

BOMBAY HIGH COURT

New Shorrock Spg

Vs.

Commissioner of Income-Tax

Income-tax Ref. No. 16 of 1949

(Chagla, C.J. and Tendolkar, J.)

16.03.1950

JUDGMENT

Chagla, C.J.

1. This was a reference under Section 21, Excess Profits Tax Act, 1940. The assesses company, the New Shorrock Spinning and Manufacturing Company, Limited, had its textile mills at Ahmedabad. Its managing agents were Mafatlal Chandulal and Co. In the assessment of the company for excess profits tax the chargeable accounting periods were, 1st January 1944 to 31st December 1944 and 1st January 1945 to 31st December 1945.

One of the questions that was raised in the taxation was whether the company was one in which the directors had a controlling interest. The company had issued 15,000 shares into which its issued capital was divided. Out of these, 1332 shares were held by Mafatlal Gagalbhai, who died on 19th July 1944. Mafatlal's son Bhagubhai held another 5604 shares. He expired on 30th September 1944. During the relevant period these 6935 shares were not transferred to any one. The total number of shares of the company was 15,600.

On 5th June 1945, Seth Navinchandra Mafatlal, one of the directors, acquired 1292 additional shares, thus making the number of shares held by the directors 8,803 out of 15,600. On 5th June 1945 the company, therefore, became a 'director controlled company.' On 1st October 1944, the total number of shares held by the directors fell to 7471. It must, however, be added that the shares which stood in the names of Mafatlal Gagalbhai and Bhagubhai Mafatlal were not transferred to any party till at least up to 5th June 1945. In connection with this question, two contentions were raised by the company (i) Navinchandra Mafatlal being one of the sons of Seth Mafatlal Gagalbhai had a beneficial interest in half the number of shares held by his father. It should, therefore, be held that he had a right to vote in respect of 666 shares. (2) In order to find out whether the directors had a controlling interest, the shares held by Mafatlal Gagalbhai and Bhagubhai Mafatlal should be excluded from the total number of shares of the company, viz. 15,600. The first contention was not accepted by the Tribunal in view of Article 58 of the articles

of association of the company.

"In our view that contention has no substance. We hold, therefore, that the Department was right on the materials on the record to treat the company as director controlled only up to 30th September 1944, and against from 5th June 1945."

The second contention was also not accepted by the Tribunal relying on 12 T. C. 573 and 12 T.C. 911. The tribunal in the view that it took held that the company was not a 'director controlled company' from 1st October 1944 to 5th June 1945.

The second question that the Tribunal had to determine was whether the commission credited to the account of the managing agents of the company was borrowed money or a debt for the purpose of Rules 2 and 24 of sch. II to the Excess Profits Tax Act. On 8th November 1913, an agreement was arrived at between the assessee company and its managing agents, which provided, among other things, as follows :

"3. That the company so long as the said company exists and carries on business either in its present name or in any other name which it may adopt shall in addition to the interest payable to the promoter-agent on his loans pay each year to the promoter-agent 17/64th (seventeen-sixty-fourth) share of the total commission calculated at the rate of 3 per cent. on the sale proceeds of all goods manufactured and sold by the company and such commission being payable every year within a fortnight after the holding of the annual general meeting of the company and such payment of commission shall be continued to be made by the said company to the promoter-agent for all times notwithstanding the fact that the part or whole of the deposit amount has been paid off by the company.

4. That the total amount of the commission payable by the company shall be ascertained every six months and shall be credited to an account called the commission account on which interest shall be allowed by the company at the rate of 6 per cent. per annum and in calculating the share of the promoter-agent in such commission under clause 3 of this agreement all interest earned in the commission account shall be included and taken into account at the time of payment.

5. That if in any year the net profits of the company after deducting depreciation should be insufficient to enable the company to declare a dividend of 6 per cent. on the paid-up capital of the company for the time being, the company will be entitled to deduct from the total amount of commission including the proportion payable to the promoter-agent under this agreement, such portion thereof not exceeding 1/3rd as is necessary to make up such deficit." The appellate Assistant Commissioner held that the commission due to the managing agents was borrowed money. The managing agents accounts came into existence by virtue of Clauses 4 and 5 of the agreement between the company and the managing agents set out above.

"This clause clearly indicates that until the company balances and closes its accounts and

determines its net-profit to see if the company can declare or not a dividend of 6 per cent. the agents cannot touch or withdraw the amounts credited to their accounts. As the agents are not allowed to draw away their dues the company allows 6 per cent. interest and the amount which earns interest is nothing else but loans or borrowings. It is not that the agents keep the amounts voluntarily with the company to earn the interest or to show an inflated liability of loans or borrowings. In fact the agents are bound to keep the amount at interest and each amount which the company does not part with but keeps at interest can be nothing else than loans or borrowings. No doubt the amounts and accounts are created as debt from within the company, but in terms of Clauses 4 and 5 they automatically become loans or borrowings by the company and as such the amount cannot be ignored from capital computation.

Again it is also important to note that in determining the capital of the C.A.P. at Rs. 17, 671, 670 the excess profits tax officer has admitted and included the borrowings by the New Shorrook and the China Mills at Rs. 18,36,725 and Rs. 2,84,000. If the managing agents' money Rs. 3,47,413 was not kept, but if it was given away there would have been so much more borrowing from the outsiders and the excess profits-tax officer in that case could not have objected to admit the borrowing by Rs. 3,50,000 more. So whether it is agents' money or somebody else's money what difference does it make to the company ? The company wanted some borrowed money for business purposes. Whether such borrowings are provided by outsiders or the agents is immaterial to the company. So why make distinction between loans by outsiders and loans by agents ? No doubt the agents' loan is an automatic loan, i.e. what the agents would have rightfully withdrawn they allowed to remain in the company to make so much less harrowing from the outsiders and that cannot and does not change the nature of agents' moneys lying with the company. In terms of clause 5, one-third of the agents' commission has to remain as a compulsory deposit to be given up by the agents if the dividends to the shareholders fall below 6 per cent. So taking every thing into consideration, I feel the appellants claim to include the managing agents dues in capital computation is fair and correct and is allowed." The Appellate Tribunal, however, held that the commission due was not a borrowing but merely and trade debt :

"Neither the clauses nor any other clause to which our attention was drawn enables the commission so accumulated to be treated as borrowing. It is clear that this was not a borrowing by the company but merely a trade debt."

At the instance of the assessee, the Tribunal referred the following questions to the High Court :

- "(1) Whether in the circumstances of the case the company was a company in which the directors had a controlling interest from 1st October 1944 to 5th June 1945.
- (2) Whether in the circumstances of the case the commission due to the managing agents was a debt due by the company or borrowed money for the purpose of Rules 2 and 2A of Schedule II to the Excess Profits Tax Act."

Chagla, C.J.

6. The only question that arises on this reference is whether the assessee company was a director-controlled company or not a director-controlled company. The total number of shares of the company are 15,600 and the period with which we are concerned is the period from 1st October 1944, to 5th June 1945. During this period, the total number of shares held by the directors was 7471. Therefore, during this period they controlled not a majority but a minority of the total votes which could be exercised as a result of the holding of shares. On these facts, the Tribunal came to the conclusion that the assessee company was not a director-controlled company. It was urged before the Tribunal, as it has been urged before us by Sir Jamshedji Kanga, that two of the directors and shareholders Mafatlal Gagalbhai and Bhagubhai Mafatlal died on 19th July 1944, and 30th September 1944, and during the material period the shares which these two persons held were not transferred to any other shareholder, and therefore, according to Sir Jamshedji, in order to determine whether the directors had a controlling interest in the company or not, we must exclude 1332 shares held by Mafatlal Gagalbhai and 5604 shares held by Bhagubhai Mafatlal. If these were excluded, then undoubtedly the directors would have the majority of votes and, therefore, the assessee company would be a director controlled company.

2. In order to appreciate this contention, we have to consider what is the true connotation of the expression used in the Excess Profits Tax Act with which we are concerned. In order that the company should be director-controlled, the directors must have the controlling interest in the company, and the question is, what exactly does the expression "controlling interest" mean. It is well settled that the interest which the directors must have need not be a beneficial interest in the shares or the company. Directors may be put on the register of a company as trustees; even so the votes which they would command and which they could exercise will have to be considered in determining who had the controlling interest in the company. But the difficulty that arises is, how is the voting strength which the directors have to be ascertained? The control which this expression contemplates is a voting control, such a control as would enable the directors at a general meeting of shareholders to get any resolution carried which would affect the administration or the management of the company. Two views have been pressed before us. The view that has been pressed before us by Sir Jamshedji is that you must determine the voting strength and the voting control by the effective votes which the directors control and which would ultimately determine the decision at a general meeting. The other view that has been pressed before us by the Attorney General is that you have got to consider the voting strength from the shares which represent votes held by the directors. If you find that the directors held a number of shares which gives them a majority of votes, then they have a controlling interest in the company. It is irrelevant to consider whether the shares held by others represent the effective votes or not and also whether the votes are exercisable under certain eventualities that may happen or due to certain adventitious circumstances. If you find that the directors do not control a majority of votes by reason of the fact that they do not hold a sufficient number of shares which

represent the majority of votes than the directors do not have a controlling interest in the company. Whether the majority which is against them exercised all their votes, whether all those votes are exercisable or not, whether they choose to come at the general meeting or not, are all irrelevant circumstance ?. What we have got to consider is not the effective votes held by the persons other than the directors; what we have to consider is the actual number of shares held by the directors which represent votes; and it is only from that aspect that we have to determine whether the directors controlled the company or not.

3. It seems to me, and I frankly confess that the position is not free from doubt or difficulty, that on the whole the view put forward before us by the Attorney General is the correct view. It is the shares in a company that represent votes and it is from the strength of the holding of the shares that the voting strength has got to be determined. If the directors controlled a majority of such votes, then so farther question arises. If they do not control a majority of such votes, then also no further question should arise because it would be impossible to investigate into what the position would be with regard to shareholders who control the majority of votes as to whether they choose to exercise all their votes or not. In this particular case which we are considering, the total number of shares of the company Rs. 15,600. Each share represents one vote, and, therefore, the total number of votes are 13,600. At the material date the directors could only control 7471 votes because they held 7471 shares. That was not the majority of the votes. Is it permissible to us to inquire as to whether the votes held by shareholders other than directors were effective or not during the material period ? Could we ask ourselves the question as to whether those votes were exercisable or not ? If we were allowed to ask ourselves that question, it is difficult to lay down any limit to such an inquiry. In this particular case Sir Jamshedji relies on the fact that Mafatlal Gagalbhai and Bhagubhai Mafatlal are dead and under no circumstances can they exercise the votes which are represented by the shares that stand in their names. But is that a logical limit to our inquiry ? Why is it not open to us to proceed further and inquire with regard to other shareholders whether they are in a position to exercise their votes or not ? A shareholder may be out of the country during the material period and not being in a position to be present at the meeting and exercise the vote. A shareholder may be detained or in other ways physically prevented from exercising his vote. Are all these purely adventitious circumstances to be taken into consideration in determining the voting strength of the directors ? In my opinion - and I shall presently deal with the authorities - in order to decide whether the directors have a controlling interest in the company or not, all that we are entitled to look at is the register of the shareholders and the articles of the company only in order to determine as to how many votes the shares carry with them. On looking at the register of shareholders, if we find that the directors hold shares which gives them a majority of votes which votes they could exercise at any general meeting and thereby carry any resolution which they desire to carry, then the directors have a controlling interest. If, on the other hand, by looking at the register of shareholders we find that the directors have only it minority of votes and by reason of that they could not carry any resolution that they wish to carry, then they have not a controlling interest. At all material times the directors must control and command a sufficient strength of votes to be able to override any opposition that may

be presented to them at a general meeting of shareholders. Whether in fact they can do so or not, is not a consideration which can weigh with the Court in deciding whether they have a controlling interest or not.

4. Turning to the authorities, the first decision which has been strongly relied upon by Sir Jamshedji is the one reported in *Inland Revenue Commissioners v. Bibby and Sons, Ltd*¹. That is the case which laid down that the controlling interest meant controlling voting power and not beneficial interest. There are certain observations of Lord Russell of Killowen and Lord Simonds on which Sir Jamshedji has relied. Lord Russell says (p. 9) :

"When the section speaks of directors having a controlling interest in a company, what it is immediately concerned with in using the words 'controlling interest' is not the extent to which the individuals are beneficially interested in the profits of the company as a going concern or in the surplus assets in a winding-up, but the extent to which they have vested in them the power of controlling by votes the decisions which will bind the company in the shape of resolutions passed by the shareholders in general meeting."

¹(1945) 14 ITR Sup. 7

Therefore, what is emphasised by the learned Law Lord is the power of controlling by votes the decision of the company. But the learned Law Lord does not refer at all to the distinction which Sir Jamshedji seeks to make that the votes must be effective votes, and votes which are not exercisable or which are not effective must be excluded from the consideration whether the directors controlled the votes or not.

5. Then turning to Lord Simonds, the observations relied on are at p. 15, and Lord Simonds asks himself the question, "What constitutes a controlling interest in a company ?" and this is the answer that he gives (p. 15) :

"It is power by the exercise of voting rights to carry a resolution at a general meeting of the company. Can the directors of the respondent company by the exercise of their voting rights carry such a resolution ? Yes; for they are the registered holders of more than half the ordinary shares of the company. Therefore they have a controlling interest in the company."

Therefore, what the learned Law Lord is emphasising is the fact that the directors in the case which he was considering were the registered holders of more than half the ordinary shares of the company. Here again, the emphasis is on the votes and on the shares which represent the votes, and if the directors have a majority of such votes then they have a controlling interest reference was also made to another decision of the House of Lords reported in *British American Tobacco Co. v. Inland Rev. Commrs*². and reliance was placed on the observations of the Lord Chancellor (Viscount Simon) (p. 31) :

"I find it impossible to adopt the view that a person who (by having the requisite voting power in a company subject to his will and ordering) can make the ultimate decision as to where and how the business of the company shall be carried on, and who thus has in fact control of the company's affairs, is a person of whom it can be said that he has not in this connection got a controlling interest in the company."

It is perfectly true that if the directors can influence the ultimate decision of the company, they have a controlling interest. But according to the decisions the ultimate control must be brought about by directors having a majority of votes on the register and not by any extraneous circumstances which may result in the majority against them being reduced to a minority.

6. Some earlier English cases were also referred to at the bar. One is the case reported in *The Glasgow Expanded Metal Co. Ltd. v. Commissioners of Inland Revenue*³, and Lord President (Clyde) expressed his opinion that the only interpretation which can be given to the expression "controlling interest" was by reference to the power which the number of Shares held by the directors gave them to control the disposal of the company's assets and the administration of its affairs at a general meeting of the company. Here again, the approach is clear. The test to be applied is the number of shares which the directors hold and it is only by reason of that holding that the directors must be in a position to control the affairs of the company. The other case is reported in *Commissioners of Inland Revenue v. Noble, Ltd.*⁴, and the judgment of Rowlatt, J. is to be found at p. 926, and

²(1942) 11 I.T.R. Sup. 23

⁴(1926) 12 Tax Cas. 911

³(1923) 12 i.e. 573

Rowlatt, J. observed that the phrase "controlling interest" had a certain well-known meaning and according to the learned Judge it meant the man whose shareholding in the company was such that he was the shareholder who was more powerful than all the other shareholders put together in general meeting. Here again, the power of the shareholder was to be judged, not by any other circumstance, not by any other consideration, but by his holding of shares. In this particular case Rowlatt, J. held that the vote which the chairman had as a casting vote under the articles of association must be considered in deciding whether the directors had a controlling interest or not. Sir Jamshedji says that Rowlatt, J. actually considered what happened at the meeting because he had considered the possibility of a casting vote being given by the chairman. That, in my opinion, is not a correct reading of this judgment. The casting vote was to be exercised pursuant to the articles of association. The vote existed by reason of the articles and that vote had to be considered as being vested in the chairman, who could exercise it in the event of there being a tie.

7. Sir Jamshedji has strongly relied on two very recent decisions of the English Court. One is *Commissioners of Inland Revenue v. James Hodgkinson (Salford) Ltd.*⁵ and the other is *Commissioners of Inland Revenue v. Monnick Ltd.*⁶. In the first case the question that Groom Johnson, J. was considering was whether a shareholder of that particular company could by a power-of-Attorney transfer his shares to the director of the company, and all that Croom-

Johnson, J. held that such a transfer was not valid and, therefore, the director was not entitled to exercise the votes of the shareholder and, therefore, those votes could not be considered in determining whether the company was a director-controlled company or not. Under the articles of association, votes could be transferred by valid proxies, and Groom. Johnson, J. has referred to these articles and has come to the conclusion that as votes were not transferred by proxies but by a power-of-attorney, the votes could not be exercised as laid down by the articles of association. Sir Jamshedji says that the very fact that Groom-Johnson, J., considered the question of votes being transferred by proxies leads one to the conclusion that in the opinion of the learned Judge the only material fact was not the holding of shares by the directors on the register of shareholders. According to Sir Jamshedji, even though a director may not hold certain shares on the register of shareholders, still he could exercise the votes represented by those shares if the share-holders had validly transferred those votes to the director by proxies, and if those votes had been so transferred, in the eye of the law the director in whose favour the proxies were executed must be deemed to be to have control over those votes. Now, one must always read a decision as deciding what it actually decides. Croom-Johnson, J., was not called upon, with respect, to decide what the position had been if the share holder had executed a valid proxy. The only narrow question that arose for his determination was whether the power-of-attorney executed by the share-holder validly transferred the voting right to the director, and that question he decided as I have already indicated. In the other case the two directors had 600 shares each out of 2,000 shares and there was a provision in the articles by which the directors could appoint one of the directors to be the chairman of the company, in which case he would have a casting vote. If no such appointment was made, the chairman had to be elected at the general meeting, and the question was whether the directors could be considered to have a controlling interest inasmuch as they were in a position to nominate one of the directors as chairman,

⁵28 Annotated T.C. 208

⁶28 Annotated T.C. 212

who would then have a casting vote and would there by have a majority of vote ? The Special Commissioner held that they ought to have regard only to the facts as they existed at the general meetings of the company, and that the casting vote at those meetings was exercisable by the person who was in fact chosen as the chairman, and who was not a director, and that, therefore, the company was not a director-controlled company during the relevant period. Therefore, under the articles, this particular vote was exercisable by the chairman of the meeting, and the question had to be considered as to who had the right to exercise this vote, and on the facts of that particular case the Special Commissioners came to the conclusion that that vote was exercisable by a person other than a director because it was a person elected at the meeting as chairman who could exercise that vote. I do not think that this case in any way militates against the principle of law enunciated in the earlier decisions to which I have referred. In this particular case under the articles this particular vote was not represented by a share, but was the result of a certain office held at the meeting. But the emphasis still is on the vote and not on whether the vote can be exercised or not.

8. In my opinion, therefore, the Tribunal was right when it came to the conclusion than looking

to the fact that the directors held 7471 shares during the relevant period out of 15,600 shares, they did not have a controlling interest in the company, and, therefore, during the material period the company was not a director, controlled company.

9. I would, therefore, answer question (1) in the negative. With regard to question (2), whether in the circumstances of the case the commission due to the managing agents was a debt due by the company or borrowed money for the purpose of Rules 2 and 2A of Schedule II, Excess Profits Tax Act, the case is wholly covered by a decision which we gave recently and which is reported in *Seksaria Biswan Sugar Factory v. Commr*⁷. In the light of that decision, the answer to question (2) is that it was a debt due.

10. Assessee must pay the costs of the reference.

Tendolkar, J.

11. I agree.

Reference answered.

⁷IT 52 Bom LR 91 : AIR 1950 Bom 200