PETITIONER:
DHARAMVIR DHIR

Vs.

RESPONDENT:
THE COMMISSIONER OF INCOME-TAX,BIHAR & ORISSA

DATE OF JUDGMENT:
05/01/1961

BENCH:
KAPUR, J.L.
BENCH:
KAPUR, J.L.
HIDAYATULLAH, M.
SHAH, J.C.

CITATION:
1961 AIR 668 1961 SCR (3) 359
CITATOR INFO :
R 1965 SC 321 (17)
R 1966 SC1053 (18)
D 1976 SC 640 (5,9)

ACT:
Income-tax--Deductions--Expenditure incurred for purpose of trade--Assessee paying share of profits in return of advance made--Whether allowable deductions--Indian Income-tax Act, 1922 (11 of 1922), ss. 10 (2)(iii) and 10(2)(xv).

HEADNOTE:
The assessee entered into a contract for working certain collieries. As he did not have the requisite funds, he entered into an agreement with M whereunder M was to advance a sum upto Rs. 11/2 lacs, but could withdraw the money at any time and stop further advances and was not liable for any losses; the assessee was to pay interest on the advances at 6% per annum in addition to a sum equivalent to 11/16th of the net profits of the business. In pursuance of the agreement M made advances to the assessee and the assessee paid interest and 11/16th of his net profits to M. The assessee claimed these amounts paid to M as allowable deductions under s. 10(2)(iii) or under s. 10(2)(xv) of the Income-tax Act. The amount paid as interest was allowed but the other sums paid were not allowed on the ground that these sums were not wholly and exclusively laid out for the purpose of the business.
Held, that the assessee was entitled to the deductions claimed. The case had to be decided according to the tenor of the agreement and the circumstances of the case. In order to justify the deduction of the sum given up had to be for reasons of commercial expediency; it may be voluntary but so long as it was incurred for the assessee's benefit, e.g., the carrying on of his business, the deduction was claimable. In the present case there was nothing to show that the assessee could have made any better arrangements or would not have lost the contract had he not entered into the agreement with M. Therefore in a commercial sense the payments were an expenditure wholly and exclusively laid out for the purpose of the business.
Commissioner of Income-tax v. Chandulal Keshavlal, [1960] 38

I.T.R. 601, followed.
Commissioner of Income-tax, Bombay v. M/s. jaggannath Kissonlal, [1961] 2 S.C.R. 644, M/s. Haji Aziz & Abdul Shakoor Bros. v. The Commissioner of Income-tax, [1961] 2 S.C.R. 651, and Strong v. Woodifield, (1906) 5 T.C. 215, relied on.
Pondicherry Railway Company v. Commissioner of Income-tax, Madras, (1931) L.R. 58 I.A. 239, distinguished.
Union Cold Storage Co. Ltd. v. Adamson, (1931) 16 T.C. 293, 360
Tata Hydro-Electric Agencies Ltd., Bombay v. The Commissioner of Income-tax, Bombay Presidency. (1937) L.R. 64 I.A. 215, Robert Addie & Sons' Colleries, Ltd, v. Commissioners of Inland Revenue, (1924) S.C. 231, Commissioner of Income-tax, Bombay Presidency v. Tata Sons Ltd. [1939] 7 I.T.R. 195, The Indian Radio and Cable Communications Company Ltd. v. The Commissioner of Income-tax, Bombay, [1937] 5 I.T.R. 270, British Sugar Manufacturers Ltd. v. Harris, [1937] 21 T.C. 528, referred to.

JUDGMENT:
CIVIL APPELLATE JURISDICTION: Civil Appeals Nos. 448 and 449 of 1959.
Appeals by special leave from the judgment and order dated February 12, 1958, of the Patna High Court in Misc. Judicial Cases Nos. 679 and 680 of 1955.
A. V. Viswanatha Sastri and Naunit Lal, for the appellant (In both the appeals).
A. N. Kripal and D. Gupta, for the Respondent (In both the appeals).
1961. January 5. The Judgment of the Court was delivered by
KAPUR, J.-These appeals by the assessee are brought against two judgments and orders of the High Court of Judicature at Patna in Income-tax references under s. 66(2) of the Income Tax Act answering the questions in the negative and against the assessees. The questions were:

(1)..."Whether on the facts and circumstances of this case Rs. 72,963-12-0 was a revenue expenditure deductible under section 10(2)(iii) or under section 10(2)(xv) of the Indian Income Tax Act?"
(2)..."Whether on the facts and circumstances of this case Rs. 76,526-1-3 was a revenue expenditure deductible under section 10(2)(iii) or under section 10(2)(xv) of the Indian Income-tax Act?"

The facts of the appeals are these: The appellant was an employee of M/s. Karam Chand Thapar & Bros. and for each of the accounting years relating to the assessment years 1947-48 and 1948-49 his salary was Rs. 10,572. He also had an income of Rs. 500 from shares in certain joint stock companies. On December 20, 1945, he entered into a contract with
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Bengal Nagpur Coal Company Ltd., for raising coal from Bhaggatdih Colliery, Jharia and actually started his business from January 1, 1946. Evidently he did not have the requisite funds for his business and therefore in order to finance it, he entered into an agreement with the Mohini Thapar Charitable Trust on February 25, 1946. The trust is a public charitable trust, which was created by Lala Karam Chand Thapar, who constituted himself as the Managing

Trustee. The relevant terms of this agreement between the appellant and the trust were that the trust was to advance a sum upto Rs. 11 lacs, the contract was to be "carried in accordance of the policy" settled between the appellant and the trust; the trust could withdraw its money at any time and to stop further advances; the trust was not to be liable for any losses; the appellant was to send monthly returns to the trust and the seventh clause was "that in consideration of the trust having agreed to finance my said contract business up to Rs. 11/2 lacs I have agreed to pay to the trust interest on the amount from time to time owing to the trust in respect of the monies to be advanced as above at the rate of 6 p.c. per annum in addition to a sum equivalent to 11/16th of the net profits of this business of mine."

In pursuance of this agreement the appellant, besides interest, paid to the trust the sum of Rs. 72,963 for the first accounting year and Rs. 76,526-1-3 for the second accounting year corresponding to years of assessment 1947-48,1948-49 and claimed these amounts as allowable deductions under s. 10(2)(iii) or under s. 10(2)(xv) of the Income-tax Act. The amount of interest has been allowed but the claim in regard to the other sums paid was disallowed by the Income-tax Officer on the ground that the agreement was not genuine and bona fide and that it was not prompted by ordinary business considerations. The matter was taken in appeal to the Appellate Assistant Commissioner who upheld the order of the Income-tax Officer. An appeal to the Income-tax Appellate Tribunal was also dismissed and so was an application

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for reference under s. 66(1), but the High Court directed the Tribunal to state the case on the questions set out above. For the two assessment years the question was the same excepting for the amounts claimed as allowable deductions.

In its order dated April 4, 1955, the Appellate Tribunal had found that the payments were not for the purpose of the business and that taking into account the nature of the accounts, the nature of the payments and the relationship between the parties, it could not be said that the amounts were wholly and exclusively laid out for the purpose of the business and therefore rejected the claim. In the statement- of the case the Tribunal has said that the average amount which had been advanced by the trust to the appellant in the first year was Rs. 18,100 and the payments made to the trust in the two years were therefore a share of profits and not expenditure laid out wholly and exclusively for the purposes of the business.

The High Court approached the question from the same angle. It was of the opinion that the question should be determined on principles of ordinary commercial trading and because the Managing Trustee was in a dominating position and only a small sum of money i.e., Rs. 18,100 on an average had been advanced, the payment of Rs. 72,963 in addition to interest was an absurdly large sum which with the interest paid work-ed) out at about 400% interest. The High Court also took into consideration the fact that the appellant was an employee of Lala Karam Chand or his company. Put in their own words the High Court observed "having regard to the relationship between the parties and having examined the clauses of the agreement of the 25th February, 1946, between the assessee and the board of trustees I am of the opinion that the real legal position in this case is that there is a joint adventure between the parties, a quasi partnership

which falls something short of partnership and that the arrangement between the parties was that the amount of profits should be ascertained and then they shall divide it up in certain specified proportions".

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The payments, therefore, did not fall within s. 10(2) (xv). The question was therefore answered in the negative and against the assessee. The appellant has come in appeal to this Court by special leave.

As far as the record goes at the relevant time the appellant was a person of comparatively small means. No doubt he was getting a salary of Rs. 10,572 a year and had about Rs. 500 from his share holdings but beyond that he does not seem to have had any other means. There is nothing to show on the record that he had any security to offer or did offer for the money that he was borrowing. Thus the trust was lending monies to the extent of Rs. 11/2 lakhs without security and upon a venture which might or might not have been successful. The Tribunal and the High Court seem to have fallen into an error by taking a mean of the advances made by the Trust to the appellant during the first accounting year. The record shows that the advances were very considerable in the first year ranging from Rs. 12,000 in January 1946 to Rs. 1,86,000 in July of that year and in the following months of that year they ranged from Rs. 59,000 to Rs. 7,000. In the following years beginning from the end of 1946 to 1953 considerable sums of money had been advanced which ranged on an average from Rs. 1,97,000 in 1947 to Rs. 3,17,000 in 1953. In regard to 1947, the Tribunal has found that the average amount of loan was Rs. 1,20,317 but according to the figures supplied by the appellant in his petition for special leave to appeal to this Court, the average comes to Rs. 1,97,919. In any case very considerable sums of money had been advanced by the Trust and as we have said above to a person who was not a businessman, who neither gave nor is shown to have been able to give any security. The agreement between the appellant and the trust has to be considered in the context of those circumstances and if taking all the surrounding circumstances into consideration the trust found it necessary to have control over the working and over the finances and had offered stringent conditions it is not a matter which can be considered to be abnormal.

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Another matter which was taken into consideration by the Tribunal was that the amounts claimed as deductible items were shown as a share of profits of the trust which had been debited in the appellant's profit and loss appropriation account or in other words the appellant as per his accounts admitted that it was an appropriation of the profits to the trust. The Tribunal thus was of the opinion that the interest to be received by the Trust was 11/16 part of the profits of the appellant's business and that the method of accounting clearly showed that the appellant was only parting with the share of profits. This, in our opinion, is an erroneous approach to the question. The case has to be decided according to the tenor of the document as it stands and the circumstances of the case. The genuineness of the document has not been challenged though an effort was made by the Revenue to so construe the document and so read the facts as to make both the amounts liable to tax in the hands of the appellant.

As to what is a deductible expense has to be viewed in the circumstances of each case. In Commissioner of Income-tax v. Chandulal Keshavlal (1) this Court observed that in

deciding whether a payment of money is a deductible expenditure, one has to take into consideration the question of commercial expediency and the principles of ordinary commercial trading. If the payment or expenditure is incurred for the purpose of the trade of the assessee it does not matter that the payment may enure for the benefit of a third party. Another test laid down in that case was whether the transaction is properly entered into as a part of the assessee's legitimate commercial undertaking in order to facilitate the carrying out of its business and it is immaterial that a third party also benefits thereby. Thus in cases like the present one, in order to justify the deduction the sum given up must be for reasons of commercial expediency. It may be voluntary but so long as it is incurred for the assessee's benefit e.g. the carrying on of his business, the deduction would be claimable. In Commissioner of Income-tax,

(1) [1960] 38 I.T.R. 601

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Bombay v. Jaggannath Kissonlal (1) the assessee executed a promissory note jointly with another person in order to raise the money for himself and for the other. The other person became insolvent and the assessee had to. pay the whole amount and claimed that amount as an allowable deduction under s. 10(2)(xv) and it was found that it was a practice in the Bombay market to borrow money on such promissory notes and there was an element of mutuality in the transaction. The loss sustained by the assessee was allowed as a deductible item on the basis that a commercial practice of financing the business by borrowing money on joint and several liability was established. In another case decided by this Court M/s. Haji Aziz & Abdul Shakoor Bros. v. The Commissioner of Income-tax (2) it was held that the expenses which are permitted as deductible are such as are made for the purpose of carrying on the business i.e. to enable a person to carry on business and earn profits in that business and the disbursements must be such which are for the purpose of earning the profits of the business. See also Strong and Company of Romsey Ltd. v. Woodifield (3). These cases therefore show that if any amount is expended which is commercially expedient and is expended for the purpose of earning profits it is a deductible expenditure.

In support of their opinion the High Court relied upon the cases hereinafter mentioned but in our opinion they do not apply to the facts and circumstances of this case. The first case referred to is Pondicherry Railway Company v. Commissioner of Income-Tax, Madras (4). In that case the assessee company, incorporated in the United Kingdom, obtained a concession of constructing a railway in the territories of Pondicherry. The assessee company was to pay to the French Government 1/2 of its net profits. The French Government on its part gave land on which the railway was to be built free of charge and also agreed to pay a subsidy. The question for decision in that case was whether the monies paid by the

(1) [1961] 2 S.C.R. 644.
(3) (1906) 5 T.C. 215.
(2) [1961] 2 S.C.R. 651.
(4) [1931] L.R. 58 I.A. 239.

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assessee company to the French Government i.e., of its net profits were allowable as a deduction under the provisions corresponding to s. 10(2)(xv). Lord Macmillan observed at p. 251:-

"A payment out of profits and conditions 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."

But these observations have been later on explained in other cases to which reference will be made presently. In Union Cold Storage Co. Ltd. v. Adamson (1) the assessee leased lands and premises abroad reserving a rent of pound 9,60,000. It was also provided in the deed that if at the end of the financial year it was found that after providing for this rent the result of the company's operations was insufficient to pay interest on charger, and debentures etc., the rent for the year was to be abated to the extent of the deficiency. In computing its profits the assessee company claimed the sums of rent paid in two respective years. They were held not payable out of the profits or. gains and were allowable deductions. At page 318 Rowlatt J. said that the sum which was to be paid by the company was a recompense in respect of possession and use of the premises abroad and the company had entered into some liabilities by way of payment for their premises and that payment was an outgoing of the business which was to be provided for and allowed before profits of the business could be ascertained. In the House of Lords Lord Macmillan distinguished the Pondicherry case,(1) by saying that in that case the ascertainment of profits preceded the coming into operation of the obligation to pay and when profits had been ascertained the obligation was to make over thereof to the French Government. Dealing with the passage above referred to Lord Macmillan said at p. 331:-

> "I was dealing with a case in which the obligation was, first of all, to ascertain the profits in a

(1) [1931] 16 T.C. 293.
(2) (1931) L.R. 8 I.A. 239.
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> prescribed manner, after providing for all outlays incurred in earning them, and then to divide them. Here the question is whether or not a deduction for rent has to be made in ascertaining the profits, and, the question is not one of the distribution of profits at all."

In Tata Hydro-Electric Agencies Limited, Bombay v. The Commissioner of Income-tax, Bombay Presidency (1) the Tata Power Co. entered into an agency agreement with Tatasons Ltd. agreeing to pay to Tatasons Ltd. a commission of 10% on the annual net profits of Tata Power Co., subject to a minimum whether any profits were made or not. Later on two persons D and S advanced funds to Tata Power Company on the condition that in addition to the interest payable to them by Tata Power Company they should each receive from Tatasons Ltd., 12 1.2% of the commission earned by Tatasons Ltd. Tatasons Ltd. assigned their entire right to the assessee company and the Tata Power Company entered into a new agency agreement with the assessee company and the assessee company received a commission and out of that paid 1/4 to D and S. Relying on Pondicherry Railway case (2) the Bombay High Court held that that was not an allowable deduction as expenditure incurred solely for earning profits. On appeal the Privy Council held that Pondicherry case did not govern the case. The nature of the transaction was held to be this

that the obligation to make the payments was undertaken by the assessee company in consideration of its acquisition of the right to property to earn profits i.e. of the right to conduct the business and not for the purpose of producing profits in the conduct of the business. Dealing with Pondicherry Railway case (2) Lord Macmillan said:-

> "In the Pondicherry case the assessees were under obligation to make over a share of their profits to the French Government. Profits had first to be earned and ascertained before any sharing took place. Here the obligation of the appellants to pay

(1) [1937] L. R. 64 I.A. 215.
(2) (1931) L.R. 58 I.A. 239.
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> a quarter of the commission which they receive from the Tata Power Co. Ltd. to F. E. Dinshaw Ltd., and Richard. Tilden Smith's administrators is quite independent of whether the appellants make any profits or not."
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> and at page 225 Lord Macmillan said:-
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> "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."

At page 226 the Privy Council accepted the following test laid down by Lord President in Robert Addie & Sons' Collieries, Ltd. v. Commissioners of Inland Revenue (1) where it is observed:-

> "What is 'money wholly and exclusively laid out for the purposes of the trade' is a question which must be determined upon the principles of ordinary commercial trading. It is necessary, accordingly, to attend to the true nature of the expenditure, and to ask oneself the question, Is it a part of the Company's working expenses; is it expenditure laid out as part of the process of profit earning".

In Commissioner of Income-tax, Bombay Presidency v. Tata Sons Ltd. (2) the company received a commission on the basis of profits. The managed company was in urgent need of money and the assessee company found a financier a Mr. Dinshaw and an agreement was entered into with the managed company and Mr. Dinshaw by which the latter agreed to lend a crore of rupees on the condition that the assessee company assigned to him a share in the commission which the assessee company might receive from the managed company. That was held to be an agreement on the part of the assessee company to share their commission with Mr. Dinshaw and it was a part of the arrangement on which the assessee company obtained finance and therefore the payment to Mr. Dinshaw was an expenditure solely for the purpose of earning profits or gains and it was not of a capital nature. At

(1) (1924) S.C. 231.
(2) (1939) 7 I.T.R. 195.
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page 203 Beaumont C.J. said that the question whether the payment of a part of the 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 on a commercial basis.

In The Indian Radio and Cable Communications Company Ltd. v. The Commissioner of Income-tax, Bombay (1) it was observed that it was 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. Lord Maugham in explaining the judgment in the Pondicherry Railway case (2) said at page 278:-

> " To avoid misconception it is proper to say that in coming to this conclusion they have not taken the view that the case is governed by the decision in Pondicherry Railway Co. Ltd. v. Commissioner of Income-tax, Madras, though that case no doubt shows light on the nature of the problem which has to be solved in the present case. It should perhaps be added that a sentence in the judgment in that case has been explained, if explanation was necessary, by Lord Macmillan in the subsequent case of W. H. E. Adamson v. Union Cold Storage Company."

As to when a deduction is claimable and when it is not, it was said at page 277 that if a company had made an apparent net profit and then had to pay to a director as a contractual recompense, the net profit would be the difference between the two but if there was a contract to pay a commission on the net profits of the year it must necessarily be held to mean as net profits before the deduction of the commission.

In British Sugar Manufacturers Ltd. v. Harris (3) the assessee company agreed to pay two other companies a certain percentage of its annual profits after deduction of expenses and debenture interest in consideration of their giving to the assessee company the full benefit of their technical and financial knowledge

(1) [1937] 5 I.T. R. 270. (2) [1931] L.R. 58 I.A. 239.
(3) [1937] 21 T.C. 528
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and experience. Certain payments were made in pursuance of that agreement and it was held that payments under the agreement were permissible deductions in computing the assessee company's profits. Dealing with the Pondicherry Railway case, (1) at page 548, the learned Master of the Rolls said:-

> " It is to be observed that Lord Macmillan in that paragraph was quite clearly using the word I profit' in one sense and one sense only; he was using it' in the sense of the I real net profit' to which Lord Maugham referred. That he was doing that is, I think, abundantly clear when the nature of the contract there in question is considered, 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 has said in a subsequent case Union Cold Storage Co. Ltd. v. Adamson (2 ) at pp. 331-2, in relation to the particular subject matter with which he was dealing."

As has been said above the question to be considered in this case is governed by the observations of this Court in Commissioner of Income-tax v. Chandulal Keshavlal & Co. (3) and the circumstances under which the trust agreed to lend the appellant such a large sum of money shows the true nature of the transaction. On the facts proved in the present case the Trust agreed to finance the business of the appellant on the terms set out in the agreement and there is nothing to show that he could have made any better arrangements or would not have lost the contract if he had failed to enter into the agreement i.e. the agreement to pay the amounts in dispute. Therefore in a commercial sense the payments were an expenditure wholly and exclusively laid out for the purpose of the business.

In our opinion, therefore, the High Court was in error and the question referred should have been

(1) [1931] L.R. 58 I.A. 239. (2) (1931) 16 T.C. 293, 331-32.

(3) [1960] 38 I.T.R. 601.

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answered in the affirmative in favour of the appellant. The appeals are, therefore, allowed and the judgments, and orders of the High Court are set aside. The appellant will have his costs in this Court and in the High Court. One hearing fee.

Appeals allowed.