**IN THE HIGH COURT OF JUDICATURE AT BOMBAY**

**ORDINARY ORIGINAL CIVIL JURISDICTION**

**INCOME TAX REFERENCE NO.104 OF 1999**

The Wallace Flour Mills Co. Ltd. .. Applicant.
v/s.
The C.I.T. Central Circle-I .. Respondent.

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Ms. A. Vissanji, a/w. Mr. S.J. Mehta, for the Applicant.

None for the Respondent.

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**CORAM: M.S.SANKLECHA, &**
**S.C. GUPTE, JJ.**
**DATE : 26 AUGUST, 2016.**

**Oral Judgment (Per S.C. Gupte, J.):**

. By this Reference under Section 256(1) of the Income Tax Act, 1961, the Income Tax Appellate Tribunal ("Tribunal") refers the following question for our opinion:-

> "Whether on the facts and in the circumstances of the case, the Tribunal was justified in law in holding that the sum of Rs.13,91,837/- which represented retrenchment compensation paid by its subsidiary to the workers of the two units which belonged to the assessee and which were transferred to the subsidiary and which amount was reimbursed by the assessee under a contractual agreement, was not allowable as an admissible deduction?"

2. This Reference relates to Assessment Year 1980-81.

3. The Assessee in the present case had four industrial units,

two in Bombay (as the city was then known) at Mazgaon and Grant Road, respectively, and one each in Goa and Bhopal. During the relevant previous year the Assessee reorganized its business by transferring some of its units and retrenching some of the employees of the other units retained by it. The units at Grant Road and Goa were transferred by the Assessee to a company floated as a 100% subsidiary of the Assessee. A scheme of voluntary retirement was offered to the employees of the other units. Under this scheme, a sum of Rs.15.23 lakhs was paid to those employees, who agreed to retire from the services voluntarily. Insofar as the units at Grant Road and Goa transferred to the newly formed subsidiary were concerned, under the transfer terms, the Assessee was to bear retrenchment compensation, if any, payable by the subsidiary to the employees of the transferred units. A payment of Rs.13.91 lakhs was required to be made to the subsidiary as a contractual liability arising out of this term.

4. The assessee claimed in the assessment proceedings both these payments (i.e. Rs.15.23 lakhs and Rs.13.91 lakhs) as allowable expenditure. The ITO disallowed the claim of the sum of Rs.15.23 lakhs paid under the scheme of voluntary retirement on the ground that the same was *ex-gratia* in nature and, according to him, even on the principle of commercial expediency, the payment was not justified. Besides, the ITO observed that the payment was made to the employees of the unit, which was closed. Insofar as the payment of Rs.13.91 lakhs was concerned, the ITO observed that the event of transfer of business was not incidental to the carrying on of the business but an extra-ordinary happening which did not constitute the Assessee's business. The ITO, in

the premises, did not allow the amount of Rs.13.91 lakhs as business expenditure.

5. When the matter went to the C.I.T. (Appeals), the C.I.T. (Appeals) was of the opinion that the disallowance of Rs.15.23 lakhs was not in order. He held that this payment, which was made in terms of an agreement with a recognised union, resulted in reduction of a lot of surplus employees in the Mazgaon unit and such retrenchment facilitated carrying on of the Assessee's business smoothly and was thus a matter of commercial expediency. The C.I.T. (Appeals) negatived the Revenue's contention concerning the payment being occasioned by a closure, observing that the Assessee continued to carry on its flour milling business even after the transfer of the two units. The C.I.T. (Appeals) also allowed the claim of Rs.13.91 lakhs towards the retrenchment compensation paid to the employees of transferred units. He held that the units were transferred to a wholly owned subsidiary and at the time of transfer it was agreed that the Applicant would be liable to pay retrenchment compensation and other retirement benefits attributable to the services of the employees with the Assessee upto the date of transfer; that it was clear that the expenditure incurred in pursuance of this agreement was to facilitate the carrying on of the business without any hindrance. The C.I.T. (Appeals), accordingly, deleted the addition.

6. The Revenue carried the matter in appeal before the Tribunal. The Tribunal agreed with the conclusion of the C.I.T. (Appeals) insofar as the payment of Rs.15.23 lakhs made by the Assessee to its own employees was concerned as unexceptionable. The Tribunal, however, held that the payment of Rs.13.91 lakhs stood on a different footing.

According to the Tribunal, that was a payment made by the Assessee, after the unit was transferred. It held that the retrenchment compensation that was paid subsequent to the transfer, though referable to the services rendered by the recipients to the Assessee, cannot be considered as an expenditure laid out wholly and exclusively for the purpose of the Assessee's own business. It held that at the time the transfer was effected, the retrenchment compensation was in the realm of a remote possibility. The liability by way of such compensation could not have been ascertained or quantified and, in the premises, the amount was not laid out for the purpose of business.

7. In these premises, the central question that we need to consider in this Reference is whether or not the expenditure of Rs.13.91 lakhs claimed by the Assessee is an amount laid out or expended wholly and exclusively for the purpose of its business within the meaning of Section 37 of the Income Tax Act, 1961. The thrust of the Tribunal's order rejecting this expenditure is that this expenditure incurred by the Assessee benefited another company and could not be considered as incurred for the Assessee's own business; that it was not necessary for the Assessee to bear it.

8. We need to first address ourselves to the question as to what is meant by the expression “wholly and exclusively” used in Section 37. Does it mean “necessarily” or does it include any expenditure incurred in the course of its business by the Assessee voluntarily and without any necessity. In the case of **Sassoon J. David and Co. P. Ltd. vs. Commissioner of Income-Tax, Bombay**[1], the Supreme Court has

1 1979 (Vol.118) ITR 261

answered this question in the context of a similar phrase used in Section 10(2)(xv) of the Income Tax Act, 1922, which is in *pari materia* with Section 37 of the present Act. The Court held that the expression "wholly and exclusively" does not mean "necessarily". The Court considered various tests in this behalf, and particularly focused on the test, viz. whether the sum of money was expended on the ground of commercial expediency and in order to indirectly facilitate the carrying on of the business, laid down in **Gorden Woodroffe Leather Manufacturing Co. vs. CIT**[2]. The Court held that any sum of money expended on the ground of commercial expediency and in order indirectly to facilitate the carrying on of the business of the Assessee have to be read disjunctively. It is ordinarily for the Assessee to decide whether any expenditure should be incurred in the course of his or its business. Such expenditure may be incurred voluntarily and without any necessity and if it is incurred for promoting the business and to earn profits, the Assessee can claim deduction under the relevant provision, even though there is no compelling necessity to incur such expenditure. The Court further held that the fact that somebody other than the Assessee is also benefited by the expenditure, did not come in the way of such expenditure being allowed by way of deduction. To the same effect are the observations of a Division Bench of our Court in the case of **Tata Sons Ltd. vs. Commissioner of Income Tax, Bombay City-3**[3]. The Division Bench in that case observed that the decided cases show that one has not got to take an abstract or academic view of what is proper expenditure laid out and expended wholly and exclusively for the purposes of one's business; One has got to take into consideration questions of commercial

2 [1962] Supp. 2 SCR 211; [1962] 44 ITR 551 (SC)
3 1950(28)ITR 460

expediency and principles of ordinary commercial trading and the main consideration that has got to weigh with the Court is whether the expenditure was a part of the process of profit making. The Division Bench relied on the observations of House of Lords in the well known case of **British Insulated and Helsby Cables Ltd. vs. Atherton**[4]. In that case, the House of Lords, after citing various cases on the point made the following observations :-

> "…. It was made clear in the above cited cases .. that a sum of money expended, not of necessity and with a view to a direct and immediate benefit to the trade, but voluntarily and on the grounds of commercial expediency, and in order indirectly to facilitate the carrying on of the business, may yet be expended wholly and exclusively for the purposes of the trade."

9. Now, in the light of this statement of law, one has to consider whether the expenditure of Rs.13.91 lakhs in the present case is an amount laid out or expended wholly and exclusively for the purposes of business. It is borne out on record that during the year under consideration and for the past three years, the Assessee was in the grip of a serious labour trouble, with plenty of litigations pending under the Industrial Disputes Act before various Labour Courts and Tribunals. In the light of these circumstances, the Assessee thought it fit to hive off its two undertakings, referred to above, to the another company, namely, M/s. Volvis Floor Mills Pvt. Ltd., which was a wholly owned subsidiary of the Assessee. The rationale of this decision is explained in the agreement for transfer entered into between the Assessee and Volvis. The agreement recites that the transfer is with a view to reorganise the manufacturing business activities of the vendor and so as to run and operate the

4 [1926] A.C. 205; 85 L.J.K.B. 336

remaining units in Bombay (referred to as A Mills) and Goa as separate units under a separate corporate existence and for better administration and control of these two units. Transfer of other units would have entailed, under Section 25FF of the Industrial Disputes Act, payment of retrenchment compensation to the employees of the units proposed to be transferred. Such payment could have been avoided only if there was an agreement between the parties, including the concerned employees, for continuity of their services with the transferee company. Therefore, with a view to ensure that the retrenchment compensation is not required to be paid at the date of transfer, the Assessee provided for a stipulation in the transfer agreement that the services of the employees shall not be interrupted by the transfer and the transferee shall be liable to continue the employees in the latter's employment with all obligations to pay wages, emoluments and benefits, including benefits in respect of gratuity, retrenchment compensation, provident fund and retirement benefits, if any. As a condition for taking over these obligations, which were otherwise the obligations of the transferor company, the transferee company insisted on a condition that in case the transferee was at any time required to pay any amount by way of gratuity, retirement compensation or any other benefit to the concerned employees, the transferee shall be entitled to claim reimbursement thereof from the Vendor Assessee. The relevant clause in this behalf in the transfer agreement is quoted below :-

> "11(c) Notwithstanding anything to the contrary herein contained, it is agreed that as between the Vendor and the Purchaser (but not vis a vis the Employees) the obligations to pay gratuity, retirement compensation and other retirement benefits to the employees as compared for the period upto 30th

> November, 1979 shall be paid by the Vendor as its own business liability or outgoing and in case the Purchaser will hereafter pay such amount to any of the concerned employees, the Purchaser shall be entitled to claim reimbursement thereof from the Vendor."

10. This agreement to reimburse the transferee company in respect of the payment attributable to the employees' services with the Assessee Company as of the date of the transfer, is, to our mind, clearly an agreement arising out of commercial expediency. The contractual obligation is undertaken by the Assessee Company with a view to conduct its business in a more efficient manner and clearly comes within the dicta referred to above.

11. The Tribunal disallowed the expenditure on the footing that the amount of Rs.13.91 lakhs was paid as retrenchment compensation subsequent to the transfer and that such payment, as on the date of the transfer, was in the realm of a remote possibility. In the first place, the expenditure of Rs.13.91 lakhs is claimed in the year the amount was actually paid and not as of the date of the transfer. It cannot, accordingly, be described as a contingent liability. Secondly, and in any event, the amount is paid not by way of retrenchment compensation but by way of discharging its commercial obligations arising under the agreement of transfer referred to above *qua* the transferee company. It is not, therefore, relevant to consider whether any retrenchment compensation *per se* was payable on the date of transfer or that any such compensation was a remote possibility. The payment is clearly in discharge of a contractual obligation undertaken by the Assessee on account of its business expediency.

12. One of the grounds for disallowing the expenditure was the transfer of the unit or cessation of its business in the light of the law laid down by the Supreme Court in the case of **Commissioner of Income-Tax, Kerala vs. Gemini Cashew Sales Corporation**[5]. The Tribunal held that the Assessee had ceased to carry on the business of the transferred unit as after the transfer it became the business of the subsidiary and therefore, the liability towards retrenchment compensation discharged by the Assessee could not be allowed as a deduction. The Tribunal relied upon the statement of law in **Gemini Cashew Sales Corporation** to the effect that a liability arising on account of closure of business cannot be allowed as expenditure for the purpose of the business. The Supreme Court holds that to be a permissible allowance the expenditure must be for the purpose of "carrying on" the business; that where accounts are maintained on the mercantile system, if the liability to make the payment has arisen during the time the business is carried on, it may appropriately be regarded as expenditure; but where the liability is, during the whole of the period that the business is carried on, wholly contingent and does not raise any definite obligation during the time the business is carried on, it cannot fall within the expression "expenditure laid out or extended wholly and exclusively" for the purpose of the business. The argument, which appears to have weighed with the Tribunal, seems to be that the liability to pay retrenchment compensation was contingent and did not arise when the "business of the (transferred) unit" was being carried on by the Assessee; and any commitment to pay retrenchment compensation after such transfer, even if it be under a contract, cannot be for the purpose of the business. There is an inherent flaw in the reasoning of the Tribunal.

5 1967 [Vol. LXV] ITR 643

The closure of business to come within the ratio of **Gemini Cashew Sales Corporation**, must be closure of the business as a whole. The Assessee carrying on business of flour milling at four units cannot be said to have closed its business after it transferred two of the four units to another company. The Assessee continued to carry on the business of flour milling, according to it presumably more smoothly and efficiently after transfer of two units, *inter alia* by undertaking the commercial obligation of discharging the compensation payable to the employees of the transferred units in the event of their future retrenchment. That is clearly an expenditure incurred for the purpose of its existing and continued business and not an expenditure occasioned by closure of business. We may, in this behalf, note the observations of the Madhya Pradesh High Court in the case of **Pradeep Pictures vs. Commissioner of Income Tax, M.P.-I**[6]. That was a case where retrenchment compensation was paid to employees upon closure of one of the two theatres owned by the assessee. The Court held that discontinuance of business at one theatre did not amount to closure of business and distinguished **Gemini Cashew Sales Corporation** on that basis. The relevant observations of the court are quoted below :

> "Now, if there is no closure of the business of exhibition of films by the assessee during the relevant assessment year, the liability of the assessee to pay retrenchment compensation on account of discontinuance of its business at one theatre, cannot be held to be a liability arising on account of closure of its business. The decision in CIT v. Gemini Cashew Sales Corporation [1967] 65 ITR 643 (SC), relied upon by the Tribunal and that in Venkatesa Colour Works v. CIT [1977] 108 ITR 309 (Mad), relied upon by the learned counsel for the

6 1983 [Vol.143] ITR 300

> Department are, therefore, distinguishable on facts. In these cases, the liability to pay retrenchment compensation had arisen on account of transfer or closure of the business carried on by the assessee and it was, therefore, held that the liability arose not in the carrying on of the business of the assessee, but after the closure of the business. As already observed, in the instant case, the discontinuance of its business by the assessee at one of its theatres did not result in a closure of that business by the assessee. Once this conclusion is reached, it must be held that the Tribunal wrongly disallowed the deduction claimed by the assessee on account of retrenchment compensation paid by it to its employees, employed at one of its theatres."

13. The Tribunal appears to have heavily relied on the decision of our Court in the case of **CIT Bombay City-I vs. W.T. Suren & Co. Ltd.**[7] Our Court in that case was concerned with payment of gratuity made consequent to a transfer of business. The Assessee in that case was a wholly owned subsidiary of the transferee company. At the date of the transfer, an option was given to the employees of the transferor company (i.e. the assessee) either to accept employment with the transferee company or accept terminal benefits, including gratuity from the transferor company as at the date of the transfer. Apart from the payment of such gratuity to the employees opting for the latter option, a sum of Rs.4.10 lakhs was paid to the transferee company towards the amount of gratuity, which would have been payable to the staff of the assessee, if they had retired on the date of the transfer. Our Court considered the character and nature of this payment. The Court held that by virtue of the fact that the employees had been taken over by the transferee company with the benefit of employment on and from the date of transfer, strictly

7 1982( Vol. 138) ITR 91

speaking with no right to claim gratuity, it was difficult to see how the payment, which was made by the assessee to the transferee company could be really treated as gratuity. The Court held that it would be more appropriate to describe the payment as a contribution made voluntarily to the transferee company in order to provide funds to it for payment of gratuity, which could be claimed by the employees from the transferee company, though in respect of the period of employment with the assessee company. The judgment of our Court in **Suren & Co.** (supra), which held the field as on the date of the Tribunal's order, was later on set aside by the Supreme Court in the case of **W.T. Suren And Co. Ltd. vs. C.I.T.**[8], holding that the amount of gratuity paid to the transferee company was not on account of transfer of the unit but on account of stopping of that business and the employees working in that unit becoming surplus resulting in termination of their services. The payment of gratuity was made by the assessee, not on its own but at the instance and on behalf of the employees, whose services, though terminated in the assessee company, were taken over by the transferee company and that this was a payment of gratuity amount with the consent of the employees. In that view of the matter, the Supreme Court held that the payment of gratuity awarded by the assessee to the transferee company was, in the circumstances of the case, an expenditure wholly laid out or expended for the purpose of the business of the assessee and was an allowable deduction. This judgment of the Supreme Court clearly supports the Assessee's case here, though in the present case, as we have noted above, we are not really concerned with the payment of gratuity, but with payment in accordance with a commercial obligation.

8 1998 [Vol.230] ITR 643

14. In that view of the matter, we are clearly of the opinion that the payment of Rs.13.91 lakhs made by the Assessee to its subsidiary is an amount expended for the purpose of the business of the Assessee, and is, thus, an admissible deduction.

15. We, accordingly, answer the question in the negative in favour of the Applicant Assessee and against the Revenue. Reference is allowed in the above terms. No order as to costs.

**(S.C. GUPTE,J.)** **(M.S.SANKLECHA,J.)**