Laxmiratan Cotton Mills Co., Ltd., ... vs Commr. Of Excess Profits Tax, U.P., ... on 23 September, 1952

Equivalent citations: AIR1953ALL65, AIR 1953 ALLAHABAD 65

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JUDGMENT

V. Bhargava, J.

1. This is a reference under Section 21, Excess Profits Tax Act, read with Section 66 (1), Income-tax Act. The assessee Messrs. Laxmiratan Cotton Mills Co., Ltd., Kanpur, is a director-controlled company incorporated under the Indian Companies Act, managed by its managing agents, Messrs. Beharilal Kailashpat. The company manufactures textiles at Kanpur. The share holders are either members of the family of Messrs. Juggilal Kamlapat or are closely connected with them. The company in addition to employing its own capital also borrows money from banks and other sources. The chief sources for borrowing money were the Imperial Bank of India and Messrs. Juggilal Kamlapat of Kanpur. The company started its operations before April 1936.

2. A notice under Section 13 (1), Excess Profits Tax Act, was served on the company on 23-9-1940, and the return required by that notice was submitted to the Excess Profits Tax Officer on 15-12-1940. Subsequently on 3-2-1942, the company applied to the Central Board of Revenue under Section 26 (1) re-questing that their standard profits may be fixed at a figure of Rs. 7,50,000 or alternatively twenty per cent. on the average capital including borrowing from all sources employed in the business during the chargeable accounting period, whichever be higher. In the application the company chose the period from 1-10-1936 to 30-9-1938 as the standard period.

In the grounds for this application, the company gave various reasons why the standard pro-fits in relation to the chargeable accounting period arrived at under Section 6 would not be fair to the company. The two principal reasons given were, firstly, that the company had succeeded in obtaining the latest type of machines calculated to give better production than other mills situate in the same area at a very low price as the equipment was purchased at a time when the prices of machinery were at their lowest so that the initial capital investment was not high; and secondly, that the profits during the standard period were particularly low as during that period trained workmen were not available and the company had to work out a scheme for training workmen for extension, to adjust uneven and un-balanced equipment, and for further experimentation and adjustment of departmental operations of the production programme of the mill, the benefit of which did not become available to the company until after the expiration of the standard period.

On this application the Board of Revenue passed an order which was communicated to the assessee by the Secretary, Central Board of Revenue through letter dated 23-4-1942 and which is reproduced below as the learned counsel for the asses-see has based his argument very considerably on it :

> "The Central Board of Revenue, having considered your application, under Sub-section (1) of Section 26, Excess Profits Tax Act, 1940;
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> (a) That, by reason of special circumstances alleged by you, it is inequitable that the standard profits of your business in relation to the chargeable accounting period commencing 1-9-1939 and ending 30-9-1939 should be computed in accordance with the provisions of Sub-section (1) of Section 6 :
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> (b) that, by reason of a specific cause peculiar to the business alleged by you, it is just that their direction should not be limited to the statutory percentage of the average amount of capital employed in the business;

and having heard your representatives in support of such application, the Central Board of Revenue has directed, that the standard profits of the business, in relation to the said chargeable accounting period shall be computed as if the profits of the standard period via. the previous year commencing 1-10-1936 and ending 30-9-1937 ;

and the previous year commencing 1-10-1937 and ending 30-9-1938 were the sum of Rs. 3,20,000."

Subsequently the assessee in reply to some communication addressed by it to the Central Board of Revenue received a letter from the Excess Profits Tax Adviser of the Central Board of Revenue intimating that the directions of the Central Board of Revenue had proceeded on the basis that the statutory average capital of the company's standard period was the sum of Rs. 12,01,735.

3. The Excess Profits Tax Officer, when making the assessment for the first chargeable accounting period, held that the average amount of capital employed during the standard period was RS. 12,01,735 and that the average amount of capital employed during the first chargeable accounting period was RS. 14,35,156, without taking into account the amounts borrowed by the assessee. To arrive at the amounts to be added to the capital employed during the chargeable accounting period in respect of borrowings from banks, the Excess Profit Tax Officer took into account the average bank borrowings during the chargeable accounting period as Rs. 13,85,304 and deducted from it bank loans at the end of the standard period which had amounted to Rs. 11,81,920, the difference of Rs. 2,03,384 was thus added by him to the capital of Rs. 14,55,156, for the chargeable accounting period arrived at without including loans from banks.

The assessee, however, claimed that in order to work out the figure to be added in respect of the loans from banks the Excess Profits Tax Officer should have deducted, from, the average bank borrowings during the chargeable accounting period, the average bank borrowings during the standard period which were only Rs. 6,09,262 instead of the bank loans at the end of the standard period which were RS. 11,81,920, so that the amount to be added should have been Rs. 7,76,042. This reference to us relates to three different chargeable accounting periods, viz. (1) 1-9-1939 to 80-9-1939, (ii) 1.10-1939 to 30-9-1940 and (iii) 1-10-1940 to 30-9-1941.

In the two succeeding chargeable accounting periods also, the average capital employed during those chargeable accounting periods was worked out by the Excess Profits Tax Officer in the same manner as for the first chargeable accounting period which has been mentioned above. The contention of the assessee before the Appellate Assistant Commissioner, against the order of the Excess Profits Tax Officer, was that the Central Board of Revenue had determined the average capital employed during the standard period to be Rs. 12,01,735 and that the Excess Profits Tax Officer was not entitled to modify this figure. It was further contended that the Excess Profits Tax Officer was wrong in calculating the amounts to be added in respect of bank loans inasmuch as, when calculating that amount, he had wrongly deducted the bank loans at the end of the standard period instead of the average bank borrowings during the standard period from the average bank borrowings during the chargeable accounting period.

The Appellate Assistant Commissioner did not accept any of these two contentions of the assessee so that the assessee's appeal was dismissed. The Income-tax Appellate Tribunal agreed with the view of the Appellate Assistant Commissioner and dismissed the appeal. Thereupon the assessee applied that certain questions be referred to this Court for decision. The tribunal, after considering the questions as drafted by the assessee and after taking into account the contentions of the department, referred the following three questions to this Court for decision :

> "1. What, in the circumstances of the case, mast be deemed to be the amount of capital of the applicant company during the standard period for the purpose of comparison with the capital employed daring the chargeable accounting period?
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> 2. Whether under the provisions of the Act and particularly Rule 5 of Schedule 1 of the Act, the increase in the average capital employed during the chargeable accounting period and the average capital employed during the standard period is (a) difference between the average bank borrowings during the two periods or (b) the difference between the average borrowings during the chargeable accounting period and the borrowed capital at the close of the standard period?
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> 3. Whether the provisions of law as contained in Sections 2, 6 and 26 and Schs. I and II, Excess Profits Tax Act, and the directions of the Central Board of Revenue, if any, have been correctly understood and applied by the Excess Profits Tax Officer to the facts of the case in computing the average capital during the standard and chargeable accounting periods."

4. Mr. Pathak on behalf of the assessee contended with reference to the first question that the Excess Profits Tax Officer was not competent to modify the figure of Rs. 12,01,735 which had been determined as the average capital employed during the standard period by the Central Board of

Revenue. But we are unable to see that there is any force at all in this contention. Neither in the statement of the case nor in the appellate order of the tribunal is there any finding of the fact that the Central Board of Revenue had determined the capital of the assessee in the standard period to be RS. 12,01,735. In the statement of the case, the manner in which this figure was arrived at by the Excess Profits Tax Officer has been described.

Reference has been made to sheet cm of the statements of account prepared by the Excess Profits Tax Officer during the assessment proceedings and this sheet cm has been made a part of the statement of the case by being included as EX. A-3 in the appendix. In this sheet, the average amounts of capital during the previous years for the years of assessment 1938-39 and 1939-40 were added together and halved in order to work out the average for the full period of these two years which was taken as standard period. Exhibit A-6 which reproduces sheet cur shows that the two figures for the average amount of capital during the previous years for the years 1938-39 and 1939-40 were taken from sheets CI and CII which are EXS. A-4 and A-5 in the appendix.

In these statements, those figures were calculated on the basis of relative capital as per statement A. This statement A is not before us as the Tribunal did not direct that it should form part of the statement of the case. However, we are not concerned with the detailed method of calculation adopted by the Excess Profits Tax Officer nor with the correctness of those calculations. Those are questions on which the decision of the Tribunal was final. It is, however, clear from these references and the statement of the case that the figure of Rs. 12,02,735 was worked out by the Excess Profits Tax Officer himself from various statements prepared by him presumably on the basis of the accounts produced before him by the assessee.

There is no indication at all that this figure was taken by the Excess Profits Tax Officer from the letter of the Excess Profits Tax Adviser to the Central Board of Revenue which has been relied upon by the assessee and which has been made part of the statement of the case as EX. L. The appellate order of the Tribunal makes the position clearer. The order of the Tribunal is EX. E1 and in para. 3 of that order of the Tribunal says :

> "The Central Board of Revenue never said that the capital employed by the appellant in his business, in the standard period was Rs. 12,01,735."

They proceeded to mention that they had been told that the Excess Profits Tax Adviser to the Central Board of Revenue wrote in a letter to the appellant that the statutory average capital of the company's standard period was the sum of Rs. 12,01,735. The Tribunal did nob hold that this letter of the Excess Profits Tax Adviser to the Central Board of Revenue was proof of the fact that the Central Board of Revenue had determined the statutory average capital of the company's period to be RS. 12,01,735. Learned counsel for the assessee further argued that when deciding an application under Section 28 (i), the Central Board of Revenue had to direct that the standard profits of the assessee shall be computed to be such greater amount, than the amount determined under the provisions of Sub-section (1) of Section 6, as the Central Board of Revenue thinks just; and in doing so, the Central Board of Revenue was bound to determine the statutory average capital for the standard period so that this communication from the Excess Profits Tax Adviser must be deemed to be proof that the amount of RX. 12,01,735 had been determined as such capital.

We do not think that there is any force in this argument as there is no requirement at all that, while passing orders on an application under Section 26 (1), the Central Board of Revenue must necessarily determine the statutory average capital of the applicant during the standard period. In these circumstances it cannot be presumed that the capital of the assessee during the standard period was actually determined by the Central Board of Revenue. The actual language of the order passed by the Central Board of Revenue which has been reproduced earlier also makes it clear that there was no such determination. The order only lays down that the standard profits of the business in relation to the chargeable accounting period are to be computed as if the profits of the standard period were the sum of Rs. 3,20,000.

This shows that the Central Board of Revenue instead of prescribing the amount of the standard profits of the aasessee's business in relation to the chargeable accounting period only prescribed the profits of the business for the standard period. Since the Central Board of Revenue merely laid down in their order the profits for the standard period, it was incumbent on the assessing authorities to work out the standard of profits in relation to the chargeable accounting period in accordance with the provisions of Section 6 accepting the figure of the profits for the standard year to be laid down by the Central Board of Revenue. This is precisely what has been done in this case by the Excess Profits Tax authorities. Their calculations have proceeded on an acceptance of Rs. 3,20,000 as the profits of the standard period and with this figure, as the basis, they have worked out the standard profits in relation to the chargeable accounting period.

They have, therefore, in no way varied any figure which was actually determined by the Central Board of Revenue and it cannot be said that their computation is, therefore, incorrect. However, even on this view held by us it is not possible to answer the first question as it has been framed by the Tribunal. The question as framed requires us to give the exact figure which must be deemed to be the capital of the company during the standard period. It is not the function of this Court to make calculations and compute the capital during the standard period. If there are any errors in computation they could have been corrected only by the appellate authorities. This Court is not concerned with such errors in computation. The question as framed cannot, therefore, be answered.

5. We may, at this stage, take the third question also before dealing with the second question.

This question is, on the face of it, one that/should not have been referred for decision to this Court. In this question, we are asked to decide whether the Excess Profits Tax Officer had correctly understood and applied the provisions of law as contained in certain specified sections and Schedules of the Excess Profits Tax Act and the directions of the Central Board of Revenue. It was the function of the Appellate Assistant Commissioner and the Appellate Income-tax Tribunal to examine the view that had been taken by the Excess Profits Tax Officer and, if he committed any mistake, to set him right. This Court is only concerned with the correctness of decision on questions of law by the Appellate Income-tax Tribunal and consequently we must refuse to answer the question whether the Excess Profits Tax Officer had or had not correctly understood and applied the provisions of law and the directions of the Central Board of Revenue.

The second question is the only question of law which, in our opinion, really calls for a decision by us. The appellate income-tax Tribunal for the purpose of working out the average capital em-ployed during the chargeable accounting period, did not take into account the difference between the average bank borrowing during the two periods and instead considered the difference between the average bank borrowings during the chargeable accounting period and the borrowed capital at the close of the standard period. The question as to which method was correct depends on the interpretation of Rule 5 of Schedule I, Excess Profits Tax Act, which is reproduced below :

> "If at any time after the close of the standard period any increase in the capital employed in a business has been effected by means of a loan from a bank carrying on a bona fide banking business, or by means of a public issue of debentures secured on the property of the company, the interest on so much of the loan or debentures as has been utilised in effecting the increase in the capital shall not be deducted in computing the profits for the purposes of excess profits tax and notwithstanding the provisions of Rule 2 of Schedule II, that amount of such loan or debentures shall not be deducted in arriving at the amount of the capital employed in the business."

This rule has to be applied with reference to Rule 2 (1) of Schedule II of the Act. Schedule II of the Act lays down the principles for computing the average amount of capital of the business in relation to a chargeable accounting period. Rule l of this Schedule gives the various items that have to be totalled together to work out the capital. Rule 2 directs that all borrowed monies and debts should be deducted when computing the average capital in relation to any chargeable accounting period. Rule 5 of Schedule I provides an exception to this Rule 2 of Schedule II and lays down that certain loans and debentures are not to be deducted in arriving at the amount of the capital employed in the business. The loans which are not to be deducted are also those loans which may be taken from a bank carrying on bona fide banking business.

There is the further requirement that these loans are not to be deducted only if, at any time after the close of the standard period, any increase in the capital employed in the business has been effected by means of such loans from a bank. In this case, there is no dispute that the borrowings under consideration were from a bank carrying on bona fide banking business, and we have only to see what part of those loans are not to be deducted from the actual capital employed during the chargeable accounting period in accordance with Rule 5 of Schedule I mentioned above. Considering the case of the first chargeable accounting period, the finding is that the average bank borrowings daring that period were Rs. 13,85,304. The average bank borrowing during the standard period which just preceded the chargeable accounting period wore Rs. 6,09,262.

In the average capital employed during the chargeable accounting period there was thus an increase as a result of borrowings to the extent of Rs. 7,76,042. This was the increase in the capital employed in the chargeable accounting period as a result of the loans which had been taken by the assessee from a bank carrying on bona fide banking business and obviously this is the amount that should have been taken into account for the purpose of applying Rule 5 of Schedule I when calculating the capital employed in the business. Mr. Jagdish Swarup, on behalf of the department, contended that the whole increase of Rs. 7,76,042 was not the result of fresh loans taken from the bank during the chargeable accounting period and that it included some increase in the average capital which had resulted because there was a heavy loan at the end of the standard period which was continued during the chargeable accounting period.

His contention was that, in calculating the amount which is not to be deducted in arriving at the amount of the capital during the chargeable accounting period, only such parts of the loan from the bank can be considered as had been taken after the close of the standard period. It appears to us that this contention is based on an interpretation of Rule 5 which is not justified. All that Rule 5 requires is that the increase in the capital employed in a business should have been effect-ed at any time after the close of the standard period by means of a loan from a bank. The rule does not require that the loan itself should have been taken after the close of the standard period. The words "at any time after the close of the standard period" only qualify the words "increase in the capital" and not the words "the loan from a bank". Even if the loan may have been taken earlier, the amount of that loan is to be deducted in case the increase in the capital is effected as a result of that loan at any time after the close of the standard period.

In the present case the average borrowings during the standard period were Rs. 6,09,262 whereas the average borrowings during the chargeable accounting period were Rs. 13,85 304. There was thus an increase in the average borrowings to the extent of RS. 7,76,042 and the whole of this increase in the average borrowings resulted in an increase in the capital employed during the chargeable accounting period which followed the standard period. Since the increase in the capital took place after the close of the standard period the whole of this difference in the average borrowings which resulted in the increase in the capital must be the amount not to be deducted, under Rule 5 of Schedule I. Learned counsel for the department, on the other hand, contended that only such loans were not to be deducted under Rule 5 of Schedule I as had not only effected an increase in the capital after the close of the standard period but as had actually been taken after the close of the standard period. Learned counsel referred us to certain examples which had been given by the Central Board of Revenue in the instructions issued by the Board to the assessing authorities for computation of excess profits. Since the method of computation given in these examples was the basis of the argument of the learned counsel before us, we may here set out one of them and consider where the error in interpretation has been committed in it. The fourth example in the instructions issued is as follows:

> Example (4) (A)--Average capital on normal basis during the standard period, Rs. 10,00,000.
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> (B) Average capital on normal basis during the chargeable accounting period, Rs. 9,00,000.
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> (C) Average borrowed money during the standard period, Bs. 50,000.
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> (D) Actual borrowed money at close of standard period, Rs. 2,00,000.

> (E) Average borrowed money during the chargeable accounting period, Rs. 2,00,000. In this case although there is an increase in the average business assets during the chargeable accounting period of Rs. 11,00,000 less Rs. 10,50,000 and that increase is all due to the increase in the average borrowed money of Rs. 2,00,000 less Rs. 50,000 the whole of this increase is due to the borrowings before the close of the standard period and, therefore, Rule 5 is not applicable.

6. It is quite clear from this example that the learned counsel wants us to interpret Rule 5 as laying down not merely that the increase in the capital of the business should have been effected at any time after the close of the standard period but also that the loan which effected the increase should also all have been taken after the close of the standard period. In the example given above the average borrowed money during the chargeable accounting period was Rs. 2,00,000/- and the average borrowed money during the standard period was Rs. 50,000/-. The increase in the average borrowed money was Rs. 1,50,000/- and this was also the extent of the increase in the capital employed during the chargeable accounting period. The whole of this increase in the average capital employed was the result of borrowings though part of this increase was the result of borrowings during the standard period and not after the close of the standard period. The increase in the average capital was, however, effected after the close of the standard period.

On the proper interpretation of Rule 5 of Schedule I it must be held that the whole of this difference in the loans to the extent of Rs. 1,50,000/- should not be deducted in computing the capital. We do not think that the language of the rule can justify the interpretation that the loans which effected the increase should itself all have been taken after the close of the standard period. In order to compute what amount of loan has been utilised in effecting the increase in the capital the loan taken even before the standard must be taken into account. Consequently, the correct method of computing the amount which is not to be deducted under Rule 5 would be to take the difference between the average bank borrowings during the chargeable accounting period and the average bank borrowing during the standard period.

7. The anomaly and injustice that would result if the interpretation put on behalf of the department on this rule is accepted can be best brought out by an example. There can be a case where an assessee takes a loan of one lac from a bank at the beginning of the standard period and maintains that loan for eleven months. In the twelfth and last month of the standard period he takes an additional loan of 12 lacs so that the borrowings from the bank in that month amount to thirteen lacs. In such a case the assessee would have the benefit of a loan of one lac for eleven months and a loan of thirteen lacs for one month during the standard period which would give him the benefit of average borrowings of two lacs for the whole standard period.

In the succeeding chargeable accounting period, the assessee maintains the loan of thirteen lacs for three months and thereafter repays twelve lacs, bringing down the loan to one lac which continues until the close of the chargeable accounting period. During the chargeable accounting period, the assessee thus has the benefit of loan from the bank to the extent of thirteen lacs for three months and one lac for nine months, giving him an increase in the average capital of four lacs during the chargeable accounting period as against two lacs in the standard period. In such a case there is an obvious increase in the capital employed in the business during the chargeable accounting period and this increase is effected during the chargeable accounting period.

The increase is also due to the borrowings from a bank and yet on the method of calculation contended by the department there would be no loan at all from the bank which can be said to have effected the increase and which should not be deducted in accordance with Rule 5 of Schedule I. In fact, on that method of calculation, instead of there being any increase in the loan there would be a decrease to the extent of nine lacs because the average borrowings during the chargeable accounting period were only four lacs and the actual loan at the close of the standard period was thirteen lacs. Since all the borrowings would have to be deducted in computing the average capital for this chargeable accounting period in accordance with Rule 2 of Schedule II, the result would be that the average capital employed during the chargeable accounting period so computed would be nine lacs less than the average capital of the standard period though, in fact, the average capital used by the assessee would be four lacs more than the average capital during the standard period.

8. It appears to us that there is one more difficulty which arises if the interpretation put by the department is accepted. In some cases Rule 5 may have to be applied where there has been lapse of a considerable period between the close of the standard period and the beginning of the chargeable accounting period. In such a case if the actual amount of the loan at the end of the standard period is deducted from the average borrowings during the chargeable accounting period, the method of calculation adopted would completely ignore the effect of all the borrowings that might have taken place during the intervening period and this would clearly be unjustified.

9. Clearly, therefore, the correct interpretation of Rule 5 is that it will apply if any increase in the capital employed in a business is effected at any time after the close of the standard period as a result of a loan taken from a bank whether the loan is taken after the close of the standard period or earlier and that the rule does not require that the loan itself should have been taken after the close of the standard period.

10. This rule came up for interpretation before the Bombay High Court in Killick Nixon & Co. v. Commissioner of Income-tax, 1945-13 I. T. R. 445 (Bom.) and before the Calcutta High Court in Commissioner of Excess Profits Tax West Bengal v. Karamchand Thapar & Bros., 1950-18 I. T. R. 722 (cal.). Both the High Courts held that for the purposes of applying Rule 5 of Schedule I of the Excess Profits Tax Act the amount which is not to be deducted has to be calculated by taking the difference between the average borrowings during the chargeable accounting period and the average borrowings during the standard period and not the difference between the average borrowings during the chargeable accounting period and the actual borrowings at the close of the standard period. The decisions of those Courts are thus in line with the view taken by us above. We answer question No. 2, accordingly.

11. We direct that the assesses shall get Rs. 500/- as costs from the department.