BOMBAY HIGH COURT

Commissioner of Income Tax

Vs.

Tata Sons Ltd

Civil Reference No. 11 of 1938

(Beaumont, C.J.)

04.11.1938

JUDGMENT

Beaumont, C.J.

1. This is a reference made by the Income Tax Commissioner under Section 66(2) of the Indian Income Tax Act. The question which he has raised is this -

> "Whether in the circumstances of the case, in computing the assessees income from their business as Managing Agents of the Tata Iron and Steel Co., Ltd., the payment of ₹ 2,94,308 to the co-sharers F. E. Dinshaw and Messrs. F. E. Dinshaw Ltd., out of the commission of ₹ 11,74,348 earned by them is allowable as an item of expenditure under Section 10 (2) (ix) of the Act or under any other provision thereof."

The material facts are that by an agreement, dated the 2nd May 1918, the assessees, were appointed managing agents of the Tata Iron and Steel Co. Ltd., and under that agreement they were entitled to receive a commission based on profits, with a minimum payment of ₹ 50,000 a year, which was not dependent on profits. In the year 1924 the Tata Iron and Steel Co., Ltd., was urgently in need of funds, and the ordinary practice in this country is for the managing agents to finance the company of which they are such agents. I do not mean to suggest that the assessees were bound in law to procure finance for the Tata Iron and Steel Co., Ltd., but for practical purposes the finance would have to be provided by them, if it was to be procured at all. Accordingly, the assessees approached Mr. F. E. Dinshaw and arranged that he should lend to the Tata Iron and Steel Co., Ltd., a core of rupees at a certain rate of interest and on security. An agreement was entered into on the 23rd June 1924 between the Tata Iron and Steel Co., Ltd., the assessees and the lender of securing the loan, and by Clause 7 of the agreement it is provided that the assessees would give and assign to the lender as from the 1st of April 1924 as share of six

annas in the rupees of the commission and other remuneration which they might be entitled to recover from the company under their agreement of the 2nd of My 1918. On reading that clause, it appeared to us that it operated as an assignment of a share of the commission (which, I may say, has since been reduced to four annas in the rupees), which the assessees were to receive from the main Company. That Company was a party to agreement, and Clause 7 appears to us to operate as an assignment of a portion of the commission under Section 130 of the Transfer of Property Act. If that view is right, no question of any reduction arises, because the portion of the income which has been assigner to the lender no longer forms part of the income of the assessees. We, therefore, stood the reference over and suggested to the Commissioner that he should raise a further question directed to this point. The Commissioner has to-day put in a lengthy opinion, in which he objects to the raising of any further question but, as for as I can see, does not suggest any answer in law to the point which we had raised. As the Commissioner objects to raising a further question, and as we are satisfied that the question which he has raised must be answered against him, we do not insist upon any further question being raised, but we express the opinion that on the true construction of the agreement of the 23rd June 1924 the portion of the commission which was assigned ceased to form any part of the income of the assessees. On the assumption that that view is wring, I will deal with the actual question raised, which is one of a character which has come before this Court on several occasions. The question is whether an agreement to pay a part of the commission in the circumstances in which it was made in this case amounts to an expenditure (not being in the nature of capital expenditure) incurred solely for the purpose of earning profits or gains within Section 10 (2) (ix) of the Income Tax Act. In two previous cases, which came before this Court, namely, *Commissioner of Income Tax, Bombay v. C. Macdonald & Co.* and the *Tata Hydro Electric Agencies, Bombay v. Income Tax Commissioner*, Bombay Presidency to which I will refer more in detail in a moment, this Court took the view that a question of this sort was determined against the assessees by virtue of the decision of the Privy Council in *Pondicherry Railway Co. v. Commissioner of Income Tax*. Having regard to the explanation of the principle which we understood, perhaps wrongly, to underly that case, which has now been given by the Privy Council in the Tata Hydro Electric Agencies case and the *Indian Radio and Cable Communication Company v. Commissioner of Income Tax, Bombay*, and also by the English Court of Appeal in *British Sugar Manufacturers Ltd. v. Harris*, I think that the Pondicherry case ceases to present any difficulty. The question whether the payment of part of a commission to a third person can be regarded as expenditure incurred solely for the purpose of earning that commission is a question which must be answered on the facts of each case and on a commercial basis. Now, it is to my mind clear in this case that the assessees were bound either to lose the commission which they we getting from the Tata Iron and Steel Co., Ltd., or to arrange for financing that Company, and we must assume that the arrangement, which they made as to finance was the wisest which could be made in the circumstances. The agreement to share their commission with the lender was part of the terms on which they managed to obtain finance, and, in my opinion, therefore, in a commercial sense the payment of this share of the commission was an expenditure solely for the purpose of earning profits or gains, viz., the remainder of the commission. In the case which I have already

mentioned, namely, The Tata Hydro Electric Agencies case, facts up to a point were virtually the same as in the present case. In that case also the present assessees had entered into an agreement with one of the Tata group of Companies - Tata Power Company, Ltd., - under which they were entitled to a commission; and in that case also the Tata Power Company, Limited, was in financial difficulties, and the agents had to find money; and they procured the money by agreeing to pay a portion of the commission to the lenders F. E. Dinshaw, Limited and Richard Tilden Smith. Subsequently however, they assigned their commission agreement to the Tata Hydro Electric Agencies, Bombay, who agreed to pay the proportion of the commission which had become payable to the lenders, and in those circumstances, the Privy Council held that so far as the assessees in that case, namely, the Tata Hydro Electric agencies, Bombay, were concerned, this payment to the lenders, which they had agreed to make, was not in any sense an expenditure incurred for the purpose of enabling them to earn profits. But it is to be noticed that in the judgment of the Privy Council delivered by Lord Macmillan this passage occurs at page 224 (of 64 I.A.) : "It was not questioned by Council for the Crown for the Crown that if the present question had arisen with Tata Sons Ltd., they would under section 10, sub-section 2(ix) have been entitled on the facts stated to deduct their payments to F. E. Dinshaw, Ltd., and Richard Tilden smith as being expenditure incurred solely for the purpose of earning their profits or gains". So that in that case the Privy Council noticed without suggesting disapproval an admission by Counsel which exactly covers, that point which we have to determine in this case. Of course, that admission is not binding on us, but in my opinion, it was an admission well founded. I think that the agreement to share commission in this case did amount to an expenditure incurred solely for the purpose of earning the profits or gains of the assessees. We therefore, answer the question raised in the affirmative. Costs on the Original Side scale to be paid by the Commissioner.

Rangnekar, J.

2. The facts are that the assessees are carrying on business as managing agents of the Tata Iron and Steel Co. Ltd., under an agreement dated the 2nd of May 1918. Clause 2 of the agreement provides of payment of commission to the managing agents on the annual net profits of the company, calculated in a particular manner there set out, subject to a minimum annual remuneration of ₹ 50,000 whether the company made any profits or not, or whether any dividends were declared or not. Clause 3 provides that in consideration of the remuneration thus granted the agents will use their best endeavours to promote the interests and business of the company. Under Clause 4 of the agreement the managing agents are given the general conduct and the sole management of the business and affairs of the company. Clause 10 provides that the agents will be at liberty to assign the whole or any portion of their earning, that is to say, the commission without thereby in any way affecting their appointment as such agents. In 1924 the company was in considerable financial difficulty and it is clear that its very existence was the retained. The assessees thereupon approached the late Mr. F. E. Dinshaw, and at their request the latter agreed to advance a crore of rupees to the company on the terms and conditions contained

in an agreement dated the 23rd June 1924 to which the Tata Iron and Steel Co, was a party. Clause 7 of that agreement provides that the agents will assign to the lender, that is, F. E. Dinshaw, a share of six annas in the rupee of the commission and other remuneration which they, as such agents, may be entitled to recover from the Tata Iron and Steel Co. Ltd. The result, in my opinion, was that the right of the managing agents to recover the Commission from the Tata Iron and Steel Co., Ltd., was assigned to F. E. Dinshaw. In the financial year 1936-37 the assessees were assessed on the total commission earned by them from the company. The company, on the other hand, claimed that a sum of ₹ 2 lacs odd which they had paid to F. E. Dinshaw, under the agreement of 1924, should be allowed as an item of revenue expenditure under Section 10, sub-section 2 (ix) of the Act. The Income Tax authorities disallowed the claim, and the substantial question on this reference is, whether this payment was rightly disallowed. Although we were told in the course of argument that the Assistant Commissioner held that the present case did not fall with in the principle of the decision in *Pondicherry Ry. Co. v. Income Tax Commissioner*, it seems to me to be clear, on the statement of the case submitted by the Commissioner of Income Tax, that he has entirely proceeded upon the principles laid down in that case, as also upon certain observations of Lord Macmillan in the *Tata Hydro Electric Agencies, Bombay v. Income Tax Commissioner, Bombay Presidency and Aden.* Now, in the Pondicherry case the facts were that the Pondicherry Railway Company Ltd. were bound to pay to the French Government one-half of its net profits, and Lord Macmillan in the Privy Council observed as follows :-

> "A payment out of profits and conditional on profits being earned cannot accurately be described as a payment made to earn profits. It assumes that profits have first come into existence. But profits on their coming into existence attract tax at that point, and the revenue is not concerned with the subsequent application of the profits."

It is not for me to say, as has been said, that the statement that a payment out of profits and condition a on profits being earned cannot accurately be described as a payment made to earn profits, is really too wide, but as pointed out by the Master of the Rolls in ***British*** *Sugar Manufacturers, Ltd. v. Harris*, Lord Macmillan in that paragraph was quite clearly using the word "profits" in one sense and one sense only; he was using it in the sense of the "real net profit", referred to in a case to which I shall presently come. The Master of the Rolls further observed as follows :

> "That he was doing that, is I think, abundantly clear from the nature of the contract there in question, which was merely a contract under which a percentage of profits was payable by the Railway Company to the French Government. There was no question of services or anything of that kind in the case; it was merely a sum payable out of profits. I do not find myself constrained by that expression of opinion, because it must be read, as Lord Macmillan had said in a subsequent case, in relation to the particular subject-matter with which he was dealing."

The subsequent case to which Greene, M. R., referred is the case of *The Union Cold Storage Co., Ltd. v. Adamson (H.M. Inspector of Taxes)*. Moreover, the sentence in the judgment in the Pondicherry case which I have quoted above was again explained by Lord Macmillan himself in *Tata Hydro Electric Agencies, Ltd. v. The Income Tax Commissioner, Bombay*. In the *Indian Radio and Cable Communications Company v. Commissioner of Income Tax, Bombay*, Lord Maugham, L.C. observed as follows :-

> "It may be admitted that, as Mr. Latter contended, it is not universally true to say that a payment the making of which is conditional on profits being earned cannot properly be described as an expenditure incurred for the purpose of earning such profits. The typical exception is that of a payment to a director or a manager of a commission on the profits of a company. It may, however, be worth pointing out that an apparent difficulty here is really caused by using the word "profits" in more than one sense. If a company having made an apparent net profits of Pounds 10,000 has then to pay Pounds 1,000 to directors or managers as the contractual recompense for their services during the year, it is plain that the real net profit is only Pounds 9,000. A contract to pay a commission at 10 per cent. on the net profits of the year must necessarily be held to mean on the net profits before the deduction of the commission, that is, in the case supposed, a commission on the Pounds 10,000."

I do not think, therefore, that the present case can be decided on the authority of the Pondicherry case. Then the Commissioner of Income Tax, as I have pointed out, proceeds upon certain observations of Lord Macmillan in *The Tata Hydro Electric Agencies, Bombay v. The Income Tax Commissioner*, Bombay Presidency and Aden. But, with respect I think, he has failed to appreciate the distinction between that case and the present case, the distinction which was admitted by Counsel for the Crown in that case and pertinently mentioned by Lord Macmillan in his judgment. In that case the facts up to a certain point, were very similar to the facts in the present case, the only distinction being that, there, the assessees were not originally the managing agents of the Tata Power Co., Ltd. They had acquired the managing agency business from the present assessees who were the original managing agents of the Tata Power Co., Ltd., and who had assigned part of their commission to them. In the course of the judgment it is pointed out by Lord Macmillan himself that "it was not questioned by Counsel for the Crown that if the present question had arisen with Tata Sons, Ltd., they would under Section 10, sub-section 2 (ix), have been entitled on the facts stated to deduct their payments to F. E. Dinshaw, Ltd., and Richard Tilden Smith as being expenditure incurred solely for the purpose of earning their profits or gains." So far as I can see the principle there laid down by Lord Macmillan was that the question whether a payment, made in the circumstances such as we have in this case, is an expenditure incurred solely for the purpose of earning profits or gains, must be determined in a commercial sense and the real question was whether the payment become necessary in the course of services rendered by the agents to their principals in their business. The argument in *The Tata Hydro Electric Agencies v. Income Tax Commissioner, Bombay Presidency and Aden*, on behalf of the

Crown was that after the acquisition of the agency business by the appellants the payments assumed a different character, and that the appellants did not any part in arranging the loan nor did they incur the liabilities in question in the course of rendering any services to the principals. That argument was accepted, and the appeal was dismissed on that broad ground. In this case it seems to me that the evidence is that the assessees took the principal part in arranging the loan for the company and incurred liabilities to third parties in the course of rendering services to their principals in their business. That being so, it seems to me that the payment was made for the sole purpose of earning profits in the conduct of the agency business and the deduction claimed by the assessees ought to have been allowed. It was argued by the Advocate-General that this payment was of the nature of capital expenditure. If that is correct, undoubtedly, the payment was rightly disallowed. But I am unable to hold, on the facts of this case, that the payment in any sense was a capital expenditure. It seems to me that the payment was made under the assignment in favor of F. E. Dinshaw, and it was made purely out of revenue earned from year to year by the assessees by way of commission from the company. I agree, therefore, that the question should be answered in the manner proposed by My Lord, the Chief Justice.

Reference answered accordingly.

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