M/S W.T. SUREN AND CO. LTD. A

*v.*

COMMISSIONER OF INCOME TAX, BOMBAY

FEBRUARY 23, 1998

[SUJATA V. MANOHAR AND D.P. WADHWA, JJ.] B

*Income Tax Act, 1922 : Section 10(2)(xv).*

*Income Tax—AY 1960-61—Business Expenditure—Gratuity—Payment of—By assessee to the transferee-company on transfer of a part of its business— Deductability of—Assessee, a private limited company, stopped and transferred the activities of its distribution unit to the transferee—However, other business of assessee continued—Assessee terminated services of the employees of that distribution unit—Transferee offered these employees similar employment with continuity of service and assured payment of gratuity due to them under it together with that accrued to them on the date of their termination if the amount thereof was higher than that calculated under the transferee's scheme- Assessee paid gratuity to those who did not join the transferee-company—However, the assessee, not of its own accord but at the instance and on behalf of the employees who joined the transferee, paid to the transferee-company the amount of gratuity due to such employees—Transferee put the amount in trust in a separate account exclusively for paying the same to such employees with the further gratuity due on account of service rendered with the transferee—Held: In the circumstances of the case, the amount of gratuity paid by the assessee to the transferee-company is an expenditure wholly laid out or expended for the purpose of business and thus an allowable expenditure—Income Tax Act, 1961, S.37(1).* C D E F

**The appellant-assessee, a private limited company, stopped the activities of its distribution unit which business was taken over the transferee-company. However, the other business of the assessee continued. The employees working in the said distribution unit became surplus resulting in termination of their services. The transferee-company offered these employees similar employment with continuity of service and right to receive gratuity due under it together with that accrued to them on the date of their termination if the amount thereof was higher then that calculated under the scheme of the transferee-company. The assessee paid gratuity directly to those employees who did not join the transferee-company. However, the assessee, not of its own accord but at the instance and on behalf of the employees who** G H

A joined the transferee-company, paid to the transferee-company the amount due to these employees. Transferee-company put this amount in trust in a separate account exclusively for paying the gratuity to these employee with further gratuity due on account of service rendered in the transferee-company.

B In its income tax return for the assessment year 1960-61 the assessee claimed the amount of gratuity paid to the transferee-company as deduction under Section 10(2)(xv) of the Income Tax Act, 1922. The Income Tax Officer disallowed the claim of deduction. The Appellate Assistant Commissioner upheld the view of the Income Tax Officer. The Income Tax Appellate Tribunal C allowed the appeal filed by the assessee. The High Court allowed the appeal field by the respondent-Revenue. Hence this appeal.

Allowing the appeal, this Court

HELD : 1. In the present case, the amount of gratuity which was paid to the transferee-company on behalf of the employees was not on account D of transfer of the distribution unit of the assessee but on account of stopping of that business and the employees working in that unit becoming surplus resulting in termination of their services. Other business of the assessee continued. Payment of gratuity amount to the transferee-company was not made by the assessee of its own but at the instance of and on behalf of the E employees whose services though terminated in the assessee-company were taken over by the transferee-company with the promise of continuity of service in the transferee-company. As far as the assessee is concerned, it was bound to make payment of gratuity to the employees whose services were terminated, and in fact, the employees who did not join the transferee-company were directly were paid gratuity. Instead of those employees getting F the gratuity amount directly, got that amount paid to the transferee-company who put that account in trust in a separate account for the exclusive use of the transferred employees and payable to them after their services in the transferee-company terminated including the gratuity due on account of service rendered in the transferee-company as per the scheme relating to G gratuity of that company. Payment of amount of gratuity to the transferee-company was made as per the scheme of the assessee and it was not an ex-gratia or some isolated payment. It was never disputed and, in fact, no question raised if the services of the employees of the assessee were not terminated and that being the position, the obligation of the assessee to make payment of gratuity to its employees was an obligation in praesenti. Therefore, H

**the payment of gratuity by the assessee to the transferee-company in the circumstances of the case was an expenditure wholly laid out or expended for the purpose of the business of the assessee and was an allowable deduction.** A
**[1088-A-H; 1089-A]**

*CIT* **v.** *Standard Furniture Co. Ltd.,* **(1979) 116 ITR 751** *(Ker), CIT* **v.** *Sarada Binding Works,* **(1985) 152 ITR 520** *(Mad)* **and** *CIT* **v.** *Salem Megnesite Pvt. Ltd.,* **(1991) 189 ITR 154 (Bom), approved.** B

*CIT* **v.** *W.T. Suren & Co. Ltd.,* **(1982) 138 ITR 91;** *(Bom), Stanes Motors (South India) Ltd.* **v.** *CIT,* **(1975) 100 ITR 788 (Mad) and** *CIT* **v.** *Salem Bank Ltd.,* **(1979) 109 (TR 224 (Mad), overruled.**

C

*CIT* **v.** *Grmini Cashew Sales Corporation,* **(1967) 65 ITR 643d, held inapplicable.**

*Calcutta Co. Ltd.* **v.** *CIT,* **(1959) 37 ITR 1 and** *CIT* **v.** *Sri Venkateswara Bank Ltd.,* **(1979) 120 ITR 207 (Mad), referred to.**

D

CIVIL APPELLATE JURISDICTION : Civil Appeal No. 479 of 1985.

From the Judgment and Order dated 29.4.81 of the Bombay High Court in I. T. R. No. 146 of 1971.

E

Joseph Vellapally, Dinesh Mathur for M/s. JBD & Co. for the Appellant.

T.L.V. Iyer, Ms. Shashi Kiran, (Harish Chandra) for B.K. Prasad for the Respondent.

The Judgment of the Court was delivered by F

**D.P. WADHWA, J.** This is assessee's appeal against judgment dated April 29, 1981 of the Division Bench of the Bombay High Court on a reference under Section 66(1) of the Income-tax Act, 1922 (1922 Act, for short) on the following question:

G

> "Whether on the facts and in the circumstances of the case, the payment of gratuity in the sum of Rs. 4,08,622/- which the assessee made to M/s. Rallies India Ltd., was an allowable deduction?"

The High Court answered the question in favour of the revenue and against the assessee. H

A As to how the reference arose, we may notice a few facts. The assessee, a private limited company, was wholly owned subsidiary of Rallis India Ltd. One of its activities was the distribution of the products of M/s. Taddington Chemical Factory Private Ltd. which was also another wholly owned subsidiary of the Rallis India Ltd. With effect from May 1, 1959 the assessee closed its unit for distribution of the products of Taddington Chemical Factory Private B Ltd. which business was taken over by Rallis India Ltd. On April 22, 1959, the assessee wrote letters to employees working in the unit dealing with distribution stating that arrangements had been made for the business conducted by the assessee to be taken over by Rallis India Ltd. and that the transfer would take effect from May 1, 1959. By this letter the employees were C further informed that arrangements had also been made whereby all the employees of the assessee of the distribution unit would be offered similar employment with Rallis India Ltd. on and from May 1, 1959. The employees were, therefore, informed that their employment was to cease on and from April 30, 1959. The employees were further told as under:

D "(A) If , for any reason, any member of the staff does not wish to accept employment with Rallis India Ltd., retiring gratuity on the normal scale will be paid to him on the close of his service with us as also one month's salary in lieu of notice.

(B)...

E

(C)....

(D) You will see that, in their offer of employment, Rallis India Ltd. undertake that, if you accept service with them from 1st May, 1959, it shall be assumed that there has been no break or interruption in F your employment and they undertake to assume liability to pay on that basis any retrenchment compensation that may become payable in the event of any subsequent retrenchment."

By separate letter of the same date Rallis India Private Ltd. also informed the employees of the assessee offering employment with that company from G May 1, 1959 on the following terms and conditions:

"1. The General terms and conditions, grades and rates of pay are set out in the terms of services of which a copy is attached.

2. Your actual work and position in the office will remain as it has been H herebefore.

3. ... A

4. ...

5. As mentioned by W.T. Suren and Co. Private Ltd. In their separate letter to you of today's date, we confirm that your past service with W.T. Suren and Co. Private Ltd. shall count as continuous with future B service with Rallis India Limited and that the change of employment on 1st May, 1959 shall not constitute a break in or interruption of employment and we hereby assume liability to pay on that basis any retrenchment compensation that may become payable in the event of any subsequent retrenchment.

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If you accept this offer of employment, will you please sign and return to us immediately the letter of acceptance which is attached."

Some of the employees of the assessee did accept the offer given by Rallis India Ltd. and some did not. On May 1, 1959 Rallis India Ltd. issued a circular No.1/59/60 to all the members of the staff. A part of the circular D concerned payment of gratuity to the employees who had come from the assessee and this was to the following effect:

"Re : Gratuity.

In order to dispel any doubt which might have arisen from our letter E of appointment dated 22nd April, 1959, we wish to make it clear that continuity of service will operate in all respect, including the computation of gratuity. In this respect, as there may be certain cases in which there will be difference between the gratuity accrued in the service of W.T. Suren and Co. Private Ltd. and the gratuity as calculated F under our gratuity scheme, it is understood that any members of the staff so affected will, on leaving the company be paid the gratuity accrued to them in the service of W.T. Suren and Co. Pvt. Ltd. as at 30th April. 1959, if it is higher than the gratuity as calculated under our scheme." G

The assessee had announced a gratuity scheme for its employees on August 31, 1953. It is as under :

"The Management have pleasure in announcing a gratuity scheme for the members of the staff as under :- H

| *No. of completed Years of service.* | *For each year of service Gratuity equivalent to:-* |
|---|---|
| 5, 6, and 7..... | Half-a-month's basic salary. |
| 8 and 9 | 3/4 month's basic salary. |
| 10 and above..... | 1 month's basic salary with a maximum of 15 month's or Rs. 15,000 which is lower. |

Gratuity will not be payable to those staff members who have been dismissed for misconduct, etc. The above Scheme is being introduced as from 1-9-1953."

In respect of the employees whose services had been terminated and who had accepted the offer to join Rallis India Ltd. with continuity of service as offered their gratuity amounting to Rs. 4,10,177.75 was paid over by the assessee to Rallis India Ltd. on April 30, 1959. This amount was held by Rallis India Ltd. on trust for the benefit of the staff of the assessee and a declaration was made to the effect that Rallis India Ltd. had no beneficial interest in the said sum of Rs. 4,10,177.75 or any part thereof. Though a part of the business of the assessee was closed and taken over by Rallis India Ltd. the other business of the assessee continued. In its return of income for the assessment year 1960-61 the assessee claimed the amount of Rs.4,08,622 as deduction. The Income-tax Officer was, however, of the view that the correct procedure was that Rallis India Ltd. alone would be entitled to claim the amount when paid by them to the employees of the assessee at the time of their respective retirement. He, therefore, declined to allow the claim of deduction of gratuity to the assessee. Being aggrieved the assessee appealed to the Appellate Assistant Commissioner contending that payment of gratuity to Rallis India Ltd. should be held to be an allowable deduction on the ground that the assesses had a liability to pay such amount on the date when the employees of the assessee were transferred to Rallis India Ltd. It was also the contention of the assessee that the amount of gratuity was actually paid to trustees of Rallies India Ltd. and that, therefore, the payment of the gratuity to the trustees should be treated as the discharge of the liability of the assessee. The Appellate Assistant Commissioner concurring with the Income-tax Officer held that there was no actual termination of the services of the employees and the discharge of the liability in question was capital in nature and he also rejected the claim of the assessee. The appeal was then taken by the assessee

to the Income-tax Appellate Tribunal where again the assessee asserted that the payment of the amount to Rallis India Ltd, had been necessitated by business considerations viz., to keep the employees contented and satisfied and, therefore, the amount should be allowed as a deduction. It was also submitted that the assessee had addressed a letter dated April 23, 1959 to its employees about ceasing of their employment on and from April 30, 1959. According to assessee this letter terminated the services of the employees and the assessee was bound to pay gratuity till that point of time. It, therefore could not be said that there existed no liability to pay any gratuity. It was also submitted that if the assessee had not paid the gratuity amount to Rallis India Ltd. the employees were well within their legal right to claim it from assessee. Revenue on the other hand asserted that the employees had waived their claim with the assessee in regard to their gratuity and, therefore, no liability survived in the hands of the assessee. Revenue also submitted that the payment made to Rallis India Ltd., was in pursuance of an arrangement with the assessee who was ceasing to carry on its main business activities which formed the structure of the assessee and thus this was nothing but in the nature of transfer of business by the assessee to Rallis India Ltd. According to the revenue, therefore, payment was rightly treated as not deductible from the business income of the assessee company. After considering rival contentions of the parties, Tribunal allowed the appeal in favour of the assesses. Tribunal held that there was termination of employment of the employees from the service of the assessee and also that there was valid discharge of the payment of gratuity; that assessee was still functioning and payment of gratuity amount was rightly claimed as deduction. At the instance of the revenue, the Tribunal referred the aforesaid question to the High Court for its opinion. No question if there was termination of the services of the employees of assessee was sought to be referred or that if the assessee was still functioning. High Court in the impugned judgment answered the question in favour of the revenue and against the assessee holding that the amount paid by the assessee to Rallis India Ltd. could not be considered as a payment of gratuity to the employees of the assessee and could not, therefore, be held to be an allowable deduction for the purpose of Section 10(2)(xv) of the Income-tax Act, 1922. High Court said that since the employees had been given the benefit or continuity of employment, in law, there was no retirement from employment of the assessee giving rise to the right in favour of the employees to claim gratuity from the assessee. In this circumstances, it was of the view that the amount paid to M/s. Rallis India Ltd. by the assessee could not be considered as a payment of gratuity to the employees and could not, therefore, be held to be allowable deduction for the purpose of Section

A B C D E F G H

A 10(2)(xv) of the 1922 Act. High Court referred to a number of judgments of other courts but it was the judgment of this Court which formed the base for the impugned decision and that was *Commissioner of Income Tax. Kerala* v. *Gemini Cashew Sales Corporation,* (1967) 65 ITR 643. This judgment considered the question if retrenchment compensation payable under Section 25FF of the Industrial Disputes Act, 1947 constituted allowable deduction
B which was answered in negative, in favour of the Revenue. High Court, however, granted certificate of fitness to appeal to this Court under Section 261 of the Income-tax Act, 1961 (for short, '1961 Act') as in its opinion the question involved in the present case was a substantial question of law of general importance which needed to be decided by this Court. The impugned
C judgment is reported in (1982) 138 ITR 91.

Before we consider the rival contentions, we may note down the relevant provisions of law both in 1922 Act and 1961 Act.

*I.T. ACT. 1922*

D

"10 - Business. (1) The tax shall be payable by an assessee under the head "Profits and gains of business, profession or vocation" in respect of the profits and gains of any business, profession or vocation carried on by him.

E (2) Such profits or gains shall be computed after making the following allowances, namely :-

xxx xxx xxx

(x) any sum paid to an employee as bonus or commission for services
F rendered, where such sum would not have been payable to him as profits or dividend if it had not been paid as bonus or commissions:

Provided that the amount of the bonus or commission is of a reasonable amount with reference to:-

G (a) the pay of the employee and the conditions of his service,

(b) the profits of the business, profession or vocation for the year in question; and

(c) the general practice in similar business, professions vocations;

H xxx xxx xxx

(xv) any expenditure not being an allowance of the nature described in any of the clauses (i) to (xiv) inclusive, and being in the nature of capital expenditure or personal expenses of the assessee laid out or expended wholly and exclusively for the purpose of such business, profession or vocation." A

*I.T. ACT, 1961* B

"36.(1) The deductions provided for in the following clauses shall be allowed in respect of the matters dealt with therein, in computing the income referred to in Section 28-

(i) ..... C

(ii) any sum paid to an employee as bonus or commission for services rendered, where such sum would not have been payable to him as profits or dividend if it had not been paid as bonus or commission.

37. (1) Any expenditure (not being expenditure of the nature described in sections 30 to 36 and not being in the nature of capital expenditure or personal expenses of the assessee), laid out or expended wholly and exclusively for the purposes of the business or profession shall be allowed in computing the income chargeable under the head "Profits and gains of business or profession" D

E

It may be noticed that provisions where no deduction shall be allowed in respect of any provision made by the assessee for the payment of gratuity to his employees on their retirement or on termination of their employment for any reason was made in the Income Tax Act, 1961 by Section 40A(7) introduced by the Finance Act w.e.f. April 1, 1973.

F

It was submitted by Mr. Vellapally that High Court went wrong in holding that there was no termination of the services of the employees of the assessee. He said the High Court wrongly addressed itself to this question of termination of services of the employees of assessee which had never been referred to it and the consequent error committed by the High Court when the High Court did not in effect refer to the question referred to it. Commenting on the decision of the Supreme Court in *Gemini Cashew Sales Corporation* (Supra) Mr. Vellapally said it was distinguishable and submitted that retrenchment compensation payable to an employee was not the same thing as gratuity. While right to gratuity accrue year after year and is payable at the termination of employment voluntarily or otherwise except when it is on G H

A account of misconduct, the right to retrenchment is not always by reason of closure of the unit or otherwise termination of employment. If the employees did not suffer any disadvantage on being taken over by Rallis India Ltd. it was the affair of the transferee company but it could not be said that there was no termination of services of the employees of the assessee. Mr. Iyer, learned counsel for revenue, did not dispute the fact that there was valid
B termination of services of the employees of the assessee. It was submitted by the assessee that the amount in question was certainly business expense and it was the liability of the assessee in praesenti and was discharged by making over the payment to Rallis India Ltd., on behalf of the employees. If we consider the balance-sheet of Rallis India Ltd. the amount in question did
C not form part of its profits and loss account. It was not a revenue receipt. It entered in the balance-sheet as trust amount. Mr. Vellapally said as to how the amount is received and utilised by Rallis India Ltd., the transferee, is also a relevant consideration. If the service of the employee is terminated, he would become entitled to the payment of gratuity as per the scheme of the assessee and instead of getting the amount directly it was paid to Rallis India
D Ltd. which created trust for that amount for the employees so transferred from assessee to it. This amount could not be forfeited by the transferee company even if an employee transferred from assessee is ultimately dismissed on the ground of alleged misconduct. He may in that case forfeit his right to get gratuity from Rallis India Ltd. accruing to him after May 1, 1959 while in the
E service of Rallis India Ltd. Mr. Vellapally, in support of his submissions, relied upon a Full Bench decision of Kerala High Court in *Commissioner of Income-Tax. Kerala* v. *Standard Furniture Co. Ltd.,* 116 ITR Kerala 751; *Commissioner of Income-Tax, Tamil Nadu-III* v. *Venkaeswara Bank Ltd.,* (1979) 120 ITR Mad 207; *Commissioner of Income-Tax* v. *Sarada Binding Works,* (1985) 152 ITR
F (Mad) 520 and *Commissioner of Income-Tax* v. *Salem Magnisite Pvt. Ltd.,* (1991) 189 ITR (BOM) 154.

Mr. Iyer in response said the amount was not paid for carrying on the business of the assessee and rather it was for closing its business and therefore could not be business expense deductible under Section 10(2)(xv)
G of the old Act. It was submitted that the arrangement of payment of amount to M/s. Rallis India Ltd. by the assessee was between these two parties and the employees of the assessee were not to fall back upon it for payment of gratuity. There was, therefore, no liability existed for the assessee to pay the gratuity to the employees. In support of his submissions he relied on three
H judgments of the Madras High Court in *Stanes Motors (South India) Ltd.* v.

*Commissioner of Income-Tax, Madras,* (1975) 100 ITR 341; *Commissioner of Income-Tax, Madras-II* v. *Pathinen Grama Arya Vysya Bank Ltd.* (1977) 109 ITR 788; and *Commissioner of Income-Tax. Tamil Nadu-III* v. *Salem Bank Ltd.,* (1979) 109 ITR 224. These three judgments were considered by the Madras High Court itself in its later judgment in *Commissioner of Income-Tax* v. *Sarada Binding Works,* (1985) 152 ITR 520. Mr. Vellapally pointed out that the impugned judgment was considered by the Bombay High Court in *Commissioner of Income-Tax* v. *Salem Magesite Pvt. Ltd.,* (1991) 189 ITR 154 where it was distinguished. Mr. Tyer's stress was that the ratio of judgments cited by him was here the expense was not laid down for the business of the assessee and so was not deductible and that it was not for conducting or carrying on the business of the assessee but for closing the same. But then what we find is that before the Tribunal and in the High Court, the whole edifice of the department was built on the stand that there was no termination of employment of the employees by the assessee and as such no liability had arisen and that the assessee was not liable to pay any gratuity. It was, however, admitted that there was no dispute as to the fact that gratuity would be allowable deduction as and when it becomes payable. The contention of the Revenue was that so far as the assessee was concerned, there was no liability for payment of gratuity to the employees directly arising as the employees would have to look forward to their claim of gratuity from M/s. Rallis India Ltd.

Since many a judgment of the Madras and Kerala High Courts rendered earlier to Full Bench of the Kerala High Court and of Sarada Binding Works of Madras High Court extensively relied upon the decision of this Court in *Gemini Cashew Sales Corporation's case,* we may consider that judgment in somewhat detail.

In *Commissioner of Income Tax, Kerala* v. *Gemini Cashew Sales Corporation,* (1967) 65 ITR 643 question before this Court was whether the allowance of Rs. 141506 constituted an allowable expenditure in the assessment of the firm for the year 1958-59 being retrenchment compensation payable under Section 25FF of the Industrial Disputes Act. The facts giving rise to the question were that there were two partners constituting the firm. One partner died on August 24, 1957 and the partnership stood dissolved. The business was taken over and continued by the surviving partner on his own account. The services of the employees of the firm were not interrupted and there was no alteration in the terms of their employment. It was urged that since the firm stood dissolved on August 24, 1957 and the undertaking was

A transferred, the employees became entitled to retrenchment compensation which the firm was liable to pay. Though the assessee failed in its claim before the Income-tax Officer and Appellant Assistant Commissioner, the Appellate Tribunal held that the firm was entitled to deduct the sum of Rs. 1,41,506 in computation of its income in the assessment year 1958-59. Kerala High Court on reference made to it at the instance of the revenue agreed with the view B of the Appellate Tribunal and said that the firm could claim as permissible outgoing amount for which liability was incurred though no actual payment was made to workmen since the firm was maintaining accounts on mercantile system,. This Court noticed the provisions of Section 25F and 25FF of the Industrial Disputes Act and also the proviso to Section 25FF which provided C that no retrenchment compensation would be payable where there has been a change of employers by reason of the transfer of -

"(a) the service of the workman has not been interrupted by such transfer;

D (b) the terms and conditions of service applicable to the workman after such transfer are not in any way less favrouable to the workman than those applicable to him immediately before the transfer; and

(c) the new employer is, under the terms of such transfer or otherwise, legally liable to pay to the workman, in the event of his retrenchment, E compensation on the basis that his service has been continuous and has not been interrupted."

This Court said:

"Liability to pay retrenchment compensation arises under Section 25FF when there is a transfer of the ownership or management of an F undertaking: it arises on the transfer of the undertaking and not before. Transfer of ownership or management of an undertaking in law operates, except in the conditions set out in the proviso, as retrenchment of the workmen. But until there is a transfer of the undertaking resulting in determination of employment, the workmen G do not become entitled to retrenchment compensation. So long as the ownership of the business continues with the employer, the right of the workmen to claim compensation remains contingent. A workman may, before the transfer of ownership of the business, himself terminate the employment: or he may die or he may become superannuated: in none of these cases the owner of the business is under any obligation H to pay retrenchment compensation to the workman. The obligation to

pay compensation becomes definite only when there is retrenchment by the employers, or when the ownership or management of the undertaking is, except in the cases contemplated by the proviso, transferred to a new employer, and not till then. The right therefore arises from determination of employment, or from transfer of the undertaking: it has no existence before these events take place." A B

This Court also referred to its earlier judgment in *Calcutta Co, Ltd.* v. *Commissioner of Income-Tax,* (1959) 37 ITR 1. It said that in that case, expenditure which it was estimated had to be incurred to discharge an existing and definite obligation enforceable against the assessee in praesenti was held a permissible deduction in the commutation of income. C

This Court held that the amount claimed as a permissible allowance by the assessee in its profit and loss account cannot, in its judgment, be regarded as properly admissible either under Section 10(1) or Section 10(2)(v) of the 1922 Act. This is how the Court said: D

"As already observed, the liability to pay retrenchment compensation arose for the first time after the closure of the business and not before. It arose not in the carrying on of the business, but on account of the transfer of the business. During the entire period that the business was continuing, there was no liability to pay retrenchment compensation. The liability which arose on transfer of the business was not of a revenue nature. Profits of a business involve comparison between the state of the business at two specific dates. Normally the liability which occurs after the last date, unless its source is in a pre-existing definite obligation, cannot be regarded as a part of the outgoing of the business debitable in the profit and loss account. A deduction which is proper and necessary for ascertaining the balance of profits and gains of the business is undoubtedly properly allowable, but where a liability to make a payment arises not in the course of the business, not for the purpose of carrying on the business, but springs from the transfer of the business, it is not in our judgment, a properly debitable item in its profit and loss account as a revenue outgoing. The claim of the firm to treat it as an item in the determination of the profits of the firm under section 10(1) of the Income-tax Act cannot, therefore, be sustained. E F G

Under section 10(2) (xv) of the Indian Income-tax Act in the computation of taxable profits (omitting parts of the clause not material) H

A "any expenditure laid out or expended wholly and exclusively for the purpose of such business, profession or vocation", i.e., business, profession or vocation carried on by the assessee, is a permissible allowance. But to be a permissible allowance the expenditure must be for the purpose of carrying on the business. Where accounts are maintained on the mercantile system, if liability to make the payment B 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 that the business is carried on, it cannot fall within the expression "expenditure laid out C or expended wholly and exclusively" for the purpose of the business."

The Tribunal when decided the matter in favour of the appellant in the present case referred to the aforesaid statement of law by this Court in the case of the same *Gemini Cashew Sales Corporation* and observed that facts in the case before it were not the same as before the Supreme Court in that D case. In our view, the Tribunal was just right.

In *Stanes Motors (South India) Ltd.* v. *Commissioner of Income-Tax, Madras,* (1975) 100 ITR 341 (Mad), the assessee claimed deduction of Rs. 56275 under section 37 of the 1961 Act which amount represented gratuity E payment to its employees transferred to the new company. The amount was calculated on the basis of the scheme of the assessee and was from the pension and gratuity reserve of the assessee. The claim of the assessee that the amount was paid in the discharge of the liability of gratuity to the employees transferred to the new company and hence allowable as deduction was negatived. High Court relied on the decision of this Court in Gemini F Cashew Sales Corporation's case. It observed as under:

"As already pointed out the liability to make payment to the employees had not arisen during the accounting period. The liability if at all was wholly contingent. The transfer of gratuity reserve from the assessee-company to the new company did not also arise in the course of the G business or for the purpose of carrying on the business but springs from the transfer of the business. Therefore, it cannot be said the expenditure was laid out or expended wholly or exclusively for the purpose of business or it was a properly debitable item in its profit and loss account as a revenue outgoing. For the foregoing reasons H we answer the first question in the negative and against the assessee."

In *CIT* v. *Pathinen Grama Arya Vysya Bank Ltd.*, (1977) 109 ITR 788 (Mad) question before the High Court was whether a sum of Rs. 18931 which formed part of the total sum transferred by the assessee to the Karur Vysya Bank Ltd., by way of gratuity to the employees for the services rendered to it, was admissible as a deduction. Again relying on the aforesaid decision in *Gemini Cashew Sales Corporation's* case, the High Court said that the principle of the decision of the Supreme Court relating to retrenchment compensation to the employees equally applied to the payment of gratuity to the employees of an assessee whose business had been transferred to another and where the transferee took over the employees with the benefit of continuity of service.

In *Commissioner of Income-Tax, Tamil Nadu-III* v. *Sri Venkateswara Bank Ltd,*. (1979) 120 ITR 207 (Mad), the assessee transferred a substantial part of its business to the Indian Overseas Bank Ltd. At the time of the transfer, the assessee paid a sum of Rs. 20,032 as "gratuity" to its employees and claimed the same as deduction in the computation of its income. The question before the High Court was whether on the facts and in circumstances of the case, the Appellate Tribunal was right in allowing the said sum as admissible deduction under Section 36(1)(ii) or under Section 37(1) of the 1961 Act. The Income-tax Officer referred to the amount as "retrenchment compensation" while the assessee claimed it as gratuity. The High Court said that in either case, the amount cannot be allowed as deduction under Section 36(1)(ii). It was found that the assessee was continuing to carry on its business. High Court observed as under:

> "The point now to be considered is whether the payment of gratuity with reference to its employees who were found to be surplus at the time of the transfer of a part of the business is an allowable deduction under s.37(1). A payment made in the course of carrying on its business as gratuity cannot be equated to a terminal payment on the closure of the business so as to be disallowed. There was no closure on the facts. Therefore, such a claim cannot also be equated to a payment made at the time of the transfer of the undertaking of the assessee as in the cases cited. It is not necessary, therefore, to go into the decision in *CIT* v. *Gemini Cashew Sales Corporation,* (1967) 65 ITR 643 SC and *CIT* v. *Pathinem Grama Arya Vysya Bank Ltd.*, (1977) 109 ITR 788 Mad. Those are cases where there had been a cessation of the business or a transfer of the undertaking as such. On the facts found, the assessee will be eligible for the allowance under s.37(1). The several clauses under s.36 do not apply here. The question

A is, therefore, answered in the affirmative as far as allowability under s.37 is concerned and in favour of the assessee."

In *Commissioner of Income-Tax, Tamil Nadu-III* v. *Salem Bank Ltd.* (1979) 120 ITR 224 (Mad), the assessee transferred its banking business to the Indian Bank Ltd. and deposited a sum of Rs. 37,560 with the transferee B bank for the purpose of ultimate disbursement to its 27 employees (who were transferred to the Indian Bank Ltd.) for the purpose of ultimate disbursement to them at the time of their retirement or earlier as per the provisions of the gratuity scheme of the assessee. The amount was claimed as expenditure under Section 36(1) (ii) or Section 37(1) of the 1961 Act. The plea of the C assessee of its case falling under Section 36(1)(ii) was not considered. The Court distinguished its earlier judgment in the case of *Sri Venkateswara Bank Ltd.* (1979) 120 ITR 207 (Mad) and said that Section 37(1) was not attracted in the case and the question referred to it was answered in negative in favour of the revenue and against the assessee. The Court observed that liability to pay gratuity could not be said to have reason at the time of the transfer as D a result of the assessee carrying on its business. It said that firstly there was no present liability to pay gratuity and the amount had been deposited with the transferee bank only in pursuance of understanding or agreement between two and not on the basis of the liability which has accrued on the date of transfer and that if the transfer had not taken place, the assessee's liability would arise as when a particular employee got a right or receive gratuity as E per the scheme applicable to the assessee. The court, therefore, said that a liability which could not have been there if the business was continued in the year of account and which arose as a result of the transaction under which the business of the assessee had been transferred could not be said to be an expenditure incurred for the purpose carrying on the business in the F accounting year in question.

In *CIT* v. *Standard Furniture Co. Ltd.*, (1979) 116 ITR 751 (Ker) (Full Bench), the question before the court was whether the expenditure of Rs. 44,44,988 was an expenditure incurred wholly and exclusively for the purpose of the business within the meaning of Section 37(1) of the I.T. Act 1961 as G applied to the assessment year 1971-72. In this case the assessee went into voluntary liquidation. It sold its stock and machinery to one Sudarsan Trading Company for a consideration of Rs. 20,09,962. The purchaser agreed to take over the services of such of the assessee's employees to whom the provisions of the Industrial Disputes Act applied. Under a provision of law relating to H payment of gratuity as in force in the State of Kerala, the assessee had

incurred a liability for the payment of gratuity to its workers which was estimated at Rs. 4,44,988. Liability of the assessee for payment of this amount was agreed to be paid by the purchaser at a future date. The purchaser paid the purchase price of the stock and machinery of the assessee minus the amount of gratuity payable to the employees which arrangement was made with the consent of the concerned employees. The High Court considered various judgments of the High Courts and also that of this Court in *Gemini Cashew Sales Corporation* and held that the amount in question was an expenditure incurred wholly and exclusively for the purpose of the business of the assessee within the meaning of Section 37(1) of the 1961 Act. It upheld the view of the Appellate Tribunal that liability for payment to which the employer was subject under the local Gratuity Act, to the workers was an expenditure wholly and exclusively laid out or expended for the purpose of the business of the assessee. The court disagreed with the view of the revenue that the incurring of expenditure for payment of gratuity much ahead of the actual time for payment of gratuity could not amount to an expenditure incurred "wholly and exclusively for the purpose of the business".

In *CIT* v. *Sarada Binding Works,* (1985) 152 ITR 520 Mad the High Court struck a different note. It had the advantage of the Full Bench decision of the Kerala High Court in *Standard Furniture Company Ltd.,* (1979) 116 ITR 751 Kerala. In this case the assessee, a registered firm, was doing business in the name Sarada Binding Works as also in the name of Chandamama Publications. Under an agreement, the assessee gave up possession of all the assets and liabilities in Chandamama publications. On a settlement of the assets and liabilities as described in the schedule to the agreement, the excess of liabilities over assets came to Rs. 67,687 and the assessee paid the said sum to the transferee who succeeded to the business of Chandamama Publications. One of the clauses of the agreement was that all the employees in that business would become employees of the transferee on terms no less favourable to them with continuity of service. Liabilities as worked out in the schedule included an amount of Rs.80,309 which was a provision for gratuity due to the employees of the business taken over by the transferee. The assessee claimed this amount as deduction. The question before the High Court was whether the appellate tribunal was right, on the facts and in the circumstances of the case, in allowing deduction of gratuity liability of Rs. 80,309.

The Court answered the question in favour of the assessee and against the revenue holding that in respect of the business that was transferred though the payment under the agreement was not made directly to the

A employees as such, the amount was paid for discharging the assessee's liability to pay gratuity to its employees for the period ending with the date of transfer and, hence, the payment should be taken to be a payment made to discharge the assessee's liability for gratuity and, hence, had to be allowed as a deduction.

B In *CIT* v. *Salem Magnesite Pvt. Ltd.*, (1991) 189 ITR 154 (Bom) the services of the employees in one of the departments of the assessee were discontinued which department was taken over by the State of Tamil Nadu. The liability of the assessee in respect of payment of gratuity to its those employees had become due which the assessee was prepared to pay to the C employees directly. However, the concerned employees desired that the payment be made to the State Government as they wanted to have advantage of continuity of service. The State Government agreed to accept the proposal and payment was made by the assessee to the State Government on behalf of the employees. The Court, in which one of us was a party (Sujata V. Manohar, J.) was of the view that the Tribunal was right in holding that the D said amount was allowable as deduction in computing the taxable profits of the assessee. Another question which was referred in that case for decision of the court was:

> "Whether on the facts and in the circumstances of the case, the E Tribunal should not have upheld the disallowance of the said amount in view of the decision of the Bombay High Court in *CIT* v. *W.T. Suren Co. Ltd.*, (1982) 138 ITR 91?"

In answer to this question, the High Court distinguished the impugned judgment by saying that no right to gratuity had accrued in favour of the F employees whose services were alleged to have been terminated. This is how the Court considered its earlier case in *W.T. Suren and Co. Ltd.* :

> "We have been taken through our decision in *CIT* v. *W.T. Suren and Co. Ltd*, (1982) 138 ITR 91. In this case, no right to gratuity had accrued in favour of the employees whose services were alleged to G have been terminated. This was so in view of the assessee's agreement with the transferee-company to take them up in employment with continuity of employment. There was thus no liability to pay gratuity to the employees as such. The assessee-company had merely made the payment in connection therewith to the transferee-company under H an agreement.

In the present case, the assessee-company had not only computed the amount payable to the employees but was also willing to make payment to them. It was the workers who did not want to receive the payment direct as they wanted continuity of service. There were negotiations between the workers and the Government of Tamil Nadu. After the agreement between them, the assessee-company paid the said amount of Rs.44 lakhs to the Tamil Nadu Government. Thus, even though the workers had the benefit of continuity of service, it was not on account of the assessee-company but as a result of a separate arrangement/agreement between the workers and the Government of Tamil Nadu. This Court's decision in *CIT* v. *W.T. Suren and Co. Ltd.* (1982) 138 ITR 91 was, therefore, rightly distinguished."

In our view, Kerala High Court in *Standard Furniture Co. Ltd.'s,* case (116 ITR 751), Madras High Court in *Sarada Binding Works,* case (152 ITR 520) and Bombay High Court in *Salem Magnesite Pvt. Ltd.'s,* case (189 ITR 154) have rightly distinguished the judgment of this Court in *Gemini Cashew Sales Corporation's,* case. Retrenchment compensation is not the same thing as gratuity. *In Gemini Cashew Sales Corporation's* case, this Court considered the question of payment of retrenchment compensation under the provisions of the Industrial Disputes Act. That Act contains the provisions under what circumstances a workman is entitled to retrenchment compensation. While Section 25F of that Act prescribed conditions precedent to the retrenchment of workmen, Section 25FF provides for compensation to workmen in case of transfer of undertakings. Right to claim retrenchment compensation remains contingent and there may be varying circumstances under which employment may cease. Yet there may not be any right to such compensation, like death, retirement, resignation etc. Under law right to retrenchment compensation arises when employer terminates the employment or undertaking of the employer is transferred and in the later case that too if the case does not fall under the proviso to Section 25FF of the Industrial Disputes Act. Those provisions cannot certainly be applied in the case of payment of gratuity. The scheme of gratuity as applicable to the members of the staff of the assessee provided as to how much gratuity would become due and payable to an employee for each of service except to one who is dismissed for misconduct etc. Gratuity is, thus, payable on the termination of employment of the employee on any account except dismissal and calculated on the basis of number of years of service and at the rate prescribed in the scheme. In the present case,

A the amount of gratuity which was paid to M/s. Rallis India Ltd. on behalf of the employees was not on account of transfer of the distribution unit of the assessee but on account of stopping of that business and the employees working in that unit becoming surplus resulting in termination of their services. Other business of the assessee, as held by the Tribunal, continued. Payment
B of gratuity amount to M/s. Rallis India Ltd. was not made by the assessee of its own but at the instance and on behalf of the employees whose services though terminated in the assessee company were taken over by M/s. Rallis India Ltd. with the promise of continuity of service in M/s. Rallis India Ltd. As far as the assessee is concerned, it was bound to make payment of gratuity to the employees whose services were terminated and, in fact, as
C noticed above, the employees who did not join M/s. Rallis India Ltd. were directly paid gratuity. Assessee was obliged to pay gratuity to those employees who had joined M/s Rallis India Ltd. Instead of those employees getting the gratuity amount directly, got that amount paid to M/s. Rallis India Ltd., who put that amount in trust in a separate account for the exclusive use of the
D transferred employees and payable to them after their services in M/s. Rallis India Ltd. terminated including the gratuity due on account of service rendered in M/s. Rallis India Ltd. as per the scheme relating to gratuity of that company. Payment of amount of gratuity to M/s Rallis India Ltd. was made as per the scheme of the assessee and it was not an ex-gratia or some isolated payment.
E It was never disputed and, in fact, no question raised if the services of the employees of the assessee were not terminated and that being the position, the obligation of the assessee to make payment of gratuity to its employees was an obligation in praesenti. Payment of gratuity amount to M/s. Rallis India was with the consent of the employees transferred there. We are, thus, of the view that payment of gratuity awarded by the assessee to M/s. Rallis
F India Ltd. in the circumstances of the case was an expenditure wholly laid or expended for the purpose of the business of the assessee and was allowable deduction. It cannot certainly be said that it was an expenditure incurred much ahead of time as the services of the employees with the assessee were terminated. Tribunal also found that the assessee was a going concern and
G only one of its department was closed. The assessee had not wound up all of its affairs. Only a part of its business was closed and transferred to *M/s. Rallis India Ltd.* in these circumstances, in our view, Tribunal was right in holding that the payment of gratuity amount was not on account of closing the business of the assessee but for the purpose of business of the assessee
H and, thus, entitled to deduction under clause (xv) of sub-section (2) of

Section 10 of 1922 Act corresponding to Section 37(1) of the 1961 Act. We, therefore, hold that the assessee, the appellant herein, is entitled to the payment of gratuity amount of Rs. 4,08,622 made to M/s. Rallis India Ltd. as an allowable deduction. A

We allow the appeal, set aside the judgment of the High Court and answer the question in affirmative in favour of the assessee and against the revenue.

V.S.S. Appeal allowed.