Hari Kailash And Co. vs Commissioner Of Income-Tax, U.P., C.P. ... on 10 January, 1952

Equivalent citations: AIR1953ALL170, [1952]22ITR195(ALL), AIR 1953 ALLAHABAD 170

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Bench: V. Bhargava

JUDGMENT

Malik, C.J.

1. The assessee-firm entered into an agreement with Messrs. E. Sefton and Company, Ltd., which company was incorporated under the Indian Companies Act with Its Head Office at Mirzapur. The assessee-firm agreed to finance the business of Messrs. E. Sefton & Company, Ltd., for purchasing raw wool and other manufacturing expenses etc. at a rate of interest mentioned in the agreement, dated 9th April 1940. The agreement further provided that this contract was to remain in force for a period of five years, that the assessee-firm and Messrs. E. Sefton and Company, Ltd., were to put up a Weaving and Finishing Plant to make blankets and blanketting at Mirzapur or at any other place which may be mutually agreed upon, that the two parties would work with the object of executing Government and private contracts for the supply of blankets, blanketting and yarn or for any other woollen products which, in the opinion of both the parties, could be profitably handled and that, during the period of five years that the business was to run, the profits were to be shared between them in the proportion of 40 per cent and 60 per cent, that is, the assessee-firm getting 60 per cent of the profits. It was further provided that, during the period of five years, the assessee-firm or Messrs. E. Sefton and Company Ltd., were not to undertake directly or indirectly a similar business without their mutual consent obtained in writing. There were other terms in this agreement, Ex.T-A, a copy of which is included in the paper book. It is not necessary for us to set out those terms. In short, the assessee-firm and Messrs E. Sefton and Company, Ltd., entered into a partnership to carry on business on certain terms and to share profits and losses, the assessee-firm further undertaking to finance the concern on certain terms mentioned in the document.

The business was carried on for a period of more than one year but on 22nd Nov., 1941, the parties mutually agreed to terminate the agreement. A sum of Rs. 25,962/-, (wrongly mentioned by the Tribunal for Rs. 25,942) was already in the hands of the assessee-firm. Under the Cancellation Agreement, dated 22nd November, 1941, it was agreed that a further sum of Rs. 25,000/- would be paid to them "in lieu of all their claims as regards damages, etc. and share of profits during the period of 'co-operation and future'". Paragraph 10 of this agreement runs as follows:

> "10. That this agreement has been entered into by the parties in a friendly spirit and leaves no malice on either side and that Mr. Shiva Lall of Messrs. S. Laul & Co. will continue to assist the "Manufacturers" (Messrs. E. Sefton & Co., Ltd.) in the matter of continuing the contracts obtained from the Government of India, as and when opportunity arises, except undertaking any pecuniary liability." The Income-tax Officer claimed that the whole of this amount of Rs. 50,962/-, was taxable income which had accrued to the assessee for the financial year ending with 31st March, 1942, which was the relevant account period for the year of assessment with which we are concerned. The assessee-firm had divided the sum of Rs. 50,962/- into two parts. He claimed Rs. 13,694/- as share of profits and Rs. 37,248/-as compensation for the termination of the contract. There was thus no dispute as regards Rs. 13,694/- and as regards Rs. 37,248/-, the matter went up to the Income-tax Appellate Tribunal which held on 16th January 1945, that "this amount will, therefore, be liable to income-tax as they are of the same nature as the profits that will accrue from time to time. The appellants have no justification to urge that they received any amount as damages after obtaining a sum for future profits also. We find that amounts received by the appellants were for the accrued as well as for the future profits."

2. The assessee-firm made an application under Section 66(1), Income-tax Act and formulated four questions for reference to this Court. The Income-tax Appellate Tribunal was of the opinion that the question formulated by it covered all the four questions formulated by the assessee-firm. The question referred to us is to the following effect: "Whether, on the facts and circumstances of the case, the receipt of Rs. 37,248/- is of the nature of a revenue receipt?"

3. In the statement of the case, the findings of fact have not been clearly set out. The way, in which the Tribunal has expressed itself, is as follows:

> "On the findings of fact arrived at by the Tribunal that the entire sum including Rs. 37,248/- in dispute was paid to the applicant in the joint venture account by which the company was to provide materials for the manufacturing of blankets and yarn and the applicant was to provide the finances by virtue of the fact of the earlier termination in not allowing the full period of five years to run and the fact that there was an agreement by which the applicant was not at liberty to do any business, the payment received was trading receipt."

It is difficult to understand what it actually means; but probably the Tribunal meant that the entire sum of Rs. 50,962/- including Rs. 37,248/- was received by reason of the earlier termination of the agreement which was to run for a period of five years and which included a clause to the effect that the assessee-firm was not at liberty to do any business during that period. If the whole of this amount was received as compensation for the earlier termination of the contract, the contract being directed to regulate the conditions under which the assessee-firm was to carry on this partnership business, the decision in -- 'Commr. of Income-tax, ' Bengal v. Shaw, Wallace & Co.', 6 ITC 178: 1932 All LJ 588 (PC), would apply and no part of the amount would be 'income' within the meaning of that term in the Indian Income-tax Act. In the statement of the case, however, the Tribunal has

apparently made a mistake as the assessee firm had admitted that the sum of Rs. 23,684/- was share of profits already earned and was not a compensation for the early termination of the contract. It is for this reason that Mr. Das has urged that we must divide the sum of Rs. 37,248/- into various components and hold that only that part of this amount, which was paid as compensation for the earlier termination of the agreement, was not taxable while the rest of it, that is, any portion of it which included the profits that had already been earned, or the interest that had already accrued, or any other sum that might have been received as actual profits for work done in accordance with the provisions of para. 10 of the Cancellation Agreement of 22nd November 1941, was taxable income. It is not possible for us to go into the question as to which part of this sum of Rs. 37,248/- was paid to the assessee-firm as compensation for the earlier termination of the agreement of 9th April 1940.

4. A large number of cases have been cited and discussed before us but, in the view that we have taken, it is not probably necessary to discuss them in any detail. The Tribunal, in the statement of the case, has expressed the opinion that the decision of their Lordships of the Privy Council in the case of -- 'Shaw, Wallace & Co.', (6 ITC 178: 1932 All LJ 588 PC), should not be relied on in determining the question which has arisen in the case before us and have relied on the decision in -- 'Bush, Beach and Gent, Ltd. v. Road', (1939) 8 ITR Sup 36. They say that the decision in -- 'Shaw Wallace's case' was under the English Income-tax Act and is not relevant. This is clearly wrong. -- 'Shaw Wallace's case' had been decided by the Calcutta High Court and the Privy Council decided it in appeal, while the judgment in -- 'Bush, Beach's case' was delivered by Lawrance J. in the King's Bench Division. The Tribunal was governed by the decision in -- 'Shaw, Wallace's case' while the decision in -- 'Bush, Beach's case' was not really relevant. Their Lordships of the Judicial Committee had pointed out in -- 'Shaw Wallace's case' that "the Indian Act is not in 'pari materia'; it is less elaborate in many ways, subject to fewer refinements, and in arrangement and language it differs greatly from the provisions with which the Courts in this country have had to deal. Under such conditions their Lordships think that little can be gained by attempting to reason from one to the other."

Sri S. C. Das for the Department has contended that the amount received should be treated as income from business. He has relied on the case of -- 'Short Brothers Ltd. v. Commissioner of Inland Revenue', (1928) 12 Tax Cas 955. In that case Short Brothers Ltd., had contracted in February and March, 1920, to build two steamers for the Hindustan Steam Shipping Co., Ltd. In November of that year they agreed to the cancellation of the contract in consideration of the payment of the sum 100,000 which was paid to them on 26th November 1920. For the assessee it was urged by Sir John Simon that it was a sum which was received by the assessee in return for which they ceased to engage in the trade or business of producing these two steam-ships. It was urged that the assessee were not carrying on their trade, which was to build ships, but they were being paid compensation for not carrying on the trade of building these two ships. This contention was not upheld and it was held that the sum of 100,000 was taxable income. Lawrence L. J. pointed out that "where a contract has been entered into in the ordinary course of business, a sum received for the cancellation of that contract is a sum which would go into the ordinary trading receipts of the company for the year in which it was received or in which it became payable, just as, if the company here had paid a sum for the cancellation of an onerous contract, they would have entered into the debits for the year the sum so paid."

Lord Hanworth M. R. said:

> "It is not denied that Messrs. Short Brothers, Limited, carry on a business of building ships, and in the course of carrying on their business they must enter into a great number of contracts, some of which are fulfilled, possibly, some of which are broken, some of which, possibly, are terminated; but in all such matters it is not argued that Messrs. Short Bros., Limited, have less power than other business firms to determine whether or not they will bring to an end, upon terms which they are disposed to agree, contracts which they have entered into, contracts which, for one reason or another, are to be terminated in the interests of one party or the other to the contract. Once one sees that a contract may be determined in the course of business, it appears to me that we have the answer to the problem which is put before us."

His Lordship held "It seems to be simply the sum paid in order that, as a matter of business, the responsibility and liability under the contract should be terminated and the business should be free to to engage in others."

5. From the above observations it is clear that there is a difference between compensation or damages paid or received for non-performance of a contract entered into in the course of business and compensation or damages paid for discontinuance of the business itself. The former may be treated as income but the amount paid for terminating a business cannot, ordinarily, be deemed to be income from, that business taxable under the Indian Income-tax Act.

6. Reliance is also placed on the decision in --'Kelsall Parsons & Co. v. Commissioner of Inland Revenue', (1938) 21 Tax. Cas 608, in which the assessee-firm carried on business as agents on a commission basis for the sale in Scotland of the products of various manufacturers and entered into agency agreements for that purpose. At the instance of the manufacturer concerned one of the agreements, which was for a period of three years, was terminated at the end of the second year in consideration of payment to the appellants of the sum of 1,500 as compensation. The question was whether this amount was a taxable profit or it was a capital receipt. The Lord President (Normand) said:

> "That was a contract incidental to the normal course of the appellants' business. Their business, indeed, was to obtain as many contracts of this kind as they could and their profits were gained by rendering services in fulfilment of such contracts..... It was a normal incident of a business such as that of the appellants that the contracts might be modified, altered or discharged from time to time, and it was quite normal that the business carried on by the appellants should be adjustable to variations in the number and importance of the agencies held by them, and to modifications of the agency agreements including modifications of their duration, which might be made from time to time..... In parting with the benefit of the contract, moreover, the appellants were not parting with something which could be described as an enduring asset of the business. The contract would have been terminated in any event as at 30th Sept. 1935..... The agreement by which the agency contract was terminated at

> September 1934, therefore effected a surrender of one year's benefit, and in return for this surrender the appellants received compensation. ..... The sum paid in this case is really and substantially a surrogatum for one year's profits."

And in the end the Lord President remarked: "In my opinion the agency agreements entered into by the appellants, so far from being a fixed framework, are rather to be regarded as temporary and variable elements of the appellants' profit-making enterprise."

These observations and the observations made by Lord Moncrieff clearly bring out the difference pointed out by us above. Lord Moncrieff divided two classes of cases of compensation paid for termination of contracts as follows: "(1) a contract may be made by a trader which is merely directed to result in trading profits being made; (2) a contract may be made by a trader which is directed to regulate the conditions under which he is to carry on his trade." In the first class of cases, if the contract is terminated or a breach thereof is made and compensation or damages are received it might be treated as trading profits. In the second class of cases, compensation received for the termination of a business cannot be treated as trading profits as it was paid for the termination of the trade or business. The amount received in such a case would ordinarily fall within the rule laid down in -- 'Shaw Wallace's case' (6 ITC 178: 1932 All LJ 588 PC) and would not be taxable. In one case, one gives up the source from which the income arises; in the other one merely gives up anticipated profits, which would have accrued to him if the contract had not been discontinued or terminated, for cash payment.

7. In the case before us, there was a contract entered into by the assessee firm on 9th April 1940, which was to run for a period of five years. It was to regulate the conditions under which the assessee firm was to carry on the trade or business. It acquired, under this agreement, certain rights and was not put under certain liabilities. By the Cancellation Agreement of 22nd November 1941, all these congeries of rights that it had acquired under the first agreement were terminated for a certain consideration. The compensation paid for termination of those rights is not taxable income and income-tax cannot be charged on that sum. The amount of Rs. 37,248 cannot, therefore, be said to be a revenue receipt. This is our answer to the question formulated by the Tribunal. The assessee-firm is entitled to its costs which we assess at Rs. 400.