

KARNATAKA HIGH COURT

Akash Films

Vs.

Commissioner of Income-Tax

ITRC Nos. 129 and 130/1984

(K. Shivashankar Bhat and K.B. Navadgi, JJ.)

04.01.1991

ORDER

K. Shivashankar Bhat, J.

1. The following question of law is referred for our answer at the instance of the assessee under the provisions of the Income-tax Act, 1961 ("the Act" for short) :

"On the facts and in the circumstances of the assessee's case, whether the Tribunal was justified in law in holding that the expenditure incurred by the assessee was hit by section 40A(3) of the Income-tax Act, 1961 ?"

2. In the course of the assessment proceedings for the year 1976-77, a sum of Rs. 50,000 was found to have been debited in the profit and loss account. This represented the loss sustained by the assessee on a picture called "Nirman". The assessee is a distributor of films and sought sole distributorship of the film "Nirman" for Andhra Pradesh for a consideration of Rs. 95,000. The agreement was dated December 6, 1974. The assessee paid a sum of Rs. 5,000 on one date in cash and a further sum of Rs. 45,000 subsequently. Since the picture was a failure, the assessee did not release the film and wrote off this sum of Rs. 50,000. The claim of the assessee for excluding this sum was rejected by the Income-tax Officer on two grounds : (i) the payment was made in cash in contravention of section 40A(3) of the Act; (ii) the loss sustained by the assessee cannot be treated as a revenue loss since the picture was never released; it was a capital loss.

3. The Commissioner of Income-tax (Appeals) accepted the contention of the assessee that the business of the assessee was distribution of films and, therefore, acquisition of a film for distribution was part of acquiring stock-in-trade. Hence, the loss sustained by the assessee was a trading loss and not a capital loss. The Commissioner of Income-tax (Appeals) held that section 40A(3) of the Act was not applicable because this was not an "expenditure" as referred to therein.

For the assessment year 1977-78, a similar deduction of Rs. 20,000 in the profit and loss account arising out of the transaction regarding another picture was disallowed by the Income-tax Officer. The Appellate Assistant Commissioner affirmed the disallowance in the said case holding that it was an expenditure incurred without following the prescription laid down under section 40A(3) of the Act. The said picture was never produced and the whereabouts of the producer were not known.

4. Before the Appellate Tribunal, the contention was confined to the applicability of section 40A(3) of the Act in both the cases. The Appellate Tribunal concluded that the payments were made to acquire stock-in-trade and, therefore, were in the nature of expenditure, and, consequently, section 40A(3) was attracted; since the payments were made in cash, they cannot be taken note of in the proceedings. Hence, this reference at the instance of the assessee.

5. The question raised by Mr. Prasad, learned counsel for the assessee, is quite interesting. Learned counsel referred to section 40A(3) of the Act which reads thus :

"Where the assessee incurs any expenditure in respect of which payment is made, after such date (not being later than the day of March 31, 1969) as may be specified in this behalf by the Central Government by notification in the Official Gazette, in a sum exceeding two thousand five hundred rupees otherwise than by a crossed cheque drawn on a bank or by a crossed bank draft, such expenditure shall not be allowed as a deduction :"

(two proviso omitted, being not necessary)

According to learned counsel, this section governs only "expenditure". If a particular sum is spent or goes out of the assessee, not as an expenditure, though deductible in the computation of the profit and loss account, the prescription laid down in section 40A(3) is not applicable. Under the Act, there is a distinction between a deduction and an expenditure. A deduction is to be made while working out the profit and loss account, while expenditure is statutory recognised under section 36 of the Act. Learned counsel referred to section 28 of the Act wherein the profits and gains of business or profession which are chargeable to income-tax are enumerated. The deductions to arrive at the chargeable income under section 28 are found in sections 30 to 43A. All these are referred to as deductions except the deductions falling under sections 35, 35A to 35E. Section 36 refers to deduction. Section 37 refers to expenditure, while section 38 again refers to deduction. Such differences are pointed out in other provisions also. The loss sustained by the assessee in the case falls within the concept of deduction attracting the principles stated by Lord Parker in *Usher's Wiltshire Brewery Ltd. v. Bruce*¹ "Where a deduction is proper and necessary to be made in order to ascertain the balance of profits and gains, it ought to be allowed... provided there is no prohibition against such an allowance". Profits should be computed after deducting the losses and expenses incurred for the purpose of the business, profession or vacation, though such losses and expenses may not be expressly allowed under

sections 30 to 43, Unless the losses and expenses are expressly or by necessary implication disallowed by the Act. Three decisions of the Supreme Court were also cited to bring out the distinction.

6. In *Badridas Daga v. Commissioner of Income Tax*², the question was whether where in an employee who was holding the power of attorney to transact business on behalf of the firm embezzled certain amount causing trading loss to the firm, the loss was deductible.

¹(1915) AC 433, 458 (HL)

² A.I.R. 1958 S.C. 783

The suit filed by the assessee against the employee was decreed but a substantial amount of the decree could not be realised. The unrealised amount was written off at the end of the accounting year as irrecoverable. The assessee claimed this sum as a deduction under section 10(1) of the earlier Act (corresponding to the present section 28). The Supreme Court answered the question in favour of the assessee holding that the loss sustained by the appellant as a result of misappropriation by the employee is one which is incidental to the carrying on of his business, and that it should, therefore, be deducted in computing the profits under section 10(1) of the Act. This decision was cited to point out the difference between expenditure and other kinds of deductions. A loss sustained as incidental to the carrying on of the business is a deductible item by itself "not because it is an expenditure but because it goes into the making of profit and loss". *Metal Box Company of India Ltd. v. Their Workmen*³, was referred to for the same proposition. The matter before the Supreme Court was under the provisions of the Payments of Bonus Act. The question was whether it was legitimate to estimate the liability towards gratuity on an actuarial valuation and deduct such estimated liability in the profit and loss account while working out the net profit. There was also the question whether such an appropriation amounted to a reserve or a provision. The Supreme Court pointed out the difference between the deductions to be made while making the profit and loss account as against an expenditure under section 36 which has to be excluded from the taxable income. At page 623, it was held that (at p. 67 of 73 ITR) :

"But the contention was that though Schedule VI to the Companies Act may permit a provision for contingent liabilities, the Income-tax Act, 1961, does not, for, under section 36(v), the only deduction from profits and gains permissible is of a sum paid by an assessee as an employer by any of his contribution towards an approved gratuity fund created by him for the exclusive benefit of his employees under an irrevocable trust. This argument is plainly incorrect because section 36 deals with expenditure deductible from out of the taxable income already assessed and not with deductions which are to be made while making the profit and loss account. In our view, an estimated liability under gratuity schemes such as the ones before us, even if it amount to a contingent liability and is not a debt under the Wealth-tax Act, if properly ascertainable and its present value is fairly discounted is deductible from the gross receipts while preparing the profit and loss

account. It is recognized in trading circles and we find no rule or direction in the Bonus Act which prohibits such a practice."

Mr. Prasad emphasized once again that there is a distinction between the concept of expenditure and other deductions under the Act by reference to this decision. The difference was highlighted again by reference to *Indian Molasses Co., Pvt., Ltd. v. Commissioner of Income Tax, West Bengal*⁴, the Supreme Court pointed out the distinction between capital expenditure and revenue expenditure, and pointed out that income-tax law does not allow as expenses all the deductions a prudent trader would make in computing his profits. A distinction is made between an actual liability in praesenti and a liability de futuro which for the time being was contingent; only the former is

³ A.I.R. 1969 S.C. 612

⁴ 37 I.T.R. 66 at page 75

deductible not the latter. At page 78, the concept of expenditure is stated :

"'Expenditure' is equal to 'expense' and 'expense' is money laid out by calculation and intention though in many uses of the word this element may not be present as when we speak of a joke at another's expense. But the idea of 'spending' in the sense of 'paying out or away' money is the primary meaning and it is with that meaning that we are concerned. 'Expenditure' is thus what is 'paid out or away' and is something which is gone irretrievably."

Mr. Chander Kumar, learned counsel for the Revenue, also relied upon this decision to point out that the assessee in the instant case is a film distributor and the payments were made to obtain the assessee's stock-in-trade which is the film to be exhibited. Therefore, this is a case where the payment is not made as a capital investment but in the course of the trading activity of the assessee and the payments were in the nature of present liability referred to by the Supreme Court in *Indian Molasses'* case (1959) 37 ITR 66. Learned counsel also point out that section 40A has non-obstante wording and the entire provisions of sections 40A would prevail over anything to the contrary contained in any other provision of the Act. Therefore, according to learned counsel, the settled distinction found between an "expenditure" and the other kinds of deductions has no bearing while construing the provisions of section 40A. Whatever goes out of the assessee has to be broadly treated as an expenditure for the purpose of section 40A(3). This apart, learned counsel pointed out that the object of section 40A(3) is to prevent the evasion of tax by prescribing the mode of payment in a particular manner before an assessee could claim the benefit of such payments for taxation purposes either by way of expenditure or deduction.

7. The Act has not defined the word "expenditure". The contention of Mr. Prasad, learned counsel for the petitioner, is based on the broad distinction made under the Act between two kinds of outgoings - (i) those sums which are to be considered while preparing the profit and loss

account; and (ii) those outgoings which are understood as business expenditure, i.e., outgoings in the course of business. In the absence of a statutory definition, the court will have to consider the meaning of a word in the manner it is understood generally by those who deal with the subject in question. Even when words are defined, the definition may not be applied having regard to the context in which the words are used. In the instant case, it is not necessary for the court to venture upon a detailed discussion on this question because, from the proved facts, it is clear that the amounts in question were paid by the assessee in the course of its business to acquire the assessee's stock-in-trade. In other words, The assessee was actually incurring a business expenditure while making the payments. The payments would fall within the concept of expenditure propounded by Sri Prasad on behalf of the assessee. If so, section 40A(3) would govern the situation directly.

8. In view of the aforesaid conclusion of ours, the answer to the question will have to be necessarily in the affirmative and against the assessee. Reference is answered accordingly.

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