

(1943) 03 BOM CK 0019**Bombay High Court****Case No:** Suit No. 440 of 1943

WALCHAND and CO. LTD.

APPELLANT

Vs

THE HINDUSTAN
CONSTRUCTION CO. LTD.

RESPONDENT

Date of Decision: March 26, 1943**Acts Referred:**

- Civil Procedure Code, 1908 (CPC) - Section 90
- Income Tax Act, 1922 - Section 48

Citation: (1944) 12 ITR 104**Hon'ble Judges:** Beaumont, C.J; Rajadhyaksha, J**Bench:** Full Bench

Judgement

BEAUMONT, C.J. - This is a special case stated u/s 90 of the Civil Procedure Code, 1908, and Order 36 asking the question :

"Whether on a true construction of clause 2 of the managing agency agreement between the plaintiff and the defendant companies, excess profits tax payable or paid by the defendant company should be deducted in calculating the annual net profits of the defendant company for the purpose of the calculation of the managing agents commission."

A similar question came before this Court recently in the case of James Finly & Co., Ltd. v. The Finlay Mills Ltd., and we held in that case that inasmuch as the agreement provided that in ascertaining the profits on which commission was based no deduction should be made for Income Tax, super-tax or any other tax on income, the parties had in effect agreed that there should be no deduction in respect of excess profits tax, which, we held was a tax on income. However, the agreement in this case is in a different form. The question turns on the construction of clause of the agreement, which is in the following terms :

"The commission of the managing agents shall be at the rate of ten per cent. per annum on the annual net profit earned by the said company calculated as shown in sub-clauses (a) and (b) hereof whether dividends are declared or not, subject however to a minimum sum of Rs. 5,000 per annum whether the company makes profit or not.

(a) In calculating the annual net profits of the said company for the purposes of calculation of the managing agents commission all proper allowances and deductions shall be made from revenue for interest on loans and deposits secured or unsecured and for working expenses chargeable against profits but no deduction shall be made for depreciation on machinery and on buildings or for or in respect of any amount carried to depreciation reserve or sinking fund or in respect of any expenditure on capital account.

(b) The said commission shall be exclusive of and shall not include any expenses incurred in connection with the establishment, maintenance, management, and up-keep of the offices of the said company and of the managing agents or any remuneration, wages, commission or bonus which shall be payable to the bankers, solicitors, counsel, pleaders, engineers, experts, managers, secretaries, superintendent commission agents, dealers, muccadums, clerks, brokers, or other officers or employees who may be employed by the managing agents for or on behalf of the said company or for carrying on and conducting the business of the said company and all expenses incurred by the managing agents in connection with the business of the said company, which expenses and charges shall be borne and paid by the said company." So that, the commission is to be based on annual net profits, to be ascertained without making the deductions specified. Under sub-clause (a) the deductions to be made are those which would normally be made in ascertaining profits for payment of dividends, calculated on rather a generous scale. In law a company is not bound generally to make allowance for depreciation before declaring a dividend, though in practice prudent companies generally do so. It may be that under (b) there are allowances which would have to be deducted from profits before dividends could be declared, and on the whole one may say that the net profits on which commission is to be paid are greater than the profits on which dividends could be paid. But there is no provision in the agreement for deduction of any tax upon income.

The special case states that the practice of the company has been to make no deduction in respect of Income Tax and super-tax paid by the company, and that practice, no doubt, is in accordance with the principles established by the authorities. It was held by the House of Lords in Ashton Gas Company v. Attorney-General, that Income Tax is payable out of profits, and, cannot be deducted in ascertaining profits. The question with which the House of Lords was dealing in that case was a statutory limit on the rate of dividend which could be paid by a company, and the House of Lords pointed out that if dividend was paid at the

statutory maximum rate plus Income Tax, that would involve exceeding the maximum. That principle has been applied to profit-sharing agreements of the character of the agreement with which we have to deal, and it has been held that an agreement to divide annual net profits is an agreement to divide profits before any deduction for Income Tax and super-tax. The argument of the managing agents is that exactly the same principle must apply to excess profits tax also. Excess profits tax was imposed in India by Act XV of 1940, and the charging section, Section 4, provides :

"Subject to the provisions of this Act, there shall, in respect of any business to which this act applies, be charged, levied and paid on the amount by which the profits during any chargeable accounting period exceed the standard profits a tax (in this Act referred to as excess profits tax) which shall, in respect of any chargeable accounting period ending on or before the 31st day of March, 1941, be equal to fifty per cent. of that excess and shall, in respect of any chargeable accounting period beginning after that date, be equal to such percentage of that excess as may be fixed by the annual Finance Act."

The percentage has since been increased. No doubt, the tax has some of the features of Income Tax, and the assessment is made on the same principles as assessment of Income Tax, and the tax has to be recovered in the same manner. There are some minor distinctions between the two taxes. Income Tax is levied on a sliding scale, whereas excess profits tax is a fixed percentage; u/s 12 excess profits tax can be deducted for the purpose of ascertaining Income Tax, which distinguishes it from super-tax; and there is no provision in cases where tax has been paid by a company for any refund being made to the share-holders such as is given in Section 48 of the Indian Income Tax Act, 1922. However, I do not think that such minor distinctions would be enough to differentiate excess profits tax from Income Tax for the purposes of the present case. But it seems to me that there is a much more vital distinction between the two taxes. Income Tax is a tax on all income with certain exceptions, whereas excess profits tax is a tax levied only on certain profits of the owner of a business. Broadly speaking, the scheme is to ascertain profits of the business before the present war started, and to impose the tax on the amount by which the annual profits in the year of assessment exceed the pre-war standard. It seems to me that one cannot lose sight of the fact that in England, where the tax originated during the 1914-18 war, and also, I think, in this country, the object of the tax was not merely to raise revenue, but also to prevent the owner of a business from making a large fortune out of what is a national danger. I think that in effect, though not in form, the tax is partly of a prohibitive character; it prohibits the owner of a business from retaining more than a certain proportion of profits which may be deemed to have arisen on account of the war. If one considers the tax in that light, it seems to me plain that the parties cannot have intended to divide between employer and employee a sum which the employer himself is not allowed to retain; nor do I see in principle any very good reason why an

employee should be allowed to benefit from the national emergency to a greater extent than an employer. No doubt the managing agents may say that their remuneration is based on the profits made as a result of their efforts, and it is not their concern that the company is not allowed to retain part of such profits. There is some force in the contention, but it is not strong enough in my view to outweigh the argument that the parties cannot have intended to divide something which neither of them was going to get. Therefore, apart from authority, I should approach a profit-sharing agreement of this nature with the presumption that, unless the parties have otherwise provided, they probably did not intend to base commission on excess profits which the employer is not entitled to retain. When one looks at this agreement, it seems to me there is nothing to negative that presumption. There is no reference in the agreement to any form of tax.

So that, apart from authority, I should be prepared to hold on this agreement that excess profits tax must be deducted in ascertaining the annual net profits out of which commission is payable. But there are English cases, which have a bearing on this matter, and which support the view which I take apart from authority. There are three cases in the English Court of Appeal as well as other cases before Courts of first instance. The first case in the Court of Appeal is Patent Casting Syndicate Ltd. v. Etherington. In that case commission was to be based on net profits. The leading judgment was given by Warrington, L.J., and I think his judgment was really based on the view, which appeals to me, that it was unreasonable to suppose that the parties intended to divide something which neither of them was going to get the benefit of. No doubt, he does rely on one distinction between Income Tax and excess profits tax, which has since been held not to be valid. He refers to Income Tax paid by a company, as being paid not by the company direct, but on behalf of the share-holders. That view did prevail at one time, but the decision of the House of Lords in Cull v. Inland Revenue Commissioners shows that that view has now been negated. But I do not think that that distinction formed the real basis of the Courts judgment.

A similar question then came before the other branch of the English Court of Appeal in Vulcan Motor & Engineering Co. v. Hampson where the commission was based on profits earned by the company. The court held that that expression had exactly the same meaning as the expression "net profits" in the earlier case, and that they were bound by the earlier case, which they followed. Of three the Judges Warrington, L.J., who was also a member of the second Bench, followed his previous decision, and naturally agreed with it. Bankes, L.J., followed the previous decision without expressing approval or disapproval, but Scrutton, L.J., indicated that, apart from authority, he would have felt a difficulty in distinguishing for the present purpose excess profits tax from Income Tax. However, the Court followed the earlier decision. Then the question again came before the English Court of Appeal in October, 1942, in *In Re The Agreement of G.B. Ollivant & Co. Ltd.*, and we have been supplied with copies of the judgments. The Court held that the effect of the

agreement in that case was that commission was to be based on the profits of the company ascertained on ordinary commercial lines. The Master of the Rolls pointed out that it is not merely common knowledge, but common-sense, that the divisible profits of a trading company cannot properly be ascertained without making deduction for excess profits tax. He noticed the earlier cases, and expressed no dissent from them; but he considered that, owing to the different language used in the agreement with which he had to deal, those cases did not bind the Court to the extent which the lower Court had supposed them to do. Lord Clauson, however, rather went out of his way to express approval of the reasons on which the earlier cases had been decided.

So that, we have three decisions of the English Court of Appeal, based on agreements not substantially different from the agreement in the present case, in which the Court held that excess profits tax must be deducted before ascertaining the annual profits for the purpose of ascertaining commission payable to an employee. Those cases support the view, which I should have been disposed to take, apart from authority, and, in my opinion, we must answer the question put to us in the affirmative and hold that excess profits tax should be deducted in ascertaining the annual net profits of the defendant company for the purpose of the calculation of the managing agents commission.

RAJADHYAKSHA, J. - I agree.

Answer accordingly.