Morvi Industries Ltd.

Vs

Commissioner of Income-Tax (Central), Calcutta

Civil Appeals Nos. 2083 and 2084 of 1970

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

05.10.1971

JUDGMENT

KHANNA J. -

This judgment would dispose of two Civil Appeals Nos. 2083 and 2084 of 1970 which have been filed on certificate granted by the Calcutta High Court and are directed against the judgment of that court whereby it answered the questions referred to the court under section 66(1) of the Indian Income-tax Act, 1922 (hereinafter referred to as the Act), for two assessment years against the assessee- appellant and in favour of the respondent.

The assessee is a limited company and the matter relates to the assessment years 1956-57 and 1957-58, the corresponding accounting years for which ended on June 30, 1955, and June 30, 1956, respectively.

The appellant-company was appointed as the managing agent of Shree Ramesh Cotton Mills Ltd., Morvi (hereinafter referred to as "the managed-company"), as per agreement dated December 30, 1946. The managed-company was a 100% subsidiary of the appellant-company. Under the terms of the agreement, the appellant-company was entitled to receive a fixed office allowance of Rs. 1,000 per mensem plus a commission at the rate of 12.5% of the net profits, an additional commission of 1.5% on all purchases of cotton and an equal amount on all sales of cloth and yarn. In the relevant years, the managed- company suffered losses and, consequently, the commission payable at 12.5% of the net profits was nil but the commission on purchase of cotton at the rate of 1.5% and on sales of cloth and yarn at the same rate, aggregated to Rs. 38,719 for the assessment year 1956-57 and Rs. 1,963 for the following year. Besides these amounts, the appellant was entitled to Rs. 12,000 per annum for each of the two years as fixed office allowance. The total amounts which the appellant was entitled to receive from the managed-company were Rs. 50,719 and Rs. 13,963 for the two tears.

The managed-company's accounting year closed on the 30th day of December and that of the appellant-company on the 30th day of June every year. Clause 2(e) of the managing agency agreement dated 30th December, 1964, contained the following terms as to when the commission would be due and payable :

> "(e) The said commission shall be due to the agents yearly on the thirty-first day of December or any other date on which the company's yearly accounts close in each and every year during the continuance of this agreement and shall be payable and be paid immediately after annual accounts of the said company have been passed by the

board of directors and auditors of the company and by the company in general meeting."

According to the above clause, the commission was due on the 31st day of December every year and it was payable immediately after the annual accounts of the managed company had been passed in the general meeting. The annual general meetings of the managed company were held to adopt the accounts on November 24, 1955, and July 21, 1956, respectively, with regard to the assessment year in question. The amounts of commission in terms of the above clause were "due" on 31st December, 1954, and 31st December, 1955, and were "payable" immediately after the 24th of November, 1955, and 21st of July, 1956, respectively.

The appellant-company relinquished the managing agency commission for the assessment year 1956-57 as per resolution dated 4th of April, 1955, of the board of directors and for the following year as per resolution dated 19th June, 1956. The amounts of the commission were thus relinquished after they had become "due" but before they were "payable" in terms of clause 2(e) of the agreement. On behalf of the appellant, it was stated that the managed-company had been suffering heavy losses in the past years and, therefore, the appellant did not consider it proper to charge any commission or the fixed office allowance and had, consequently, relinquished the same.

The Income-tax Officer included the sums of Rs. 50,719 and Rs. 13,960 in the total income of the appellant for the two assessment years in question. The Income-tax Officer took the view that in so far as the fixed office allowance was concerned, it had been given to the appellant to enable it to recoup the expenses incurred on behalf of the managed-company and the relinquishment was, therefore, made ex gratia. As regards the commission, the Income-tax Officer held that it had become due to the appellant at the end of the accounting year of the managed-company, and if the commission had been forgone after it had become due, it was taxable on accrual basis. The Appellate Assistant Commissioner and the Income tax Appellate Tribunal affirmed the order of the Income-tax Officer. According to the Tribunal, the commission became due to the appellant yearly on the last day of the accounting year of the managed-company, though the actual payment was deferred to a later date. Postponement of the actual payment after the income had accrued was held to be inconsequential. Likewise, the relinquishment of the income after it had become due, in the opinion of the Tribunal, was inconsequential. Claim was then made by the appellant that the amount relinquished should be treated as a permissible expenditure under section 10(2) (xv) of the Act. The above claim was rejected and it was observed that the total loss carried over at the end of the year 1955 of the managed-company was Rs. 14,95,221. As a result of forgoing the amounts of the managing agency commission, according to the Tribunal, the financial position of the managed-company did not become stronger while that of the appellant- company became weaker. The relinquishment was consequently held to be not for the benefit of the appellant.

At the instance of the appellant, the Tribunal referred the following two questions to the High Court :

"(1) Whether, on the facts and in the circumstances of the case, the sums of Rs. 50,719 and Rs. 13,963 forgone by the assessee by its directors' resolution dated April 4, 1955, and June 19, 1956, respectively, were liable to be included in its total income for the accounting years ending June 30, 1955, and June 30, 1956 ?

(2) If the answer to question No. 1 be in the affirmative, whether the assessee is entitled to claim an allowance of an equivalent amount as expenditure under the

provisions of section 10(2) (xv) of the Indian Income-tax Act ?"

The High Court agreed with the view taken by the Tribunal. It was observed that the accrual of income was complete within the accounting year of managed company and as no relinquishment had been done before the amount became due, the case strictly came within the ambit of section 4(1) (b) (i) of the Act. The relinquishment, it was further observed, was a unilateral act of the appellant. As regards the second question, the High Court found that the relinquishment had not been made for the purpose of facilitating the legitimate commercial undertaking or by way of commercial expediency. The appellant's case was thus held to be not covered by section 10(2) (xv) of the Act.

Mr. Maheshwari has assailed the findings of the High Court. Regarding the first question, the learned counsel contends that, as the amounts in question were never received by the appellant but were relinquished, there arose no tax liability for those amounts. As regards the second question, Mr. Maheshwari submits that the relinquishment of the amounts should be construed as permissible expenditure under section 10(2) (xv) of the Act. There is, in our opinion, no substance in any of the above contentions.

So far as the first question is concerned, we find that, according to clause 2(e) of the managing agency agreement reproduced above, the commission for the two years in question became due to the appellant on the 31st day of December, 1954, and the 31st day of December, 1955. The appellant also became entitled to receive fixed office allowance of Rs. 12,000 for each of the two years. It, therefore, can be said that the income of Rs. 50,719 had accrued to the appellant on 31st December, 1954, and of Rs. 50,719 had accrued to the appellant on 31st December, 1954, and of Rs. 13,973 on the 31st December, 1955. The fact that the payment of the managing agency commission was deferred till after the accounts had been passed in the meetings of the managed- company did not affect the accrual of the income of those amounts on December 31, 1954, and December 31, 1955, respectively. According to section 4(1) (b) (i) of the Act, subject to the provisions of this Act, the total income of any previous year of any person includes all income, profits and gains from whatever source derived which if such person is resident in the taxable territories during such year, accrue or arise or are deemed to accrue or arise to him in the taxable territories during such year. The dictionary meaning of the word "accrue" is "to come as an accession, increment, or produce : to fall to one by way of advantage : to fall due". The income can thus be said to accrue when it becomes due. The postponement of the date of payment has a bearing only in so far as the time of payment is concerned, but it does not affect accrual of income. The moment the income accrues, the assessee gets vested with the right to claim that amount even though it may not be immediately. There also arises a corresponding liability of the other party from whom the income becomes due to pay that amount. The further fact that the amount of income is not subsequently received by the assessee would also not detract from or efface the accrual of the income, although the non-receipt may, in appropriate cases, be a valid ground for claiming deductions. The accrual of an income is not to be equated with the receipt of the income. That the two, accrual and receipt of income, have different connotations is also clear from the language of section 4 of the Act. Clause (a) of sub-section (1) of section 4 of the Act deals with the receipt of income while the accrual of income is dealt with in clause (b) of that subsection.

The appellant-company admittedly was maintaining its account according to the mercantile system. It is well known that the mercantile system of accounting differs substantially from the cash system of book- keeping. Under the cash system, it is only actual cash receipts and actual cash payments that are recorded as credits and debits; whereas under the mercantile system, credit entries are made

in respect of amounts due immediately they become legally due and before they are actually received; similarly, the expenditure items for which legal liability has been incurred are immediately debited even before the amounts in question are actually disbursed. Where accounts are kept on mercantile basis, the profits or gains are credited though they are not actually realised, and the entries thus made really show nothing more than an accrual or arising of the said profits at the material time. The same is the position with regard to debits made. (See Indermani Jaita v. Commissioner of Income-tax).

In the case of Commissioner of Income-tax v. Shoorji Vallabhdas and Co. (1962) 46 I. T. R. 144, 148 (S. C.).

> "Income-tax is a levy on income. No doubt, the Income-tax Act takes into account two points of time at which the liability to tax is attracted, viz., the accrual of the income or its receipt; but the substance of the matter is the income. If income does not result at all, there cannot be a tax, even though in book-keeping, an entry is made about a 'hypothetical income', which does not materialise. Where income has, in fact, been received and is subsequently given up in such circumstances that it remains the income of the recipient, even though given up, the tax may be payable. Where, however, the income can be said not to have resulted at all, there is obviously neither accrual nor receipt of income, even though an entry to that effect might, in certain circumstances, have been made in the books of account".

The assessee-firm, who was the managing agent of two shipping companies in that case, gave up 75% of the managing agency commission with a view to get the managing agency transferred to two private companies. It was held that this was not a case of a gift by the assessee to the managed-companies of a portion of income which had already accrued, but an agreement to receive a lesser remuneration than what had been agreed upon. In the present case, the amounts of income for the two years in question were given up unilaterally after they had accrued to the appellant-company. As such, the appellant could not escape the tax liability for those amounts.

Coming to the second question, we find that the appellant could claim deduction of the amounts under section 10(2) (xv) of the Act if the amounts had represented an expenditure laid out or expended wholly and exclusively for the business of the appellant. There is, however, nothing to show that the amounts were relinquished for the purpose of the appellant's business. The present is not a case wherein the amounts due to the assessee were given up on ground of commercial expediency or for advancing the business interests of the assessee. The conclusion of the learned judges of the High Court in this respect, in our opinion, is well-founded.

The result is that the appeals fail and are dismissed but, in the circumstances, without costs.

Appeals dismissed.

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