Commissioner of Income-Tax, Kerala

Vs

Gemini Cashew Sales Corporation, Quilon.

Civil Appeal No. 702 of 1966

(J. C. Shah, S. M. Sikri, V. Ramaswami-I JJ)

20.04.1967

JUDGMENT

SHAH J.

Two persons - Walter and Ramasubramony - carried on business in cashewnuts as partners in the name and style of Messrs. Gemini Cashew Sales Corporation. The partnership was dissolved on the death of Ramasubramony on August 24, 1957, and the business was taken over and continued by Walter on his own account. The services of the employer were not interrupted and there was no alteration in the terms of employment of the employees of the establishment.

In proceedings for assessment of tax it was urged on behalf of the firms that an amount of Rs. 1,41,506 taken into account under the head "Gratuity payable to workers of the business" in settling the accounts of the firm till August 24, 1957 was a permissible outgoing. The Income-tax Officer rejected the claim and the Appellate Assistant Tribunal held that the by the transfer of the under taking to the Walter, there was no interruption in the employment of the workmen of the establishment. that the terms and conditions of the service applicable to the workmen were not altered to their detriment that Walter had not expressly agreed to take over the liability for compensation payable under s. 25FF of the Industrial Disputes Act, 1947 and since there was dissolution of the partnership on August 24, 1957 and the undertaking was transferred, the workmen became entitled to retrenchment compensation, which the firm was liable to pay. The Tribunal accordingly held that the firm was entitled to deduct the sum of Rs. 1,41,506 in the computation of the income in the assessment year 1958-59.

In recording their opinion of the following question submitted by Tribunal,

> "Whether the allowance of Rs. 1,41,506 constitutes an allowable expenditure in the assessment of the firm of the year 1958-59",

the High Court of Kerala observed that in the determination of the taxable profits of the firm till its dissolution, considerations about the liability to pay retrenchment compensation devolving upon Walter as the assignee of the business for valuable consideration were irrelevant and since it was maintaining accounts on mercantile system, the firm could be claim as a permissible outgoing the amount for which liability was incurred though no actual payment was made to the workmen. The commissioner of Income-tax appeals with special leave, against, the order of the High Court recording an answer in the affirmative.

The subject-matter of the claim was retrenchment compensation payable to payable to workmen of

the establishment under s. 25FF of the Industrial Disputes Act, 1947, section 25F of the Industrial Disputes Act, 1947, provides :

> "No workmen employed in any industry who has been in continuous service for not less than one year under an employer shall retrenched by that employer until -
>
> (a) the workmen has been given one months notice in writing indicating the reasons for retrenchment and the period of notice has expired or the workman has been paid in lieu of such notice, wages for the period of the notice :
>
> Provided that no such notice shall be necessary if the retrenchment is under an agreement which specifies a date for the termination of services;
>
> (b) the workman has been paid, at the time of retrenchment compensation which shall be equivalent to fifteen days' average pay for the every completed year of service or any part thereof in excess of six months; and
>
> (c) notice in the prescribed manner is served on the appropriate Government."

Section 25FF as substituted Act 18 and 1957 with effect from November 28, 1956 provides :

> "Where the ownership or management of an under taken is transferred whether by agreement or by operation of law from the employer in relation to that undertaking to a new employer every workman who has been in continuous service for not less than one years in that the undertaking immediately before the such transfer shall be entitled to notice and compensation in accordance with the provisions of Section 25F, as if the workman had been retrenched :
>
> Provided that nothing in this section shall applying to a workman in any case where has been a change of employers by reason of the transfer if -
>
> (a) the service of the workman has not been interrupted by such transfer;
>
> (b) the terms and conditions of services applicable to the workman after such transfer are not in any way less favourable to the workmen 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. compensation on the basis of that his service has been continuous and has not been interrupted by the transfer."

Under s. 25FF the right of the workmen to retrenchment compensation arises on transfer of ownership or management from the employer in relation to the under taking to anew employer. But in the conditions set out in the proviso no such right accuses. it is common ground that the first and the second conditions in the proviso are satisfied. Counsel for the Commissioner contended that the third condition of the proviso was also satisfied. and no right of retrenchment compensation arose in favour of the workmen under s. 25FF of the Industrial Disputes Act. Counsel for the Commissioner contended that the liability of the partners in the firm is continued by one of the partners after its dissolution and the services of the workmen are not made less favorable, the partner continuing the business may appropriately be held liable to pay to the workmen retrenchment compensation on the

footing that the service of the workmen had been continuous. Counsel relied upon the view expressed by the Calcutta High Court in Alex A. Apcar (Jr) & Company v. M. V. Gan and others in which it was observed that a change of partnership by inclusion or retirement of partner. which legally changes the constitution of the firm does not resultin a "change of business or employer within the meaning of s. 25F and 25FF".

Counsel for the assessee relied upon a judgment of this Court in Anakapalia Co-operative Agricultural and Industrial Society v. Its Workmen and others (1) in support of the contention that on a bonafide transfer of an undertaking the workmen employed in the undertaking are entitled to retrenchment compensation under s. 25FF against the transferor. That however was a case in which the transferee had decline to re-employ the workmen of the transferor and the first condition of the provision was not fulfilled. That case can have no application to the present case.

In the view we take, that the allowances claimed is not proper outgoing, or allowances in computing the profits of the assessee, we do not express any opinion on the question whether the workmen of the undertaking became entitled to retrenchment compensation on the transfer of the undertaking to Walter.

Liability to pay retrenchment compensation arises under s. 25FF when there is a transfer of the ownership or management of an undertaking; it arises on the 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 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 the ownership of the business, himself terminated the employment : he may die or he may become superannuated; in none of these cases the owner of the business is under any obligation to pay retrenchment compensation to the workman. The obligation to pay compensation becomes definite only when there is retrenchment of the employer, or when the ownership or management of the undertaking is, except in the cases contemplated by the proviso, transferred to the new employer, and not till then, The right therefore arises from determination of employment, or from the transfer of the undertaking : it has no existence before this events take place.

The judgment of this Court in Calcutta Company Ltd v. Commissioner of Income-tax, West Bengal (2) on which reliance was placed by counsel for the assessee has no bearing on the present case, for in that case, expenditure which it was estimated had to be incurred to discharge an existing and definite obligation enforceable against the assessee in present 1 was held a permissible deduction in the computation of income. The Calcutta Company Ltd had sold plots of land for building purposes undertaking to develop them within six months by laying out roads, providing drainage and installing lights, etc. In the accounts of the Company maintained according to the mercantile system, the Company had credited the full sale price of the plots agreed to be paid the purchasers, but not actually received, and against the price it debited an estimated sum as expenditure for the development it had undertaken to carry out, even though no part of the amount was actually spent. By the terms of the sale, the Company had undertaken an unconditional obligation which was enforceable against it : the liability was not contingent upon the happening of a future event. It was held by this Court that the outgoing debited was properly admissible.

The decision of the House of Lords in Owen (H. M. Inspector of Taxes) v. Southern Railway of Peru Ltd. (1) on which counsel for the assessee relies also does not assist the assessee. In that case

under the Peruvian law the Southern Railway of Peru Ltd. was bound to pay its employees in Peru prescribed compensation payments upon termination of their services, subject to the fulfillment by the employee of certain conditions. The amount to be paid depended on the length of the service and rate of the pay at the end of the period of service. The Company set apart from the gross profits of each year sums prospectively payable under the Peruvian law as compensation on the termination of the employment. In proceedings for the assessment to tax of the Company made under Case I of Sch. D of the Income Tax Act, 1918 (8&9 Geo. 5, Ch. 40), it was contended on behalf of the Company that upon proper principles of commercial accountancy compensation calculated to have accused due to each employee from year to year as deferred remuneration was properly allowable as deduction. The special Commissioners upheld the claim of the Company on the ground that it was a matter of correct accountancy practice to make provision in the accounts for the sums in question. The matter reached the House of Lords in appeal from an order on a reference under 64 of the Income-Tax Act, 1952. The House held that where a number similar contingent obligations arise from trading, there is no rule of law which prevents the deduction of a provision for them in ascertaining annual profits, if a sufficiently accurate estimate can be made. But a majority of the House held that the "provision claim by the Company throughout the proceeding was not permissible by reason of the absence of discount and other factors". Lord MacDermott observed at p. 635.

> "..... as a general proposition it is, I think right to say that in computing his taxable profits for a particular year a trader who is under a definite obligation to pay his employees for their services in that year an immediate payment and also a future payment in some subsequent year, may properly deduct not only the immediate payment but the presence value of the of the future payment provided such present value can be satisfactorily determined or fairly estimate. Apart from special circumstances such a procedure, if practicable, is justified because it brings the true cost of trading in a particular year into accounts for that year and thus promotes ascertainment of the "annual profits or gains arising or accruing from" the trade."

Lord MacDermott was of the view that the provision made by the company led to anomalies, and was not admissible as made and the case should be remitted to the special Commissioners whether it is practicable to arrive at a satisfactory deductions. Lord Radcliffe with with whom the Lord Chancellor and Lord Tucker agreed was of the view that there is no rule of law which forbid the introduction of a provision for future payments in or payment out, if the right to receive them or the liability to make them, is in legal terms contingent at the closing of the relevant year.

The question which arises in the present case is not about the admissibility of a provision made by the trade by the adoption of a reasonable satisfactory method estimating the present value of an obligation which may arise in future to pay a sum of money to his employees. The question that falls to be determined is whether the liability which arises on transfer of the businesses to be regarded as a permissible outgoing in the account of the business is transferred. Broadly stated, the present value on commercial valuation of money to become due in future, under a definite obligation, will be a permissible outgoing or deduction in computing the taxable profits of a trader, even if in certain condition the obligation may cease to exist because of forfeiture of the right. Where, however, the obligation of the trader is purely contingent, no question of estimating its present value is arise, for to be a permissible outgoing of allowance, there must be in the year of account be a present obligation capable of commercial valuation.

As already observed, the liability to pay retrenchment compensation arouse for the first time after

the closure of the business and not before. It arouse not on the carrying of the business, but on account of the transfer of the business. During the entire period that the business was continuing, their was no liability to pay retrenchment compensation. The liability which arouse 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 the part of the outgoing of the business debitable in the profits and loss accounts. 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 profits 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 s. 10(1) of the Income-tax Act cannot therefore, be sustained.

Under s. 10(2) (xv) of the Indian Income-tax Act in the computation of taxable profits (omitting part of the clause not material) "any expenditure laid out or expended wholly and exclusive 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 for the purpose of the carrying on the business. Where accounts are maintained on the mercantile system, if liability to make the payment 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 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 or expended wholly and exclusively" for the purpose of the business.

Two cases illustrative of the principle may be noticed. It was held by the Madras High Court in Commissioner of Income-tax, Madras v. Indian Metal and Metallurgical Corporation (1) that a provision made in the annual accounts maintained by an employer setting apart by was of a reserve to meet the liability, if any, to which the employer may become subject in the event of retrenching workmen because of the necessity of retrenchment of the services of the staff, was not a liability in praesenti in the year of account, but was only a contingent liability which may arise on the happening of a particular contingency and was not allowable as a deduction in assessment of tax. This court in dealing with a case under the Wealth Tax Act in Standard Mills Company Ltd. v. Commissioner of Wealth Tax, Bombay (2) held that a liability under the award of the Industrial Court to pay gratuity to its employees at certain rates on death while in service, or on voluntary retirement or resignation after fifteen year's continuous service, or on termination of service after certain specified periods, but not if the employee was dismissed for dishonesty or misconduct, was a mere contingent liability which arouse only when the employment of the employee was determined by the death, incapacity, retirement or resignation; the liability did not exist in praesenti.

The amount of Rs. 1,41,506/-claimed as a permissible allowance by the assessee in its profits and loss account cannot, in our judgment, be regarded as properly admissible either under s. 10 (1) or s. 10 (2) (xv) of the Income-Tax Act. The answer to the question must, therefore, in the negative.

The appeal is allowed and the order passed by the High Court is set aside. The Commissioner will be entitled to his costs in this Court.

R. K. P. S. Appeal Allowed.

</html