ALLAHABAD HIGH COURT

Haji Rahmat Ullah and Co.

Vs.

Commissioner of Income-tax

Income-tax Ref. No. 391 of 1962
(M.C. Desai, C.J. and R.S. Pathak, J.)

06.04.1965

JUDGMENT

R. S. PATHAK, J.

1. The assessee, Messrs. Haji Rahmat Ullah and Co., was a partnership firm which carried on the business of supplying goods under contract with the military department during the last World War. The assessee entered into contracts for the supply of fowl and eggs to the military authorities at Dehra Dun and Ranikhet during the period commencing April 1, 1943, and ending March 31, 1944. It then entered into two subleases with Messrs. Abdul Salam and Brothers, Lucknow, for the supplies to be made at Dehra Dun and Ranikhet in return for a fixed commission of Rs. 600 per mensem. Messrs. Abdul Salam and Brothers further sublet the Dehra Dun contract to Messrs. Zahur Ahmad Mohd. Yusuf and that pertaining to Ranikhet to Messrs. Musaraf Ali Iqbal Ahmad. The contracts between the assessee and the military department specified the rates at which supplies were to be effected, and in the contracts entered into by the assessee with Messrs. Abdul Salam and Brothers and by the latter with the sub-lessees it was expressly stipulated that supplies would be made at those specified rates.

2. In as much as the assessee was entitled to a commission at Rs. 600 per mensem only, the Income-tax Officer assessed its profits under the contract for the assessment year 1944-45 at Rs. 7,200.

3. It seems that subsequently it was discovered that the contractual rates of supply were less than the cost of the supplies. The assessee made repeated representations to the military authorities for enhancing the rates. The first representation which was made on February 16, 1945, some months after the close of the chargeable accounting

period during which the supplies had been effected, was turned down by the military authorities on February 23, 1945, in the view that the fluctuation in the market rates since the submission of the tender by the assessee had been negligible in the case of chicken and there had been no increase in the price of eggs. Another representation made thereafter was rejected on May 31, 1945. The military authorities informed the assessee that no useful purpose would be served by pursuing the matter further and that no action would be taken upon any application for enhancing the rates. The assessee, undaunted, sought an interview with the military authorities, but that was also refused. It persevered, however, in its attempts, and it appears that after making successive representations its attempts bore fruit, and it succeeded in persuading the military authorities to grant two successive enhancements of the rates, once in July, 1946, and again in May, 1947. As a result of this, it received an amount totalling Rs. 1,42,989 in addition to what had already been received upon the rates specified in the contracts. One of the sub-lessees, namely Messrs. Zahur Ahmad Mohd. Yusuf, claimed that it was entitled to the amount so received in respect of the supply of goods made at Dehra Dun. As the assessee seemed to be reluctant in acknowledging the claim, Messrs. Zahur Ahmad Mohd. Yusuf instituted a suit before the Civil Judge, Dehra Dun, and succeeded in obtaining a decree for Rs. 66,000 against the assessee. Out of the amount of Rs. 1,42,989 the assessee paid out the sum so decreed, and after deducting litigation expenses in the sum of Rs. 14,980, found itself with a balance of Rs. 62,009.

4. The Income-tax Officer initiated proceedings against the assessee under Section 34 of the Income-tax Act, 1922, and under Section 15 of the Excess Profits Tax Act, 1940, for the purpose of bringing to tax the amount received by the assessee, and in the assessments so made the sum of Rs. 62,009 was treated as profits taxable in the hands of the assessee for the assessment year 1944-45 in the income-tax assessment and as the profits of the chargeable accounting period ending March 31, 1944 in the excess profits tax assessment. Upon appeal by the assessee against the two assessments, the Appellate Assistant Commissioner held in the income-tax appeal that the conditions necessary for acquiring jurisdiction when initiating proceedings under Section 34(1) (a) were not satisfied and, therefore, the income-tax assessment was a nullity, and in the excess profits tax appeal he found that the profits had not accrued during the chargeable accounting period ending March 31, 1944, as the assessee did not enjoy any right during that period to receive the two payments in question, and holding that these amounts could not be considered in that chargeable accounting

period, he set aside the assessment.

The Excess Profits Tax Officer appealed against the order of the Appellate Assistant Commissioner in the excess profits tax case. The Income-tax Appellate Tribunal allowed the appeal, holding that the amounts received by the assessee arose directly out of the performance of the contract during the chargeable accounting period ending March 31, 1944, and was, therefore, a trading receipt, and further that as the entire contract was executed during that chargeable accounting period and the payments received arose directly out of that contract, they fell to be taxed as the profits of that chargeable accounting period. The assessee then obtained a reference of the following question for the opinion of this Court :

> "Whether the sum of Rs. 62,009 received by the assessee in 1946 could be assessed to excess profits tax for the chargeable accounting period ending on 31-3-1944?"

5. The statement of the case refers to the sum of Rs. 62,009 as resulting from the enhancement of the rates, once in July, 1946, and then in May, 1947. It is not clear why the question refers to the year 1946 alone.

6. Two contentions have been raised before us on behalf of the assessee. One is that the sum of Rs. 62,009 could not be assessed as profits relating to the chargeable accounting period ending March 31, 1944, and the other is that the sum was not assessable in the hands of the assessee at all because it was entitled merely to a commission of Rs. 600 per mensem. As regards the latter contention, we cannot allow the assessee to raise it because this question was not raised before the Appellate Tribunal nor, even though not raised, has it been decided by it. It does not also, we think, arise out of the question referred by the Appellate Tribunal. Consequently, we shall confine ourselves to the consideration of the first contention only.

7. The case of the assessee is that the payment made by the military authorities did not flow from any contractual obligation but were made ex gratia and that, therefore, were not related to the contract under which the supplies were effected. For the Department, however, it is pointed out that Clause 11 of the Special Conditions of the contract provided for review of the rates specified in the schedule to the contract, and it is urged that the rates were enhanced in favor of the assessee pursuant to that clause. Clause 11 reads :

> "The rates referred to in the Schedule are subject to revision every three months proportionately according to any increase or decrease that may have occurred in the market rates, provided that such fluctuation is not less than 10 per cent above or below the market prevailing at the time of conclusion of the contract. Fluctuation of 10 per cent or less will be disregarded."

Now, from the order of the Appellate Tribunal out of which the question of law has been referred, it does not appear that the point was ever raised before the Appellate Tribunal that the subsequent enhancement of the rates and the consequent payments were made by virtue of this clause. The Appellate Tribunal has not referred to it at all, and there is no finding that it was by virtue of this clause that the rates were enhanced. The position is obscure. It was for the department to establish before the Appellate Tribunal that the enhancement of rates was effected pursuant to this clause if the case was, as it seems to be now, that the payment was not ex gratia but was referable to a term of the contract. In order to prove that the rates were enhanced by virtue of this clause, the Department would have shown before the Appellate Tribunal that the revision was effected because the market rates fluctuated above 10 per cent of the rates specified in the schedule. The clause could be invoked only if there was an increase of that order in the rates. Whether or not there was such increase is a matter pertaining to the realm of fact, and in the absence of any consideration devoted to it by the Appellate Tribunal we cannot proceed on the basis that the rates were enhanced pursuant to that clause. In the circumstances, upon the bare facts found by the Appellate Tribunal in appeal and contained in the statement of the case before us, it is not possible to hold that the payments in question were not ex gratia but arose consequent to a revision of the rates made obligatory under the contract.

8. Can it be said that the payments were made because of any right in the assessee under the contract? The contract obliged the assessee to ensure the supply of goods and entitled it to receive payment at the scheduled rates. The contract in itself did not entitle the assessee to any rates higher than those specified in the schedule. The payments which the assessee subsequently received arose from enhancement of the rates, and the rates were enhanced because of the decision of the military authorities to do so. Not until the military authorities decided to enhance the rates could it be said that the assessee had any right to receive the payments. The assessee maintained its accounts on the mercantile system. Before it could receive the payments it was necessary for it to have the right to receive them, and the right to receive accrued or

arose only after the military authorities had decided to raise the rates to a higher figure. In *Commissioner of Income-tax v. Kalicharan Jagannath,* [1] a Bench of this Court held that unless the rates were enhanced by virtue of a right in the assessee in that behalf under the contract it could not be said that the right to receive payment consequent upon enhancement of the rates accrued to the assessee under the contract and that it accrued during the period when the contract was executed. This decision was noted with approval by the Supreme Court in *Commissioner of Income-tax, Madras v. Gajapathy Naidu,* [2] In that case, the Supreme Court held that the circumstance that the income arose out of an earlier transaction could not empower the Income-tax Officer to relate it back to the year in which the transaction took place, and that the question was to be determined by reference to the provisions of Section 4 (1) (b) (i) of the Income-tax Act which declared that income, profits and gains could be included in the total income of a previous year if they accrued or arose during that year.

9. In the instant case, the Appellate Tribunal has proceeded on the view that the chargeable accounting period with reference to which the profits are liable to be considered is the period during which the supplies were effected. It repelled the contention that the relevant period is the period in which the right to receive the profits accrued or arose. In support of the basis adopted by the Appellate Tribunal, the Department has referred to the test adopted by the Courts in England and reflected in *J. P. Hall and Co. Ltd. v. Commissioners of Inland Revenue* [3] *Commissioners of Inland Revenue v. Gardner Mountain and D'Ambrumenil Ltd.,* [4] and *Severne v. Dadswell.* [5] This Court in Kalicharan's case. 1961-41 ITR 40 (All) (supra) found itself unable to accept those decisions as laying down the law for this country, and the Supreme Court entirely concurred with that view in Gajapathy Naidu's case. 1964-53 ITR 114 (supra).

10. It is contended for the Department that Kalicharan's case, 1961-41 ITR 40 (All) (supra) and Gajapathy Naidu's case, 1964-53 ITR 114 (supra) were decided on the provisions of the Income-tax Act, and that the instant case, which concerns itself with the Excess Profits Tax Act, falls to be decided on the view taken by the Courts in England. We find it difficult to accept that contention.

Section 4 of the Excess Profits Tax Act declares :

> "Subject to the provisions of this Act, there shall, in respect of any business to which this Act applies, be charged, levied and paid on the amount by which the profits during any chargeable accounting period exceed the standard profits a tax (in this Act referred to as 'excess profits tax') which shall, in respect of any

chargeable accounting period. . ... be equal to fifty per cent of that excess....."

Therefore, excess profits tax is attracted in respect of a business to which the Act applies when the profits during any chargeable accounting period exceed the standard profits. What is taxed is the excess of the profits during a chargeable accounting period over the standard profits. The question is : What is meant by "the profits during any chargeable accounting period"? Is the question to be determined on the basis that the profits are to be identified with the income taxes under the Income-tax Act in the previous year corresponding to the relevant chargeable accounting period, subject, of course, to such limitations as can be expressly spelt out from the Excess Profits Tax Act? Or, are those profits to be determined with reference to some completely different principle? First, we must remember that the Excess Profits Tax Act is not an entirely independent Act in the sense that it proceeds upon completely different notions of taxation and has its source in an entirely distinct tax concept. The Legislature considered that because of the extraordinary situation created by the war a person carrying on business would in all likelihood earn abnormal profits, profits which were certainly in excess of what he would have earned if War had not broken out, and which would accrue to him not because of any particular effort on his part but because of conditions created by the War. Such a person would enjoy an additional boom in profit-making, and in order to appropriate a percentage of these extra profits or 'excess profits" this levy was introduced. That that was the object of the Act is clearly seen if regard be had to the mode of computing the "standard profits" which is minimum level above which the profits during a chargeable accounting period become liable to tax. It is these extra profits which are intended to bear excess profits tax. From the scheme of the Income-tax Act and the Excess Profits Tax Act it is clear that the two statutes are complementary. This aspect of the legislation was considered by the Bombay High Court in *Commissioner of Income-tax v. Raipur Manufacturing Company Ltd.,* [6] where Kania, J. observed :

> "The Excess Profits Tax Act as shown by the preamble itself is a legislation to impose tax on excess profits arising out of certain business. The Income-tax Act is the principal legislation which imposes a tax on the income of a person. Section 6 divides the income under five heads which are chargeable to tax. The fourth head is profits and gains of business, profession or vocation. Out of that a certain portion is carved out by the Legislature for the purpose of imposing the excess profits tax. I am unable to accept the contention of the Commissioner

> that the Excess Profits Tax Act is an entirely independent legislation, which is connected with the Income-tax Act only to the extent it is expressly so stated in the Excess Profits Tax Act. The scheme of the two Acts clearly shows that the Excess Profits Tax Act is a legislation intended to tax the profits of certain businesses in excess of a certain limit as provided in that Act. It is therefore complementary to the Income-tax Act by its very nature."

In this context, it would seem ex facie that if the profits earned during a certain period are taxable under the Income-tax Act, it is part of those very profits (the "excess profits") which is liable to excess profits tax. Whether the profits in the one case can be identified with the profits in the other can be determined by reference to the period in which they accrue or arise. It is apparently for this reason that throughout the Excess Profits Tax Act one finds provisions at various places which point to a correlation between that Act and the Income-tax Act. Section 5 of the Excess Profits Tax Act declares that the business to which the Act applies is a business, of which any part of the profits during the relevant chargeable accounting period falls to be taxed under the Income-tax Act as one of the categories of income mentioned in Sections 4 (1) (b) (i), 4 (1) (b) (ii) or 4 (1) (c) of the Income-tax Act. If it is a business, a part of the profits of which is liable to income-tax by virtue of those provisions, it is a business for the purposes of levying excess profits tax also. In respect of such business, declares Section 4 of the Excess Profits Tax Act, tax shall be levied on the amount by which the profits during the chargeable accounting period exceed the standard profits. What is meant by "profits" has been defined by Section 2 (19) as "profits as determined in accordance with the First Schedule". The First Schedule contains the rules for the computation of profits for the purposes of excess profits tax. Rule 1 provides that the profits of a business during the standard period or during any chargeable accounting period shall, subject to the provisions of the Schedule be computed on the principles on which the profits of a business are computed for the purposes of income-tax under Section 10 of the Income-tax Act, 1922. Where the profits of the standard period have already been determined for the purpose of an assessment under the Income-tax Act, 1922, the second proviso to Rule 1 says that the profits so determined shall, subject to the adjustments required by the Schedule, be taken as the profits during that period for the purpose of excess profits tax. It is not necessary for the Excess Profits Tax Officer to compute the profits of the standard period again, because that would have already been done in the income-tax assessment inasmuch as the standard period is under Section 6 (2) the "previous year

as determined under Section 2 of the Indian income-tax Act, 1922, for the purposes of the income-tax assessment for the year ending March 31 of any of the years 1937 to 1940. It is a principle well accepted in the law relating to excess profits tax that for the purpose of determining the excess profits the computation of the profits of the chargeable accounting period and of the standard profits must be made on a comparable basis, i.e., if the profits of the one period are computed on the basis of certain principles, the same principles should, subject to such adjustments as the Excess Profits Tax Act requires, underlie the computation of the profits in respect of the other period. Inasmuch as the second proviso to Rule 1 states that the profits during the standard period which have already been determined for the purpose of an income-tax assessment shall be the profits during that period for the purpose of excess profits tax, that is clear indication that the profits of the chargeable accounting period must also be determined on the basis on which they are determined under the Income-tax Act. Reference may also be made to R of the Schedule which declares that the profits of a business during the standard period shall be computed on the same basis and in the same manner as the profits of that business are under the Income-tax Act, as amended by the Income-tax (Amendment) Act, 1939, computed for the chargeable accounting period, notwithstanding that the Income-tax (Amendment) Act, 1939, may not have been in force in the standard period. This provision also demonstrates that the computation of profits in a standard period and the profits of the chargeable accounting period are intended to be made on the same basis, so that in computing the income of the standard period on the one hand and the chargeable accounting period on the other, like would be compared with like. Indeed, it was for this reason that R. 2 was enacted : see *Ahmedabad Manufacturing and Calico Printing Co. v. Excess Profits Tax Commissioner.* [7]

Another provision of the Excess Profits Tax Act also persuades us to the conclusion that the profits during the chargeable accounting period must be computed on the same basis as are profits for an income-tax assessment. That is Section 21, which states that Section 13 of the Income-tax Act shall apply as if it was a provision of the Excess Profits Tax Act and referred to excess profits tax instead of Income-tax. Section 13 of the Income-tax Act requires an assessment to be made in accordance with the method of accounting regularly employed by the assessee. Unless no method of accounting has been regularly employed or the method employed is such that the true profits cannot properly be deduced therefrom, the Income-tax Officer is bound to follow the method employed by the assessee. Under the income-tax law, the basis of accounting may be founded on the cash system or the mercantile system. There may

also be cases of a hybrid system which combines features of both systems. If the assessee following the mercantile system, the profits earned by him can be treated as the profits of a particular period only if the right to receive those profits accrued or arose during that period. Consider an assessee who maintains his accounts on the mercantile system, and who performs some work during a certain year but acquires the right in some other year to receive payment by reason of the work already done. He is entitled to say that the payment must be considered as profits of the year when the right to receive it accrued, and not of the year when the work was done. It will not be open to the Revenue to hold that the payment must be treated as the profits of the year in which the work was performed merely because the payment was made by reason of that work. If that view can be open to the Revenue, no sanctity can be attached, for the purposes of assessment, to the method of accounting regularly employed by the assessee. That sanctity is conferred by the provisions of Section 13 of the Income-tax Act, and that provision has been made applicable to excess profits tax assessments. In *E. D. Sassoon and Co. Ltd. v. Commissioner of Income-tax,* [8] the Supreme Court had before it appeals arising under the Income-tax Act and under the Excess Profits Tax Act, and upon all those appeals one common question of law was considered by it and that question was decided on the basis that the profits must be related to the period in which the right to receive them accrued or arose. While taking this view, the Supreme Court did not draw any distinction between an income-tax assessment and an excess profits tax assessment.

11. From a comprehensive appreciation of all these considerations, it appears to us that the "profits during the chargeable accounting period" are those profits respecting which a right to receive has accrued or arisen during that period. If the right to receive those profits has accrued or arisen subsequently, then even though they have accrued or arisen by reason of work done during the chargeable accounting period, they are not liable, because of that circumstance, to be treated as the profits of that chargeable accounting period.

12. The Revenue has relied upon *Commissioner of Income-tax v. Thiagaraja Chetty,* [9] The Supreme Court in that case was considering merely whether a sum which had been debited as an item of revenue expenditure in the books of the company and simultaneously credited to the account of the managing agency commission could be said to have accrued as income to the managing agents. Upon the principles embodied in the mercantile system of maintaining accounts, they held that those entries showed

that the sum had undoubtedly accrued to the managing agency firm, and that merely because the sum had not been actually paid by the company to the managing agency firm did not mean that the amount had not accrued to the firm.

13. Reference has also been made to *National Petroleum Co. Ltd. v. Commissioner of Income-tax,* [10] The Bombay High Court found that the assessee had paid to the Port Trust Authorities a sum on account of the duty imposed upon him. In litigation in respect of the imposition, the Calcutta High Court held that the demand for payment was valid. Upon these facts, the Bombay High Court pointed out that what was paid by the assessee was a proper payment of duty and properly debitable to the profit and loss account as an expense in the year of payment, that no sum could be said to have been due from the Port Trust Authorities to the assessee merely because the payment had been made by the assessee under protest and the assessee had treated it, during the pendency of the litigation, as a debt due to him by those authorities, and had treated it as a bad debt only upon the decision of the Calcutta High Court.

14. Our attention has also been invited to *Calcutta Co. Ltd. v. Commissioner of Income-tax,* [11] but in that case the assessee, on the mercantile system followed by it, entered the expenditure by debit entries in its accounts, and the Supreme Court held that inasmuch as the assessee was bound to carry out the development of the plots and, therefore, incur expenditure within six months of the dates of the deeds of sale, there was a clear liability on its part to suffer that expenditure, and the amount debited in the accounts, even though not then capable of exact quantification and not actually disbursed, was nevertheless an amount which the assessee could claim as a permissible deduction for the purpose of computing its profits or gains under Section 10 (1) of the Income-tax Act.

15. We were also referred to *Turner Morrison and Co. Ltd. v. Commissioner of Income-tax, West Bengal.* [12] where the Supreme Court held that when goods were sold by the assessee as the agent of a foreign company, the gross sale proceeds received by it in India contained the income, profits and gains lying dormant or hidden or otherwise embedded in those sale proceeds.

16. We have carefully considered these several cases, and are unable to see how they are relevant to the question before us. In none of the cases was the Court called upon to decide whether a payment received subsequent to a chargeable accounting period

was liable to be treated as the profits of that period merely because the work, which occasioned the payment, was done during that period.

17. We are of the view that the sum of Rs. 62,009 received by the assesses did not constitute profits liable to be considered in its hands in the chargeable accounting period ending March 31, 1944, for the purpose of determining the excess profits tax for that period. The question referred to this Court is answered in the negative.

18. A copy of this judgment, under the seal of the Court and the signature of the Registrar, shall be sent to the Income-tax Appellate Tribunal.

19. The assesses is entitled to its costs, which we assess at Rs. 200.

Reference answered.

Cases Referred.

1. 1961-41 ITR 40 (All)
2. 1964-53 ITR 114
3. (1921) 12 Tax Cas 382
4. (1947) 29 Tax Cas 69
5. (1954) 35 Tax Cas 649
6. 1946-14 ITR 725: AIR 1947 Bom 54
7. 1950-18 ITR 727: AIR 1950 Bom 295
8.1954-26 ITR 27
9. 1953-24 ITR 525 (530): (AIR 1953 SC 527 (528-529))
10. 1945-13 ITR 336 (Bom)
11. 1959-37 ITR 1
12. 1953-23 ITR 152