the request of the mill, the guarantor has agreed to execute this bond;

IV. Now the conditions of the above written bond are such that the mill shall -

(a) either export by September 30, 1971, the shortfall in the quantity of export of sanforized cloth for the period up to December 31, 1969, referred to in clause II(3) above, in addition to the mill's export obligation in respect of sanforized cloth for the years 1970 and 1971 in accordance with the agreements dated March 5, 1970, entered into by the mill with the Government;

(b) or pay of the Government the aforesaid sum or such sum, in the event of the mills exporting any part of the shortfall referred to in para. II(3) by September 30, 1971, which becomes payable by the mills to the Government at the rate of 10 paise per linear yard in respect of the actual shortfall in the export obligation outstanding as on September 30, 1971;

(c) the mill shall furnish all particulars as regards exports of sanforized cloth effected by them in terms of this bond within two months from 30-9-1971 duly certified as true by the chartered accountant after due verifications of the Customs Forms, etc., as already prescribed showing actual quantity of the sanforized cloth exported."

5. It is in the context of this scheme, the broad features of which have been set out above, and the bond, the relevant provisions of which are also extracted above, that we have to answer the question referred to us.

6. At the time of hearing of this reference the argument addressed to us on behalf of the revenue can be summed up as under :

7. Although the amount of ₹ 18,247 was described as a sum calculated at the rate of 11 paise per metre of the cloth exported short of the quantity specified in conditions Nos. 2 and 3 of the bond executed by the assessee-company in favour of the President of India, it was in reality and substance not liquidated damages but was amounting for all intents and purposes to the payment akin to penalty for infraction of the law or in any case committing an act opposed to the public policy adumbrated by the Government of India in the relevant circulars and press-notes issued by the Government in the matter of use of the aforesaid trade mark for expansion of the textile industry in the third plan period by linking up the said user with the export of cloth produced in the relevant period. In other words, it was contended that the payment in question is a penalty or one akin to penalty and its very nature segregates the expenses of trade inasmuch as the same was not incurred by the assessee-company in its character of trader. The exaction of the amount in question and its consequent payment by the assessee-company under the special permit granted by the Textile Commissioner and the bond executed by the assessee-company in favour of the President of India in pursuance of the said special permit was not a payment of mere damages for breach of contract, though it may not be exactly in the nature of penalty paid under the terms of a statute for contravention of any statutory provisions. None the less it was a payment akin to penalty for contravention of the public policy enunciated by the Government of India and implemented by the Textile Commissioner in the matter of the said user by making it

obligatory on the importer to export a prescribed quantity of cloth manufactured in the relevant period.

8. The above contentions of the revenue were sought to be repelled on behalf of the assessee-company by urging that in the ultimate analysis can this payment be equated to a penalty entailed or imposed for infraction of a statute ? In the submission of the assessee-company, there is no infraction or breach of any statute or a statutory provision which can be even remotely spelled out in the facts and circumstances of this case. There is no breach of public policy in this case, according to the assessee-company, which will convert this amount of liquidated damages into exaction of payment akin to that of penalty and there is no distinction in principle laid down by this court in *Additional Commissioner of Income-tax v. Rustam Jehangir Vakil Mills Ltd*[2]*.,* where this court has held that such payments are incidents of the produce of cloth by the manufacturer depending upon the exercise of option which he will exercise in view of the technical or technological reasons of his own production and machinery and they cannot be treated as payments extracted or required for infraction of law.

[2][1976] 103 ITR 298 (Guj),

9. In *Additional Commissioner of Income-tax v. Rustam Jehangir Vakil Mills Ltd.*[3]*,* a similar question arose before a Division Bench of this court where the assessee-companies were limited companies manufacturing cotton textiles. Under the Cotton Textiles (Control) Order, the assessee-companies were under obligation to produce the cloth of a certain count. As the assessee-companies failed to produce the type of cloth they were under obligation to produce, they paid a sum of ₹ 91,387 as prescribed under clause 21C of the Cotton Textiles (Control) Order, 1948, in the previous year corresponding to the relevant assessment year 1969-70. The assessee claimed the said amount as expenditure on the ground that it was laid out wholly and exclusively for the purpose of the business of the assessee. The Income-tax Officer disallowed the claim which in appeal was upheld by the Appellate Assistant Commissioner. In further appeal by the revenue against the said order of the Appellate Assistant Commissioner, the Tribunal upheld the decision of the Appellate Assistant Commissioner and allowed the claim of deduction as admissible reserve expenditure laid out wholly and exclusively for purpose of the business. On reference, the Division Bench of this court by its decision of 6/ November 6,7, 1975, held that it cannot be said that by failing toe produce the whole or part of the minimum quantity of cloth specified in the direction issued by the Tribunal Textile Commissioner the particular manufacture commits and infraction of the law. On the contrary, it was held by the Division Bench, the scheme is that the law itself given as option to the producer concerned to adopt one of the three courses and if he complies with the law by choosing one of the three options offered to him, he cannot be said to commit any infraction of law, and hence, there was no question of any amount paid as penalty or any amount paid being akin to penalty and it was incidental to carrying on the assessee's business and, therefore, allowable. The relevant portion of clause 21-C of the Cotton Textiles (Control) Order, 1948, provided as under :

"21-C. (1) Where the Textile Commissioner has issued directions under sub-clause (1) of clause 21-A to any producer to pack a specified quantity of cloth during the period specified in the directions - ....
(b) such producer may, in lieu of packing the whole or part of the minimum quantity of cloth specified in the said direction, make payment to the Textile Commissioner in respect of the deficiency at such rates as may be specified by the Central Government and within such time as may be determined by the Textile Commissioner."

9.1. The Division Bench thereafter referred to the contention advanced on behalf of the revenue in the following terms - See [1976] 103 ITR 298, 303, 304, 305 (Guj) :

"The only question is, whether, as urged by Mr. Kaji on behalf of the revenue the payment made by the producer concerned to the Textile Commissioner in respect of the deficiency of cloth when he was not packed (produced) the whole or part of the minimum quantity of cloth specified in the direction issued to him can be said to be a payment akin to penalty. In terms it does not amount to penalty but the question that we have to considers, whether looking to the scheme of the Cotton Textiles (Control) Order, it is akin to payment of penalty."

9.2. The question so raised on the contention of the revenue was answered by the
[3][1976] 103 ITR 298 (Guj)
Division Bench as under :

"On a plain reading of clause 21-C(1) (b), in the context of the scheme of clauses 21-A and 21-C as a whole, it is clear the producer to whom the Textile Commissioner has issued direction under clause 21-A to pack the minimum quantity of a particular type of cloth during the particular period specified in the direction, has three options; either he can comply with the direction and during the original period specified in the direction or during the extended period, the producer can pack the minimum quantity and then meet the requirements of that particular direction. It is also open to him to produce and pack during the relevant period cloth in excess of the minimum quantity specified in the direction and in that eventuality, he becomes eligible under clause 21-C(1)(a) for receiving cash payment but way of assistance from the Textile Commissioner. The third option a valuable to the producer is not to pack the whole or part of the minimum quantity of cloth as specified in the direction issued by the Textile Commissioner and in that eventuality, in lieu of packing the whole or part of the minimum quantity of cloth, make payment to the Textile Commissioner at such rates as may be specified by the Central Government and within such time as may be determined by the Textile Commissioner. The scheme contemplated by the Cotton Textiles (Control) Orders is with a view to satisfy and practically to meet the requirements of the consumers on the other. As was

pointed out to the Tribunal in the course of the arguments when the case of the assessee concerned in Income-tax Reference No. 16 of 1974, *Addl. Commissioner of Income-tax v. Rustam Jehangir Vakil Mills Ltd*[4]*.,* was being argued before the Tribunal, the textile mills concerned may not have the required machineries to produce the controlled variety of cloth which the Textile Commissioner had directed the mills to produce. In the case of this particular assessee, the machinery could only produce finer variety of cloth and not be particular variety of controlled cloth produce finer variety of cloth and not the particular variety of controlled cloth which the Textile Commissioner had directed the mills to produce and hence it was not possible for the textile mills to produce and pack the required quantity of the controlled cloth. That is one aspect. It is also from the technical point of view the question of what is known in technical language as the 'production mix' of each textile unit concerned depending upon the availability of raw material and depending upon the ruling prices for the controlled variety of cloth on the one hand and the price of raw cotton and the quality and quantity of cotton available in the market and the capacity of the installed machinery of the particular textile mill to manufacture the particular type of cloth up to the particular quantity on the other hand. It is because of these variable factors which go on varying from unit to unit and from time to time that the Cotton Textiles (Control) Order has left it to the option of the producer concerned to decide whether the producer would produce the minimum quantity specified in the direction issued by the Textile Commissioner or soul exceed the minimum quantity or would not produce the minimum quantity with in whole or in part and make the payment contemplated by clause 21- C(1) (b). Under these circumstances. the words used in clause 21-C, namely, that the 'producer may, in lieu of packing the whole or part of the minimum quantity,..... make payment' 'go to indicate that the option has been given to the producer to

[4][1976] 103 ITR 298 (Guj)

decide whether he would produce any part of the minimum quantity of cloth specified in the direction issued by the Textile Commissioner or would not produce any part of that minimum quantity and decide to make the payment to the Textile Commissioner at the rates specified by the Central Government and within the time determined by the Textile Commissioner..... Thus, far from the payments being in the nature of penalty or akin to penalty, the payment contemplated by clause 21-C(1)(b) is a necessary concomitant of the option that the producer concerned may have exercised while deciding not to produce and pack the whole or part of the minimum quantity specified in the direction of the Textile Commissioner."

10. We are of the opinion that having regard to the terms contained in the bond we find that it is optional for the manufacturers to achiever the export target prescribed for them or to pay to the Government the sum or sums calculated at the rate of 10 paise by linear yard to cover up the shortfall in the export obligations. The option envisaged in the bond entered into between the parties clearly indicates that the option was with the manufactures and that option may be availed

of for a variety of reasons in the interest of commercial expediency. The export obligations which the textile manufacturers may have incurred for the use of trade mark "sanforized" may not be fulfilled for varies factors over which the manufactures may not have control. The trend and competition in the international market, the quality and quantity of the goods produced by the manufactures may be some of the factors which may ultimately have a bearing on the question of achieving the target. In the interest of business, textile manufacturers opt for payment of compensation or damages to cover up the shortfall in the export obligations. It is not doubt true that the word used in the scheme which we have set out above for the sum to be paid in default of fulfilling the export obligations. It is not doubt true that the word used in the scheme which we have set out above for the sum to be paid in default of fulfilling the export obligation has been described as a penalty but in the ultimate analysis it is the substance of the transaction between the parties which was to be considered for purposes of determining what is the nature and import of the scheme and the bond executed in person there of. The exercise of option, as stated above, may be the result of the commercial expediency as well as certain extraneous factors over which the manufacturers might not have the control and, therefore, in view of the scheme and the bond with which we are concerned here, it cannot be said that there is a breach of a public policy which may render the payment, agreed to be made for the default arising as a result of the breach, as one akin to penalty. Under no circumstances, without violence to the language, it can be said to be infraction of the law. In that view of the matter, therefore, we do not find any reasons to interfere with the order of the Tribunal when it viewed the payment in question as expenses wholly and exclusively laid out for the business. In that view of the matter, therefore, we answer the question referred to us in the affirmative and in favor of the assessee. The Commissioner of Income-tax shall pay costs of this reference to the assessee.

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