
**Commissioner of Income Tax, Kerala Vs The Travancore Sugars and
Chemicals Ltd.**

Income Tax Reference Case No. 16 of 1962 and Civil Appeal No. 324/65

Court: High Court Of Kerala

Date of Decision: April 5, 1968

Acts Referred:

Income Tax Act, 1961 " Section 10, 10(1), 10(2)(xv), 10(4A), 12(2)#Partnership Act, 1932 " Section 29

Citation: (1968) KLJ 499

Hon'ble Judges: T.C. Raghavan, J; M.U. Isaac, J; K.K. Mathew, J

Bench: Full Bench

Advocate: C.T. Peter, for the Appellant; C.M. Devan, S. Padmanabhan, for the Respondent

Final Decision: Allowed

Judgement

By Court after the expression of opinion by the third Judge Present: K.K. Mathew J.

1. In conformity with the majority opinion, we answer the question referred, in the affirmative in favor of the assessee. We also direct both parties

to bear their respective costs. A copy of this order will be sent to the income tax Appellate Tribunal as required by law.

Raghavan J: This reference came before a Division Bench of this Court (M. S. Menon C.J. and Madhavan Nair J.) in August 1963; and this Court

answered the question referred

Whether on the facts and in the circumstances of the case, the payment of Rs.42.480/ by the assessee to the Travancore Government under the

agreements dated 18-6-1937 and 28-1-1947 was allowable u/s 10 of the Income tax Act

in the negative against the assessee-company. The company took up the matter before the Supreme Court; and the Supreme Court allowed the

appeal. This Court, relying mainly on the preamble to the agreement between the company and the Government of Travancore which contained an

expression that the payment was ""also in consideration"", held that the expenditure was not of a revenue nature, but of a capital nature, in other

words, towards the unpaid portion of the purchase price. In view of that, this Court did not consider the other contention raised by the Revenue

that the agreement showed only a payment by way of division of earned profits of a common venture between the company and the Government.

The Supreme Court held that the payment was not in the nature of a capital payment, but was in the nature of a revenue payment. Still, the

Supreme Court observed that since the other questions, one, whether the company was right in the contention that the payment was tantamount to

a diversion of profits by paramount title, two, whether the contention of the Revenue that the transaction should be treated as a joint venture with

an agreement to share profits was right, and three, whether section 10 (2)(xv) of the income tax Act of 1922 applied to the payment, were not

decided by this Court, the Supreme Court could not give an answer to the question referred. For considering those questions, and answering the

question referred, the Supreme Court has remanded the case. The judgment of the Supreme Court is reported in Travancore Sugars and

Chemicals Ltd. Vs. Commissioner of Income Tax, Kerala, , The case comes up before us for fresh consideration on the lines pointed out by the

Supreme Court.

Though it appears that the Revenue contended both before this Court and before the Supreme Court that the payment would be a division of

earned profits of a common venture between the company and the Government, the counsel of the Revenue submits before us that the Revenue

has no such case and that the said question need not be considered. I therefore proceed to consider only questions 1 and 3 pointed out by the

Supreme Court, namely, whether the company is right in its contention that the payment was in effect a diversion of profits by paramount title, and

whether section 10 (2) (xv) of the income tax Act applies to the payment.

The assessee is a limited company carrying on business of manufacturing sugar, running a distillery and running a tincture factory. The company

purchased three concerns from the Government of Travancore, one, the Travancore Sugars Ltd., two, the Government Distillery at Nagercoil, and

three, the Government Tincture Factory at Trivandrum. The original document of purchase was on 18th June 1937. clause 7 of which relating to

the payment before us, runs:

(7) The Government shall be entitled to twenty percent of the net profits earned by the company in every year subject however to a maximum of

rupees forty thousand per annum, such net profits for the purposes of this clause to be ascertained by deduction of expenditure from gross income

and also after-

(i) provision has been made for depreciation at not less than the rates of allowance provided for in the income tax law for the time being in force,

and

(ii) payment of the secretaries and treasurers' remuneration.

This clause was substituted by another agreement dated 28th January 1947; and the substituted clause reads:

The Government shall be entitled to ten per centum of the net profits of the company in every year. For the purpose of this clause net profits means

the amount for which the company's audited profits in any year are assessed to income tax in the State of Travancore.

For the assessment year 1958-59 the amount payable under this clause to the Government came to Rs.42,480/-; and the nature of this payment is

the question at issue before us. The Appellate Assistant Commissioner held, relying on *Pondicherry Railway Co. Ltd. v Commissioner of income*

tax (1931) 3 I. T. C. 363, that the amount was not an allowable deduction., while the income tax Appellate Tribunal held, relying on *BRITISH*

SUGAR MANUFACTURERS, LTD. Vs. HARRIS (INSPECTOR OF TAXES)., that the expenditure was made in order to earn profits and

hence an allowable deduction.

This Court held that since the preamble to the agreement of January 1947 mentioned that the payment was "also in consideration", it was "part of

the purchase price", in other words, it was "for the purpose of acquiring" the concerns. If it was part of the purchase price or for acquiring the

concerns, naturally it was a payment in the nature of a capital payment: and that was what this Court held. The Supreme Court reversed that

decision. Ramaswami J., who spoke for the Court, observed at pages 570-571 of the reports

It is often difficult, in any particular case, to decide and determine whether a particular expenditure is in the nature of capital expenditure or in the

nature of revenue expenditure. It is not easy to distinguish whether an agreement is for the payment of price stipulated in installments or for making

annual payments in the nature of income. The court has to look not only into the documents but also at the surrounding circumstances so as to

arrive at a decision as to what was the real nature of the transaction from the commercial point of view. No single test of universal application can

be discovered for a solution of the question. The name which the parties may give to the transaction which is the source of the receipt and the

characterization of the receipt by them are of little consequence. The court has to ascertain the true nature and character of the transaction from the

covenants of the agreement tested in the light of surrounding circumstances.

His Lordship then examined the transaction in the light of the aforesaid principles. Under the agreement of 1937 the cash consideration fixed for the

assets of the Travancore Sugars was 3.25 lakhs of rupees; the cash consideration for the Government Distillery was to be fixed by joint valuation

by the engineers to be appointed by the parties; and the cash consideration for the assets of the Government Tincture Factory was to be the value

according to the books. Thus, the cash part of the consideration for the three concerns was ascertained or was at least ascertainable. It was over

and above these cash payments that the annual payments contemplated by clause 7 had to be made. Considering this aspect, Ramaswami J.

observed again at page 571

With regard to the second part of the consideration there are three important points to be noticed. In the first place, the payment of commission of

twenty per cent on the net profits by the appellant in favor of the Government is for an indefinite period and has no limitation of time attached to it.

In the second place, the payment of the commission is related to the annual profits which flow from the trading activities of the appellant-company

and the payment has no relation to the capital value of the assets. In the third place, the annual payment of 30 per cent commission every year is

not related to or tied up, in any way, to any fixed sum agreed between the parties as part of the purchase price of the three undertakings. There is

no reference to any capital sum in this part of the agreement. On the contrary, the very nature of the payments excludes the idea that any

connection with the capital sum was intended by the parties. It is true that the purchaser may buy a running concern and fix a certain price and the

price may be payable in a lump sum or may be payable by installments. The mere fact that the capital sum is payable by installments spread over a

certain length of time will not convert the nature of that payment from capital expenditure into a revenue expenditure, but the payment of

installments in such a case would always have some relationship to the actual price fixed for the sale of the particular undertaking. As we have

already mentioned, there, is no specific sum fixed in the present case as an additional amount of price payable in addition to the cash consideration

and payable by installments or by any particular method.

These were the considerations which weighed with the Supreme Court in holding that the annual payments under clause 7 were not in the nature of

capital expenditure, but were only in the nature of revenue expenditure. For this conclusion the Supreme Court relied on a decision of the Court of

Appeal in Commissioners of Inland Revenue v 36/49 Holdings Ltd., (in liquidation) (1943) 25 Tax Cas.173; and the Supreme Court also referred

with approval to the decision of the Bombay High Court in The Commissioner of Income Tax Vs. The Kolhia Hirdagarh Co., Ltd., .

From the above reasoning of the Supreme Court what appears is that, in its opinion, the payment was not towards purchase price, because the

unpaid purchase price was neither a fixed sum nor an amount which could be ascertained by any method. In other words, if the unpaid purchase

price was a fixed amount and that fixed or ascertained amount was to be paid in installments, the payments would be towards unpaid purchase

price and consequently capital payments: or even if the unpaid purchase price was not a fixed figure, still, if the installments were to continue for a

definite term, then also the payments would be towards unpaid purchase price, because the unpaid purchase price in such a case was

ascertainable. If, on the other hand, the payments bore no proportion to the unpaid purchase price, if the payments were based on a proportion of

the income and were to continue for an indefinite period-for all time as in this case, then the payments were not towards the unpaid purchase price

and hence not capital payments: and in such a case, the payments could only be revenue payments. "

Now about the question whether the payment concerned was in effect a diversion of profits by paramount title of the Government. The decisions

relied upon by the company before the Supreme Court were the decision of the Privy Council in *Raja Bejoy Singh Dudhuria v Commissioner of*

income tax (1933) 1 ITR 135 and the decision of the Supreme Court in *Poona Electric Supply Co. Ltd. v Commissioner of income tax* (1966) 57

ITR 521. The same decisions have been cited before us; and a few other decisions have also been cited. The counsel of the Revenue relies mainly

on the decision of the Privy Council in *Pondicherry Railway Co.*'s case and a few other decisions. All the decisions cited before us were

considered by Subba Rao J. who spoke for the Court in the decision of the Supreme Court already referred to, namely, *Poona Electric Supply*

Co. Ltd., v Commissioner of income tax, excepting *The Commissioner of Income Tax, Bombay City II Vs. Shri Sitaldas Tirathdas*, and

Fatehchand Murlidhar and Another Vs. Commissioner of Income Tax, Calcutta, . Therefore, I proceed to consider mainly the said decision of the

Supreme Court and its applicability to the present case; and I shall also consider the two other decisions of the Supreme Court not considered by

Subba Rao J.

In the first case the *Poona Electric Supply Co. Ltd.* carried on the business of distribution of electricity under a license issued by the Government.

Under the *Electricity (Supply) Act of 1948* the company's "clear profit" in any year should not exceed "reasonable return" as defined under the

Act; and the excess, if any, the company had to distribute among its consumers in the form of rebate. The company claimed deduction of amounts

said to have been credited on this score to the "Consumers" Benefit Reserve Account"; and the question before the Supreme Court was whether

those amounts were allowable deductions. Subba Rao J. observed at page 525 of the reports

Under section 10(1) of the income tax Act, tax shall be payable by an assessee under the head "profits and gains of business" in respect of profits

and gains of any business carried on by him. The said profits and gains are not profits regulated by any statute, but profits in a business computed

on business principles. They are business profits and not statutory profits. They are real profits and not notional profits. The real profit of a business

man u/s 10(1) of the income tax, Act cannot obviously include the amounts returned by him by way of rebate to the consumers under statutory

compulsion. It is as if he received only from the consumers the original amount minus the amount he returned to them.

The learned Judge then considered the several decisions cited before the Supreme Court and ultimately summarized the conclusions thus at page

530:

income tax is a tax on the real income, i.e., the profits arrived at on commercial principles subject to the provisions of the income tax Act. The real

profit can be ascertained only by making the permissible deductions. There is a clear-cut distinction between deductions made for ascertaining the

profits and distributions made out of profits. In a given case whether the outgoings fall in one or the other of the heads is a question of fact to be

found on the relevant circumstances, having regard to business principles. Another distinction that shall be borne in mind is that between the real

and the statutory profits, i.e. between the commercial profits and statutory profits. The latter are statutorily fixed for a specified purpose.

The same principle was laid down by the Supreme Court in Commissioner of income tax v Sitaldas Tirathdas. In that case Sitaldas Tirathdas, the

assessee had to pay under a consent decree a certain amount every year to his wife and children by way of separate maintenance. He claimed that

amount as a deduction, and relied on the decision of the Privy Council in Raja Bejoy Singh Dudhuria's case already referred to. There, the step-

mother of the Raja had brought a suit for maintenance and a compromise decree was passed for Rs. 1,100/- per month to her. The Judicial

Committee held.

In the present case the decree of the court by charging the appellant's whole resource with a specific payment to his step-mother has to that extent

diverted his income from him and has directed it to his step-mother: to that extent what he receives for her is not his income. It is not a case of the

application by the appellant of part of his income in a particular way, it is rather the allocation of a sum out of his revenue before it becomes income

in his hands.

The Supreme Court held that this observation of the Privy Council did not apply to the case before it. At pages 374-375 Hidayatullah J. observed:

In our opinion, the true test is whether the amount sought to be deducted, in truth, never reached the assessee as his, income. Obligations, no

doubt, there are in every case, but it is the nature of the obligation which is the decisive fact. There is a difference between an amount which a

person is obliged to apply out of his income and an amount which by the nature of the obligation cannot be said to be a part of the income of the

assessee. Where by the obligation income is diverted before it reaches the assessee, it is deductible; but where the income is required to be applied

to discharge an obligation after such income reaches the assessee, the same consequence, in law, does not follow.

Thus, in the opinion of the Supreme Court, the maintenance payment made by Sitaldas Tirathdas to his wife and children was an obligation he had

to discharge from out of his income, while the maintenance paid by Raja Bejoy Singh Dudhuria to his step-mother was a diversion of income out of

his revenue before it became in his hands. The principle is the same as the one laid down by Subba Rao J. in Poona Electric Supply Co.'s case.

Now about the other decision of the Supreme Court in Murlidhar Himatsingka's case. M.H. was a partner in firm A and he entered into a sub-

partnership, firm B, with his sons and grandson, under which his share of the profit and loss in firm A were to belong to firm B. The question arose

whether the share of profit of M.H. in firm A had to be assessed in his individual name or to be included in the assessment of firm B; and the

Supreme Court held that by an overriding obligation, the sub-partnership agreement, the profit became the income of firm B, though it passed

through the hands of M.H. This again confirmed the principle that "it is the nature of the obligation which is the decisive fact.

In, the light of the above principles laid down by the Supreme Court, when I consider the facts of the case before us, what emerges is this. The

amount payable to the Government under the agreement can in no sense be called profits of the company computed on business principles. No

business-man will include this amount as part of the real profits or commercial profits of the company on business principles. What has been

characterized as "statutory profits" by Subba Rao J. applies to the amount before us, which really forms part of the "contractual profits", if I may

use that expression: in the case before the Supreme Court it was regulated by the Electricity (Supply) Act, while in the case before us it is being

controlled or regulated by the contract between the company and the Government. This amount really belonged to the Government, but was

collected by the company to be paid over to the Government. Again, what was the nature of the obligation of the company under which it paid this

amount to the Government? If the payment were towards unpaid purchase price, it was an obligation which the company was bound to discharge

from its moneys. The Supreme Court held that the payment was not towards purchase price. Under the agreement between the Government and

the company the latter was bound to pay it: obviously, by this contractual obligation a part of the income of the concerns was diverted to the

Government before it became income in the hands of the company: therefore, it was a deduction by superior title, as it were, of the Government.

The counsel of the Revenue relies mainly on the following passage from the decision of Lord Macmillan in Pondicherry Railway Co.'s 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 profits on their coming into existence attract tax at that point, and the revenue is not concerned with the

subsequent application of the profits.

This passage was considered by Subba Rao J., and his Lordship also pointed out that Lord Macmillan himself explained this observation in the

later decision in Union Cold Storage Co. Ltd. v Adamson (1931) 16 Tax Cas. 293. Therefore, this case cannot be pressed into service in support

of the contention of the Revenue that this amount formed part of the real profits of the company.

In this view the other question, namely, whether section 10(2) (xv) applies, does not arise. Still, since the Supreme Court has directed us to

consider that question as well, I proceed to consider the same. Even assuming that the amount forms part of the real or commercial profits of the

company, will it be an allowable deduction u/s 10(2) (xv)- as an amount expended or laid out for earning profits ? Under the contract between the

company and the Government, the amount is to be paid to the Government if the company works the concerns and earns profit. At this stage I

may remind that the Revenue has no case that the working of the concerns is a joint venture between the company and the Government with an

agreement to share profits. It is a venture of the company alone; and the question is whether the company has to pay this amount out of its real

profits or whether the payment is essential to make or earn its real profits. If, under the agreement between the company and the Government, the

company cannot work the concerns and earn profits without paying the amount to the Government, I do not know how it is not an expenditure

incurred or laid out for the purpose of the company's business in order to earn profits-for working the concerns and earning profits. Looking at the

question in this way (and, in my opinion, this is the only way how the question can be looked at), I feel that the amount is an allowable deduction

u/s 10(2) (xv) of the income tax Act as well.

The decisions relied upon by the company before the Supreme Court on this question were THE INDIAN RADIO AND CABLE COMMUNICATIONS COMPANY, LTD. Vs. THE COMMISSIONER OF INCOME TAX, BOMBAY PRESIDENCY and ADEN., and BRITISH SUGAR MANUFACTURERS, LTD. Vs. HARRIS (INSPECTOR OF TAXES)., ; and the decision cited by the Revenue before the

Supreme Court was again Pondicherry Railway Co.'s case. These three decisions were considered by Subba Rao J. in Poona Electric Supply

Co.'s case already referred to, though the Supreme Court did not consider the question of application of Section 10(2) (xv) in that case. The

passage strongly relied upon by the counsel of the Revenue in Pondicherry Railway Co.'s case is the one already extracted by me; and Subba Rao

J. considered the same. His Lordship observed at page 526:

The distinction between a payment out of profits and a payment to earn profits is unexceptionable. The difficulty is to ascertain in each case

whether a particular payment falls under one or other of the two categories.

Then His Lordship considered Indian Radio and Cable Communication Co. Ltd. v Commissioner of income tax and pointed out that it was not

universally, true 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; the typical exception was that of a payment to a director or a manager of a commission on the

profits of a company. The payment with which I am concerned in this reference is also one of that type- a payment to earn profits; and hence it

becomes allowable u/s 10(2) (xv).

I may advert to one more argument of the counsel of the Revenue before I close. The counsel argues that one sentence from clause 7 of the

agreement of 1947 shows that the payment is out of the real profits of the company. The sentence is

For the purpose of this clause net profits means the amount for which the Company's audited profits in any year are assessed to income tax in the

State of Travancore.

(The underlining is mine).

The counsel lays stress on the word "assessed". He argues that the real or commercial profits of the company alone are assessed; and it is only

after such assessment that a part of the profits are to be paid to the Government. I do not agree. As I have already stated, the real profits of the

company cannot include this amount. What the sentence extracted above shows is only that for the purpose of fixing the share of the Government

the net profits have to be taken as the assessable income of the company; and the real profits of the company are what remain after the payment of

the 10 per cent due to the Government. In this connection, I would only extract the passage.

Once you realize that as a matter of construction the word "profits" may be used in one sense for one purpose and in another sense for another

purpose, I think you have the real solution of the difficulties that have arisen in this case.

from the judgment of Greene M.R. in *British Sugar Manufacturers Ltd. v Harris* already referred to. Subba Rao J. considered this passage and also

another passage from the same judgment of the Master of the Rolls which said that there were "two funds of so-called profits" which came into the

picture, the first one, the fund which had to be ascertained for calculating the amount payable, which, once that amount had been ascertained,

ceased to have any further usefulness, and the other, the one necessary to ascertain the divisible profits, for which purpose it was necessary to take

another account, which would also take into account the sum that had been paid (vide page 528 of *Poona Electric Supply Co.'s case*). All this

applies to the present case: the audited profits assessed to income tax mentioned in clause 7 is the first fund; and that amount less the amount paid

to the Government is the second fund. Therefore, I reject this contention as well.

For the foregoing reasons, I answer the question in the affirmative in favor of the assessee.

Isaac, J. I regret I am unable to agree with the Judgment of my learned brother. I shall briefly state the facts of the case, and the reasons which

persuaded me to differ from him.

This reference has been made by the income tax Appellate Tribunal, Madras Bench, u/s 66(1) of the Indian income tax Act, 1922 (hereinafter

referred to as the Act) on the application of the Commissioner of income tax, Kerala. The question of law referred for the opinion of this court is:

Whether on the facts and in the circumstances of the case, the payment of Rs. 42,480/- by the assessee to the Travancore Government under the

agreements dated 18-6-1937 and 28-1-1947 was allowable u/s 10 of the income tax Act?

This question was answered in the negative and in favor of the Commissioner by a Division Bench of this Court by its judgment dated 20th August,

1963. But, in Civil Appeal No. 324 of 1965, it was set aside by the Supreme Court by judgment dated 20th September 1966; and the case was

remanded for being re-heard and dealt with by this court in accordance with the directions given in the said judgment. Accordingly, the case has

come before us. The reference arose out of the order of the Appellate Tribunal in I.T.A. No.10000 of 1959-60 dated the 18th February, 1961;

and it relates to the assessment year 1958-59. The assessee is the Travancore Sugars and Chemicals Ltd. There was another company

incorporated in Travancore called ""Travancore Sugars Ltd."" , in which the Government of Travancore held the largest number of shares. Steps

were taken to wind up that Company; and an agreement was entered into between Travancore Government and Messrs. Parry & Co., Ltd.,

Madras on the 18th day of June, 1937, by which it was agreed that M/s Parry & Co., Ltd., shall float another Company, the object of which

would be, among other things, to purchase the entire assets of the Travancore Sugars Ltd., as well as the Government Distillery at Nagercoil, and

the Government Tincture Factory at Trivandrum, and that the Government shall sell to this new company to be floated their entire assets in the

above three concerns for a cash consideration in respect of the assets of each concern and subject to the terms and conditions contained in the

said agreement. The agreement provided that the cash consideration for the sale of the assets in Travancore Sugars Ltd. would be Rs. 3.25 lakhs,

and that the cash consideration for the sale of the assets in the other concerns would be the amount arrived at in the manner stated therein. Clauses

6 and 7 of the agreement are important for the purpose of this case, and they read as follows:

6. ""The Company shall maintain separate books of account in respect of the sugar business, Distillery and Tincture Factory and such books of

account and all connected documents shall be open to inspection by the officers of Government authorized in that behalf.

7. The Government shall be entitled to twenty per cent of the net profits earned by the Company in every year subject however to a maximum of

Rupees forty thousand per annum, such net profits for the purposes of this clause to be ascertained by deduction of expenditure from gross income

and also after;-

(i) provision has been made for depreciation at not less than the rates of allowances provided for in the income tax law for the time being in force,

and

(ii) payment of the Secretaries & Treasurers ""remuneration

2. The above agreement was implemented by the parties, as a result of which the assessee-company was floated, and the assets of the Travancore

State in the three concerns mentioned therein were purchased by the assessee. On the 28th day of January, 1947, the assessee and the State of

Travancore entered into another agreement by which it was agreed that the terms of the agreement dated 18th June 1937 would be continued as

from 1st August, 1945, except that clause 7 thereof shall be deleted and the following be substituted therefore.

The Government shall be entitled to ten per centum of the net profits of the Company in every year. For the purpose of this clause net profits

means the amount for which the Company's audited profits in any year are assessed to income tax in the State of Travancore.

3. In the previous year ending 30-4-1957, relevant for the assessment year 1958-59, the assessee paid pursuant to clause 7 of the agreement a

sum of Rs.42,480/- to the State of Kerala, who is the successor of the State of Travancore. In the computation of income for the assessment year,

the assessee did not claim this amount as an allowance. But, in the course of the hearing before the Appellate Assistant Commissioner, the

assessee filed an additional ground, claiming the said amount as an expenditure u/s 10 (2) (xv) of the Act. He allowed the ground to be raised but

rejected the claim. The assessee filed an appeal before the Appellate Tribunal, which held that the payment made to the Government is

expenditure made in order to earn the profits of the business and not expenditure out of earned profits".

4. This Court, in its judgment dated 20th August, 1963, extracted the following part of the preamble to the agreement executed between the

assessee and the State of Travancore on 28th January, 1947:-

WHEREAS on the 18th June 1937, an agreement (hereinafter called "the principal agreement") was entered into between M.R. Rv. Rao Bahadur

Rajyasevanirata N. Kunjan Pillai Avl., Chief Secretary to Government acting for and on behalf of the said Government of His Highness the

Maharaja of Travancore of the one part and Sir William Wright, K.t., C.B.E., of Messrs. Parry & Co. Ltd., Madras, acting for and on behalf of

the said Messrs. Parry & Co. Ltd., of the other part, whereby the said Government should sell and the company should purchase the assets

including the lands of the Travancore Sugars Ltd., with the buildings, outhouses, machinery and other things attached thereto and more particularly

described in the Schedule "A" annexed to the said principal agreement, the factory known as the Government Distilleries situate at Nagercoilin

South Travancore with lands, buildings, machinery and other things attached thereto and more particularly described in the schedule "B" annexed

to the principal agreement, and all the assets of the factory known as the Government Tincture Factory situated at Trivandrum and more

particularly described in the schedule "C" annexed to the principal agreement for the cash consideration in the said principal agreement mentioned

and also in consideration inter alia that the said Government should be entitled to 20% (Twenty per cent) of the net profits earned by the Company

in every year subject however to a maximum of Rs. 40,000/- per annum, such net profits for purposes of the said agreement to be ascertained

after the deductions set out in clause 7 of the said agreement.

And the court said:

It is clear from the above extract that the payment under clause 7 is part of the purchase price; and if such is the case, the amounts paid in

pursuance of that clause will constitute an expenditure not of a revenue but of a capital nature. In other words they were spent not for the purpose

of carrying on the concern but for the purpose of acquiring it,

5. The correctness of both the findings contained in the above judgment, namely, (1) that the payment under clause 7 is part of the purchase price,

and (2) that it will constitute an expenditure not of a revenue but of a capital nature was canvassed before the Supreme Court. Dealing with this

contention the Supreme Court said:

The court has to ascertain the true nature and character of the transaction from the covenants of the agreement tested in the light of surrounding

circumstances. Examining the transaction from this point of view it is clear in the present case that the consideration for the sale of the three

undertakings in favor of the appellant was:

(1) the cash consideration mentioned in the principal agreement, viz., clauses 3, 4(a) and 5(a), and

(2) the consideration that Government shall be entitled to twenty per cent of the net profits earned by the appellant in every year subject to a

maximum of Rs.40,000 per annum.

Then, the court dealt with the second part of the consideration; and it said:

With regard to the second part of consideration there are three important points to be noticed. In the first place, the payment of commission of

twenty per cent on the net profits by the appellant in favor of the Government is for an indefinite period and has no limitation of time attached to it.

In the second place, the payment of the commission is related to the annual profits which flow from the trading activities of the appellant - company

and the payment has no relation to the capital value of the assets. In the third place, the annual payment of 20 percent commission every year is not

related to or tied up, in any way, to any fixed sum agreed between the parties as part of the purchase price of the three undertakings. There is no

reference to any capital sum in this part of the agreement. On the contrary, the very nature of the payments excludes the idea that any connection

with the capital sum was intended by the parties. It is true that the purchaser may buy a running concern and fix a certain price and the price may

be payable in a lump sum or may be payable by installments. The mere fact that the capital sum is payable by installments spread over a certain

length of time, will not convert the nature of that payment from the capital expenditure into a revenue expenditure, but the payment of installments in

such a case would always have some relationship to the actual price fixed for the sale of the particular undertaking. As we have already mentioned,

there is no specific sum fixed in the present case as an additional amount of price payable in addition to the cash consideration and payable by

installments or by any particular method. In view of these facts we are of opinion that the payment of the annual sum of Rs.42,480/- in the present

case is not in the nature of capital expenditure but is in the nature of revenue expenditure and the judgment of the High Court of Kerala on this

point must be over-ruled.

Finally, the Supreme Court held that ""even if the payment of the Commission to the Government by the assessee is not capital but revenue

payment, certain other questions arise for consideration in this case"". Those questions, as formulated in the judgment of the Supreme Court, are the

following:

(1) ""In the first place, it has to be determined whether the appellant is right in his argument that the payment of the commission is tantamount to

diversion of profits by a paramount title;

(2) ""In the second place, the respondent has contended that the transaction should be treated as a joint venture with an agreement to share profits

between the appellant and the Government; and

(3) ""In the third place, the High Court has to examine whether the requirements of S. 10(2) (xv) have been satisfied in this case.

These are the questions which the Supreme Court has directed this court to consider in dealing with this reference afresh. At the hearing before us,

the learned counsel for the Revenue submitted that the income tax Department has no case that the transaction between the assessee and the

Travancore Government is a joint venture, and that the second question formulated by Supreme Court does not arise and need not be considered.

Hence, only the remaining two questions fall for consideration.

6. The question has often arisen before courts, when a person pays a share of the profits of his business to another under an obligation arising

under law or contract, whether the said payment is an application of the profits, or a diversion of the same by over-riding obligation or a paramount

title. In the former case, he received the whole income, and he is taxable thereon. In the latter case, the income which is diverted does not reach

him; it is not his income, and he is not taxable on the income thus diverted. The principle to be applied for determining this question is well- settled;

though its application to the particular facts of a case may not always be easy. The principle is stated by the Supreme Court in The Commissioner

of Income Tax, Bombay City II Vs. Shri Sitaldas Tirathdas, as follows:

There is a difference between an amount which a person is obliged to apply out of his income and an amount which by the nature of the obligation

cannot be said to be a part of the income of the assessee. Where by the obligation income is diverted before it reaches the assessee it is

deductible; but where the income is required to be applied to discharge an obligation after, such income reaches the assessee, the same

consequence, in law, does not follow. It is the first kind of payment which can truly be excused and not the second. The second payment is merely

an obligation to pay another a portion of one's own income, which has been received and is since applied. The first is a case in which the income

never reaches the assessee, who even if he were to collect it, does so, not as part of his income, but for and on behalf of the person to whom it is

payable.

The application of the above principle presents no difficulty to the facts of this case. The assessee has no case, nor is it possible to contend, that the

business is a joint venture of the assessee and the Government. Naturally, the whole profits of the business goes to the assessee. There is nothing in

the agreement to support the contention that the whole profits do not reach the assessee, and that a part of it is diverted and goes to the

Government. On the other hand, clause 7 of the agreement, under which the payment is made states in definite terms that what the Government is

entitled to get is "ten per cent of the net profits of the company in every year" and that, for the purpose of this clause, "net profits" means "the

amount for which the company's audited profits in any year are assessed to income tax in the State of Travancore." This again means that what the

Government gets is a percentage of the "total income" of the assessee on which it is assessed to income tax. In making the payment, the assessee is

only discharging its obligation to satisfy one part of the consideration for the sale of the three undertakings by the State of Travancore to the

assessee, in the manner provided in the agreement. This is, therefore, a very clear case of application by the assessee of its income pursuant to a

contract, which it has entered into with the Government.

7. The learned counsel for the assessee however contended that the above decision has no application to the facts of this case, and that on a true

construction of the agreement, this is really a case of diversion of part of the profits of the business by a paramount title. In support of this

contention, the learned counsel first cited the decision of the Supreme Court in Poona Electric Supply Co. Ltd. Vs. Commissioner of Income Tax,

Bombay, . The assessee in that case was a company, which carried on the business of distribution of electricity under a license issued by the

Government. Under the Electricity (Supply) Act, 1948, the company's "clear profit" in any year should not exceed the amount of "reasonable

return" as defined under the Act. The excess, if any, after making some deductions has to be distributed to its consumers in the form of rebate. The

question which arose for determination was whether the amount received by the company in excess of the "clear profit and credited by the

company to the "Consumers" Benefit Reserve Account" was deductible in computing the assessable income of the company. There is a very

instructive discussion of the case law by Subba Rao J. in that case; and His Lordship stated that the decisions lead to the following result:

income tax is a tax on the real income, i.e., the profits arrived at on commercial principles subject to the provisions of the income tax Act. The real

profit can be ascertained only by making the permissible deductions. There is a clear-cut distinction between deductions made for ascertaining the

profits and distributions made out of profits. In a given case whether the outgoings fall in one or the other of the heads is a question of fact to be

found on the relevant circumstances, having regard to business principles. Another distinction that shall be borne in mind is that between the real

and the statutory profits, i.e., between the commercial profits and statutory profits. The latter are statutorily fixed for a specified purpose.

In applying the above propositions to the facts of that case, His Lordship said:

The appellant-company is a commercial undertaking. It does business of the supply of electricity subject to the provisions of the Act. As a business

concern its real profit has to be ascertained on the principles of commercial accountancy. - As a licensee governed by the statute its clear profit is

ascertained in terms of the statute and the schedule annexed thereto. The two profits are for different purposes-one is for commercial and tax

purposes and the other is for statutory purposes in order to maintain a reasonable level of rates. For the purposes of the Act, during the accounting

years the assessee credited the said amount to the "Consumers" Benefit Reserve Account". They were a part of the excess amount paid to it and

reserved to be returned to the consumers. They did not form part of the assessee's real profits. So, to arrive at the taxable income of the assessee

from the business under Section 10(1) of the Act, the said amounts have to be deducted from its total income.

It is clear from the passage extracted above, that this decision has no application to the facts of the present case, the distinguishing features of

which have been already indicated.

8. The assessee's learned counsel next referred to another decision of the Supreme Court in *Mudlidhar Himatsingka and another v Commissioner*

of Income-tax, Cal (1966) 62 ITR 328). In that case M, who was a partner in a registered firm A entered into a sub-partnership, firm B, which

provided, among other things, that the profits and losses of M in firm A shall belong to firm B, and shall be borne and divided in accordance with

the shares specified therein. The question for decision was whether the whole of M's share of the profits in firm A was assessable in his individual

income, or only part thereof, which alone he got as a result of the division of the same among the partners of firm B. In dealing with this question,

the court quoted with approval the test laid down by Hidayathullah J. in *The Commissioner of Income Tax, Bombay City II Vs. Shri Sitaldas*

Tirathdas, for determining whether a payment by a person of a share of his profits to another amounts to diversion of income by a paramount title.

The relevant passage from His Lordship's judgment has been extracted above. Then after a detailed discussion of the case law, the court dealt

with the question which arose for determination in that case as follows

The question then arises whether the interest of the sub-partnership in the profits received from the main partnership is of such a nature as diverts the

income from the original partner to the sub-partnership. Suppose that A is carrying on a business as a sole proprietor and he takes another person

B as a partner. There is no doubt that the income derived by A after the date of the partnership cannot be treated as his income; it must be treated

as the income of the partnership consisting of A and B. What difference does it make in principle where A is not carrying on a business as a sole

proprietor but as one of the partners in a firm? There is no doubt that there is this difference that the partners of the sub-partnership do not become

partners of the original partnership. This is because the law of partnership does not permit a partner, unless there is an agreement to the contrary,

to bring strangers into the firm as partners. But as far as the partner himself is concerned, after the deed of agreement of sub-partnership, he cannot

treat the income as his own. Prior to the case of *Cox v Nickman* ((1860) 8 H.L. Cas.268, sub-partners were even liable to the creditors of the

original partnership. Be that as it may, and whether he is treated as an assignee within section 29 of the Indian Partnership Act, as some cases do,

a sub-partner has definite enforceable rights to claim a share in the profits accrued to or received by the partner.

And the court held:

In our view, in the case of a sub-partnership, the sub-partnership creates a superior title and diverts the income before it becomes the income of

the partner. In other words, the partner in the main firm receives the income not only on his behalf but on behalf of the partners in the sub-

partnership.

The facts of the above case and the principles applied for determination of the question raised therein have no application to the case of the

assessee in this case, for the reasons already stated.

9. Reliance was placed by the assessee before the Supreme Court on the decision of the Privy Council in *Raja Bejoy Singh Dudhuria v*

Commissioner of Income Tax, Bengal (1933) 1 ITR 136). The assessee's learned counsel cited that decision also before us. In that case, the

assessee succeeded to the family ancestral estate on the death of his father. His step-mother obtained a consent decree for monthly payment of a

fixed sum by the assessee for her maintenance, declaring that it was a charge on the estate. Upholding the assessee's claim that the amount paid to

the step mother as maintenance should be excluded from the income, the Privy Council said:

But their Lordships do not agree with the learned Chief Justice in his rejection of the view that the sums paid by the appellant to his step-mother

were not "income" of the appellant at all. This in their Lordship's opinion is the true view of the matter.

When the Act by S. 3 subjects to charge "all income" of an individual, it is what reaches the individual as income which it is intended to charge. In

the present case the decree of the court by charging the appellant's whole resources with a specific payment to his step-mother has to that extent

diverted his income from him and has directed it to his step-mother; to that extent what he receives for her is not his income. It is not a case of the

application by the appellant of part of his income in a particular way, it is rather the allocation of a sum out of his revenue before it becomes income

in his hands.

The above decision was sought to be applied in the case of The Commissioner of Income Tax, Bombay City II Vs. Shri Sitaldas Tirathdas, ,

wherein the assessee claimed that an amount payable by him to his wife and children under a maintenance decree should be excluded in computing

the assessable income. In rejecting this claim, the Supreme Court said:

In our opinion, the present case is one in which the wife and children of the assessee who continued to be members of the family received a portion

of the income of the assessee, after the assessee had received the income as his own. The case is one of application of a portion of the income to

discharge an obligation and not a case in which by an overriding charge the assessee became only a collector of another's income. The matter in

the present case would have been such an overriding charge had existed either upon the property or upon its income, which is not the case.

Bejoy Singh Dudhuria's case does not, therefore, give any support for the contention of the assessee's learned counsel. Some more decisions

were cited at the hearing; but it is unnecessary to refer to them,; in view of the authoritative pronouncement on the question of law involved in the

case, in the decisions already cited.

10. The next question for consideration is whether the payment of a part of the profits of the business to the Government under clause 7 of the

agreement is an allowable deduction u/s 10 (2) (xv) of the Act. This provision reads as follows

10(2) "Such profits or gains shall be computed after making the following allowances, namely:

(xv) any expenditure not being an allowances of the nature described in any of the clauses (i) to (xiv) inclusive, and 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.

As already stated, the payment of the share of the profits is a part of the consideration for the purchase of the three concerns of the State of

Travancore by the assessee. Such payment is not an expenditure, but only a discharge of the assessee's own liability and even if it is considered an

expenditure, it can under no circumstances be an expenditure "laid out wholly or exclusively for the purpose of such business" within the meaning of

the above provision. The assessee's learned counsel, therefore, presented the case in a different form. He submitted that what is paid to the

Government is the Government's share of the income from the business, that the assessee gets only the balance, and the assessee's income is only

what the assessee gets from the business. In support of this contention, the learned counsel relied on the decision of the Travancore-Cochin High

Court in the (1955) 28 ITR 505 . The assessee in that case took a mining lease from the State of Travancore, undertaking to pay to the lessor a

certain rate of royalty, and also a percentage of the assessee's profits. The question for decision was whether the percentage of profits paid to the

Government was an allowable expenditure. The court held that, on a true construction of the contract between the parties, the payment did not

amount to a sharing of the profits; but it was an additional royalty in consideration of the lease, and it is an allowance to be made in computing the

assessee's profits. Such a payment is obviously an expenditure incurred wholly and exclusively for the purpose of the business. This case does not,

therefore, support the contention of the assessee's learned counsel in this case.

11. The assessee's learned counsel also cited the decision of the Court of Appeal in BRITISH SUGAR MANUFACTURERS, LTD. Vs.

HARRIS (INSPECTOR OF TAXES), . In that case, a company carrying on a manufacturing business agreed with two other companies to pay

them a stated percentage of its net profits in consideration of their giving to the company the full benefit of their technical and financial knowledge

and experience. It was held that, in computing the profits of the company for the purpose of income tax, the Company was entitled to deduct the

sums so paid to the other companies. This is also, as held by their Lordships, a clear case of "money wholly and exclusively laid out or expended

for the purposes of the trade" This decision does not, therefore, help the assessee.

12. The learned counsel for the Revenue relied on the decision of the Privy Council in Tata Hydro-Electric Agencies Ltd., v Commissioner of

income tax, Bombay, (1937) 5 ITR 202 in support of the contention that the payment made by the assessee to the Government under clause 7 of

the agreement is not liable for deduction in computing the assessable income. In that case, the Tata Power Co., entered into an agency agreement

with Tata Sons Ltd., agreeing to pay Tata Sons Ltd. for services to be rendered by them a commission of 10% on the annual net profit of the Tata

Power Co. Subsequently, two other persons advanced funds to the Tata Power Co., on condition that, in addition to interest payable to them by

the Tata Power Co. on the money advanced, they should each of them get from Tata Sons Ltd. 12 1/2% of the commission earned by Tata Sons

Ltd. under the agency agreement. The rights under the agency agreement were purchased by the assessee from Tata Sons Ltd. Accordingly, the

Tata Power Co. entered into new agency agreement with the assessee; and the assessee also entered into new agreements with the two persons

who had advanced funds to the Tata Power Co. The question was whether the payment of a part of the commission, which the assessee got from

the Tata Power Co. to the two persons who had advanced funds to the company, was an expenditure incurred for earning profits. The Privy

Council answered it in the negative and against the assessee. The following passage appearing in the judgment of the Privy Council is instructive;

and it states the reason for the decision:

Their Lordships recognize and the decided cases show how difficult it is to discriminate between expenditure which is and expenditure which is

not, incurred solely for the purpose of earning profits or gains. In the present case their Lordships have reached the conclusion that the payments in

question were not expenditure so incurred by the appellants. They were certainly not made in the process of earning their profits; they were not

payments to creditors for goods supplied or services rendered to the appellants in their business: they did not arise out of any transactions in the

conduct of their business. That they had to make those payments no doubt affected the ultimate yield in money to them from their business but that

is not the statutory criterion. They must have taken this liability into account when they agreed to takeover the business. 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. If the purchaser of a business

undertakes to the vendor as one of the terms of the purchase that he will pay a sum annually to a third party, irrespective of whether the business

yields any profits or not, it would be difficult to say that the annual payments were made solely for the purpose of earning the profits of the

business. It would seem to make no difference that the annual sum should be made payable out of a particular receipt of the business, irrespective

of the earning of any profit from the business as a whole.

13. It is unnecessary to refer to more decided cases, as the reasons stated by the Privy Council in the above decision for disallowing the claim of

the assessee in that case fully apply to this case. It follows that the amount paid by the assessee to the Government under Clause 7 of the

agreement cannot be excluded from its profits, nor is the said amount liable for deduction u/s 10(2) (xv) of the Act in computing the assessee's

taxable income.

In the result, I answer the question referred in this case again in the negative, and in favor of the Commissioner of income tax, Kerala. By Court

Since we are not agreed on the answer to be sent to the Appellate Tribunal, we place the case before our Lord Chief Justice for directions

regarding further hearing under the proviso to Section 66A(1) of the income tax Act. Mathew J. (On difference of opinion between Raghavan and

Isaac J.J.)

The assessee here is a limited company incorporated under the Travancore Companies Regulation and is carrying on the business of manufacturing

sugar. It also runs a distillery and a tincture factory. The assessee-company was floated with a view to taking over the business assets of a

company called Travancore Sugars Ltd., which was being wound up and in which the State Government held the largest number of shares, the

Government Distillery at Nagercoil and the business assets of the Government Tincture Factory at Trivandrum. An agreement was entered into

between the Government of Travancore and Sir William Wright on behalf of Parry & Co. Ltd., the promoters of the assessee-company. Under the

said agreement, the assets of all the three concerns were agreed to be sold by the Government of Travancore to the assessee-Company. It is not

necessary to set out all the clauses in the agreement. Apart from the cash consideration for the transfer of the assets clause 7 of the agreement

provided that:

the Government shall be entitled to twenty per cent, of the net profits earned by the company in every year subject however to a maximum of

Rupees forty-thousand per annum, such net profits for the purposes of this clause to be ascertained by deduction of expenditure from gross income

and also after-

(i) provision has been made for depreciation at not less than the rates of allowances provided for in the income tax law for the time being in force,

and

(ii) payment of the Secretaries & Treasurers' remuneration.

On the 28th January, 1947, clause 7 was substituted by another clause, which reads:

The Government shall be entitled to ten per centum of the net profits of the company in every year. For the purpose of this clause net profits means

the amount for which the company's audited profits in any year are assessed to income tax in the State of Travancore.

2. For the assessment year 1958-59, the corresponding previous year being 1st May, 1956 to 30th April 1957, the amount payable to

Government under the aforesaid clause came to Rs. 42,480/-. The Appellate Assistant Commissioner disallowed the claim of the assessee for

deduction of this amount on the ground that the clause virtually provided for sharing the profits after they came into existence. On appeal by the

assessee, the income tax Appellate Tribunal held that the case will come within the principle of the decision in *British Sugar Manufacturers, Ltd., v*

*Harris (Inspector of Taxes)*¹, and that the payment was an expenditure made to earn the profits of the business and not an expenditure paid out of

the earned profits, and allowed the appeal. At the instance of the Department, the Tribunal referred the following question to the High Court:

Whether on the facts and in the circumstances of the case, the payment of Rs.42,480 by the assessee to the Travancore Government under the

agreements dated 18-6-1937 and 28-1-47 was allowable u/s 10 of the income tax Act?

3. This court held that the payment of the aforesaid amount constituted capital expenditure and was not an allowable deduction u/s 10(2) (xv) of

the income tax Act. Against this judgment, an appeal was preferred by special leave to the Supreme Court. The Supreme Court held that the

amount is not capital expenditure but revenue payment and sent back the case to this court for decision of certain questions, namely, whether "the

payment of the commission is tantamount to diversion of profits by a paramount title"; whether "the transaction should be treated as a joint venture

with an agreement to share profits" between the assessee and the Government, and whether "the requirements of section 10 (2) (xv) have been

satisfied in this case".

4. When the case came before the Division Bench the question whether the transaction should be treated as a joint venture with an agreement to

share the profits between the assessee and the Government was not pressed by the Revenue. Raghavan J. answered the other two questions in the

affirmative and in favor of the assessee whereas Isaac J. answered them in the negative and in favor of the Revenue.

5. So, the two questions which require consideration are: (1) whether payment of the amount is a diversion of profits before they reached the

assessee by an overriding title and (2) whether the amount is an allowable deduction u/s 10 (2) (xv) of the income tax Act.

6. The Supreme Court has held that the payment of the amount was not towards purchase price because the unpaid purchase price was neither a

fixed sum nor an amount which could be ascertained by any method and so it is not in the nature of capital expenditure.

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7. Whether the payment concerned is a diversion of the profits by a paramount title has to be decided keeping in view of the principle laid down by

the Privy Council in Raja Bejoy Singh Dudhuria v Commissioner of income tax², and by the Supreme Court in Commissioner of income tax v

Sitaldas Tirathdas³ and Murlidhar Himatsingka and another v Commissioner of income tax, Calcutta⁴

8. In Raja Bejoy Singh Dudhuria v Commissioner of income tax², the assessee succeeded to the family ancestral estate on the death of his father.

Subsequently his step-mother brought a suit for maintenance against him in which a consent decree was made directing the assessee to make a

monthly payment of a fixed sum to his step-mother and declaring that the maintenance was a charge on the ancestral estate in the hands of the

assessee. In computing his income, the assessee claimed that the amounts paid by him to the step-mother under the decree should be excluded. It

was held by the Judicial Committee that the sums paid by the assessee to his step-mother were not "income" of the assessee at all and that the

decree of the court by charging the appellant's whole resources with a specific payment to his step-mother had to that extent diverted his income

from him and had directed it to his step-mother, and to that extent what he received for her was not his income. At the moment when the estate

passed on to him there was a liability on the estate which was not quantified and when it was so done by the decree of the court the entirety of the

estate became, so to speak, charged with it and that portion of the income payable to the step-mother had to be treated as the income of the step-

mother and not of the assessee.

9. In *The Commissioner of Income Tax, Bombay City II Vs. Shri Sitaldas Tirathdas*, the assessee had to pay under a consent decree a certain

amount every year to his wife and children by way of separate maintenance. He claimed a deduction of the amount from the income and relied on

the decision of the Privy Council in *Raja Bejoy Singh Dudhuria v Commissioner of income tax* (1933) 1 ITR 135, Hidayatulla J., as he then was,

said:

In our opinion, the true test is whether the amount sought to be deducted, in truth, never reached the assessee as his income. Obligations, no

doubt, there are in every case, but it is the nature of the obligation which is the decisive fact. There is a difference between an amount which a

person is obliged to apply out of his income and an amount which by the nature of the obligation cannot be said to be a part of the income of the

assessee. Where by the obligation income is diverted before it reaches the assessee, it is deductible; but where the income is required to be applied

to discharge an obligation after such income reaches the assessee, the same consequence, in law, does not follow.

The maintenance paid by Sitaldas Tirathdas to his wife and children under the consent decree was an obligation he had to discharge from out of his

income while the maintenance paid by Raja Bejoy Singh to his step-mother was a diversion before it became income in his hands. The difficulty in

drawing the line between the two types of cases is illustrated by the decision of the Supreme Court in *Fatehchand Murlidhar and Another Vs.*

Commissioner of Income Tax, Calcutta, . In that case, M.H. was a partner in firm A and he entered into a "sub-partnership with his sons and

grandson in firm B under which his share of the profit and loss in firm A were to belong to firm B. The question arose whether the share of profit of

M.H. in firm A had to be assessed in his individual name or to be included in the assessment of firm B. The Supreme Court held that by an

overriding obligation, namely, the formation of the sub-partnership agreement, the profit became the income of firm B, though it passed through the

hands of M.H.

10. Let us look at the nature of the obligation in this case. The obligation to pay amount arose out of an agreement, which is a part and parcel of

the agreement, under which the assessee became entitled to the assets of the three concerns. Although the payment of the amount is not part of the

consideration for the purchase of the three concerns it is a payment which the assessee has agreed to make. It might be remembered that in

addition to selling the assets of the three concerns, the Government undertook the obligations enumerated in clauses 4 (b) and (c) and clause 5(c)

of the agreement (See Annexure A). And the Government could have enforced by action the payment in case the assessee refused to pay. It is

said that by the clause in question, there is no diversion of the profits of the assessee but only an application of a part of the profits, that the profits

are earned by the assessee and then a percentage of it paid over by the assessee to the Government. Reliance was placed on the observation of

Lord Macmillan in AIR 1931 165 (Privy Council) , to support the contention. In that case, the assessee-company, incorporated in the United

Kingdom, obtained a concession for constructing a railway - in the territories of Pondicherry. The assessee-company was to pay to the French

Government half 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 was whether the monies paid by the assessee-company to the French Government were

allowable deductions under the provision corresponding to section 10 (2)(xv). Lord Macmillan observed at page 170:-

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.

But these observations have been explained in later cases. In Union Cold Storage Co. Ltd., v Adamson (1930) 16 Tax Cases 293 the assessee

leased lands and premises abroad reserving a rent of ₹9,60,000. It was provided in the deed that if at the end of the financial year it was found

that after providing for the rent the result of the company's operations was insufficient to pay interest or charges 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. 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 has to be provided for and allowed before

profits of the business could be ascertained. In the House of Lords, Lord Macmillan distinguished the Pondicherry Railway Company case 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 half thereof to the French Government. Dealing with the passage above referred to, Lord Macmillan

said at pages 331-32:

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

11. The same question was considered in VITHALDAS THAKORDAS AND COMPANY Vs. COMMISSIONER OF Income Tax

BOMBAY., . There, the facts were: After the death of V, Who had during his life time carried on in his own name a bullion business, the assessee,

a firm of partners, entered into an arrangement with the widow of V. for the use of V's name for their bullion business. Under the arrangement, in

consideration of the widow having agreed to allow the partners to use the name of V. for the purpose of the partnership business the partners

agreed to pay her out of the net profits of the business in the first instance an amount equivalent to two annas in the rupee of the net profits. The

partners also agreed that neither she nor the estate of V. would be liable for the debts or losses of the partnership and that she would not be

deemed a partner in the business. The partnership deed provided that after payment of the aforesaid amount to the widow, the balance of the net

profits was to be divided between the partners in certain proportions. No term was fixed for the duration of the use of the goodwill. In the

accounting year the assessee made a net profit of Rs. 40,470 and the widow was paid Rs. 5,059, being her share of the profits. In considering the

question whether the amount was an allowable deduction, the court said:

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 two 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 after those payments are made, the real profits are ascertained which attract the tax; and it is these 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 observations of Lord Macmillan in Pondicherry Railway Company case were considered in BRITISH SUGAR MANUFACTURERS, LTD.

Vs. HARRIS (INSPECTOR OF TAXES), . In that 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 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

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 out of the profits which were liable to tax. Dealing with the Pondicherry Railway Company case, the

learned Master of the Rolls said:

It is to be observed that Lord Macmillan in that paragraph was quite clearly using the word, "profit" in one sense and one sense only; he was using

it in the sense of the "real net profit" to which Lord Maugham referred. That he was doing that is, I think, abundantly clear when the nature of the

contract that is 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 said in a subsequent case, *Union Cold*

Storage Co., Ltd., v Adamson, (1930) 16 Tax Cases 293 at 331-332) in relating to the particular subject-matter with which he was dealing.

The court finally held that the sum is an allowable deduction holding that it is not an appropriation of the profits of the partnership after they had

been ascertained, that the agreement was not in the nature of a joint venture or a quasi partnership, and that the payment was a revenue

expenditure wholly and exclusively incurred for the purpose of the business and was admissible as deduction u/s 10(2)(xii) of the income tax Act.

12. In *Poona Electric Supply Co. Ltd. v Commissioner of income tax, Bombay* (1965) 57 T.R. 391, the Company carried on the business of

distribution of electricity under a license issued by the Government. Under the Electricity (Supply) Act, 1948, the company's "clear profits" in any

year should not exceed "reasonable return" as defined under the Act; and the excess, if any, the Company had to distribute among its consumers in

the form of rebate. The Company claimed deduction of the amounts said to have been credited to the "Consumers' Benefit Reserve Account", and

the question before the Supreme Court was whether those amounts were allowable deductions. Subbi Rao, J., as he then was, observed that u/s

10(1) of the income tax Act, tax shall be payable by an assessee under the head "profits and gains of business" in respect of profits and gains of

any business carried on by him, and that the said profits and gains are not profits regulated by any statute, but profits in a business computed on

business principles, that what is to be ascertained is the business profit and not statutory profit. He further observed that the real profit of a

businessman u/s 10(1) of the income tax Act cannot obviously include the amounts returned by him by way of rebate of the consumers under

statutory compulsion and that it is as if he received only from the consumers the original amount minus the amount he returned to them. His

Lordship summarized his conclusions at page 530 thus:

income tax is a tax on the real income, i.e., the profits arrived at on commercial principles subject to the provisions of the income tax Act. The real

profit can be ascertained only by making the permissible deductions. There is a clear-cut distinction between deductions made for ascertaining the

profits and distributions made out of profits. In a given case whether the outgoings fall in one or the other of the heads is a question of fact to be

found on the relevant circumstances, having regard to business principles. Another distinction that shall be borne in mind is that between the real

and the statutory profits, i.e., between the commercial profits and statutory profits. The latter are statutorily fixed for a specified purpose.

13. In the Poona Electric Company's case computation of the profits was regulated by the Electricity (Supply) Act, whereas in the case in hand it

is regulated by the contract, between the company and the Government. In computing the real profits of the assessee here, I think, the payment

made to the Government has to be deducted. The fact that in the substituted clause 7, it is said that out of the net profits of the company, the

Government will be entitled to 10% would not make it a payment out of the real profits of the company. We must remember the distinction

between apparent profit and real profit. What is taxed under the Income- tax Act is only the profits of the company calculated on commercial

principles. In the Privy Council case of THE INDIAN RADIO AND CABLE COMMUNICATIONS COMPANY, LTD. Vs. THE COMMISSIONER OF INCOME TAX, BOMBAY PRESIDENCY and ADEN., , Lord Maugham said:

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 profit of ₹10,000 has then to pay ₹1,900 to directors and managers as the

contractual recompense for their service during the year, it is plain that the real net profit is only ₹9,000.

14. When a trader makes a payment which is computed, in relation to profits, the question that arises is: Does the payment represent a mere

division of profits with another party, or is it an item of expenditure the amount of which is ascertained by reference to profits. The payment would

be allowable in the second case, but not in the first.

14. Now let us see whether the payment is an expenditure wholly and exclusively laid out for the purpose of the business and ascertained with

reference to profits

15. Viscount Cave, L.C. observed in *Atherton v British Insulated & Helsby Cables Ltd.* 10 T.C. 155, at 191 (M.L.)

A sum of money expended, not of necessity and with a view to a direct and immediate benefit to the trade, but voluntarily and on the grounds of

commercial expediency and in order indirectly to facilitate the carrying on of business, may yet be expended wholly and exclusively for the

purposes of the trade.

What is money wholly and exclusively laid out for the purposes of business must be determined upon the principles of commercial trading. Thus,

remuneration of commission payable to directors, managers, agents or other employees, and ascertained by reference to profits, is deductible as a

business expense (See the decision in Commissioner of income tax v Bombay Burma Trading Corporation. (1941) ITR 155

16. Reliance was placed by the Revenue upon the decision in Tata Hydro-Electric Agencies Ltd. v Commissioner of income tax, Bombay 1937 5

ITR 202, 209, and it was contended that the payment is not an expenditure laid out wholly and exclusively for the purpose of the business. In that

case, the Tata Power Company entered into an agency agreement with Tata-sons 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 Tata-sons Ltd., 12 1/2% of the commission earned by Tata-sons Ltd; Tata-sons 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 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 the Pondicherry Railway 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. Lord Macmillan observed:

In the present case their Lordships have reached the conclusion that the payments in question were not expenditure so incurred by the appellants.

They were certainly not made in the process of earning their profits; they were not payments to creditors for goods supplied or services rendered

to the appellants in their business: they did not arise out of any transactions in the conduct of their business. That they had to make those payments

no doubt affected the ultimate yield in money to them from their business but that is not the statutory criterion. They must have taken this liability

into account when they agreed to take over the business. 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.

It might be observed that the decision turned upon the interpretation of the clause 10(2)(xv) before it was amended in 1939. Before this clause was

amended in 1939, allowance was given in respect of any non-capital expenditure ""incurred solely for the purpose of earning such profits or gains"".

Now under the amended law the expenditure should be laid out ""wholly and exclusively for the purpose of such business"". The two expressions are

not synonymous; the latter is wider than the former. Expenditure may be for the purpose of the business although it may not be incurred for the

purpose of earning the profits of the business. (See the decision in Commissioner of Income Tax, Bombay City-I, Bombay Vs. Jagannath Kisonlal,

17. Section 10(2) (xv) requires that the expenditure should be wholly and exclusively laid out for the purpose of the business, but not that it should

be necessarily laid out for such purpose. Therefore, expenses wholly and exclusively laid out for the purpose of trade should, subject to the

fulfillment of the other condition be allowed under this clause even though the outlay is unnecessary or unnecessarily large, unless the case falls u/s

10(4A) q.v. The further test of necessity is, by contrast, imposed u/s 4(3)(vi) and Section 7(2)(ii). The judgment of the Supreme Court in Eastern

Investments Ltd. Vs. Commissioner of Income Tax, West Bengal, establishes that in the absence of fraud, the questions whether a transaction had

the effect of diminishing the assessee's taxable income, whether it was a prudent or wise transaction, and whether it was necessary for the assessee

to enter that transaction, are irrelevant in determining whether expenditure relating to that transaction should be allowed u/s 12(2); and the same

considerations would apply under this clause. I think, the payment in question was an expenditure laid out wholly and exclusively for the purpose of

the business and ascertained with reference to profits. I agree with the opinion of Raghavan J. and hold that the amount is an allowable deduction

and would answer the question in the affirmative and in favor of the assessee.