BOMBAY HIGH COURT

H.M. Kashiparekh

Vs.

Commissioner Of Income-Tax

I.T. Ref. No. 51/X of 1954

(S.T. Desai and V.S. Desai, JJ.)

02.04.1960

JUDGMENT

S.T. Desai, J.

1. This Reference raises a question of some importance and the income under assessment relates to managing agency commission. It is a trite saying that income-tax is not and cannot be cast on logical lines. No considerations of equity or hardship can be permitted to control the application of the Act. Nor is it permissible to the Court to disregard any axiomatic principle of tax law. One such principle expressed in the laconic style of Lord Macnaghten is that income-tax is a tax on income - an expression of wide connotation and elastic ambit. Another principle - one of computation which also may be regarded as axiomatic - is that in assessing the yearly profits and gains of a business for the purpose of the Income-tax Act, each year is a self-contained period. We have said all this at the very outset, because we have been very strongly reminded by Mr. G. N. Joshi, learned Counsel for the Revenue, that we are bound to act in conformity with this principle of computation. We agree that it is incumbent on the Court to see that there is no departure on its part from any fundamental concept or principle of tax law. There is nothing, however in these axiomatic rules or anything formidable about them which militates against the simultaneous application of another basic principle of tax law which requires the Court - cases of deemed income apart - to see that ultimately it is the real income of the assessee which alone is brought to tax and not any artificial or notional income that may be said to have accrued to him.

2. The lassessee company is the Managing Agent of The Gujarat Paper Mills Ltd. Ahmedabad. The assessment year was 1950-51 and the relevant accounting year was 1-4-1949 to 31-3-1950. It earned during the accounting year a commission of Rs. 1,17,644-4-0. At the instance of the managed company, the assessee company surrendered Hs. 97,000/.-. The Income-tax Officer accepted that position, but the Commissioner of Income-tax disapproved of the same and served a notice on the assessee company under Section 33-B(1). He passed an order directing the

Income-tax Officer to include the amount of Rs. 97,000/- in the assessee company's total income for the assessment year 1950-51. The matter was carried to the Tribunal and one of the contentions urged on behalf of the assessee company was that Clause 5 of the Managing Agency Agreement authorised the managed company to cut down a portion of the commission earned by the managing company and that, therefore, the surrender or Rs. 97,000/- was justified. Clauses (5) and (6) of that Agreement may be set out in full :

> "(5) The Agent's firm shall receive and the Company hereby agrees to pay to the said Agents a commission at the rate of 5 per cent (five per cent) on the total proceeds of sale of all paper, cardboards, pulp, and all other raw materials and goods manufactured or produced by the Company.
> Provided however that if in any year the profits of the said Company after providing for depreciation of the Company's machinery and Buildings and other charges is not sufficient to pay a dividend at the rate of 6 per cent per annum on the Capital of the said Company issued and paid, the said Agents' Firm shall give up to the said Company, such portion of their commission as is necessary to make up such deficit but not exceeding the one third of the entire commission to which the said Agents' Firm shall be entitled to receive in that particular year.
> 6. The commission payable shall be credited to the Agents' Account on the first of every month and it shall carry interest at the rate of 6 per cent per annum, such commission shall be payable at the interval of six months or a year as the Agents may determine".

It is clear from the above that the maximum amount that the assessee company was bound to forego was only 1/3rd of Rs. 1,17,644-4-0 i.e. Rs. 39,214-12-0. That was the view taken by the Tribunal which decided in favour of the assesses company only to the extent of that amount and rejected the contention of the assessee company as to the balance of the amount of surrender Viz. Rs. 57,785-4-0. At the instance of the assessee company, the matter has been referred to this Court and the following questions of law have been raised in the Statement of the Case :

> (i) Whether the order of the Commissioner of Income-tax under Section 33-B(1) during the pendency of the proceedings under Section 34 of the Act is illegal or void?
> (ii) Whether the amount of Rs. 97,000/- surrendered by the assessee company could be allowed as a revenue deduction under See. 10(2)(xv) of the Act?
> (iii) If the answer to question (ii) is in the negative, whether the sum of Rs. 57,785/-(Rs. 97,000/- - Rs. 39,215/-) could legally be included in the assessee company's total income for the assessment year ended 31st March 1950? Nothing has been said before us as to Question No. 1 on either side and it will not be necessary for us to say anything about the same. As to Questions 2 and 3 learned Counsel both for the assessee company and the Revenue have stated before us that the questions require some recasting though on different considerations. It will be convenient to do so after we have examined the arguments on either side on the points urged before us.

(3) The Reference came up for hearing before Chagla, C.J., and Tendolkar, J., on 24th February 1955. It appears that the question whether the amount forgone by the assessee company was on the ground of commercial expediency or not was regarded as one of importance by the Court and a supplemental Statement of Case was felt necessary. In the judgment of the learned Chief Justice, it is mentioned :

"The second question arises out of the surrender by the assessee of a sum of Rs. 97,000/- which was part of the managing agency commission earned by the assessee, and the assessee claimed this deduction as permissible under Section 10(2)(xv) of the Act. The Tribunal has held that this was not a permissible deduction, but no facts arc set out which led the Tribunal to come to this conclusion.

Now, what is necessary to be considered is whether this sum of Rs. 97,000/- was given up for reasons of commercial expediency. If the amount was given up for reasons of commercial expediency, then we have already held that it would be a permissible deduction under Section 10(2)(xv). If, on the other hand, this amount was not given up for reasons of commercial expediency, then it would not be a permissible deduction under Section 10(2)(xv)". The supplemental Statement of the Case was made in August, 1956. In that Statement of the Case is set out the finding recorded by the Tribunal on the question of commercial expediency and the folding is that the surrender of the balance of Rs. 57,839-12-7 was by reason of commercial expediency. The hearing of the Reference was allowed to stand over from time to time because the question of commercial expediency was going to be decided by their Lordships of the Supreme Court in a matter which had been carried to that Court. That point has now been decided and the decision is in agreement with the view which was expressed by this Court on that question and the Reference now comes up before us for final disposal.

(4) At the outset, it was argued by Mr. Palkhiwalla, learned Counsel for the assessee company, that the finding being in favour of the assessee company, the principal question should be answered in its favour. Mr. G. N. Joshi, learned Counsel for the Revenue, drew our attention to the position that the question of commercial expediency was not the only question that arose for determination Counsel contended that even if the amount of Rs. 57,839-12-7 had been foregone by the assessee company on ground of commercial expediency that was not in the accounting year which ended on 31st March 1950 but that was done in December 1950 as a result of two resolutions, one passed by the managed company and the other passed by the assessee company. As the contention does arise for our determination, we have heard arguments on the same. In order to appreciate the arguments, it is necessary to set out here some further facts which have bearing on the present controversy in the Profits and Loss Account of the managed company, there is an entry of Rs. 20,644-4-0. The details of the entry there stated are as under :

"To

Managing Agents Commission ... 1,17,644-4.0

Less given up 97,000.0-0

20,644-4.10."

A resolution was passed by the Board of Directors of the Managed Company at a meeting held on 7th December 1950. The material part of that resolution is as under :

> "The Agents placed before the Board the Balance Sheet and the particulars of Profit and Loss Accounts audited by the Auditors together with their Report for the year 1-4-1949 to 31-3-1950, and after explanation and discussion the same were approved and it was decided that the Directors should sign the Balance Sheet and the Profit and Loss Account in token of such approval. Accordingly the Directors singed the same and thereafter it was resolved that in respect of the said Balance Sheet and particulars of the Profit and Loss Account which show the amount of profit which now comes to Rs. 57,839-12-7 by reason of the Agents Company having given up for the benefit of the Mills Company Rs. 97,000/- out of their commission and adding thereto Rs. 37,690-1-6 being the balance brought forward from the last year the total profit comes to Rs. 95,799-14-3 and it is recommended to the shareholders that the same be allocated as follows".. Mr. Joshi has asked us to take on record a copy of a similar resolution of the Board of Directors of the assessee company and we have done so. That resolution is on the same lines as the resolution passed by the Board of Directors of the managed company. Since learned Counsel has strongly relied on that resolution, that resolution also may be set out here :
> "The agents produced before the Board the audited Statement of Profit and Loss Account and the Balance Sheet for the year 1-4-49 to 31-3-50 which was sanctioned after clarifications and discussions, and it was decided that the directors should affix their signatures in token thereof on the statement of Profit and Loss Account and Balance Sheet. On this occasion after the directors had signed, it was resolved that the said Balance Sheet and the statement of Profit and Loss Account showing the amount of Rs. 1,20,844-13-9 after deducting therefrom expenses relating to commission, interest, etc. out of that amount of Rs. 97,000/- is hereby resolved to be forgone in the interest of the mill company. As a result the sum of Rs. 23,844-13-9 remains. Adding therein the last year's credit balance of Rs. 1,623-3-5 the Profit and Loss Account shows the amount of Rs. 25,468-1-2 which the shareholders are recommended to allocate as under:". Succinctly stated the contention on behalf of the Revenue is that the income accrued to the assessee company in the accounting year, whereas the surrender on ground of commercial expediency of the amount of Rs. 57,000/- odd out of the same took place eight months after the expiry of the accounting year and, therefore, it could not be treated as an expenditure incurred in the accounting year.
> (5) The contention urged on behalf of the assessee company is twofold. It has been urged firstly that in any event and in any view of the case, it is the real income of the assessee company for the accounting year that is liable to tax and that real income cannot be arrived at without taking into account the amount which was forgone by the assessee company. The second contention urged by Mr. Palkhiwalla is that the amount of Rs.

57,000/- odd had been given up by the assessee company on the ground of commercial expediency when the quantum of the entire amount of commission was determined and, therefore, it must necessarily be treated as an expenditure of the year of which the determined amount is taken as the income. It will not be necessary for us to decide the second contention of Mr. Palkhiwalla and we have not heard Counsel for the Revenue on the same. In our opinion, the first contention of Mr. Palkhiwalla is substantial and must prevail.

(6) Counsel for the Revenue does not question the importance of what he describes as the doctrine of real income. His contention strongly urged before us, however, is that a party who follows the mercantile system of account - there is no dispute that the assessee company follows the mercantile system of account - cannot avail of the benefit of the doctrine where, for instance as in the case before us, the income of managing agency commission is credited in the books in one year and has been surrendered by him in the next year. In such a case, his income accrues in the year in which it is entered in the books and if the surrender is not made and entered in the same year, no question of real income can arise. It is said that the surrender can, if at all, be taken into consideration only in the year in which it is made i.e. in the next accounting year, and according to learned Counsel for the Revenue, in that next year also, he would not be able to avail of the same as an item of expenditure because it could have no bearing on the managing agency commission that may accrue to him in that year. Therefore, so the argument for the Revenue had to run, unless the surrender was made in the very year in respect of which the commission became due, the amount of the commission even if it was wholly surrendered, would yet remain liable to tax. In support of his argument, Mr. Joshi relied on the following observations of their Lordships of the Privy Council in *Commissioner of Income-tax v. S. M. Chitnavis*[1],

"For the purpose of computing yearly profits and gains, each year is a separate self-contained period in regard to which profits or losses sustained before its commencement are irrelevant".

Of course, if this principle that you have to measure the income of the year of assessment bearing in mind that for the purpose of computation each year is a separate self-contained period is so absolute that it has no relation with the principle of real income, the Court must arrive at the result suggested by Mr. Joshi.

4. The two rules that income-tax is annual in its structure meaning thereby that for computation each year is a distinct self-contained unit and the other that the income to be taxed is the real income of the assessee do not seem to us to be incompatible or irreconcilable. Mr. Joshi also is not prepared to go so far as that and has fairly stated that there is no antithesis between the two rules. The facts of a case may present some difficulty in applying the rules but the conflict would, in our opinion, be rather apparent than real. The facts of a given case may create the impression of a discrepant situation but the apparent discrepancy can be resolved in a manner not

inconsistent with the basic concepts underlying the two rules. In our judgment, they permit of harmonious application, though the application to a degree must depend on the circumstances of each case. Some propositions could be formulated but whether a general formula applicable to all circumstances could be hit on we rather doubt.

5. Though it may not be possible to prescribe a general formula which may successfully compose every conflicting situation, the position in law seems clear to us that in applying the two rules to particular transactions regard must be had to the true legal rights and the true situation. A fair interpretation of the transaction and the situation would lead to a preferable and if we may say so a correct solution than sheer adherence to one rule and discounting of the other. If this be the true approach and we feel little doubt that it is, the result cannot be said to flow from any non-conformity with the rule that income-tax is annual in its structure and organization. One merit of this approach would be the avoidance on the one hand of any a priori construction of a legal situation for the purpose of attracting tax to it and on the other allowing escape from liability. After all, each case must depend and its decision turn on its own facts and circumstances and that is how we

[1]59 Ind App 290 at p. 297 : (AIR 1932 PC 178 at p. 181)

prefer to deal with this case.

6. The leading facts to our mind are these. The assessee company had surrendered a part of its managing agency commission for a series of years. A chart showing such surrender is on the record and forms part of the case. The managing agency agreement, the material and relevant part of which we have already set out, in terms contains a provision affecting the quantum of the commission payable by the managed company to the managing company. The proviso must be read as part and parcel of Clause 5 and so read, the clause makes it abundantly clear that the quantum of the remuneration that the managing company would ultimately receive would depend on the sufficiency of profits to pay a dividend in the manner there stated. If the profits are not sufficient, the managing company is under a legal obligation to forgo a part of its commission. The amount of commission to be forgone for the purpose of making up such deficit however is not to exceed l/3rd of the entire commission which the managing company would otherwise become entitled to receive in a particular year.

7. Then come the balance sheet of the company and the two resolutions which we have already set out. The system adopted by the assessee company was the mercantile system. A good deal of argument has been advanced before us by Mr. Joshi, who has drawn our attention to a number of decisions explaining the meaning of the expression "mercantile system". The connotation of that expression is well understood and it is not necessary to burden this judgment with citations from those decisions. In the course of his argument, learned Counsel for the Revenue stated that there must have been entries in the books of the managed company and the managing company in consonance with clause 5 of the managing agency agreement. Only the balance sheet of the

company seems to have been brought on the record and the entries in those books do not form part of the Statement of the Case. Even so, we shall proceed on the footing that the assessee company having followed the mercantile system of account, there must have been entries made in its books in the accounting year in respect of the amount of the commission. In our judgment, we would not be justified in attaching any particular importance in this case to the fact that the company followed the mercantile system of account. That would not have any particular bearing in applying the principle of real income to the facts of this case. Incidentally, we may observe that we ourselves pointed out in the case of the *Commissioner of Income Tax v. Shoorji Vallabhdas and Co*[2]*.,* that the question whether the income accrued or not is not a mere matter of cogency of the entries made in the account books of the assessee but is essentially one of substance and of the real nature of what happened; a mere book entry is not conclusive of the question whether the assessee had become entitled to the sums or not. It may also be mentioned that in that case we were dealing with an assessee who followed the mercantile system of account. The crucial question before us, therefore, is whether the two facts - one the amount of Rs. 1,17,644-4-0 which would have become payable to the managing company but for the surrender and the factum of surrender are to be isolated or treated as of cogency in determining the actual accrual of income, by which we mean the real income of the assessee company. If the fact of forgoing or surrendering the amount of Rs. 57,000/- odd is to be regarded as of cogency in the context of the present point of real income and if it be remembered that the surrender was made at the time of ascertaining the quantum of the

[2] 1959-36 ITR 25 (Bom)

commission payable to the assessee company and further if it be remembered, as now found by the Tribunal, that the surrender was made *bona fide* and on grounds solely of commercial expediency, it seems very difficult to us to see how the Revenue is justified in contending that the real income of the assessee was something different than the amount of Rs. 20,000/- which was shown by it at the time of assessment as its income from managing agency commission. To accede to that suggestion would lead to a result highly unfair, though that is not a consideration which can be permitted to influence as in deciding any matter when we have to give effect to the provisions of a fiscal enactment. At the same time, we would not be justified in being unmindful of the consequences of any opinion which we may give on a Reference. The enquiry must depend mainly on the broad aspect and the fact and circumstances of the particular case and not on any wire-drawn technicality.

8. It will be convenient to refer at this stage to one or two decisions very strongly relied on by Mr. Joshi. Referring to the case of *Wallace Brothers and Co. Ltd. v. Commissioner of Income Tax*[3]*,* learned Counsel drew our attention to the proposition that liability to tax arises by virtue of the charging section alone and it arises not later than the close of the previous year but the quantification of the amount payable is postponed. This proposition has not been disputed by learned Counsel for the assessee company.

9. Another case on which Mr. Joshi has placed reliance is *Commissioner of Income-tax v.*

K.R.M.T.T. Thyagaraja Chetty[4], and he has drawn our attention to the following observations at pp. 533-534 (of ITR) :

> "Lastly it was urged that the commission could not be said to have accrued, as the profit of the business could be computed only after the 31st March, and therefore the commission could not be subjected to tax when it is no more than a mere right to receive. This argument involves the fallacy that profits do not accrue unless and until they are actually computed. The computation of the profits whenever it may take place cannot possibly be allowed to suspend their accrual. In the case of income where there is a condition that the commission will not be payable until the expiry of a definite period or the making up of the account, it might he said with some justification, though we do not decide it, that the income has not accrued, but there is no such condition in the present case". Of course, these are weightly observations and we are dutifully bound to follow the principle there enunciated. But it may be mentioned that the observations are not made in the context of real income for the question of real income did not arise for their Lordships' consideration as it does in the case before us. It may also be noticed that the proposition which found favor with their Lordships carried with it certain qualifications and one of those qualifications related to the existence of any condition about the making up of the account and that aspect of the matter was left open in express terms.

10. Now the argument of Mr. Palkhiwalla before us is that having regard to the facts and circumstances of the case before us it cannot be said that any income - any real income - accrued to the assessee company till the accounts were made for the purpose of satisfying

[3](1948) 16 ITR 240

[4]1953-24 ITR 525

the requirements of Clause (5) of the Managing Agency Agreement and particularly the proviso to the same. There is, in our opinion, force in this argument. Another facel of the same argument for the assessee company has been presented in this manner. If the year in which income was earned is chosen as the year of taxability, the subsequent settlement of the liability must relate back to the year in which the income was earned. Then, it is said that the right of the assessee company to receive the commission arose only after the accounting year and only when accounts were made up in December, 1950. The crux of the whole argument is that it is the real income of the assessee company that must he ascertained and that alone should be taxed.

11. In the present case surrender of commission has been made *bona fide* and as a matter of commercial expediency and at an early point of time when accounts were made up. We need not recapitulate what we have already stated. The accrual of the commission, the making of the accounts, the legal obligation to give up a part of the commission and the forgoing of the commission at the time of the making of the accounts are not disjointed facts. There is a dovetailing about them which cannot he ignored.

12. We do not think it to be in accord either with the authorities cited that the principle of real

income is to be so subordinated as to amount virtually to negation of it when a surrender or concession or rebate in respect of managing agency commission is made agreed to or given on grounds of commercial expediency simply because it takes place some time after the close of an accounting year. In examining any transaction and situation of this nature the Court would have more regard to the reality and specialty of the situation rather than the purely theoretical or doctrinaire aspect of it. It will lay greater emphasis on the business aspect of the matter viewed as a whole when that can be done without disregarding statutory language.

13. For all these reasons, we are of the opinion that the veal income of the assessee company was Rs. 20,000/- odd and the amount of Rs. 57,839-12-7 cannot be included in the real income of the accounting year. The opinion we give is in no respect out of harmony with any statutory provision, the decisions on the question of accrual of income or the principle that income-tax is annual in its structure.

14. There remains for consideration one other contention which is strongly urged before us by Mr. Joshi. It is said that the point about real income is totally a new point and there is not a word about it in the judgment of the Tribunal. Mr. Joshi has drawn our attention to the Order of the Tribunal. In our opinion, the Statement of the Case as well as the questions submitted by the Tribunal go to show that the point was raised by the assessee company. What we have got to see is whether a new contention which was not before the Tribunal is sought to be raised. It is not possible to say that such is the position in the case before us. We may also mention that all the relevant and necessary facts are to be found in the Statement of the Case. Therefore, the argument that a new contention is sought to be raised by the assessee company must be negatived.

15. We have already set out the questions referred to this Court by the Tribunal. Questions 1 and 2 will remain as they are. The 3rd question requires to be reframed. We shall do so as under :

> "Whether the sum of Rs. 57, 785/- could legally be included in the assessee company's total income for the assessment year ended 31st March, 1950? Our answer to the question is in the negative.

16. In view of our answer to the question No. 3, it is not necessary to answer the first two questions.

17. Commissioner to pay the costs.
Reference answered accordingly.