Supreme Court of India
Badridas Daga vs The Commissioner Of Income-Tax on 25 April, 1958
Equivalent citations: 1958 AIR 783, 1959 SCR 690
Author: T V Aiyyar
Bench: Aiyyar, T.L. Venkatarama

PETITIONER:
BADRIDAS DAGA

Vs.

RESPONDENT:
THE COMMISSIONER OF INCOME-TAX

DATE OF JUDGMENT:
25/04/1958

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

CITATION:
1958 AIR 783 1959 SCR 690

ACT:
Income Tax-Deduction-Misappropriation by employee-Loss incidental to the conduct of the business-Indian Income-tax Act, 1922 (II Of 1922), S. 10(1), (2)(Xi), (2)(XV).

HEADNOTE:
The appellant engaged an agent for the purposes of carrying on his business and conferred on him large powers of management including authority to operate on bank accounts. While acting under such authority the agent withdrew moneys from the bank and used them for the discharge of his personal debts. The appellant was able to recover from the agent only a part of the amount misappropriated by him, and the balance had to be written off at the end of the accounting year as irrecoverable. The question was whether the amount which was misappropriated and found irrecoverable was allowable as a deduction under the Indian Income-tax Act in determining the profits of the appellant.
Held, that the amount in question is not allowable either as a bad debt under s. 10(2)(Xi) or as a business expenditure under S. 10(2)(XV) Of the Indian Income-tax Act, 1922. It can, however, be deducted in computing the profits of the appellant under

691
s. 10(1) of the Act as a loss incidental to the carrying on of his business.
Where an agent or an employee of a businessman in charge of the business is given authority to operate on the bank accounts and withdraws moneys in the purported exercise of that authority, his action is referable to his character as such authorised agent or employee and any loss resulting from misappropriation of the money by him would be one incidental to the carrying on of the business, and it is not necessary to show that the money was withdrawn for the conduct of the business.
Curtis v. J. & G. Oldfield, (1925) 9 Tax Cas. 319 and Rama-swami Chettiar v. Commissioner of Income-tax, Madras, (1930) I.L.R. 53 Mad. 904, explained and distinguished.
Venkatachalapathy Iyer v. Commissioner of Income-tax, (1951) 20 I.T.R. 363, Lord's Dairy Farm Ltd. v. Commissioner of Incometax, (1955) 27 I.T.R. 700 and Motipur Sugar Factory Ltd. v. Commissioner of Income-tax, (1955) 28 I.T.R. 128, approved.

JUDGMENT:

CIVIL APPELLATE JURISDICTION: Civil Appeal No. 149 of 1956. Appeal by special leave from the judgment and order dated December 22, 1954, of the former Nagpur High Court in Misc. Civil Case No. 36 of 1954.

R. J. Kolah, J. M. Thakar, Ramesh A. Shroff, J. B. Dadachanji, S. N. Andley and Rameshwar Nath, for the appellant.

H. N. Sanyal, Additional Solicitor-General of India, K.N. Rajagopala Sastri and R. H. Dhebar, for the respondent. 1958. April 25. The Judgment of the Court was delivered by VENKATARAMA AIYAR J.-This is an appeal against the judgment of the High Court of Nagpur in a reference under s. 66(1) of the Indian Income-tax Act, 1922, hereinafter referred to as the Act.

The appellant is the sole proprietor of a firm called Bansilal Abirchand Kasturchand, which carries on business as money-lenders, dealers in shares and bullion and commission agents in Bombay, Calcutta and other places. He is a resident of Bikaner, and manages the business at the several places through agents. During the relevant period, the agent of the firm at Bombay was one Chandratan, who held a power-of-attorney dated May 13, 1944, conferring on him large powers of management including authority to operate on bank accounts. During the period, November 15, 1944, to November 23,1944, the agent withdrew from the firm's bank account sums aggregating to Rs. 2,30,636-4-0, and applied them in satisfaction of his personal debts incurred in speculative transactions. On November 25, 1944, the cashier of the firm sent a telegram to the appellant informing him of the true state of affairs. Thereupon, the appellant went to Bombay on December 3, 1944, and on the 4th, cancelled the power-of-attorney given to the agent, and by notice dated

December 6, 1944, called upon him to pay the amounts withdrawn by him. The agent replied on December 8, 1944, admitting the misappropriation of the amounts and pleading for mercy. On January 16,1945, the appellant filed a suit against him in the High Court of Bombay for recovery of Rs. 2,30,636-4-0 and that was decreed on February 20, 1945. A sum of Rs. 28,000 was recovered from Chandratan and adjusted towards the decree and the balance of Rs. 2,02,442-13-9 was written off at the end of the accounting year as irrecoverable.

Before the Income-tax authorities, the dispute related to the question whether this amount of Rs. 2,02,442-13-9 was an admissible deduction. The Tribunal found that the amount in question represented the loss sustained by the appellant owing to misappropriation by his agent, Chandratan, but held on the authority of the decision in Curtis v. J. & G. Oldfield, Limited (1) that it was not a trading loss and therefore could not be allowed. On the application of the appellant, the Tribunal referred the following question of law for the decision of the High Court, Nagpur: Whether the said sum of Rs. 2,02,442-13-9 being part of the amount embezzled by the assessee's Munim is allowable as a deduction under the Indian Income-

(1) (1925) 9 Tax Cas. 319.

tax Act either under Section 10(1) or under the general principles of determining the profit and loss of the assessee or Section 10(2)(xv) ? "

The learned Judges held that the case was governed by the decision in Curtis v. J. & G. Oldfield, Limited (1), and answered the question against the appellant. An application under s. 66(A)(2) for a certificate was also dismissed and thereafter, the appellant applied for and-obtained leave to appeal to this Court under Art. 136, and that is how the appeal comes before us.

The question whether moneys embezzled by an agent or employee are allowable as deduction in computing the profits of a business under s. 10 of the Act has come up for consideration frequently before the Indian courts, and the decisions have not been quite uniform. Before discussing them, it is necessary that we should examine the principles that are in law applicable to the determination of the question. Three grounds have been put forward in support of the claim for deduction: (1) that the los 3 sustained by reason of embezzlement is a bad debt allowable under s. 10(2)(xi) of the Act; (2) that it is a business expense falling within s. 10(2)(xv) of the Act; and (3) that it is a trading loss, which must be taken into account in computing the profits under s. 10(1) of the Act. As regards the first ground, the authorities have consistently held that the deduction is not admissible under s. 10(2)(xi) of the Act, and that, in our view, is correct. A debt arises out of a contract between the parties, express or implied, and when an agent misappropriates monies belonging to his employer in fraud of him and in breach of his obligations to him, it cannot be said that he owes those monies under any agreement. He is no doubt liable in law to make good that amount, but that is not an obligation arising out of a contract, express or implied. Nor does it make a difference that in the accounts of the business the amounts embezzled are shown as debits, the amounts realised towards them, if any, as credits, and the balance is finally written off. They are merely journal entries adjusting the accounts and do not import a contractual liability.

(1)(1925) 9 Tax Cas. 319.

Nor can a claim for deduction be admitted under s. 10(2)(xv), because moneys which are withdrawn by the employee out of the business till without authority and in fraud of the proprietor can in no sense be said to be " an expenditure laid out or expended wholly and exclusively " for the purpose of the business. The controversy therefore narrows itself to the question whether amounts lost through embezzlement by an employee are a trading loss which could be deducted in computing the profits of a business under s. 10(1). It is to be noted that while s. 10(1) imposes a charge on the profits or gains of a trade, it does not provide how those profits are to be computed. Section 10(2) enumerates various items which are admissible as deductions, but it is well settled that they are not exhaustive of all allowances which could be made in ascertaining profits taxable under s. 10(1). In Incometax commissioner v. chitnavis (1), the point for decision was whether a bad debt could be deducted under s. 10(1) of the Act, there having been in the Act, as it then stood, no provision corresponding to s. 10(2)(xi) for deduction of such a debt. In answering the question in the affirmative, Lord Russel observed:

" Although the Act nowhere in terms authorizes the deduction of bad debts of business, such a deduction is necessarily allowable. What are chargeable in income-tax in respect of a business are the profits and gains of a year; and in assessing the amount of the profits and gains of a year account must necessarily be taken of all losses incurred, otherwise you would not arrive at the true profits and gains."

It is likewise well settled that profits and gains which are liable to be taxed under s. 10(1) are what are understood to be such according to ordinary commercial principles. ,The word " profits..... is to be understood ", observed Lord Halsbury in Gresham Life Assurance Society v. Styles (2), " in its natural and proper sense-in a sense which no commercial man would misunderstand ". Referring to these observa-

(1) (1932) L. R. 59 I.A. 290, 296, 297.

(2)(1892) A.C. 309, 315 ; 3 Tax Cas. 185, 188.

tions, Lord Macmillan said in Pondicherry Railway Co.v.Income-tax Commissioner (1):" English authorities can only be utilized with caution in the consideration of Indian income-tax cases owing to the differences in the relevant legislation, but the principle laid down by Lord Chancellor Halsbury in Gresham Life- Assurance Society V. Styles (2), is of general application unaffected by the specialities of the English tax system. "

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. If that is established, then the deduction must be allowed, provided of course there is no prohibition against it, express or implied, in the Act. These being the governing principles, in deciding whether loss resulting from embezzlement by an employee in a business is admissible as a

deduction under s. 10(1) what has to be considered is whether it arises out of the carrying on of the business and is incidental to it. Viewing the question as a businessman would, it seems difficult to maintain that it does not. A business especially such as is calculated to yield taxable profits has to be carried on through agents, cashiers, clerks and peons. Salary and remuneration paid to them are admissible under s. 10(2)(xv) as expenses incurred for the purpose of the business. If employment of agents is incidental to the carrying on of business, it must logically follow that losses which are incidental to such employment are also incidental to the carrying on of the business. Human nature being what it is, it is impossible to rule out the possibility of an employee taking advantage of his position as such employee and misappropriating the funds of his employer, and the loss arising from such misappropriation must be held to arise out of the carrying on of business and to be incidental to it.

(1) (1931) L.R. 58 I.A. 239, 252.

(2) (1892) A.C. 309, 315; 3 Tax Cas. 185, 188 And that is how it would be dealt with according to ordinary commercial principles of trading.

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. If, for example, a thief were to break overnight into -,he premises of a moneylender and run away with funds secured therein, that must result in the depletion of the resources available to him for lending and the loss must, in that sense, be a business loss, but it is not one incurred in the running of the business, but is one to which all owners of properties are exposed whether they do business or not. The loss in such a case may be said to fall on the assessee not as a person carrying on business but as owner of funds. This distinction, though fine, is very material as on it will depend whether deduction could be made under s. 10(1) or not.

We may now examine the authorities in the light of the principles stated above. In Jagarnath Therani v. Commissioner of Income-tax (1), the facts were that the assessee who was carrying on business entrusted a sum of Rs. 25,000 to his gumastha for payment to a creditor, but he embezzled it. The question referred for the opinion of the High Court was whether that sum could be allowed as deduction in the computation of profits. In answering it in the affirmative, the learned Judges observed that according to the practice obtaining in England, sums embezzled by employees were allowed as deductions and referred to statements of the law to that effect from Sanders' Income- tax and Super-tax, Murray and Carters' Guide to Income-tax Practice and to the following passage in Snellings' Dictionary of Income-tax and Super-Tax Practice: ,,If a loss by embezzlement can be said to be necessarily incurred in carrying on the trade it is allowable as. deduction from profits. In an ordinary case it springs directly from the necessity of deputing (1)(1925) I.L.R. 4 Pat. 385.

certain duties to an employee, and should therefore be allowed. "

They accordingly allowed the deduction as "a loss incidental to the conduct of the business".

In Ramaswami Chettiar v. Commissioner of Income-Tax, Madras (1), the assessee was carrying on banking business in several places in India and in Burma. On October 21, 1926 thieves broke into the strong room in the business premises at Moulmiengyum and stole cash and currency notes of the value of Rs. 9,335. The question was whether this amount could be allowed as a deduction. It was held by the majority of the Jndges that it could not be. In the judgment of the learned Chief Justice, the law was thus stated:

" If any one is paid a sum due to him as profits and he puts that in his pocket and on his way home is robbed of it, it would be, I think, difficult to contend that such a loss was incidental to his business. Still more so when he has reached his home and put those profits in a strong room or some other place regarded by him to be a place of safety. 1 can well understand that, in cases where the collection of profits or payment of debts due is entrusted to a gumastha or servant for collection and that person runs away with the money or otherwise improperly deals with it, the assessee should be allowed a deduction because such a loss as that would be incidental to his business. He has to employ servants for the purpose of collecting sums of money due to him and there is the risk that such servant may prove to be dishonest and instead of paying the profits over to him, convert them to his own use. But I cannot distinguish the present case from the case of any professional man or trader who, having collected his profits, is subsequently robbed of them by a stranger to his business. In this case, none of the thieves were the then servants of the assessee, although one of them had formerly been his cook. "

These observations, while they support the right of the asssee to deduction of loss resulting from (1)(1930) I.L. R. 53 Mad. 904, 906, 907.

embezzlement by an employee, also show the extent and limits of that right.

In Bansidhar Onkarmal V. Commissioner of Incometax (1), there was a theft of money by an accountant, but it took place after the office hours, and it was held, following the decision in Ramaswami Chettiar v. Commissioner of Income-tax (2) that it could not be allowed as a deduction under s. 10(1) of the Act, as it was not incidental to the carrying on of the trade. But it was observed by Narasimham J. who delivered the leading judgment that it might have made a difference if the theft had been by the accountant during the office hours. In Venkatachalapathy Iyer v. Commissioner of Income-tax (3), the assessees were a firm of merchants engaged in the business of selling yarn. Its accountant was one Rajarathnam lyengar, whose duty it was to receive cash on sales, make disbursements and maintain accounts. He duly entered all the transactions in the cash book but when striking the balance at the end of each day he short- totalled the receipts and overtotalled the disbursements and misappropriated the difference. The question was whether the amounts thus embezzled could be deducted. On a review of the authorities, Satyanarayana Rao and Raghava Rao JJ. held that the loss was incidental to the carrying on of the business and should be allowed. The appellant contends that this decision is decisive in his favour ; but the learned Judges of the Court below were of the opinion that on the facts it was distinguishable and that the present case fell within the decision in Curtis v. J. & G. Oldfield, Limited (4).

It is necessary to examine the decision in Curtis v.J. & G. oldfield (4) somewhat closely, as the main controversy in the Indian courts has been as to what was precisely determined therein. There, the facts were that the managing director of a company who was in exclusive control of its business, had, availing himself of his position as such managing director, withdrawn large amounts from time to time and applied them to his own personal affairs. This went on for (1) [1949] 17 I.T.R. 247.

(3) [1951] 20 I.T.R. 363.

(2) (1930) I.L.R. 53 Mad. 904, 906, 907.

(4) (1925) 9 Tax Cas. 319.

several years prior to his death, and thereafter, the fraud was discovered, and the amounts overdrawn by him were written off as irrecoverable. The question was whether these amounts could be allowed as a deduction, and it was answered in the negative by Rowlatt J. Now, it should be observed that the learned Judge did not say that amounts embezzled by an employee in the course of business would not be admissible deductions. On the other hand, he observed: " I quite think, with Mr. Latter, that if you have a business..... in the course of which you have to employ subordinates, and owing to the negligence or the dishonesty of the subordinates some of the receipts of the business do not find their way into the till, or some of the bills are not collected at all, or something of that sort, that may be an expense connected with and arising out of the trade in the most complete sense of the word."

He went on to observe:

" I do not see that there is any evidence at all that there was a loss in the trade in that respect. It simply means that the assets of the Company moneys which the Company had got and which had got home to the Company, got into the control of the Managing Director of the Company, and he took them out. It seems to me that what has happened is that he has made away with, receipts of the Company de hors the trade altogether in virtue of his position as Managing Director in the office and being in a position to do exactly what he likes."

Thus, what the learned Judge really finds is that the embezzlement was not connected with the carrying on of the trade but was outside it, and on that finding, the decision can only be that the deduction should be disallowed. But the learned Judges in the Court below would appear to have read the above observations as meaning that, as a rule of law, embezzlements made prior to the receipts of the amounts by the assessees would be incidental to the carrying on of the trade and therefore admissible, but that embezzlements made after receipt are not connected with the carrying on of the trade and are therefore inadmissible. We do not so read those observations. It is a question turning on the facts of each case whether the embezzlement in respect of which deduction is claimed took place in the carrying on of the business, and the observations of the learned Judge that it did not so take place have reference to the facts of that case, and can afford no assistance in deciding whether in a given case the embezzlement was incidental to the conduct of the business or not.

Now, in Curtis v. J. & G. Oldfield Limited(1), the company was doing business in wine and spirit, and in such a business it is possible to hold that when once the price is realised and put into the bank, the trading has ceased and that the subsequent operations on the bank account are not incidental to the carrying on of the trade. But here, we are dealing with a banking business, which consists in making advances, realising them and making fresh advances, and for that purpose, it is necessary not merely to deposit amounts in banks but also to withdraw them. That is to say, a continuous operation on the bank account is incidental to the conduct of the business. The theory that when once moneys are put into the bank they have " got home " and that their subsequent withdrawal from the bank would be de hors the business, will be altogether out of place in a business such as banking. It will be a wholly unrealistic view to take of the matter, to hold that the realisations have reached the till when they are deposited in the bank, and that that marks the terminus of the business activities in money-lending.

It should also be mentioned that in Curtis v. J. &'G. oldfield (1) though the assessee was a company, it was found that the shares were all held by the members of the Oldfield family, that the company had no auditor and no minutes book, that there was Cc an almost entire absence of balance sheets ", and that one of the members, Mr. J. E. Oldfield, was in management with wide powers. In view of the fact that he (1) (1925) 9 Tax Cas. 319.

had a large number of shares in the company and that it was in substance a private company, his withdrawals would be more like a partner overdrawing his account with the firm than an agent embezzling the funds of his employer, and it could properly be held that such overdrawing has nothing to do with the trading activities of the firm, whose profits are to be taxed. It would, therefore, be an error to suppose that the observations made by Rowlatt J. in the above context could be regarded as an authority for the broad proposition that as a matter of law, and irrespective of the nature of business, there could be no business activities with reference to moneys after they have been collected, and that, in consequence, embezzlement thereof could not be incidental to the carrying on of business. And we should further add that it would make no difference in the admissibility of the deduction whether the employee occupies a subordinate position in the establishment or is an agent with large powers of management.

Subsequent to the decision now under appeal, the Bombay High Court had occasion to consider this question in Lord's Dairy Farm Ltd. v. Commissioner of Income-tax (1). On a review of the authorities including the decision in Curtis v. J. & G. Oldfield, Limited (2), Chagla C. J. and Tendolkar J. held that loss caused to a business by defalcation of an employee was a trading loss, and that it could be deducted under s. 10(1). In Motipur Sugar Factory Ltd. v. Commissioner of Income-tax (3), an employee who had been entrusted with the funds of a company for purposes of distribution among sugarcane growers in accordance with statutory rules, was robbed of them on the way. It was held by Ramaswami and Sahai JJ. that the loss was incidental to the conduct of the trade, and must be allowed. We agree with the decisions in Venkatachalapathy Iyer v. Commissioner of Incometax (4), Lord's Dairy Farm Ltd. v. Commissioner of Income-tax (1) and Motipur Sugar Factory Ltd. v. Commissioner of Income-tax(3).

(1) [1955] 27 I.T.R. 700.(2) (1925) 9 Tax Cas.

319. (3) [1955] 28 I.T.R. 128.(4) [1951] 20 I.T.R. 363.

It was argued for the respondent that there was no evidence, much less proof, that when Chandratan withdrew funds from the bank, he did so for the purpose of making any advance, and that, therefore, the withdrawal could not be held to have been for the conduct of the trade. That, in our opinion, is not necessary. When once it is established that Chandratan was in charge of the business, that he had authority to operate on the bank accounts, and that he with- drew the moneys in the purported exercise of that authority, his action is referable to his character as agent, and any loss resulting from misappropriation of funds by him would be a loss incidental to the carrying on of the business. It was also contended that the power-of-attorney dated May 13, 1944, under which Chandratan was constituted agent related not only to the business of the appellant but also to his private affairs, and that there was no proof that the embezzlement was in respect of the business assets of the appellant and not of his private funds. No such question was raised before the Income-tax authorities, and their finding assumes that the moneys which were misappropriated were business funds. We are also not satisfied that, on its true construction,, the authority conferred on the agent by the power-of.attorney extended to the personal affairs of the appellant.

In the result, we are of opinion that the loss sustained by the appellant as a result of misappropiriation by Chandratan is one which is incidental to the carrying, on of his business, and that it should therefore deducted in computing the profits under s. 10(1) of the, Act. In this view, the order of the lower court must be set aside and the reference answered in the, affirmative. The appellant will get his costs of this appeal and of the reference in the Court below.

appeal allowed.