BOMBAY HIGH COURT

Vithaldas Thakordas

Vs

Commissioner of Income-Tax

(Stone, C.J.)

08.10.1946

JUDGMENT

Stone, C.J.

1. The judgment about to be delivered by my learned brother is the judgment of the Court.

Chagla, J.

2. This is a reference under Section 66(1) of the Indian Income-tax Act and is with regard to the assessment for income-tax purposes of Messrs. Vithaldas Thakordas & Co., a firm, in respect of the assessment year 1942-43, the relevant accounting period being the 1st November, 1940, to the 20th October, 1941.The point which we have to determine concerns the sum of Rs. 5,059 and is a short one, though not one which is free from difficulty. As referred to us by Tribunal, the questions asked are :-

(1) Whether in the circumstances of the case the payment of Rs. 5,059 made by the assessee firm to Mrs. Tarabai widow of the Vithaldas Thakordas was rightly held to be an appropriation of profits ?

(2) If the sum paid to Mrs. Tarabai was an item of expenditure, whether in the circumstances it was an item of revenue expenditure, and admissible for deduction under Section 10(2)(xii) of the Indian Income-tax Act, 1939 ?

On the 1st of November, 1930, Mr. Vithaldas Thakordas died, leaving his widow, Bai Tarabai, him surviving. He had, during his lifetime, carried on in his own name a bullion business of which he was the proprietor, and upon his death under arrangements made by Bai Tarabai in the first instance with five persons and subsequently with four of them the name "Vithaldas Thakordas" was used by three persons in carrying on their business in partnership. One of the four persons died and on the 25th of January, 1939, by a partnership deed of that date, the firm

was reconstituted by the three survivors and a new arrangement was entered into by the new partnership with Bai Tarabai for the use of the name "Vithaldas Thakordas." Whether the consideration, being the sum of Rs. 5,059 paid by the new partnership to Bai Tarabai for the use of the name, is a deduction within the meaning of Section 10(2)(xii) of the Act must depend not only upon the construction of that sub-section but upon the nature of the arrangements entered into by partners. However, when this reference first came before this Court, the arrangements, which it now appears were evidenced by a written document, were not included in the case referred to us. Accordingly on the 11th of October, 1944, the reference was remitted back to the Tribunal, and our learned brother Kania in delivering the judgment of this Court said :-

> "In the absence of the necessary findings about the nature and the terms of arrangement between Mrs. Tarabai and the assessee firm we are unable to consider the questions referred to us. Under the powers vested in this Court under Section 66(4) of the Act we therefore the matter back to the Tribunal to enable them to state to the Court further facts in respect of the nature and terms of arrangement between Mrs. Tarabai and the assessee firm in connection with the use of the name of Messrs. Vithaldas Thakordas & Co. by the assessee firm in respect of their bullion business in the year of account."

Section 10(2) of the Act provides that profits and gains of any business, profession or vocation shall be computed after making the allowances mentioned in the sub-paragraphs to that sub-section and it is with sub-paragraph (xii) with which we are concerned. It is as follows :-

> "any expenditure (not being in the nature of capital expenditure or personal expenses of the assessee) laid out or expended wholly and exclusively for the purpose of such business, profession or vocation."

So in order to come within sub-paragraph (xii) the sum in question must be an expenditure, which is not in the nature of a capital expenditure, and it must be an expenditure "wholly and exclusively for the purpose of the business.

In this case it is submitted by Mr. Setalvad on behalf of the Commissioner that the Rs. 5,059 is not an expenditure at all, because it is said the payment represents a share of profits and it is also submitted that in any event it is a capital expenditure The Tribunal has now submitted its supplemental case and has annexed to it the letter of agreement dated the 30th of January, 1939, addressed to Bai Tarabai and signed by the three partners. The partnership deed of the 25th January, 1939, is to be found annexed to the original case. By that document the three persons parties thereto mutually agreed that they should become partners on the terms thereinafter contained, and after stating the nature of their business the deed provides that the partnership should commence from the 27th January, 1939, and that the firm shall be "Vithaldas Thakordas

& Co." Paragraphs 6 and 7 are as follows :-

"6. In consideration of Bai Tarabai, widow of Vithaldas Thakordas, having agreed to allow the partnership to use the name of Vithaldas Thakordas for the purpose of the partnership, the partnership shall out of the net profits of the business pay to her the said Bai Tarabai in the first instance an amount equivalent to two annas in the rupee of the net profits. In case the partnership suffers the loss the said Bai Tarabai shall be liable for any part thereof.

7. After payment of the amount as aforesaid to Bai Tarabai out of the net profits the balance of the net profit shall be divided between the partners in the following proportions :-

(1) The said Jamnadas Monji shall be entitled to 0-7-0. (2) The said Maganlal Lalji shall be entitled to 0-3-9; and (3) The said Ratilal Chhabildas shall be entitled to 0-3-3 in the unit of 14 annas; and they shall in the like proportion bear all the losses.

8. Nothing in this agreement shall constitute the said Bai Tarabai a partner in the firm of Messrs. Vithaldas Thakordas & Co."

The letter of the 30th January, 1939, addressed to Bai Tarabai is headed "Re : Partnership agreement between," and then follow the names of the three partners. The rest of the document is in these terms :-

> "We beg to not that an agreement has been arrived at between us and you that in consideration of your having agreed to allow us the use of the name of Vithaldas Thakordas and to carry on our business in the firm name of Vithaldas Thakordas & Co., we shall out of the net profits of the business pay to you in the first instance an amount equivalent to two annas in the rupee of such net profits.

In case the partnership suffers any loss you will not be liable for any part thereof.

By reason of your having allowed us the use of the name of Vithaldas Thakordas and/or by the payment of the share in the net profit as aforesaid you will not be deemed to be a partner in the said firm of Messrs. Vithaldas Thakordas & Co., and neither you nor your heirs executors administrators or assigns or the estate of the said Vithaldas Thakordas will be in any way liable for the debts or losses of the said partnership.We hereby further agree to keep you and the estate and effects of Vithaldas Thakordas deceased harmless and indemnified against all loss or damage that you or the estate of Vithaldas Thakordas may suffer by reason of your having allowed us the use of the name of Vithaldas Thakordas as aforesaid."

It is clear on these two material documents, the partnership deed and the letter written by the three partners to Bai Tarabai, that Bai Tarabai allowed the use of the goodwill to the partnership

firm for a consideration of her receiving two annas in the rupee of the "net profits" of the firm. No term is fixed for the duration of the use of the goodwill and apparently the agreement is terminable at will.In the accounting year the firm made a net profit of Rs. 40,470 and Bai Tarabais share in these profits came to Rs. 5,059. The question which arises for our determination is whether this amount is an expenditure not being in the nature of a capital expenditure which has been expended wholly and exclusively for the purpose of the partnership business.In our opinion it is clear that the expenditure is not in the nature of a capital expenditure. By paying a two annas share in the net profit the partnership did acquire any asset. It paid a fee or rent for the use of the goodwill and that can only be a revenue expenditure. If the partnership acquired the goodwill by paying a lump sum, undoubtedly that would have been a capital expenditure; or even in instead of paying a lump sum it had paid the amount fixed for the goodwill by certain instalments, each instalment would have been in the nature of a capital expenditure. But in this case, as the partnership did not acquire anything in the nature of a permanent asset, the payment to Bai Tarabai is not a capital but a revenue expenditure. The case of Ogden v. Medway Cinemas, Ltd. is very similar to the one before us. There the assessee obtained the lease of a hall to be used as a cinema theatre, and by a supplemental deed executed on the same day the assessee was also permitted the use of the goodwill for an annual payment of 500 Pounds. Mr. Justice Finlay held that the payment of 500 Pounds was not the payment of the capital sum but was a necessary revenue expense of the assessee.The other and more important question is whether the amount paid to Bai Tarabai is the appropriation of the profits of the partnership after they have been ascertained ? Or is it a permissible deduction which has got to be made before the profits of the firm are ascertained ? Under Section 10, sub-section (1), of the Act the tax is made payable by the assessee in respect of the profits or gains of his business; and under sub-section (2) such profits or gains are to be computed after the allowances set out in that sub-section have been made; and one of such allowances is the expenditure wholly and exclusively for the purpose of the business mentioned in sub-clause (xii) of Section 10(2) of the Act. Once the permissible deductions are made out of the profits, the profits attract the tax and it is no concern of the revenue authorities how these profits are appropriated or distributed or what the destination of the profits might be. Therefore the narrow question that we have got to consider is whether the assessees are entitled to deduct the payment made to Bai Tarabai as reasonable expenditure before the profits of the firm become liable to tax or is the payment made after the profits have been ascertained and become liable to taxation, and the payment to Bai Tarabai is nothing more than a mere distribution of part of the profits.It is contended by Mr. Setalvad that the payment to Bai Tarabai is a payment out of the profits and conditional on profits being earned, and strong reliance is placed on the statement of Lord Macmillan in the Pondicherry case :-

"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 profit on their coming into existence attract tax at that point and the revenue is not concerned with the subsequent application of the profits."

But this statement of Lord Macmillan has been the subject of considerable comment in subsequent cases. As I shall presently point out, the principle was enunciated by Lord Macmillan in rather wide terms and subsequent cases have definitely laid down that this particular observation of the learned law Lord should be read in, and confined to, its own context. In Union Cold Storage Co., Ltd. v. Adamson, the assessee company claimed that the rent it paid on lands and premises leased by it should be allowed as a deduction. There was a provision in the agreement that the rent payable bore some relation to the profits earned by the company. The House of Lords held that the payments were not payable out of the profits or gains and that they were allowable deductions. Lord Macmillan was at pains in this case to explain the observations he had made in the Pondicherry case to which I have referred and he was careful to observe that that the particular observation applied to the facts found in that case; and Lord Maugham in the Indian Radio and Cable Communications Companys case expressly stated that it was not universally true to say that a payment, the making of which was conditional on profits being earned, could not properly be described as an expenditure incurred for the purpose of earning such profits. He further observed that the difficulty mainly arose because the word " profits" was used in more than one sense. He points out that if a company makes a net profit of 10,000 pounds and has then to pay 1,000 pounds to directors or managers for services rendered 10,000 pounds are only the apparent profits, but the real profits are 9,000 pounds.Therefore in every case the Court has got to consider what are the real profits of the assessee and what are the apparent profits. It is only the real profits that attract the tax; and even though the language used in the material documents may be "net profits," the Court must look to the substance of the transaction and not the form. In this case the two documents I have referred to provide that Bai Tarabai has got to be paid to annas in the rupee of the "net profits." But the two annas in the rupee have to be paid for the use of the goodwill which is essential for the carrying on of the business. Therefore first the apparent profits of the partnership are ascertained and two annas in the rupee are paid out to Bai Tarabai out of those profits; and other those payments are made, the real profits are ascertained which attract the tax; and it is the real profits that are distributed among the partners in the proportion laid down in the partnership agreement, making up what is described as a unit of 14 annas.The observation of Lord Macmillan in the Pondicherry case was again considered in British Sugar Manufacturers, Ltd. v. Harris. In this case a company carrying on a manufacturing business agreed with two other companies to pay them a stated percentage of its net profits."Net profits" were to be ascertained after payment of all expenses of the company and after providing for interest on debentures, but before making any provisions for depreciation. The Court of Appeal held that in computing its profits for the purposes of income-tax, the company was

entitled to deduct the sums so paid as being "money wholly and exclusively laid out or expended for the purposes of the trade." Lord Greene, the Master of the Rolls, pointed out that the "net profits" were to be arrived at upon a conventional basis, not the basis upon which the company would ascertain its profits for commercial purposes or the basis upon which it would ascertain its profits for income-tax purposes; and the percentage was to be paid out of these conventional profits and not the profits which were liable to tax. In the case before us also Bai Tarabai receives two annas in the rupee out of a fund which, although described as net profits, is really an artificial fund ascertained for the purpose of giving to Bai Tarabai her share under the agreement. The master of the Rolls were also appreciated the difficulty of distinguishing cases which are for a payment of a share of profits simpliciter and a payment of remuneration which is deductible in truth before the profits divisible are ascertained; and he confesses that the line between these two classes of cases was very difficult to draw. The Master of the Rolls further made it clear that the observations of Lord Macmillan in the Pondicherry case referred to profits in the sense of real net profits.

This High Court, in Commissioner of Income-tax, Bombay v. C. Macdonald and Company, applied the principle of the Pondicherry case. In that case the assessee as the managing agents of a company received the sum of Rs. 97,000. From this amount they paid Rs. 19,000 odd to third parties under certain agreements to pay them a proportion of the gross income and they claimed that in assessing their profits they were entitled to have a deduction of this sum of Rs. 19,000 odd from the amount of Rs. 97,000 received by them. The Court of Appeal (sic) rejected their contention. But it is to be noted that the learned Chief Justice, Sir John Beaumont, expressly points out in his judgment that it had not been argued that the sums paid to third parties came within any of the various deductions allowed by the Indian Income-tax Act. On the other hand, the High Court in Commissioner of Income-tax Bombay Presidency v. Tata Sons Limited held that the payment to a financier of the state of the commission earned by Tata Sons Limited in order to obtain finance for the purposing of financing the Tata Iron and Steel Company Limited was an expenditure incurred by the assessee solely for the purposes of earning their profits and was a permissible deduction. Sir John Beaumont frankly confessed that in the past he had wrongly understood the principle of the Pondicherry case ; but the subsequent decisions had made the position clear. He observes that 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.It has been further contended by Mr. Setalvad that the agreement between Bai Tarabai and the partners of the firm is in the nature of a joint adventure or a quasi partnership and, therefore, what Bai Tarabai and the partners of the firm are doing are really sharing the real profits of the firm. Emphasis has been laid on the remarks of the Lord Maugham in delivering the judgment of the Judicial Committee in Indian Radio and Cable Communications Company

Ltd. v. Commissioner of Income-tax, Bombay Presidency and Aden. In that case the assessee company agreed to pay one-half of its net profits to another company in consideration of certain advantages to be received by the assessee company from the other company. The assessee company contended that the payment of the share of the net profits was in the nature of rent and, therefore, it was entitled to deduct it from its net profits. The contention of the assessee company was rejected by the Privy Council. Lord Maugham pointed out that the one-half share of the profits was made payable as part of the consideration in respect of a number of different advantages which the assessee derived from the agreement and not all of them was shown to be of purely temporary character and, therefore, the Privy Council came to the conclusion that the agreement as a whole was much more like one for a joint adventure for a term of years between the assessee company and the other company.

It is impossible to contend that in the case before us the partnership is receiving a number of advantages from Bai Tarabai. The agreement between the firm and Bai Tarabai is a simple and all that the partnership is doing is paying an amount fixed by reference to profits as a fee or charge for the use of the goodwill granted to it by Bai Tarabai. In our opinion it would not be correct to say that this agreement is in the nature of a joint adventure or a quasi partnership.Finally it was argued by Mr. Setalvad that the amount paid by the partnership firm to Bai Tarabai is not an expenditure expended wholly and exclusively for the purposes of the business. It is argued that this amount was not paid for the purposes of producing profits in the conduct of the business, but was paid in order to acquire the right to conduct the business in the particular name. It is not possible to accept this contention. The name in which a business is carried on is an important factor and the reason why the partnership paid for the goodwill was in order to attract more customers and earn more profits. The observations in the judgment delivered by Lord Macmillan in the Tata Hydro-Electric Agencies case, must be read in the light of the facts found in that case; he said :-

> "In short, the obligation to make these payments was undertaken by the appellants in consideration of their acquisition of the right and opportunity to earn profits, that is, of the right to conduct the business, and not for the purpose of producing profits in the conduct of the business."

In that case Tata Sons Limited, who were the managing agents of Tata Power Company Limited, assigned the agency agreement to the assessee, Tata Hydro-Electric Agencies Limited. The Tata Power Company entered into a new agreement with the assessee on terms identical with their agreement with Tata Sons Limited whereby they agreed to pay to Tata Hydro-Electric Agencies Limited a commission of 10 per cent. on the annual net profits of the Tata power Company. The assessee company entered into an agreement with two financiers D and S and agreed to pay each of them 12 1/2 per cent. of the commission earned by them from the Tata Power Company. The

assessee company claimed one-fourth of the amount of the commission earned by them and paid to D and S as an allowable deduction. Their contention was rejected by the Privy Council. It is important to note that it was found as a fact that the assessee company had agreed to pay a share in the commission to D and S whether the business of the assessee company yielded any profit or not, and as the share in the commissioner was to be paid irrespective of whether profits were made or not, the Privy Council found it difficult to hold that the payment was made solely for the purposes of earning the profits of the business. It will also be remembered that in the case of Ogden v. Medway Cinemas, Limited, to which have referred earlier, Mr. Justice Finlay held that the payment for goodwill was a necessary revenue expense of the company.In our judgment the sum paid to Bai Tarabai is an item of revenue expenditure and admissible for deduction under Section 10(2)(xii) of the Income-tax Act. Accordingly the first question referred to us must be answered in the negative and the second question in the affirmative.The Commissioner must pay the costs throughout.

Reference answered accordingly.