COMMISSIONER OF INCOME-TAX, BOMBAY

v.

M/S. ABDULLABHAI ABDULKADAR

1960

December 6.

(J. L. KAPUR, M. HIDAYATULLAH and J. C. SHAH, JJ.)

Income-tax—Commission Agent's liability to pay for non-resident principal—Test of deductible business loss—Indian Income-tax Act, 1922 (11 of 1922), ss. 10(1), 10(2)(xi), 42(1), 43.

The respondent was a registered firm carrying on business as commission agents, and for the purpose of income-tax it was treated as the agent of a non-resident principal doing business outside India. Under s. 42(1) of the Indian Income-tax Act the respondent was deemed to be the assessee and had to pay Rs. 3,78,491 as income-tax on behalf of the non-resident principal. After allowing for the amounts lying with the respondent-firm the account of the non-resident principal showed a debit balance of Rs. 3,20,162. The respondent treated this amount as a bad debt and claimed it as a deductible loss. The Income-tax Officer and the Appellate Assistant Commissioner disallowed the respondent's claim but the Income Tax Appellate Tribunal held it to be an allowable deduction being a bad debt incurred as a result of the respondent's business activities with the non-resident principal. The High Court treating the amount as a deductible business loss incurred by the respondent affirmed the decision of the Income-tax Tribunal. On appeal by the Commissioner of Income-tax,

Held, that the respondent was not entitled to the reduction claimed by it. The liability to pay imposed upon it under s. 42(2) of the Income-tax Act did not arise directly from the carrying on of the business nor was it incidental to the business. The loss was not a commercial loss incurred in the respondent-firm's own business but it arose out of the business of another person and that was not a permissible deduction within s. 10(1) or s. 10(2)(xi) of the Act.

Gresham Life Assurance Society v. *Styles*, (1892) 3 T. C. 185 (H. L.), referred to.

Commissioner of Income-tax v. *Sir S. M. Chitnavis*, (1932) L. R. 59 I. A. 290, followed.

Badridas Daga v. *Commissioner of Income-tax*, [1959] S.C.R. 690 and *Curtis* v. *J. and G. Oldfield, Ltd.*, (1925) 9 T. C. 319, discussed.

Lord's Dairy Farm Ltd. v. *Commissioner of Income-tax, Bombay*, [1955] 27 I.T.R. 700, *Calcutta Co., Ltd.* v. *Commissioner of Income-tax*, [1959] 37 I.T.R. 1 and *C.I.R.* v. *Hagart and Burn Murdoch*, [1929] A.C. 386, not applicable.

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CIVIL APPELLATE JURISDICTION: Civil Appeal No. 312 of 1959.

Appeal from the judgment and order dated August 23, 1956, of the Bombay High Court in Income-tax Reference No. 21 of 1956.

Hardyal Hardy and *D. Gupta*, for the appellant.

A. V. Viswanatha Sastri and *I. N. Shroff*, for the respondent.

1960. December 6. The Judgment of the Court was delivered by

Kapur. J.

KAPUR, J.—This is an appeal by special leave brought by the Commissioner of Income-tax against the judgment and order of the High Court of Bombay answering the question in favour of the assessee. The question referred by the Tribunal was:

"Whether on the facts and in the circumstances of the case the amount of Rs. 3,20,162 is an allowable deduction under Section 10(2)(xi) or 10(2)(xv) of the Income-tax Act?"

which was amended by the High Court as follows:

"Whether on the facts and in the circumstances of the case the amount Rs. 3,20,162 is an allowable deduction"

and was answered in the affirmative and against the appellant.

The facts of the case shortly stated are these: The respondent is a registered firm carrying on business as commission agents. It was treated as the agent of a non-resident principal Haji Mohamed Syed Al Barbari of Port Sudan (hereinafter referred to as the 'non-resident principal'). It was carrying on the business of export of cloth and kariana (i.e., miscellaneous goods) to Aden, Saudi Arabia and Sudan. It used to supply goods from India to the non-resident principal, who on his part, was sending cotton to the respondent and other merchants for sale in India. For the years 1942-43, 1943-44, 1944-45 and 1945-46, the respondent firm was treated as the agent of the non-resident principal under s. 43 of the Income-tax Act

(which will hereinafter be termed 'the Act') for the purpose of income-tax and Excess Profits Tax. The respondent firm had to pay in all Rs. 3,78,491 under s. 42(1) of the Act and after allowing for the amounts which were in its hands the account of the principal non-resident showed a debit balance of Rs. 3,20,162. For the year of assessment, 1953-54, the respondent firm treated this amount as a bad debt and claimed it as a deductible loss to be set off against profits. The Income-tax Officer treating this claim as one under s. 10(2)(xv) of the Act, disallowed it. The Appellate Assistant Commissioner treated it as one under s. 10 (2)(xi) of the Act and he also disallowed it. On appeal to the Income-tax Appellate Tribunal it was held to be a bad debt and an allowable deduction as it was incurred as a result of the business activities which the respondent firm was carrying on with the non-resident principal. At the instance of the Commissioner of Income-tax, the case was stated to the High Court and the High Court modified the question and answered the same in the affirmative, i.e., against the appellant. The High Court held that as the law imposed an obligation upon the respondent firm to discharge the liability and it was incidental to the business of the respondent the amount was a deductible loss; and even if it was not a debt, then also the amount could be claimed by the assessee as a business or trading loss, because in arriving at the true profit of the respondent's business that loss had to be deducted. The High Court thus applied s. 10(1) of the Act to the amount claimed by the respondent.

The allowability of the amount in dispute depends upon the nature of the liability imposed upon the respondent firm. The contention of the respondent's counsel was that it was carrying on foreign trade and had dealings with a foreign merchant and in the course of the business there were imports and exports and therefore the inter-connection between the respondent firm and the non-resident principal was so intimate as to invite the application of s. 42(1), i.e., the establishment of agency as contemplated in that section. The liability to pay arises under s. 42(2) which provides :

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"Where a person not resident or not ordinarily resident in the taxable territories carries on business with a person resident in the taxable territories, and it appears to the Income-tax Officer that owing to the close connection between such persons the course of business is so arranged that the business done by the resident person with the person not resident or not ordinarily resident produces to the resident either no profits or less than the ordinary profits which might be expected to arise in that business, the profits derived therefrom or which may reasonably be deemed to have been derived therefrom, shall be chargeable to income-tax in the name of the resident person who shall be deemed to be, for all the purposes of this Act, the assessee in respect of such income-tax."

Relying on this provision it was argued that the nature of the respondent's business was foreign trade which was inter-connected with the business of the non-resident principal. Its nature was such as to attract the imposition of liability on the respondent firm under s. 42(2) of the Act and therefore the loss so incurred must be taken to be incidental to and arising out of the business of the respondent.

"The thing to be taxed", said Lord Halsbury, L. C., "is the amount of profits and gains. The word 'profits' I think is to be understood in its natural and proper sense—in a sense which no commercial man would misunderstand": *Gresham Life Assurance Society* v. *Styles* (1). Hence even if a deduction is not specifically enumerated in sub-section (2) of s. 10 it would still be a debitable item to reflect the taxable profits. The Privy Council in *Commissioner of Income-tax* v. *Sir S. M. Chitnavis* (2) held that the Act nowhere authorises the deduction of bad debts of a business, such a deduction is necessarily allowable because what is chargeable to income-tax in respect of a business are the profits and gains of a year and in assessing the amount of profits and gains of that year account must necessarily be taken of all losses incurred, otherwise true profits and gains cannot be ascertained. In order

(1) (1892) 3 T.C. 185, 188 (H.L.).
(2) (1932) L.R. 59 I.A. 290, 296.

that a loss may be deductible it must be a loss in the business of the assessee and not payment relating to the business of somebody else which under the provisions of the Act is deemed to be and becomes the liability of the assessee. The loss becomes allowable if it "springs directly from and is incidental" to the business of the assessee. The decision therefore mainly depends upon whether the loss claimed is a business loss of that nature. In our opinion the amount which became payable by the respondent firm cannot be called its business loss. In order to be deductible the loss must be in the nature of a commercial loss and, as has been said above, must spring directly out of it and must really be incidental to the business itself. It is not sufficient that it falls on the trader in some other capacity or is merely connected with his business.

Counsel for the respondent relied upon a judgment of this Court in *Badridas Daga* v. *The Commissioner of Income-tax* (1). In that case an agent of the assessee engaged for the purpose of carrying on of the assessee's business had authority to operate a bank account. Acting under such authority the agent withdrew from the bank monies and put them to his personal use. The assessee was able to recover from the agent only a part of the amount misappropriated and the balance was written off as irrecoverable debt and it was held that it was not allowable under s. 10(2)(xi) or 10(2)(xv) of the Act but it was a loss deductible in computing the profits under s. 10(1) of the Act as a loss incidental to the carrying on of his business. Counsel relied on the following observation of Venkatarama Ayyar, J., at p. 695:

"The result is that when a claim is made for a deduction for which there is no specific provision in s. 10(2), whether it is admissible or not will depend on whether having regard to accepted commercial practice and trading principles it can be said to arise out of the carrying on of the business and to be incidental to it."

That passage has to be read in the circumstances of

(1) [1959] S.C.R. 690.

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that case where the employment of agents was incidental to the carrying on of the business and it was observed that it logically followed that the losses which were incidental to such employment were also incidental to the carrying on of the business. At page 696, it was observed:—

"At the same time it should be emphasised that the loss for which a deduction could be made under s. 10(1) must be one that springs directly from the carrying on of the business and is incidental to it and not any loss sustained by the assessee, even if it has some connection with his business."

Reference may also be made to an English decision in *Curtis* v. *J. & G. Oldfield Ltd.* (1). In that case the managing director of a company of wine and spirit merchants embezzled monies of the company and that was claimed as a loss as a bad debt and it was held that it was not a trading loss and was therefore not an admissible deduction. In that case the contention of the Crown was that the sum was not an ordinary trading debt and therefore could not be a bad debt and that the loss was not connected with and did not arise out of the trade. Rowlatt, J., said at p. 330:

"When the Rule speaks of a bad debt it means a debt which is a debt that would have come into the balance-sheet as a trading debt in the trade that is in question and that it is bad. It does not really mean any bad debt which, when it was a good debt, would not have come in to swell the profit."

In the present case the liability was imposed upon the respondent firm because it was treated as an agent within the meaning of s. 42(1) of the Act and the liability was imposed because of the deeming provision in sub-s. (2) of s. 42 of the Act. Can it be said, in the present case, that the liability imposed upon the respondent firm was a business debt arising out of the business of the respondent or to use the words of Venkatarama Ayyar, J., "springs directly from the carrying on of the business and is incidental to it or is a trading debt in the business of the respondent firm." As we have said above, that condition has not

(1) (1925) 9 T.C. 319.

been fulfilled and the loss which the respondent has incurred is not in its own business but the liability arose because of the business of another person and that is not a permissible deduction within s. 10(1) of the Act. It is not a loss which has to be deducted in respect of the business of the respondent from the profits and gains of the respondent's business.

Counsel for the respondent also relied on *Lord's Dairy Farm Ltd.* v. *Commissioner of Income-tax, Bombay* (1). That was a case of embezzlement by an employee and it was held that the loss directly arose from the necessity of employing cashiers and therefore the loss by embezzlement was a trading loss but in that very case it was held that before a claim could be made for deduction of a debt as bad debt it must be a debt in law. That case is not applicable to the facts of the present case and is of little assistance in the decision of the question before us. Counsel for the respondent next relied on *Calcutta Co., Ltd.* v. *The Commissioner of Income-tax* (2). It was held in that case that the expression "profits and gains" has to be understood in its commercial sense and that there could be no computation of profits and gains until the expenditure necessary for earning those profits and gains is deducted therefrom and that when there is no specific provision in s. 10(2) in regard to claim made, its allowability will depend on accepted commercial practice and trading principles and it will be allowed if it can be said to arise out of the carrying on of the business and is incidental to it. As a principle it is unexceptionable but it does not carry the matter any further.

It was next contended that the matter falls within s. 10(2)(xi) of the Act, i.e., it is in respect of the business. This contention has even less substance than the claim of deduction under s. 10(1). Under cl. (xi) also a debt is only allowable when it is a debt and arises out of and as an incident to the trade. Except in money-lending trade debts can only be so described

(1) [1955] 27 I.T.R. 700. (2) [1959] 37 I.T.R. 1.

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if they are due from customers for goods supplied or loans to constituents or transactions of a similar kind. In every case the test is, was the debt due as an incident to the business; if it is not of that character it will be a capital loss. Thus a loan advanced by a firm of Solicitors to a company in the formation of which it acted as legal adviser is not deductible on its becoming irrecoverable because that is not a part of the profession of a Solicitor: *C. I. R.* v. *Hagart & Burn Murdoch* (1).

In our opinion the High Court was in error in answering the question in favour of the respondent. We therefore allow this appeal, set aside the judgment and order of the High Court and answer the question against the respondent. The appellant will have his costs in this Court and in the High Court.

Appeal allowed.

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December 6.

HOSHIARPUR ELECTRIC SUPPLY CO.

v.

COMMISSIONER OF INCOME TAX, SIMLA

(J. L. KAPUR, M. HIDAYATULLAH and J. C. SHAH, JJ.)

Income Tax—Assessee's receipts for installing new electricity installations—If "Profit" or capital—Indian Electricity Act, 1910 (9 of 1910), Schedule c. 6 (1)(b)—Indian Income-tax Act, 1922 (11 of 1922), s. 66(1).

The assessee, an electricity supply undertaking, received certain sum of money for new service connections granted to its customers. Part of this amount was spent for laying mains and service lines. The Income-tax Officer treated the entire amount as trading receipt. In appeal the Appellate Assistant Commissioner excluded the cost of laying service lines and the mains and treated the balance as taxable income. The Appellate Tribunal agreed with the Appellate Assistant Commissioner and held that the service connection receipts were trading receipts and the "profit element" therein was taxable income in the hands

(1) [1929] A.C. 386; (1929) 14 T.C. 433.