Narain Swadeshi Weaving Mills

Vs

The Commissioner of Excess Profits Tax

Civil Appeal No. 145 of 1953

(CJI M. C. Mahajan, T. L. Venkatarama Ayyar, Ghulam Hasan, S. R. Dass, N. H. Bhagwati JJ)

25.10.1954

JUDGMENT

DAS J. -

This appeal by special leave arises out of a consolidated reference made on the 19th April, 1949, under section 66(1) of the Indian Income-tax Act read with section 21 of the Excess Profits Tax Act by the Income-tax Appellate Tribunal, Madras Bench. The reference arose out of four several proceedings for assessment to excess profits tax of the appellant, the chargeable accounting periods being periods ending with 31st March of each of the years 1942, 1943, 1944 and 1945.

The relevant facts appearing from the consolidated statement of the case are as follows :-

> Narain Swadeshi Weaving Mills, the appellant before us (hereinafter referred to as the assessee firm), is a firm constituted in 1935 upon terms and conditions set forth in a deed of partnership dated the 6th November, 1935. The partners were Narain Singh and two of his sons, Ram Singh and Gurdayal Singh, their respective shares in the partnership being 6 annas, 5 annas and 5 annas. The business of the firm which was carried on at Chheharta, Amritsar, in the Punjab, was the manufacture of ribbons and laces and for this purpose it owned buildings, plant, machinery, etc.

On the 7th April, 1940, a public limited liability company was incorporated under the name of Hindustan Embroidery Mills Ltd. The objects for which the company was established were to purchase, acquire and take over from the assessee firm the buildings and leasehold rights, plant, machinery, etc., on terms and conditions mentioned in a draft agreement and the other objects set forth in the Memorandum of Association of the said company. Out of the total subscribed capital represented by 41,000 shares 23,000 shares were allotted to the assessee firm. Of these 23,000 shares so allotted 20,000 shares were not paid for in cash but the remaining 3,000 shares were paid for in cash. The directors of the company were Narain Singh and his three sons Ram Singh, Gurdayal Singh and Dr. Surmukh Singh and one N. D. Nanda, a brother-in-law of Gurdayal Singh. Dr. Surmukh Singh was at all material times residing in South Africa. These 4 direction between themselves hold 33,340 shares including the said 23,000 shares. The company was, accordingly, a director controlled company.

The funds available to the company were not sufficient to enable it to take over all the assets of the assessee firm. The company, therefore, purchased only the buildings and the leasehold rights therein but took over the plant, machinery, etc. on lease at an annual rent of Rs. 40,000.

On the 28th July, 1940, the company executed a managing agency agreement in favour of Uppal and Co., a firm constituted on the same day with Ram Singh and Gurdayal Singh, two of the sons of Narain Singh, as partners with equal shares. Under the managing agency agreement dated the 28th July, 1940, Uppal and Co., was to be paid 10% of the net profits of the company besides salary and other allowances mentioned therein.

On the 25th January, 1941, the company appointed as its selling agent Ram Singh and Co., a firm which came into existence on the same day with Ram Singh, Gurdayal Singh and Dr. Surmukh Singh, the three sons of Narain Singh, as partners, each having an one-third share. The terms of this partnership were recorded in writing on the 17th March, 1941. Ram Singh and Co., was to get a commission of 3% on the net sales and 6% on the gross income of the company.

In the two new firms so constituted Narain Singh had no share and eventually with a view to make up for his loss the shares of the partners in the assessee firm were modified by an agreement made by them on the 21st April, 1941. Under this agreement Narain Singh was to get a 12 annas share and the two sons Ram Singh and Gurdayal Singh 2 annas share each. All the three firms mentioned above, namely, the assessee firm, Uppal and Co., and Ram Singh and Co., were registered as firms under section 26A of the Indian Income-tax Act.

On the facts summarised above, the Excess Profits Tax Officer came to the conclusion that the main purpose of the formation of the company and the two firms of Uppal and Co., and Ram Singh and Co., was the avoidance of liability to excess profits tax. Accordingly, on the 16th November, 1944, the Excess Profits Tax officer issued notices under section 10A of the Excess Profits Tax Act to the company and the three firms. Eventually, however, the proceedings against the company were dropped and the Excess Profits Tax Officer considered the case of the three firms only. He held that the three firms were really one and he, therefore, amalgamated the income of all three and proceeded to assess the assessee firm to excess profits tax on that basis for the four several chargeable accounting periods mentioned above.

Under sub-section (3) of section 10A the assessee company preferred four several appeals to the Appellate Tribunal. In their order the Appellate Tribunal considered the four following issues :

> (1) Whether the income of the firms styled as "Uppal & Co.," and "Ram Singh & Co.," could be amalgamated with the income of the assessee firm under the provisions of section 10A of the Excess Profits Tax Act ?
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> (2) Whether the share of income of Dr. Surmukh Singh, a partner in the selling agency of Ram Singh & Co., could be included under section 10A in the excess profits tax assessment of the assessee firm ?
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> (3) Whether the lease money obtained by the assessee firm could be legally treated as business profits liable to excess profits tax ?
>
> (4) Whether proper opportunity under section 10A had been given to the assessee firm ?"

Before the Appellate Tribunal, as before the Excess Profits Tax Officer, the assessee firm objected to the application of the provisions of section 10A of the Excess Profits Tax Act. The contention was that as the assessee firm did not, during the relevant chargeable accounting periods, carry on any business within the meaning of section 2(5) of the Excess Profits Tax Act, section 10A had no

application and, therefore, the profits of Uppal & Co., and Ram Singh & Co., could not be amalgamated with its own income. In other words, the argument was that there must be an existing business of an assessee during the relevant period before section 10A could be applied in respect of transactions concerning that business. The Appellate Tribunal took the view that instead of using the plant, machinery, etc., for its own manufacture the assessee firm turned that revenue yielding asset into another use by letting it out on an annual rent of Rs. 40,000 and that this was certainly an adventure in the nature of trade as contemplated by section 2(5) of the Excess Profits Tax Act read with rule 4 of Schedule I thereto. Accordingly, it decided issue No. 3 against the assessee firm holding that the assessee firm carried on business in the letting out of the plant, machinery, etc., on hire and the lease money obtained thereby could be legally treated as business profits liable to excess profits tax. On issue No. 1 the Appellate Tribunal agreed with the Excess Profits Tax Officer that it was evident beyond doubt that a definite scheme was adopted creating separate charges in order to avoid excess profits tax by the three firms, namely, the assessee firm, Uppal & Co., and Ram Singh & Co., taken together. The first step in the scheme was the formation of the company. The second step was the appointment of Uppal & Co., as managing agents instead of appointing the assessee firm itself. The third step was the creation of the firm Ram Singh & Co., for taking up the selling agency of the company and the final step was to adjust the shares of the partners of the assessee firm so as to equalise, as far as possible, the share of Narain Singh with the shares which his sons got in the several firms. The Appellate Tribunal held that all the various steps noted above need not necessarily have been fictitious or artificial but they were certainly translations so as to attract the operation of section 10A. The Appellate Tribunal decided issues Nos. 2 and 4 against the assessee. All the four appeals were accordingly dismissed by the Appellate Tribunal.

The assessee firm thereupon preferred four several applications under section 66(1) of the Income-tax Act read with section 21 of the Excess Profits Tax Act praying that the following questions arising out of the order of the Appellate Tribunal be referred to the High Court :-

> (1) Whether, under the facts and circumstances of the case, the application of section 10A with a view to amalgamating the income of the firms "Uppal & Co." and "Ram Singh & Co.", with the income of the appellant firms was correct and valid in law ?
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> (2) Whether, in view of the facts admitted on record, the share of income of Dr. Surmukh Singh, a partner in the selling agency and not a partner in the appellant firm, could be legally included along with the share of income of S. Ram Singh and S. Gurdial Singh and is this inclusion at all within the purview of section 10A ?
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> (3) Whether, in view of the facts, circumstances and observations on record, the lease money obtained by the appellant firm could be legally treated as business profits or profits from an adventure in trade liable to excess profits tax ?
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> (4) Whether the type of a notice served on the appellant, under the facts and the circumstances of the case, legally amounts to a proper opportunity under section 10A of the Excess Profits Tax Act, and if not what is the legal effect of such opportunity being not afforded ?
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> (5) Whether the proceedings under section 10A were not null and void ab initio, for want of necessary previous sanction from the Inspecting Assistant Commissioner of Excess Profits Tax, the fact of such previous sanction having been obtained being neither mentioned in the order nor proved before the Appellate Tribunal at the time

of hearing although expressly required by the Court.

The Appellate Tribunal declined to refer questions (4) and (5) sought to be raised by the assessee firm and no grievance has been made before us on that score. The Appellate Tribunal referred the earlier three questions after reforming the same so as to read as follows :-

> (1) Whether there is any evidence before the Tribunal to support the conclusion that the main purpose of the transactions was the avoidance of excess profits tax ?
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> (2) Whether on the facts admitted or proved the share of income of Dr. Surmukh Singh in the firm of Ram Singh & Co., can be legally included along with the share of income of Ram Singh and Gurdayal Singh ?
>
> (3) Whether on the facts and circumstances of the case the leasing of machinery, etc., by the assessee firm to the company was a business within the meaning of section 2(5) of the Excess Profits Tax Act ?

The learned counsel appearing for the assessee firm submitted before the High Court that the third of the referred questions should be discussed and decided first, but the High Court took the view that the decision of the first question was a necessary preliminary to the consideration of the third question. Taking up, then, the first question first the High Court referred to the several facts found by the Appellate Tribunal and described as steps and regarding them as circumstantial evidence came to the conclusion that it could not be said that there was no evidence upon which the Tribunal was justified in coming to the conclusion that the formation of the firms, Uppal & Co., and Ram Singh & Co., was mainly for the purpose of avoidance or reduction of liability to excess profits tax. In the result, the High Court held that the three firms, the assessee firm, Uppal & Co., and Ram Singh & Co., were in fact one and the same and on that basis proceeded next to take up the third question. After referring to section 2(5) and certain judicial decisions, the High Court concluded as follows :-

> "The argument of Mr. Pathak when applied to the present case would have force were it a fact that the sole concern of the assessee firm was the receipt of hire of machinery from a company or firm, in which the assessee firm had no interest. But this is not the state of affairs. On the finding under the first question referred, the assessee firm, the firm of managing agents and the firm of selling agents are really one and the same firm. This firm and its partners held the majority of shares in the company. The agreement for payment of Rs. 40,000 as rent of machinery is an agreement between the assessee firm and the company which the assessee firm controls. The business of the assessee firm was, and in effect still is, the manufacture of ribbons and laces, and the receipt of Rs. 40,000 is a profit from that business diverted into the pockets of the assessee firm."

The High Court accordingly answered the third question in the affirmative and against the assessee firm. The necessary certificate of fitness for appeal to this Court having been refused by the High Court, the assessee firm obtained special leave of this Court to prefer the present appeal.

The learned counsel appearing for the assessee firm has submitted before us - and we think rightly - that the approach of the High Court was erroneous in that they took up the discussion of question No. 1 first. That question, as framed, proceeded on the assumption that section 10A applied to the

case and only raised the question as to whether there was any evidence to support the finding of the Appellate Tribunal arrived at as a result of the enquiry under that section, namely, that the main purpose of the transaction was the avoidance of excess profits tax. The long title and the preamble of the Excess Profits Tax Act refer to the imposition of tax on excess profits arising out of certain businesses. Section 4, which is the charging section and section 5 which lays down the application of the Act to certain business, clearly postulate the existence of a business carried on by the assessee on the profits of which the excess profits tax can be imposed. Therefore, if there is such a business during the relevant period, then and then alone can arise the question of the applicability of section 10A. If there is no such business as is contemplated by the Act, then the Act does not apply and section 10A cannot come into operation at all. Before the Excess Profits Tax Officer can embark upon an enquiry as to whether a transaction was effected for the avoidance or reduction of liability to excess profits tax and to make such adjustments as he considers appropriate there must be proof that the assessee was, during the chargeable accounting period, carrying on any business of the kind referred to in section 5 of the Act. Logically, therefor, the Appellate Tribunal as well as the High Court should have taken up question No. 3 first, for on a decision of that question would depend the applicability of section 10A and if that question were answered in favour of the assessee firm the further question of law as raised in question No. 1 would not, in such event, arise. The approach of the High Court was, therefore, logically misconceived on the facts of this case.

What then are the facts found by the Appellate Tribunal apart from its findings under section 10A ? The findings are that after the formation of the company the assessee firm was left with no business at all. The company purchased the leasehold rights in the lands and buildings where the plant, machinery, etc., were installed. The firm as such ceased to manufacture any ribbons and laces. It was left with the plant, machinery, etc., which it did not require and which ceased to be a commercial asset in its hands, for it had no longer any manufacturing business at all. Further, the assessee firm had put it out of its power to use the plant, machinery, etc., for it had no right in the lands and buildings where the plant, machinery, etc., had been installed. In these circumstances, the assessee firm let out the plant, machinery, etc., to the company. It was thenceforth the company which was carrying on the business of manufacturing ribbons and laces and for that purpose hired the plant, machinery, etc., from the assessee firm. Prima facie it was the company which appointed the managing agents and the selling agents. Ex facie and apart from the alleged result of any enquiry under section 10 or section 10A of the Excess Profits Tax Act those were not transactions of the assessee firm. The assessee firm was, therefore, left only with some property which at one time was a commercial asset but had ceased to be so. The assessee firm thereupon let out that property on rent. The question is whether such letting out in such circumstances amounted to carrying on of a business.

> "Business" as defined in section 2(5) of the Excess Profits Tax Act includes amongst others, any trade, commerce or manufacture or any adventure in the nature of trade, commerce or manufacture. The first part of this definition of "a business" in the Excess Profits Tax Act is the same as the definition of a business in section 2(4) of the Indian Income-tax Act. Whether a particular activity amounts to any trade, commerce or manufacture or any adventure in the nature of trade, commerce or manufacture is always a difficult question to answer. On the one hand it has been pointed out by the Judicial Committee in Commissioner of Income-tax v. Shaw Wallace & Co. ((1932) I.L.R. 59 Cal. 1343), that the words used in that definition are no doubt wide but underlying each of them is the fundamental idea of the continuous exercise of an activity. The word "business" connotes some real, substantial and systematic or organised course of activity or conduct with a set purpose. On the

others hand, a single and isolated transaction has been held to be conceivably capable of falling within the definition of business as being an adventure in the nature of trade provided the transaction bears clear indicia of trade. The question, therefore, whether a particular source of income is business or not must be decided according to our ordinary notions as to what a business is. The case of Commissioner of Excess Profits Tax, Bombay City v. Shri Lakshmi Silk Mills Ltd. ([1952] S.C.R. 1), decided by this Court is clearly distinguishable. There, the respondent company which was formed for the purpose of manufacturing silk cloth installed a plant for dying silk yarn as a part of its business. During the relevant chargeable accounting period, owing to difficulty in obtaining silk yarn on account of the war, it could not make any use of this plant and it remained idle for some time. In August, 1943, the plant was let out to another company on a monthly rent. The question arose whether the income received by the respondent company in the chargeable accounting period by way of rent was income from business and assessable to excess profits tax. It should be noted that in that case the respondent company was continuing its business of manufacturing silk cloth. Only a part of its business, namely, that of dying silk yarn had to be temporarily stopped owing to the difficulty in obtaining silk yarn on account of the war. In such a situation, this Court held that that part of the assets did not cease to be commercial assets of that business since it was temporarily put to different use or let out to another and accordingly the income from the assets would be profits of the business irrespective of the manner in which that asset was exploited by the company. This Court clearly indicated that no general principle could be laid down which would be applicable to all cases and that each case must be decided on its own circumstances according to ordinary common sense principles. In the case before us the assessee firm's business had entirely closed. It no longer manufactured any ribbons and laces. It had accordingly no further trading or commercial activity. It could not in fact use the plant, machinery, etc., after the land and the buildings where they were installed had been sold to the company. In these circumstances the assessee firm let out the plant, machinery, etc., on an annual rent of Rs. 40,000. These facts are very similar to those found in Inland Revenue Commissioners v. Broadway Car Co. Ltd. ([1946] 2 A.E.R. 609). There the war conditions had reduced the company's business to very small proportions. In that situation it was observed that in that case the company dealt with part of its property which had become redundant and was sublet purely to produce income - a transaction quite apart from the ordinary business activities of the company. The ratio decidendi in that case which was noticed in the judgment of this Court appears to us to apply to the facts found in the present case apart from the findings under section 10A. Applying also the common sense principle to the fact so found it is impossible to hold that the letting out of the plant, machinery, etc., was at all a business operation when its normal business activity had come to a close. It is interesting to note that sub-sections (3) and (4) of section 12 of the Indian Income-tax Act recognise that letting out of plant, machinery, etc., may be a source of income falling under the head "other sources" within that section and not necessarily under the head "business" dealt with in section 10 of that Act. In the facts and circumstances of this case, therefore, the letting out of the plant, machinery, etc., cannot be held to fall within the body of the definition of "business" under section 2(5) of the Excess Profits Tax Act. In this view of the matter it is not necessary for us to express an opinion as to the meaning or implication of the proviso to that definition or rule 4(4) of Schedule I to the Act. In our opinion, in the facts and

> circumstances of this case, question No. 3 should have been answered in the negative.

The question of law raised in the third question being answered in favour of the assessee firm, the question of the applicability of section 10A of the Excess Profits Tax Act could not arise, for the assessee firm having, during the relevant period, no business to which that Act applied section 10A could not be invoked by the revenue and, therefore, the question whether there was evidence to support the finding of the Tribunal under that section could not arise. On the contrary, the further question of law which would really arise out of the order of the Appellate Tribunal consequent upon the aforesaid answer to question No. 3 would be whether under the facts and circumstances of the case the application of section 10A with a view to amalgamating the income of the firms Uppal & Co., and Ram Singh & Co., with the income of the assessee firm was correct and valid in law and that was precisely the first, question which the assessee firm sought to raise by its application. In our view the High Court should not only have answered question No. 3 in the negative but should also have raised, as a corollary to that answer to question No. 3, the further question of law on the lines indicated in question No. 1 of the assessee's petition. In other words, the High Court should have, after answering questing No. 3 in the negative reframed the referred question No. 1 by restoring question No. 1 as suggested by the assessee firm in its petition and should have answered the question so restored in the negative and in favour of the assessee.

For the reasons stated above, we allow this appeal, reframed question No. 1 restoring the first question suggested by the assessee firm, namely -

> "Whether under the facts and circumstances of the case the application of section 10A with a view to amalgamating the income of the firms Uppal & Co., and Ram Singh & Co., with the income of the appellant firm was correct and valid in law ?" and we answer the question so reframed in the negative. Question No. 2 must be answered in the negative and in favour of the assessee by way of necessary corollary. We also answer question No. 3 in the negative. The appellant will be entitled to the costs of this appeal and we order accordingly.

Appeal allowed.

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