

Indore Malwa United Mills Ltd., Indore

Vs

State of Madhya Bharat and Others

Civil Appeal No. 1013 of 1963

(J. C. Shah, S. M. Sikri, K. Subha Rao JJ)

01.10.1964

JUDGMENT

SUBBA RAO, J.

This appeal by certificate preferred against the order of the High Court of Madhya Pradesh, Indore Bench, raises the question whether an item of Rs. 42,63,090-14-7 should have been allowed as a trading loss in computing the profits of the appellant-company under section 3 of the Indore Industrial Tax Rules, 1927.

The facts may be briefly stated. The appellant, Indore Malwa United Mills Ltd., is a public limited company incorporated and registered under the Indore Companies Act, 1914. Since the incorporation, it has been carrying on business of manufacturing cloth. Under the memorandum of Association of the said company, for the purpose of the textile business, it was authorized to raise or borrow money from time to time and to invest its funds, inter alia, in loans to others. For the purpose of carrying on the business, the appellant-company originally appointed M/s. Karimbhai Ibrahim & Co. Ltd. as its managing Agents. On June 8, 1926, the head of directors of the appellant-company passed a resolution to the following effect :

"Resolved that surplus fund of the company be invested with the agents in current account with the company at the same rate of interest, viz., 6 per cent."

On November 28, 1929, the appellant-company entered into an agreement with M/s. Karimbhai Ibrahim & Sons Ltd. whereunder they were appointed as the managing agents of the appellant-company in place of M/s. Karimbhai Ibrahim and Co. Ltd. On July 19, 1932, the Board of Directors reaffirmed the resolution of June 8, 1926. Pursuant to the power conferred on the managing agents under the said agency agreement and the said resolution, Karimbhai & Sons Ltd. borrowed large sums of money from outsiders, entered them in the appellant-company's accounts and invested large sums with themselves "in current account with the company" in terms of the said resolution and utilized the same for their own purposes. Before the Annual general body meeting they used to bring large amounts into the accounts of the company and show that they had paid off their debts. After satisfying the general body they would again withdraw large sums for their purposes. The general body was also aware of the loans and indeed it approved the said transactions. In the year 1933 the managing Agency company went into liquidation. For the assessment year 1941, the appellant-company submitted its return of income and claimed thereunder a deduction, among other items a sum of Rs. 49,13,316, under the head of bad debt and trading loss written off in the profit and loss account of the appellant-company - we are only concerned in this appeal with this item and, therefore, it is not necessary to notice any other particulars of the assessment. The Assessing

Authority allowed only Rs. 6,41,913-2-0 as bad debt and disallowed the amount due from Karimbhai Ibrahim & Sons Ltd. on the ground that the said borrowings were not made for the purpose of the company. On appeal, the Appellate Authority also took the same view. On further appeal, the High Court confirmed the finding of the appellate authority on the ground that the losses incurred by the company were really dehors the business of the company, though they might involve fraudulent conduct of the managing agents. Hence the present appeal.

Mr. A. V. Viswanatha Sastri, learned counsel for the appellant contended that the employment of the managing agents was incidental to the carrying on of the appellant's business, that as the managing agents had the power to borrow funds for the appellant-company and invest the surplus in loans to themselves, the loss caused by such investment was also incidental to the carrying on of the appellant's business and, therefore, the said loss was deductible in arriving at the trading profits of the appellant-company.

Mr. Sen, learned counsel for the respondents, raised before us two contentions, namely, (1) the assessment in question was made under the Indore Industrial Tax Rules, 1927, that under the said rules tax was payable only in respect of the profits or gains of any cotton mill industry and that profits or loss pertaining to the money-lending activity of the appellant-company could not possible be subject to tax or deduction under the said Rules; and (2) the debt due by the managing agents was not a trading debt inasmuch as the Managing Agents borrowed moneys not necessary for the business of the appellant-company and lent to themselves the said amount and, therefore, it was a loss incurred by the appellant dehors the business of the company.

The first question raised by Mr. Sen is based upon the distinction between the Indore Industrial Tax Rules and the corresponding provisions of the Indian Income-tax Act. It is said that the Indore Industrial Tax Rules are only concerned with the cotton mill industry and the tax payable thereunder is in respect of the said industry, while under the Income-tax Act, the tax is payable in respect of the income of the business of the assessee. But a perusal of the proceedings during all the stages does not disclose that any such argument was advanced at any time. Assuming that the contention was correct, if it had been raised before, the assessee might have been in a position to establish by relevant evidence that the particular amount borrowed by the Managing Agents was from and out of the amounts borrowed for the purpose of the said industry. We cannot allow a question which at its best is a mixed question of fact and law to be raised for the first time before us. We do not propose to express our opinion on the same one way or the other. We shall proceed with the appeal on the basis that for the purpose of deducting trading losses in computing trading profits there is no difference between the Income-tax Act and the relevant Indore Industrial Tax Rules.

The only question, therefore, is whether the loss claimed in the present case was a trading loss which is deductible in computing the profits of the company. The relevant principal of law has been laid down by this court in *Bardridas Daga v. Commissioner of Income-tax* ([1959] S.C.R. 690, 695). There, after considering the relevant decisions on the subject, this court laid down the following test :

"The result is that when a claim is made for a deduction for which there is no specific provision in section 10(2), whether it is admissible or not will depend on whether, having regard to accepted commercial practice and trading principles, it can be said to arise out of the carrying on of the business and to be incidental to it. If that is established, then the deduction must be allowed, provided of course there is no prohibition against it, express or implied, in the Act."

Where an agent employed by the appellant for the purpose of carrying on his business in exercise of the powers conferred on him operated on the bank accounts, withdrew moneys from it and used them for discharging his personal debts, this Court in the said decision found no difficulty in holding that the amount misappropriated and found irrecoverable was an allowable deduction under the Income-tax Act. The only difference between that case and the present one is that agent misappropriated the amount in that case, whereas in the present case the managing agents, in exercise of the powers conferred by the appellant, borrowed the moneys, but failed to return the same. If embezzlement of moneys entrusted to an agent is incidental to a business, by the same token moneys legally utilized by the agent must more appropriately be incidental to the business. In a recent decision in Commissioner of Income-tax, U. P. v. M/s. Nainital Bank Ltd. ([1965] 1 S.C.R. 340) this court held that an amount lost to the bank by dacoity was a loss incidental to the business of banking. There, in the course of the business, large amounts were kept in the bank premises, and this court held that the risk of loss by dacoity was incidental to a banking business. If that be so, the fact that the managing agents brought into the company's till large amounts than the company's business demanded at a particular point of time would not make the borrowings or the lending of money to themselves any the less incidental to the sanctioned business operations.

The question is not whether the Managing Agents committed a fraud on the company, but whether the amounts borrowed were the funds of the company. If the creditors had filed a suit against the company, could it have restricted the suit on the ground that the managing agents had no power to borrow the amounts for the reason that at the time they borrowed, the amounts were in excess of the requirements of the business ? Decidedly not. There would not have been defence to such a suit. After the borrowing the money became the company's money. That apart, there was no question of fraud in this case, for the profit and loss account and the balance sheet placed the general body meeting of the company every year brought to its notice the total amount the company borrowed through the managing agents and the general body approved of it. The only fraud, if any, consisted in the practice followed by the managing agents in bringing into the accounts of the company the entire amount lent to them in order to satisfy the shareholders that nothing was going wrong.

The next step is the borrowing of money by the Managing Agents from the company. Under the memorandum of association as well as under the express power conferred by the said resolution, the company, through the Managing Agents, could invest its funds by way of loans. If there was no mishap the managing agents would have paid the entire amount and if they did not, the company could have recovered the entire amount from them. The result, therefore, was that both the borrowing by the Managing Agents on behalf of the company from third parties and the lending to themselves created legal obligations. They were obligations created in the course of the business. The money lent would be a debit item in the accounts of the company in accordance with the accepted commercial practice and if the amount was realized it would be a credit item. Both would be proper items of accounts for ascertaining the profit and loss of the company. If the debt became irrecoverable, it would be a bad debt.

We, therefore, find no difficulty in holding that the said debt which had become irrecoverable was a trading loss deductible in computing the profit of the appellant-company in the assessment year. It was a loss incidental to the appellant's business and is certainly sanctioned by commercial practice and trading principles. We, therefore, hold that the High Court went wrong in holding that the said amount represented loss incurred by the appellant dehors its business.

In the result, the appeal is allowed. The appellant will have its costs here and in the High Court.

Appeal allowed.

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