PRIVY COUNCIL

Tata Hydro-Electric Agencies, Ltd., Bombay

Vs.

Commissioner of Income-tax, Bombay Presidency and Aden (PC)

Privy Council Appeal No. 46 of 1936
(Lord Russell of Killowen, J. Lord Macmillan And Sir John Wallis.JJ.)

12.03.1937

JUDGMENT

LORD MACMILLAN J.

1. The appellants are a private limited company who carry on the business of managing agents of the Tata Power Company Limited and of certain other hydro-electric companies in India. They acquired this agency business from their predecessors, Tata Sons Limited, under an assignment dated 21st November 1929 whereby Tata Sons Limited transferred to the appellants their whole rights and interest as agents of the hydro-electric companies under their subsisting agreements with these companies, but subject, as to their rights and interest under their agreement; with the Tata Power Company Limited, to their obligations under two agreements with *F. E. Dinshaw Limited* and Richard Tilden Smith respectively. The assignment was declared to be to the intent that the appellants should thenceforth be and act as the agents of the hydro-electric companies and be entitled to all benefits and advantages contained in and conferred by the agreements between Tata Sons Limited and these companies and should perform and be bound by all the obligations and duties thereby imposed, and further that the appellants should receive all commissions and other remuneration to which Tata Sons Limited were entitled thereunder. The appellants for their part covenanted to carry out and perform the terms and conditions of the agreements with *F. E. DinshawLimited* and Richard Tilden Smith and to indemnify Tata Sons Limited against any consequences of the non-observance thereof. They further undertook, if so required, to enter into separate agreements in their own names with *F. E. DinshawLimited* and Richard Tilden Smith in the same terms.

2. Under the agency agreement between Tata Sons Limited and the" Tata Power

Company Limited, which was dated 24th September 1919 and the benefit of which the appellants thus acquired, the remuneration of Tata Sons Limited for their services consisted of a commission of 10 per cent. on the annual net profits of the Tata Power Company Limited, with a minimum of Rs. 50,000 whether that company should make any profits or not, and they were also entitled to have their expenses reimbursed. In return for this remuneration Tata Sons Limited undertook to use their best endeavours to promote the interests of the Tata Power Company Limited. The agreement was declared to be assignable and the Tata Power Company Limited undertook to recognize any assignees as their agents and, if required, to enter into an identical agency agreement with such assignees. It was also declared to be lawful for Tata Sons Limited to assign the whole or any part of their earnings under the agreement.

3. It appears that in 1926 the Tata Power Company Limited were urgently in need of financial assistance to the extent of over a crore of rupees. Tata Sons Limited, their then managing agents, who, as the Commissioner of Income-tax puts it in his statement of facts, "had to find the money," approached *F. E. Dinshaw Limited* and Richard Tilden Smith who agreed to provide the necessary funds. One of the conditions on which they agreed to do so was that, in addition to the interest payable by the Tata Power Company Limited for the loan, they should each receive from Tata Sons Limited two annas in the rupee, or 12? per cent. of the commission earned by Tata Sons Limited under their agency agreement with the Tata Power Company Limited. Two agreements embodying this obligation were entered into between Tata Sons Limited and *F. E. DinshawLimited* and Richard Tilden Smith respectively, dated 15th and 19th October 1926 being the agreements referred to in the assignment by Tata Sons Limited of their agency business to the appellants. It will be observed that as the remuneration of Tata Sons Limited depended, subject to a minimum, on the prosperity of the Tata Power Company Limited, they had an interest in assisting the Tata Power Company, Limited to obtain the financial accommodation required for the conduct of their business.

4. After the acquisition of the agency business by the appellants the Tata Power Company Limited, in fulfilment of their obligation under their agreement with Tata Sons Limited, entered into a new agency agreement with the appellants dated 17th December 1929 in terms identical with those of their previous agreement with Tata Sons Limited, and the appellants also entered into agreements with *F. E. Dinshaw Limited* and the administrator of the estate of Richard Tilden Smith (who had meantime died), dated 23rd February and 19th May 1932 respectively, in terms

identical with those of the previous agreements between Tata Sons Limited and these parties.

5. By this series of transactions complete-novation was effected with the result that the appellants came in room and place of Tata Sons, Ltd. in all respects both as regards the right to receive from the Tata Power Co., Ltd. the stipulated agency remuneration and as regards the obligation to pay out of that remuneration 12? per cent. to F. E. Dinshaw Ltd. and 12? per cent. to Richard Tilden Smith's administrator. In the year 1932 the appellants duly earned and received payment from the Tata Power Co. of their commission of 10 per cent. on the net profits of that company and duly paid over to F. E. Dinshaw Ltd. and to Richard Tilden Smith's administrator 12? per cent. thereof each, or 25 per cent. in all. The assessment of the appellants' income for tax purposes for the fiscal year to 31st March 1934, which is in question in the present appeal, is based on their income, profits and gains for the year 1932 and the question is whether in the computation for tax purposes of their income, profits and gains for that year they are entitled to deduct a sum representing the 25 per cent. of the commission earned and received from the Tata Power Co., Ltd. which they paid over to F. E. Dinshaw Ltd. and Richard Tilden Smith's administrator under the agreements above mentioned. The gross commission received by the appellants was Rs. 5,17,288 and the one-fourth thereof which they claimed to deduct was Rs. 1,29,322. Under Section 10(2), Income-tax Act the profits or gains of any business carried on by the assessee are to be computed after making allowance for : IX. any expenditure (not being in the nature of capital expenditure) incurred solely for the purpose of earning such profits or gains.

6. The Income-tax Officer refused to allow the appellants to deduct the sum in question in the computation of the profits or gains of their business and the Assistant Commissioner took the same view. The appellants then requested the respondent to refer to the High Court the legal question of the admissibility of the deduction. The respondent in doing so, expressed, as required by the Act, his own opinion which was also to the effect that the deduction was inadmissible. He founded his opinion on the case in *Pondicherry Railway Co., Ltd. v. Commissioner of Income-tax, Madras,* which he submitted was on all fours with the present case and he also referred to the case of *Bharat Insurance Co. v. Commissioner of Income tax, Lahore,* in which the Pondicherry case1 was followed. The questions of law as formulated by the Commissioner of Income-tax were as follows:

(1) Whether in the circumstances of the case and in view of the provisions of

Sections 4 (1) and 10 of the Act, the assessee company has been correctly assessed on the total amount of Rs. 5,17,288 received by it as profits and gains of the business carried on by it as the managing agents of the Tata Power Co., Ltd.

(2) Whether under the provisions of 8. 10 of the Act or under any other provision thereof the assessee company is entitled to have a deduction from the said profits and gains amounting to Rs. 5,17,288 to the extent of Rs. 1,29,322 paid by it to certain parties under the agreements, Exs. F and G (being the agreements between the appellants and F. E. Dinshaw, Ltd. and Richard Tilden Smith's administrator respectively) on the ground that this latter amount was nothing but expenditure incurred solely for the purpose of earning the said profits or gains or on any other ground.

7. In the High Court the appellants were also unsuccessful. The Chief Justice Sir John Beaumont in his judgment held that the whole 10 per cent. commission received by the appellants from the Tata Power Co., Ltd. was properly included without deduction in the assessment of the profits or gains of the appellants' business, in conformity with the decision in ***C. Macdonald and Co. v. Commissioner of Income-tax, Bombay, AIR 1935 Bombay 197=156 IC 274=37 Bom LR 126=7 ITC 466.***within which the learned Chief Justice said that the present case exactly fell. He further expressed the opinion that the question whether the expenditure in question was incurred solely for the purpose of earning the profits or gains of their business was a question of fact and that as there was no finding of fact on which the Court could hold that the deduction claimed was one falling within the statute, the question must be answered in the negative. By their order of 27th March 1935, the High Court accordingly answered the first of the questions stated by the Commissioner in the affirmative and the second in the negative.

8. In the case of C. Macdonald and Co.,3to which the learned Chief Justice refers, the assessees carried on the business of managing agents of another company from whom they received a commission for their services. This commission the assessees were bound under an agreement to share with certain third parties and they claimed that the shares of their commission which they paid over to these third parties should be excluded or deducted in the computation of the profits or gains of their agency business. The Court held that the case was governed by the decision in the Pondicherry case and that the whole commission received by the assessees must be included without deduction in the computation of their income for tax purposes.

9. Before their Lordships counsel for the Crown did not seek to support the judgment of the High Court in the present case on the ground that it was ruled by the decision in the Pondicherry case,1and in their Lordships' view he was well-advised in recognizing the clear distinction between that case and the present case. In the Pondicherry case the assessees were under obligation to make over a share of their profits to the French Government. Profits had first to be earned and ascertained before any sharing took place. Here the obligation of the appellants to pay a quarter of the commission which they receive from the Tata Power Co., Ltd. to F. E. Dinshaw Ltd. and Richard Tilden Smith's administrator is quite independent of whether the appellants make any profit or not. Indeed, if on their year's operations as a whole they were to make a loss and incur no liability to income-tax they would nevertheless have to pay away a quarter of the commission in question to the parties named. The commission in truth is not profit or gain; it is only an item or factor in the computation of the appellants' profits or gains. Their Lordships regard this as a fundamental distinction. In the case of C. Macdonald and Co.3it would rather appear that the commission which was received by the assessees and which they were bound to share with certain other parties was the sole source of income of the assessees, but, be this as it may, the decision in that case cannot be supported by the authority of the Pondicherry case, *Pondicherry Railway Co., Ltd. v. Commissioner of Income-tax, Madras,* on whatever other ground it may be justified.

10. It was not questioned by counsel for the Crown that, if the present question had arisen with Tata Sons Ltd., they would, under Section 10(2) (ix), have been entitled on the facts stated to deduct their payments to F. E. Dinshaw Ltd., and Richard Tilden Smith as being expenditure incurred solely for the purpose of earning their profits or gains. But he submitted that after the acquisition of the agency business by the present appellants the payments assumed a different character. The appellants, he said, did not take any part in obtaining the loans nor did they incur the liabilities in question in the course of rendering any services to their principals. The obligation to make the payments in question was taken over by them as part of the transaction whereby they acquired the agency business from Tata Sons Ltd., and the payments were therefore made not for the purpose of earning profits in the conduct of the agency business but in fulfilment of the terms on which they purchased the business.

11. Their Lordships recognize and the decided cases show how difficult it is to discriminate between expenditure which is and expenditure which is not, incurred solely for the purpose of earning profits or gains. In the present case their Lordships

have reached the conclusion that the payments in question were not expenditure so incurred by the appellants. They were certainly not made in the process of earning their profits; they were not payments to creditors for goods supplied or services rendered to the appellants in their business; they did not arise out of any transactions in the conduct of their business. That they had to make those payments no doubt affected the ultimate yield in money to them from their business but that is not the statutory criterion. They must have taken this liability into account when they agreed to take over the business. In short the obligation to make these payments was undertaken by the appellants in consideration of their acquisition of the right and opportunity to earn profits, that is of the right to conduct the business, and not for the purpose of producing profits in the conduct of the business. If the purchaser of a business undertakes to the vendor as one of the terms of the purchase that he will pay a sum annually to a third party, irrespective of whether the business yields any profits or not, it would be difficult to say that the annual payments were made solely for the purpose of earning the profits of the business. It would seem to make no difference that the annual sum-should be made payable out of a particular receipt of the business, irrespective of the earning of any profit from the business as a whole. The case of a transferee of a business undertaking liability, for example, for the rents under current leases of the premises in which the business was carried on by the transferor and is to be carried on by the transferee is quite a different case, for the rents paid are clearly an outlay necessary for the earning of profit. In the case in *Addie (R.) and Sons' Collieries, Ltd. v. Commissioners of Inland Revenue,* the Lord President Clyde, dealing with corresponding words in the British Income-tax Act, says at p. 235 :

> What is 'money wholly and exclusively laid out for the purposes of the trade' is a question which must be determined upon the principles of ordinary commercial trading. It is necessary, accordingly, to attend to the true nature of the expenditure, and to ask oneself the question: Is it a part of the company's working expenses; is it expenditure laid out as part of the process of profits earning ?

12. Adopting this test their Lordships are of opinion that the deduction claimed by the appellants is inadmissible as not being expenditure incurred solely for the purpose of earning the profits or gains of the business carried on by the appellants. They thus reach the same result as the learned Judges of the High Court but on different grounds, and they would only add in conclusion that with all respect they do not share the view expressed by the learned Chief Justice that the question whether the payments in question were admissible deductions under Section 10(2) (ix) was not open to

argument in the High Court on the facts as found. Their Lord-ships will accordingly humbly advise His Majesty that the appeal be dismissed and the order of the High Court of 27th March 1935 be affirmed. The respondent will have his costs of the appeal.

Appeal dismissed.

Cases Referred.

AIR 1931 PC 165 =132 IC 619=58 IA 239=54 Mad 691 (PC)

AIR 1934 PC 45 =147 IC 899=61 IA 41=15 Lah 224 (PC)

AIR 1931 PC 165=132 IC 619=58 IA 239=54 Mad 691 (PC).

(1931) SC 231= 61 Sc LR 185=1924 SLT 346=8 Tax Cas 671