# The Commissioner Of Income-Tax, Delhi vs The Delhi Flour Mills Co., Ltd., Delhi on 3 October, 1958

## Equivalent citations: 1959 AIR 185, 1959 SCR SUPL. (1) 28, AIR 1959 SUPREME COURT 185, 1959 35 ITR 15, 1959 29 COM CAS 69, 1959 CALLJ 282, 1959 SCJ 380, ILR 1959 PUNJ 319

## Author: A.K. Sarkar

## Bench: A.K. Sarkar, P.B. Gajendragadkar

PETITIONER:
THE COMMISSIONER OF INCOME-TAX, DELHI

Vs.

RESPONDENT:
THE DELHI FLOUR MILLS CO., LTD., DELHI

DATE OF JUDGMENT:
03/10/1958

BENCH:
SARKAR, A.K.
BENCH:
SARKAR, A.K.
AIYYAR, T.L. VENKATARAMA
GAJENDRAGADKAR, P.B.

CITATION:
1959 AIR 185 1959 SCR Supl. (1) 28
CITATOR INFO :
RF 1961 SC 692 (12)

ACT:
Excess Profits-Assessment-Assessee company's agreement with managing agents-Commission on net profits-Computation -Tax, if can be deducted-- " Net profits ", meaning of.

HEADNOTE:
An agreement between the assessee company and its managing agents provided : " In consideration for acting as managing agents the company should pay to the firm remuneration at Rs. 750/- p.m..... and in addition a commission equal to of the annual net profits. Such net profits will be arrived at after allowing the working expenses, interest

on loans and due depreciation, but without setting aside anything to reserves or other special funds ". The question was whether the excess profits tax payable by the company should be deducted from its profits for the purpose of arriving at the annual net profits of which a percentage should be paid to the managing agents as their commission under the agreement.

Held ' that,, the words " net profits " in the agreement meant divisible profits, profits divisible between the company and the managing agents, and that in ascertaining such profits, deduction had to be made, besides the items expressly mentioned in the agreement, of excess profits tax payable by the company.

James Finlay & Co., Ltd. v. Finlay Mills Ltd., (1942) 47 Bom. L.R. 774 and Walchand & Co., Ltd. v. Hindusthan Construction Co., Ltd., (1943) 45 Bom. L.R. 951, considered.

Ashton Gas Company v. Attorney-General, [1906] A.C. 10 and Re G. B. Ollivant & Co. Ltd.'s Agreement, [1942] 2 All E. R. 528, distinguished.

JUDGMENT:

CIVIL APPELLATE JURISDICTION : Civil Appeal No. 211 of 1955. Appeal from the judgment and order dated.December 30, 1952, of the Punjab High Court in Civil Reference Case No. 18 of 1952.

H. J. Umrigar and R. H. Dhebar, for the appellant. Hardayal Hardy, for tile respondents.

1958. October 3. The Judgment of the Court was delivered by SARKAR J.-By an agreement made in 1936, the assessee company appointed a firm as its managing agents. The agreement provided that the managing agents would be remunerated in the manner following:

> "In consideration for acting as Managing Agents the Company should pay to, the firm remuneration at Rs. 750 p.m. or such principal sum as may from time to time be deemed reasonable by the Directors and in addition a commission equal to 10% of the annual net profits. Such net profits will be arrived at after allowing the working expenses, interest on loans and due depreciation, but without setting aside anything to reserves or other special funds."

The question is whether the commission payable to the managing agents under this agreement is to be ten per cent. of the profits of the assessee without deduction of the excess profits tax payable by it oil its profits or after deduction.

The question has arisen in the course of the assessment of excess profits tax payable by the assessee. The Excess Profits Tax Officer held that the commission has to be ascertained on the profits remaining after deduction of excess profits tax. This view was upheld by the Appellate Assistant

Commissioner on an appeal being taken to him by the assessee. On a further appeal by the assessee to the Appellate Tribunal it was held that the commission has to be ascertained on the profits without any deduction of the tax. The revenue authorities then applied for and obtained, an order from the Tribunal referring the following question for decision by the High Court:

> " Whether on a true construction of the Managing Agency Agreement between the assessee Company and its Managing Agents entered into in 1936, the relevant clause of which is quoted above, the Excess Profits Tax payable should be deducted from the profits of the Company for the purpose of arriving at the annual net profits of which a percentage should be paid to the Managing Agents as their commission."

The High Court answered the question in the negative.

The present appeal is by the revenue authorities against the judgment of the High Court.

The question is a short one. It is one of construction of the managing agency agreement. Of course, whatever is payable under this agreement to the managing agents as their remuneration is a proper expense of the business of the assessee and has to be deducted in ascertaining its profits and it is upon such profits that excess profits tax has to be assessed. There is no dispute about this. The dispute has arisen because the remuneration of the managing agents is we leave out now the minimum and fixed remuneration of Rs. 750 per month as to which no question arises and with which we are therefore not concerned-itself to be calculated on the profits. The dispute is whether the proper construction of the agreement is that the profits, a percentage of which is to be paid to the managing agents as their remuneration, are the profits before deduction of excess profits tax or after.

What then is the true construction ? The agreement is that "the net profits will be arrived at after allowing the working expenses, interest on loans and due depreciation but without setting aside anything to reserves or special funds." We can leave out the things expressly made not deductible for as to these no question arises, the question being whether something more, namely, excess profits tax, can be deducted. Working expenses, interest on loans and due depreciation have however been expressly made deductible in ascertaining the net profits. If these are all the deductions that can be made, excess profits tax cannot be deducted for it does not come under any one of them. But it seems to us that the agreement was not intended to lay down all the deductions that can be made. It is not in dispute that expenses like overhead expenses, litigation expenses and similar other expenses properly incurred for carrying on the business can be deducted in arriving at the net profits. These would not be included within "working expenses " for that expression is usually understood as referring to expenses debitable to the trading account as having been incurred directly in making the income shown there. If this were not the sense in which the expression "

> working expenses " was used and it was meant to cover all revenue expenses incurred, then there would have been no need to mention interest on loans and depreciation separately, for, these latter would have been included as revenue expenses in the expression " working expenses ". We are therefore inclined to think

that there are other items besides those expressly mentioned, which have to be deducted before the net profits can be arrived at.

What then are these other items? That will depend on what the parties must be taken to have had in mind when they used the words " net profits ". The intention of the parties as to what they meant by these words can be best gathered by trying to find out what they were about in making the agreement. The parties were a master and a servant and they were fixing the remuneration of the servant. They decided that profits or no profits, the servant would have a certain fixed sum per month. They also agreed that the servant would besides the fixed sum, have a certain portion of the net profits. The net profits, whatever they were, would of course be a variable figure; in some years they would be more or less than in other years. The parties therefore agreed that the remuneration of the servant would increase or decrease as the net profits were larger or smaller. But why did they do so ? Obviously because they thought that it was fair that the servant's remuneration should be commensurate with the benefit that his work produced for the master; the larger such benefit was, the larger the servant's remuneration and vice versa. It is difficult to imagine that the parties agreed that remuneration would be paid for profits earned by the servant's efforts of which the master did not get the benefit. This view of the matter becomes clearer when one remembers that besides the variable remuneration dependent oil the profits, the servant had a fixed minimum remuneration. The agreement, therefore, was essentially one to share the profits; the agreement was that part of the profits was to go to the servant and part enure for the master's benefit. If this is the true construction of the agreement, as we think it is, then it follows that the net profits contemplated by the parties are such profits as can be divided between the master and the servant; they are such of which both the master and the servant get the enjoyment in stated proportions. In other words, they are the divisible profits of the company, divisible, that is to say, between the master and the servant. In order that the divisible profits can be ascertained, excess profits tax has of course to be deducted. As to that there does not seem to be any doubt, for, that part of the profits which is taken away by the State as excess profits tax, is not available either to the master or the servant and cannot therefore be divided between them.

It is said that the agreement cannot be construed in this way because that would be adding a word to it; the word 'divisible not being there, is introduced into the agreement to support this construction. This however is not so. No word is being introduced but the words used are only being explained. It is only stating that the parties meant by "

net profits ", the divisible profits. It is really stating the same thing in different words.

It is also no objection to the view that we take, that excess profits tax is a part of the profits itself It perhaps is so but it is no part of the " net profits "

> contemplated by the parties. It is a part which has to be deducted in arriving at the net profits, that is to say, the divisible profits which alone the parties had in mind. As a matter of construction of the agreement before us,-and we do not think that the question involved in this case can be decided in any other way-therefore, we come to the conclusion that the " net profits " mean the divisible profits and are to be ascertained after deduction of excess profits tax which is payable by the assessee. That is how the matter strikes us apart from any authority. We now turn to some of the authorities which were cited at the bar. They are In re Condran, Condran v. Stark (1), Patent Castings Syndicate Ltd. v. Etherington (2), Vulcan Motor and Engineering Co. v. Hampson (3 ), Re G. B. Ollivant & Co. Ltd.'s Agreement James Finlay & Co. Ltd. v. Finlay Mills Ltd. and Walchand & Co. Ltd. v. Hindusthan Construction Co. Ltd. (6). These cases however all turn on the construction of the agreements involved in them. They are therefore not of much assistance in construing the agreement that we have before us, for, each agreement has to be construed according to the words contained in it and the circumstances in which it was made. The judgment in Re G. B. Ollivant & Co. Ltd.'s Agreement (supra) referred to earlier is that of the House of Lords.

In the judgment delivered in this case by the Court Appeal reported in (1942) 2 All E. R. 528 which was affirmed by the majority of the House of Lords, Lord Greene M. R. warned that in questions of this kind authorities were of no assistance. Referring to the earlier English cases mentioned above, he said (p. 532):

> " They decide that on the true construction of the agreements there in controversy, the phrase " net profits "

in Etherington's case, the phrase " profits earned by the company " in Vulcan's case and the phrase " net profits " in Condran's case, all meant the divisible profits of the company in the first two cases and of the partnership in the third. They went on to decide a matter which I should have thought was not open to question, namely, that in ascertaining divisible profits excess profits duty fell to. be deducted ..... But beyond that, those authorities do not appear to me to afford any assistance. The first part of the decisions, as to the meaning of " profits " or net profits in those particular agreements, does not help, because the language is entirely different from that used in the present case; and the second part of the decisions, namely, that in ascertaining divisible profits excess profits duty is to (1) [1917] 1 Ch. 639. (3) [1921] 3 K. B. 597.

(5) (1942) 47 Bom. L.R. 774.

(2) [1919] 2 Ch. 254.

(4) [1942] 2 All E. R. 528.

(6) (1943) 45 Bom. L.R. 951.

be deducted, is, as I say, a matter for which I should have thought authority was not required..... Like the earlier cases, Re O. B. Ollivant & Co. Ltd.'s Agreement (1) also 'turned on the language of the ;agreement involved in it and is not therefore of any great assistance. The Indian cases mentioned earlier were also decided on the agreements with which they were concerned. In the James Finlay & Co. Ltd. case (2) the agreement provided that the "

> net profits" were to be ascertained before setting aside any sum " for payment of income-tax, super-tax or any other tax on income ". It was held that " any other tax on income "

included excess profits tax which could not therefore be deducted. Beaumont C. J. observed in this case that it having been held that income-tax being something which is payable out of the profits and not a liability to be deducted in ascertaining the profits, it was difficult to explain why the same' principle should not apply to excess profits duty. He also said that a distinction had been made between the two taxes in the English cases, to some of which we have earlier referred, but he did not think it necessary to consider whether all the grounds of distinction were sound, because in the case before him he thought that excess profits tax had been expressly dealt with. In the Walchand & Co. Ltd. case the agreement was very much like the agreement that we have before us. It provided that the managing agents would be paid ten per-cent. of the annual net profits earned by the company and also stated that in arriving at the net profits certain deductions would be made which included the working expenses and that certain other deductions would not be made, but no mention was made of excess profits tax as being deductible or otherwise. Beaumont C. J. who was a member also of the bench which decided this case, held that the agreement was a profit sharing agreement and the net profits had to be ascertained after deducting excess profits tax. Now we do not refer to these judgments (1) [1942] 2 All E. R. 528. (2) (1942) 47 Bom. L.R. 774.

(3) (1943) 45 Bom. L.R. 951.

as supporting anything that we say but because the High Court unwittingly fell into the error of thinking that the Walchand & Co. Ltd. case (1) came before the James Finlay & Co. Ltd. case (2) and that in the latter case Beaumont C. J. had doubted the correctness of what he had said in the former. These observations are wholly wrong because, the James Finlay & Co. Ltd. case (2) was decided long before the Walchand & Co. Ltd. case (1) had been decided. Neither do we find that there is any conflict between the two cases. In the Walchand & Co. Ltd. case (1), Beaumont C. J. gave reasons for making a distinction between income-tax and excess profits tax and thought that the distinction between them made in the English cases to which we have referred, was not of substance. We do not think it necessary to say anything as to whether Beaumont C. J. was right in this view.

Oil behalf of the assessee we were pressed with the same contention that as it has long been held that income-tax could not be deducted in ascertaining the net profits of a company, excess profits tax could not also be deducted, for, they were substantially of the same nature each being a tax on the profits. Indeed in Ashton Gas Company v. Attorney- General (3), where the House of Lords had to construe the provision in the incorporating statute of the Gas Company which provided that the profits to be distributed among the shareholders in any year should not exceed a given rate, the

following observation occurs in the opinion delivered by Lord Halsbury L. C. at p. 12:

> " Income-tax is a charge upon the profits; the thing which is taxed is the profit that is made, and you must ascertain what is the profit that is made before you deduct the tax- You have no right to deduct the income-tax before you ascertain what the profit is, I cannot understand how you can make the income-tax part of the expenditure."

Now it seems to us that there is nothing in the Ashton Gas Co. case(3) which prevents us from (1) (1943) 45 Bom. L.R. 951. (2) (1942) 47 Bom. L.R. 774. (3) [1906] A. C. 10, 12.

holding that in ascertaining the net profits for the purpose of the agreement that is before us, excess profits tax has to be excluded. That was not a case of profit sharing. It was not concerned with deciding what sums are deductible in arriving at the divisible profits in a profit sharing agreement. That is what we have to decide. Therefore we think that the Ashton Gas Co. case (1) does not assist in answering the question that has arisen in this case. Nor do we think it necessary in the present case, as we have said earlier, to decide whether there are distinctions between income-tax and excess profits tax. We are not concerned with the question whether income-tax should be deducted before the net profits under the agreement can be ascertained. We will assume that it cannot be. It is common sense and also firmly established on the authorities to which reference has already been made, that in ascertain- ing the divisible profits excess profits tax has to be deducted. As we have construed the agreement in this case, net profits mean the divisible profits and therefore they can be arrived at only after deduction of excess profits tax.

We wish now to refer to the minority opinions in the House of Lords in Re G. B. Ollivant & Co. Ltd.'s Agreement (2) on which the High Court seems largely to have based its decision. The dissenting opinion of Viscount Simon L. C. arose from the fact that he did not think that the word profits in the agreement then before the House meant the divisible profits. With the reasons for this view we are not concerned for these turned on the wording of that agreement. Having held that the word profits did not mean the divisible profits, he proceeded to consider whether excess profits tax could be deducted in ascertaining the net profits and in doing so said that as income-tax could not be deducted as held in the Ashton Gas Co. case (1), neither could excess profits tax, for, both were parts of the profits. He also said that the Court of Appeal was wrong in thinking that excess profits tax could be debited to the profit and loss account and therefore held that the net profit (1) [1906] A.C. 10, 12.

(2) [1942] 2 All E. R. 528.

which is usually shown in that account has to be ascertained without deducting excess profits tax. We are not concerned with this part of the opinion of the Lord Chancellor either. It was given on the basis that the profits were not the divisible profits and we are concerned only with divisible profits. The other dissentient speech was by Lord Macmillan. He said substantially what Viscount Simon had said, and therefore it is unnecessary to deal with his view separate y. It does not however appear to us that the dissentient Judges in the House of Lords held that if the profits were the divisible profits, excess profits tax could not be deducted before these could be ascertained. In the view that

we have taken of the agreement before us, we cannot, therefore, derive any assistance from the dissentient opinions.

One other case, namely, N. M. Rayaloo Iyer & Sons v. The Commissioner of Income-tax, Madras (1), was brought to our attention. This case also purports to follow the reasoning adopted in the minority judgments in Re G. B. Ollivant & Co. Ltd.'s Agreement (2) and actually relied on the authority of the judgment under appeal. It is therefore unnecessary to refer to it further.

It had been contended by the learned advocate for the appellant that even if the net profits mentioned in the agreement were not the divisible profits and even if income- tax could not be deducted to ascertain these profits, excess profits tax was a proper deduction to be made. It was said that excess profits tax was for this purpose different in nature from income-tax, for, (a) under s. 12 of the Excess Profits Tax Act, 1940, excess profits tax was deductible as an expense for the purpose of income-tax assessment; (b) that where the employer is a company, as in the present case, the income-tax paid is refundable to the shareholders which excess profits tax is not; (c) that excess profits tax is a " debt " of the business and therefore an outgoing, and

(d) that it was in the nature of a licence fee upon the payment of which alone the business could be carried on. It is unnecessary to consider these points as in our view the net profits in this case were (1) [1954] 26 I.T.R. 265. (2) [1942] 2 All E. R. 528.

the divisible profits and whether excess profits tax is distinguishable from income-tax for any of these reasons or not, it is properly deductible.

We should also refer to an argument advanced by the assessee which was founded on s. 87-C of the Indian Companies Act, 1913, introduced by an amendment made in 1936, which provides that the remuneration of the managing agents of a company shall be a fixed percentage of its net annual profits, and that in calculating the net profits no deduction in respect of any tax or duty on income is to be made. It is said that the statute incorporates the universal commercial practice and therefore in construing the present agreement excess profits tax cannot be deducted. We are not aware whether the section incorporates any practice but we think that this contention is entirely unfounded for the section was applied only to a managing agency agreement made after the amending Act came into force, while the agreement in the present case was made before that date.

Lastly, we have to point out that nothing turns on the fact that at the date the agreement under consideration was made, Excess Profits Tax Act had not come on the statute book nor perhaps been thought of, and therefore could not have been in the contemplation of the parties. If the net profits, are the divisible profits, everything necessary to be excluded to arrive at the divisible profits has to be deducted whether it was in the contemplation of the parties or not. It is easy to imagine instances. Suppose after the agreement the Government imposed a licence fee on the payment of which alone the business could have been carried on and that licence fee was not in the contemplation of the parties when the agreement had been made. None the less it has clearly to be deducted in finding out the divisible profits. In the result we would answer the question framed in the affirmative.

The appeal is therefore allowed with costs in this Court and in the High Court.

Appeal allowed.