Commissioner of Income-Tax, Bombay City

Vs

Chunilal V. Mehta & Sons P. Ltd.

Civil Appeal No. 1535 of 1968

(K.S. Hegde, A.N. Grover JJ)

11.08.1971

JUDGMENT

HEGDE J. -

In this appeal by special leave, the questions that arise for decision relate to the taxability under section 10(5A) of the Indian Income-tax Act, 1922 (in bring "the Act") of a certain amount received by the assessee-firm as compensation to the termination of its managing agency.

The assessee is a private limited company and, at the relevant time, it was under voluntary liquidation. It was incorporated in June, 1945, by converting an erstwhile partnership firm into a private limited company. The partnership firm had entered into a managing agency agreement on June 15, 1933, with a public limited company called "The Century Spinning and Manufacturing Co. Ltd." Under the said agreement, the assessee was to continue as managing agents for a minimum period of 21 years, and thereafter, until that firm chose to resign its office or is removed from office by the managed-company. During the period of 21 years stipulated in the agreement, the managed-company had not right to remove the managing firm from its office except for reasons mentioned in the agreement. During the period the assessee continued to act as the managing agents, the agreement provided that the managing agents will get a minimum remuneration of Rs. 6,000 a month and if its remuneration is found at the close of the year to be less than 10 per cent. of the gross profit of the company, the managing agents were to be paid a further additional sum to make the aggregate remuneration received by it equal to 10 per cent. of the gross profit of the company for that year. The agreement further provided that if the managing agents' services were terminated before the period of 21 years stipulated in the agreement excepted for reason mentioned in clause 15 of the agreement, the managing agents would be entitled to received from the managed-company as compensation or liquidated damages for the loss of office the sum mentioned in clause 14 of the agreement.

In about April, 1951, a large holding of the managed-company was acquired by a group of shareholders who were hostile to the managing agents. Thereafter, the relationship between the managing agents and the managed-company became strained. On April 23, 1951, the directors of the managed-company passed a resolution terminating the services of the assessee-firm as managing agents. This resolution was affirmed by the shareholders at their extraordinary general meeting held on May 23, 1951. In pursuance of the resolution of the resolution of the board of directors on April 23, 1951, a notice of termination of the managing agency was issued to the managing agents. In reply the assessee claimed compensation of Rs. 50 lakhs for the unlawful termination of its services. But the managed-company was prepared to pay Rs. 2,34,000 as compensation calculating the compensation at Rs. 6,000 a month for the unexpired period of the agency, i.e., 3 years, 2 months

and 7 days, and Rs. 4,600 as remuneration for the 23 days of April, 1951. The assessee refused to accept that amount. Thereafter, the assessee sued the managed-company on the original side of the Bombay High Court claiming a sum of Rs. 28 lakhs as compensation for the unlawful termination of its services. The managed-company resisted that suit. The suit was decreed on November 17, 1955, in the sum of Rs. 2,34,000 and that decree was affirmed in appeal. The trial judge as well as the appellate Bench held that under the terms of the agreement the assessee was only entitled to liquidated damages at the rate of Rs. 6,000 per month for the unexpired terms of its agency. The assessee received the amount decreed in December, 1955.

Till the insertion of section 10(5A) into the Act by the Finance Act of 1955 (15 of 1955), compensation received by a managing agent for the termination of his agency was considered as a capital receipt, by section 10(5A) provided that any compensation or other payment due to or received by a managing agent of an Indian company at or in connection with the termination or modification of his managing agency agreement with the company shall be deemed to be profits and gains of a business carried on by the managing agent, and shall be liable to tax accordingly. This provision is not retrospective in operation.

As seen earlier, the compensation with which we are concerned in this case was received by the assessee in December, 1955. In the assessment year 1956-57, the Income-tax Officer overruling the objections of the assessee included the said amount as the profits of the business of the assessee during the previous year. Admittedly, the assessee maintained its accounts according to the mercantile system of accountancy. The assessee's contention before the Income-tax Officer that the receipt in question cannot be brought to tax in the assessment year 1956-57 as it became due in 1951, was rejected by the Income-tax Officer. In appeal, the Appellate Assistant Commissioner agreed with the view taken by the Income-tax Officer. He opined that the amount became due to the assessee only when it was decreed by the High Court on November 17, 1955, and, therefore, it was assessable in the assessment year 1956-57. But, on a further appeal, the Tribunal held that, on the facts and in the circumstances of the case, the compensation in question became due to the assessee on April 23, 1951, and, therefore, it could not be brought to tax in the assessment year 1956-57. At the instance of the Commissioner, the tribunal submitted under section 66(1) of the Act, the following two questions of law for the opinion of the High Court :

> "(1) Whether, on the facts and in the circumstances of this case, the compensation for termination of the managing agency accrued to the assessee on 23rd April, 1951 ?
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> (2) Whether, on the facts and in the circumstances of this case, the compensation of Rs. 2,34,000 and interest thereon was taxable under section 10(5A) of the Indian Income-tax Act, in the assessment year 1956-57 ?"

The High Court answered the first question in the affirmative and the second question as follows :

The amount of compensation of Rs. 2,34,000 will not be liable to tax, but the amount of interest thereon will be taxable under section 10(5A) in the assessment year 1956-57.

Aggrieved by that decision, the Commissioner of Income-tax, Bombay City, has brought this appeal.

We shall first address ourselves to the question as to whether, on the facts and in the circumstances of this case, the compensation for termination of the managing agency accrued to the assessee on April 23, 1951. The answer to this question depends upon the true effect of the terms of the

agreement between the managing agents and the managed-company. There is no dispute that the termination of the managing agency did not fall within the scope of clause 15 of the agreement which provides that the managing agent shall not be entitled to receive from the company any compensation for the loss of the office of agents to the company if such loss arises from any of the causes mentioned therein. It is clear - that was also the view taken by the High Court in the suit filed by the assessee against the managed-company - that the assessee was entitled to get compensation under clause 14 of the agreement. That clause provides :

> "In case the firm shall be deprived of the office of agents of the company for any reason or cause other than or except those reasons or causes specified in clause fifteen of these presents the firm shall be entitled to receive from the company as compensation or liquidated damages for the loss of such appointment at sum equal to the aggregate amount of the monthly salary of not less than rupees six thousand which the firm would have been entitled to receive from the company for and during the whole of the then unexpired portion of the said period of twenty-one years if the said agency of the firm had not been determined."

In the suit filed by the assessee against the managed-company, the only controversy between the parties was whether that clause should be read along with clause 10 of the agreement which provided for the payment of remuneration to the managing agents during the continuance of the managing agency agreement or whether the compensation payable should be determined solely on the basis of clause 14. Relying on the expression "not less than Rs. 6,000" in clause 14, the assessee contended that Rs. 6,000 referred to in the clause is merely the minimum but the actual compensation should be determined in the manner provided in clause 10. The High Court rejected that contention. According to the High Court, clause 14 not only provided for the payment of damages for improper termination of the services of the managing agents but it also stipulated the damages two which they were entitled. In its opinion, that clause had quantified the damages to which the managing agents were entitled. It opined that the damages payable to the assessee-firm were liquidated damages. The High Court further held that the expression 'not less than Rs. 6,000" means a definite sum of Rs. 6,000, neither more nor less. We are in entire agreement with the view taken by the High Court in that suit. It is plain from the language of clause 14 of the agreement that the assessee was entitled to a definite sum under that clause. In other words, it was entitled to liquidated damages. Hence, we agree with the answer given by the High Court to the first question referred to earlier.

Now, coming to the second question, the answer to the same depends upon the interpretation to be placed on section 10(5A). Earlier, we have set out that provision to the extent necessary for our present purpose. That section takes in "payment due to or received". In the matter of payments, there are two aspects, viz., (1) payments due, and (2) payments received. The mercantile system of accountancy takes note of "payments due" whereas the cash system of accountancy recognises only payments received. Mercantile system of accountancy, a double entry system, is maintained on the basis of accrual of rights to receive or liability to pay a certain sum of money, unlike in the case of cash system of accountancy which merely takes note of actual receipts or disbursements.

We have earlier come to the conclusion that the compensation with which we are concerned in this case became due to the assessee in April, 1951, though it was actually received by the assessee in December, 1955. Now arises the question to what circumstances the expression "received" therein is applicable ? They do not mean the same thing. Our income-tax law is familiar with these two expressions. That law permits an assessee to adopt his own system of accountancy subject to certain

conditions and his tax liability is determined on the basis of the system of accountancy adopted by him. In other words, the Act permits the assessee to adopt either the mercantile system of accountancy or the cash system of accountancy and the system adopted by him would be the basis on which he should be assessed. It is not necessary in this case to deal with the exceptions to that rule. We have to read section 10(5A) along with the other provisions in the Act. If so read, it is clear that the expression "due to" in that section refers to those assesses who maintain their accounts according to the mercantile system of accountancy and the expression "received by" applies to those assessees who adopt the cash system of accountancy. As observed by this court in Commissioner of Income-tax v. A. Gajapathy Naidu :

> "When an Income-tax Officer proceeds to include a particular income in the assessment, he should ask himself, inter alia, two questions, namely : (1) what is the system of accountancy adopted by the assessee, and (ii) if it is the mercantile system, subject to the deeming provisions, when has the right to receive accrued ? If he comes to the conclusion that such a right accrued or arose to the assessee in a particular accounting year, he should include the said income in the assessment of the succeeding assessment year."

Herein also we have to ask ourselves the question, bearing in mind the fact that the system of accountancy adopted by the assessee is the mercantile system, as to when the assessees right to get the compensation arose. We have already held that it arose in April, 1951.

It was urged on behalf of the department that, as the assessee disputed the quantum of compensation to which it was entitled, we must hold that its right to get the amount arose when that dispute was determined by the High Court. We are unable to accede to this contention. As mentioned earlier, the right of the assessee to get compensation for unlawful termination of its services and the quantum of compensation to which it was entitled were clearly prescribed in the agreement. It was also so held by the High Court in the suit between the assessee and the managed-company. The fact that the assessee was claiming an exorbitant sum to which it was not entitled will not convert its right into a contingent right. In Thiagaraja Chettiar & Co. v. Commissioner of Income-tax, the High Court of Madras held that, where a managing agent is entitled under the terms of the managing agency agreement to remuneration at a certain percentage on the annual net profits of the company, the remuneration payable to the managing agent accrued when the net profits of the company for the year are ascertained. The mere fact that, owing to disputes between the company and the managing agent the company had not credited the managing agent with the remuneration due to the latter in its accounts would not entitle the managing agent to claim that the remuneration due to him had not accrued and should not be assessed to income-tax until the company had credited him in its accounts with the amount of commissioner due to him. We are in agreement with the ratio of that decision and that ratio governs the facts of the present case.

The ratio of the decision of the Bombay High Court in F. E. Hardcastle & Co. (Private) Ltd. v. Commissioner of Income-tax is also to the same effect.

It was next urged on behalf of the department that section 10(5A) is a code in itself and, in applying the provisions therein, no reliance should be placed on the system of accountancy which the assessee generally adopts. It was further urged that, as the liability under section 10(5A) is a new liability and as the receipt with which we are concerned was received in December, 1955, after section 10(5A) was incorporated into the Act, we must, by a legal fiction, deem that the amount became due only in December, 1955. We see no basis for this argument. The language of section

10(5A) is plain and unambiguous. That provision has now become an integral part of the Act. Therefore, the deemed payment under that provision stands on the same footing as any other payment. The fact that the assessee included the receipt in question in its profit and loss account in the year 1955 is a wholly immaterial circumstances. That circumstances does not afford any basis for the argument that, for this particular receipt, the assessee adopted a different system of accountancy. Obviously, because of the dispute between the assessee and the managed-company, the assessee did not enter the amount in question in the year in which it became due. Method of maintaining accounts is one thing and the actual entries in the accounts maintained is a different thing. What is relevant is the method of accountancy and not the actual entries.

For the reasons mentioned above, we agree with the answers given by the High Court to the questions of law referred to it. This appeal is accordingly dismissed with costs.

Appeal dismissed.

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