Commissioner of Income-Tax, Madras

Vs

K. R. M. T. T. Thiagaraja Chetty & Co.

Civil Appeals Nos. 131, 131-A and 131-B of 1952

(CJI M. Patanjali Sastri, S. R. Dass, N. H. Bhagwati, Vivian Bose, Ghulam Hasan JJ)

14.10.1953

JUDGMENT

GHULAM HASAN J. –

1. These three appeals arise from the judgment and order of the Madras High Court dated 2nd February, 1950, delivered on a reference by the Income-tax Appellate Tribunal (hereinafter referred to as 'The Tribunal'), whereby the High Court answered the first referred question in the negative, and as regards the second question, Satyanarayana Rao J. answered it in the affirmative, while Viswanatha Sastri J. answered it in the negative, as a result of which the judgment of Satyanarayana Rao J. for 1942-1943 and are filed by the Commissioner of Income-tax, while Appeal No. 132 of 1952 which relates to 1943-1944 is filed by the assessee, and is dealt with separately.

The two questions which were referred in respect of the first group of appeals are as follows :-

> (1) Whether there is any material for the Tribunal's finding that the appellants (respondents in this case) were being assessed on cash basis in the prior years ?
>
> (2) Whether on the facts and in the circumstances of the case the Appellate Tribunal's finding that the sum of Rs. 2,26,850 could not be assessed for the assessment year 1942-43 is correct in law ?

The assessee is a registered firm (hereinafter referred to as 'the firm') consisting of K. R. M. T. T. Thiagaraja Chetty and his two sons. The firm is the managing agent of Shri Meenakshi Mills, Ltd. (hereinafter referred to as the Company) owning a spinning mill at Madura. The firm also conducted insurance business and the business of ginning cotton in a ginning factory at another place. Under the terms of the agreement the managing agents were entitled to a remuneration of Rs. 1,000 per mensem and a commission of 1/2 per cent. on all purchases, 1 per cent. on all sales and 10 per cent. commission on the net profits of the mills before allowing for depreciation. The firm had plenary powers of management of the affairs of the company subject to general supervision of the directors. It was to have charge and custody on behalf of the company of all the property, books of accounts, papers and documents and effects belonging to the company. It was required to keep at the expense of the company proper and complete books of account of all purchases and sales and of all payments made and moneys received on behalf of the company. It had to defray all the expenses of maintaining a suitable office and a staff of assistants and clerks sufficient to transact the business of the firm as managing agents of the company. Clause 16 is most important and lays down that the firm shall be at liberty to retain, reimburse, and pay themselves out of the funds of the company, all charges and expenses, legal or otherwise and all the costs and expenses of providing and

maintaining offices for the company and the salaries of clerks, servants, agents or workmen and all moneys expended by them on behalf of the company and all sums due to the firm for commission or otherwise.

The company made considerable profit in the assessment year 1942-43 and the firm became entitled to commission to the tune of Rs. 2,26,850-5-0. The firm did not show this sum in the return on the ground that it was not actually received in the year of account, viz., by the 31st March, 1942. It relied upon a resolution of the Board of Directors of the company, dated the 30th March, 1942, by which they had decided to keep the aforesaid amount in suspense without paying it on the ground that an amount of two lakhs odd was due to the company from the firm. It appears that the firm owed a debt to the company for a long time past which was outstanding. The firm wrote on the 30th March, 1942, to the company requesting that the debt be written off. The firm also wrote that on account of the extraordinary increase in the volume of business, it found it difficult to bestow adequate attention on all the aspects of the mill business and proposed that the direct responsibility for sales and purchases may be transferred to some other agency, leaving the general supervision over the entire management in the firm's hands. The firm agreed to forego its commission on purchases and sales and agreed to take half of the commission on the net profits. The directors by their resolution, passed on the same date, refused to write off the amount without consulting the general body of shareholders and pending the settlement of the dispute resolved to keep the amount in suspense.

The Income-tax Officer held that the firm followed the mercantile method of accounting and not the cash basis and that the income having accrued became assessable whether received or not. The actual amount payable to the firm in accordance with the terms and conditions of the agreement for the year 1942-43 was not disputed. The Appellate Assistant Commissioner confirmed the assessment and dismissed the appeal of the assessee. The Commissioner upheld the view that the income was determined on the mercantile basis and that the income had accrued or arisen to the assessee within the meaning of section 4(1)(b)(i) of the Income-tax Act, and the mere fact that the amount was put in the suspense account did not alter the fact that the income had accrued to the firm. Upon the matter being carried further in a appeal by the assessee, the Tribunal held that the income had not accrued to the firm and that the amount should be excluded from taxation as not having been received during the accounting year. The two questions aforementioned were then referred at the instance of the Commissioner by the Tribunal to the High Court.

As already stated, the opinion on the first question was unanimous, both the learned Judges Satyanarayana Rao J. and Viswanatha Sastri J. holding against the assessee that there was no material for the Tribunal's assessed on cash basis in previous years, the latter observing that findings in respect of 1942-43 and 1943-44 were mutually inconsistent, for in respect of the latter assessment year the Tribunal had held that the sum of Rs. 2,20,702 was assessable to income-tax, though the amount merely stood as a credit to the firm in the books of the company and has not been drawn by the firm.

It is contended by Mr. Somayya on behalf of the firm that the finding of the commissioner that the firm was not paid in cash in the prior years was set aside by the Tribunal and being a finding of fact ought not to have been interfered with by the High Court. The firm had raised this question before the Tribunal at the time of the reference and had contended that no question of law arose from its order, as it was concluded by finding of fact. The Tribunal, however, repelled this contention observing that the question was one of law, as it related to the existence of any material for the finding. The High Court upon such question being referred applied its mind to the precise question

and came to the conclusion that there was no material for the finding that the firm was being assessed on cash basis in the prior years. The case of Commissioner of Income-tax, Bihar and Orissa v. Maharajadhiraja of Darbhanga (60 I.A. 106.) does not support the contention of Mr. Somayya. There the Income-tax Officer had computed the profits of the business for a particular year by taking into account both actual receipts of interest in that year and sums treated by the assessee in that year as receipts of interest by their transference to the interest register from what might be regarded as a suspense account. The Privy Council held that there was nothing illegal or contrary to principle in the computation arrived at by the Income-tax Officer. The High Court under section 66(1) had to decide the question of law raised by the first question and decided it against the assessee. Nor can it be said that in answering the question, the High Court acted illegally or contrary to principle. Admittedly, the firm kept no separate books of accounts other than the books of accounts of accounts of the company in which there was a ledger containing entries relating to the remuneration and commission paid in cash to the firm. The sum of Rs. 2,26,850-5-0 was debited as a revenue expenditure of the company as having been paid to the firm in the books of accounts of the company kept by the firm and was also allowed as a deduction in computing the profits and gains of the company for the purposes of income-tax for 1941-1942. The fact that certain moneys were drawn in cash by the firm from time to time does not necessarily lead to the inference that the firm kept its accounts on a cash basis. Anyone familiar with commercial transactions knows that even in accounts kept on a mercantile basis there can be entries of cash credits and debits. We see no flaw in the conclusion reached by the High Court on the first question.

The next question that falls to be determined is whether the sum of Rs. 2,26,850-5-0 was part of the profits and gains which had accrued to the firm during the accounting year 1941-42. The undisputed facts are that the amount in question was the commission earned by the firm as managing agents of the company. In the books of the company maintained by the firm the aforesaid sum was debited as an item of revenue expenditure and the profits were computed after deducting that sum. The amount was simultaneously credited to the managing agents' commission account. Under these circumstances, it is idle to contend that the aforesaid sum had not accrued. There can be no doubt under the circumstances that the aforesaid sum was income which had accrued to the firm. The only question is whether the aforesaid sum ceased to be income by reason of the fact that on the 30th March the sum was carried to the suspense account by a resolution of the directors as a result of the request made by the firm that the outstanding debt due from it may be written off. It is true that the sum was not drawn by the firm but that can hardly affect the question of its liability to tax, once it is established that the income had accrued or arisen to the firm. The mere fact that the company was withholding payment on account of a pending dispute cannot be held to mean that the amount did not accrue to the firm.

The resolution of the directors itself shows beyond doubt that the amount in question was treated as belonging to the firm though its payment was deferred on account of a pending dispute. As Viswanatha Sastri J. tersely put it "The sum had irrevocably entered the debit side of the company's account as a disbursement of managing agency commission to the firm and had been appropriated to the firm's dues and the same sum could not again be entered in a suspense account at a later date. The sum, therefore, belonged to the firm and had to be included in the computation of the profits and gains that had accrued to it unless the firm had regularly kept its accounts on a cash basis, which is not the case here".

A reference to the ledger folios in the books of the company shows that apart from the managing agents' monthly remuneration of Rs. 1000 which has duly entered in their account the amount in question also finds a place in the ledger as outstanding charges against the company and as credits in

favour of the firm. The journal entries in the company's books are the same.

Section 10 of the Act makes "profits and gains of business, profession or vocation" carried on by an assessee liable to tax. Section 12 makes "income from other sources in respect of income, profits and gains of every kind" liable to tax. By section 13 income, profits and gains shall be computed for the purposes of both those sections in accordance with the method of accounting regularly employed by the assessee, but there is a proviso that, if no method of accounting has been regularly employed, or if the method employed is such that, in the opinion of the Income-tax Officer, the income, profits and gains cannot properly be deduced therefrom, then the computation shall be made upon such basis and in such manner as the Income-tax Officer may determine.

The Income-tax Officer on computing the income of the assessee would have followed the mercantile system or the cash basis whichever was employed by the assessee. There is some evidence, though not conclusive, on the record that the assessee followed the mercantile system of accountancy. This appears from the assessment orders filed in the case, but apart from this, the Income-tax Officer had full authority under the proviso to compute the profits upon such basis and in such manner as he thought fit.

The case of St. Lucia Usines and Estates Company Ltd. v. Colonial Treasurer of St. Lucia ([1924] A.C. 508.) was relied upon strongly before us as it was in the High Court in support of the contention that the sum not having been paid to or realized by the firm no income can be said to have accrued to the firm. In that case the assessee company sold all its property in St. Lucia in 1920 and ceased to reside or carry on business there. In 1921 interest upon the unpaid part of the purchase price was payable to it, but was not paid. The company was liable to pay income-tax for the year 1921 under the Income-tax Ordinance, 1910, of St. Lucia, only if the interest above mentioned was 'income arising and accruing' to it in 1921. It was held that though the interest was a debt accruing in 1921, it was not 'income arising or accruing' in 1921, and that the company was not liable. The decision was based upon the meaning of the word 'income' as used in the Ordinance which was said to cannot the idea of something "coming in". Lord Wrenbury who delivered the judgment of the Privy Council construed the words "income arising or accruing" as money arising or accruing by way of income and not "debts arising or accruing". The learned Law Lord observed "A debt has accrued to him (taxpayer) but income has not". It is clear that the case related to the meaning of the word "income" as used in the Ordinance and can be no authority on the question of the assessment of profits and gains under the Indian Income-tax Act.

The next case relied upon is Dewar v. Commissioners of Inland Revenue ([1935] 2 K.B. 351.). In that case one of the executors became entitled to a legacy which carried interest for such time as it remained unpaid. The testator's estate was sufficient at all material times to enable interest to be paid on the legacy but the legate acting on the advice of his accountant did not demand the legacy or interest thereon. It was held that as the legatee had not received interest, there was no income in respect of which he could be charged to sur-tax. The decision turned upon the language of Schedule D clause I, sub-clause (b) of the English Income-tax Act of 1918, as distinguished from clause 1(a). Clause 1(a) deals with annual profits or gains arising or accruing from any kind or property whatever..... but clause (b) imposes a tax in respect of "all interest of money, annuities and other annual profits." Lord Hanworth M. R. drew the distinction between the two clauses and observed that the case was one of interest of money and fell under clause (b) and not under clause (a). Under that clause the tax was limited to any interest of money whether the same is received and payable half-yearly or any shorter or more distant period. The learned Master of the Rolls observed : "If the interest on the legacy in this case has not arisen to the respondent, if he had not become the

dominoes of this sum, if it does not lie to his order in the hands of his agent, can it be said that it has arisen to him ? I think the answer definitely upon the facts must be : No, it has not."

Lord Maugham L. J. put the question thus : "I think in the present case two circumstance may be accurately stated in regard to the sum of pounds 40,000 which it is said can be brought into charge. The first is that the sum of pounds 40,000 was not during the year of assessment a debt due by the executors to Mr. Dewar, and secondly, that the sum in question may never be paid or received at all."

The case of Commissioner of Taxes v. The Melbourne Trust, Limited ([1914] A.C. 1001.) turned on the construction of the charging section in the Income-tax Act 1903 of Victoria, whereby a company was liable to pay tax upon the profits earned in or derived in or from Victoria..... In this case the surplus realized by the assessees over the purchase price for the assets sold after making all just deductions was taxed as profits but it was held that they were entitled to hold in suspense part of the surplus realised to meet possible losses on other assets and that under the circumstances the profits was earned for the purposes of the Act only when distributed to the shareholders.

Having considered all these cases, we are of opinion that neither of them has any bearing upon the facts and circumstances of the present case.

Lastly it was urged that the commission could not be said to have accrued, as the profit of the business could be computed only after the 31st March, and therefore the commission could not be subjected to tax when it is no more than a mere right to receive. This argument involves the fallacy that profit do not accrue unless and until they are actually computed. The computation of the profits whenever it may take place cannot possibly be allowed to suspend their accrual. In the case of income where there is a condition that the commission will not be payable until the expiry of a definite period or the making up of the account, it might be said with some justification, though we do not decide it, that the income has not accrued, but there is no such condition in the present case. Clauses 7 & 8 of the agreement which relate to the payment of the commission and the calculation of the profits mean no more that this that the commission will be quantified only after certain deductions had been made and not that the commission will not accrue until the profits have been ascertained. The quantification of the commission is not a condition precedent to its accrual. If the profits of the company are said to have accrued on the 31st of March, upon a parity of reasoning, it must be conceded that the commission also accrued on the same date. The date has as much to do with the accrual of the commission as it has to do with the accrual of the profits.

It was faintly suggested that the managing agency was not a business but this is immaterial for income-tax purposes because section 13 will apply to cases both under sections 10 and 12, so we refrain from deciding the point. We may, however, point out in passing that in two cases Tata Hydro-Electric Agencies, Ltd. v. Commission of Income-tax, Bombay ([1937] 5 I.T.R. 202.) and Commissioner of Income-tax, Bombay Presidency v. Tata Sons Ltd. ([1939] 7 I.T.R. 195.) it was assumed that the managing agency is business but the point was directly decided in Inderchand Hari Ram v. Commissioner of Income-tax, U.P. and C.P. ([1952] 22 I.T.R. 108.) that it is so.

For the foregoing reasons, we accept the view taken by Viswanatha Sastri J. and allow the appeals. The respondent shall pay the costs of the Commissioner both this court and before the High Court.

Appeal allowed.

Agent for the appellant G. H. Rajadhyaksha.

Agent for the respondent : S. Subramanian.

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