Supreme Court of India
Commissioner Of Income-Tax, ... vs Gemini Cashew Sales Corporation, ... on 20 April, 1967
Equivalent citations: 1967 AIR 1559, 1967 SCR (3) 727
Author: S C.
Bench: Shah, J.C.

PETITIONER:
COMMISSIONER OF INCOME-TAX, KERALA

Vs.

RESPONDENT:
GEMINI CASHEW SALES CORPORATION, QUILON

DATE OF JUDGMENT:
20/04/1967

BENCH:
SHAH, J.C.
BENCH:
SHAH, J.C.
SIKRI, S.M.
RAMASWAMI, V.

CITATION:
1967 AIR 1559 1967 SCR (3) 727

ACT:
Income-Tax Act, 1922, s. 10(1) and 10(2) (xv)-Partnership dissolved on death of one partner-Whether liability to pay retrenchment compensation under s. 25FF on transfer of business to surviving partner a permissible deduction as liability of a revenue nature.

HEADNOTE:
A partnership of two partners was dissolved on the death of one of them on August 24, 1957 and the business was taken over by the surviving partner on his own account. The services of the employees were not interrupted and there was no alteration in their terms of employment. In proceedings for assessment to income-tax for the assessment year 1958-59 it was urged on behalf of the firm that an amount of Rs. 1,41,506 taken into account under the head "gratuity payable to workers of the business" in settling the accounts of the firm till August 24, 1957 was a permissible outgoing. The Income-tax Officer rejected the claim and the Appellate Assistant Commissioner confirmed his order. However, the Tribunal, in appeal, held that on the dissolution of the firm, the workmen became entitled to retrenchment compensation under s. 25FF of the Industrial Disputes Act,

1947 and the firm was therefore entitled to the deduction. The High Court, upon a reference, confirmed this view.
On appeal to this Court,
HELD : The amount claimed by the assessee as a permissible allowance in his profit and loss account could not be regarded as properly admissible either under s. 10(1) or under s. 10(2)(xv) of the Income-Tax Act, 1922. [735 B]
Under the proviso to s. 25FF the liability.to pay retrenchment compensation arose for the first time after the closure of the business and not before. It arose not in the carrying on of the business, but on account of the transfer of the business. It was not therefore a liability of a revenue nature and could not be treated as a permissible deduction under s. 10(1). [733 H]
Alex A. Apcar (Jr.) & Company v. M. V. Gan and Others, A.I.R, 1960 Cal. 14, referred to.
Anakpalia Cooperative Agricultural and Industrial Society v. Its, Workmen & Others, [1962] 2 LL.J. 621, Calcutta Company Ltd. v. Commissioner of Income-tax, West Bengal, 37 I.T.R. 1 and Owen (H. M. Inspector of Taxes) v. Southern Railway of Peru Ltd., 36 T.C. 602, distinguished.
Where accounts are maintained on the mercantile system, if liability to make a payment has arisen during the time the business is carried on. and the expenditure is for the purpose of carrying on the business, it may be deductible under Section 10(2)(xv) but where the liability is during the whole of the period that the business is carried on wholly contingent and does not raise any definite obligation during that time it cannot fall
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within the expression "expenditure laid out or expended wholly or exclusively" for the purpose of the business. [734 D-E)
Commissioner of Income-tax, Madras v. Indian Metal and Metallurgical Corporation, 51 I.T.R. 240 and Standard Mills Company Ltd. v. Commissioner of Wealth-tax, Bombay, 63 I.T.R. 470, relied on.

JUDGMENT:

CIVIL APPELLATE JURISDICTION: Civil Appeal No. 702 of 1966. Appeal by special Leave from the judgment and order dated July 30, 1964 of the Kerala High Court in Income-tax Referred Case No. 20 of 1963.

S. T. Desai, S. K. Aiyar and R. N. Sachthey, for the appellant.

T. V. Viswanath Iyer, S. K. Dholakia, and O. C. Mathur, for the respondent.

The Judgment of the Court was delivered by Shah, J. Two persons-Walter and Ramasubramony-carried on business in cashewnuts as partners in the name and style of Messrs. Gemini Cashew Sales Corporation. The partnership was dissolved on the death of Ramasubramony on August 24, 1957, and the business was taken over and continued by Walter on his own account. The services of the employees were not interrupted and there was no alteration in the terms of employment of the employees of the establishment. In proceedings for assessment of tax it was urged on behalf of the firm that an amount of Rs. 1,41,506 taken into account under the head "Gratuity payable to workers of the business" in settling the accounts of the firm till August 24, 1957, was a permissible outgoing. The Income-tax Officer rejected the claim and the Appellate Assistant Commissioner confirmed that order. The Income-tax Appellate Tribunal held that by the transfer of the undertaking to Walter, there was no interruption in the employment of the workmen of the establishment, that the terms and conditions of service applicable to the workmen were not altered to their detriment, that Walter had not expressly agreed to take over the liability for compensation payable under S. 25FF of the Industrial Disputes Act, 1947, and since there was dissolution of the partnership on August 24, 1957 and the undertaking was transferred, the workmen became entitled to retrenchment compensation, which the firm was liable to pay. The Tribunal accordingly held that the firm was entitled to deduct the sum of Rs. 1,41,506 in the computation of income in the assessment year. 1958-59. In recording their opinion on the following question submit- ted by the Tribunal, "Whether the allowance of Rs. 1,41,506 constitutes an allowable expenditure in the assessment of the firm for the year 1958-59", the High Court of Kerala observed that in the determination of the taxable profits of the firm till its dissolution, considerations about the liability to pay retrenchment compensation devolving upon Walter as the assignee of the business valuable consideration were irrelevant, and since it was maintaining accounts on mercantile system, the firm could claim as a Permissible outgoing the amount for which liability was incurred though no actual payment was made to the workmen. The Commissioner of Income-tax appeals with special leave, against the order of the High Court recording an answer in the affirmative.

The, subject-matter of the claim was retrenchment compen- sation payable to workmen of the establishment under s. 25FF of the Industrial Disputes Act, 1947, Section 25F of the In- dustrial Disputes Act, 1947, provides :

> "No workman employed in any industry who has been in continuous service for not less than one year under an employer shall be retrenched by that employer until-
>
> (a) the workman has been given one month's notice in writing indicating the reasons for retrenchment and the period of notice has expired, or the workman has been paid in lieu of such notice, wages for the period of the notice:
>
> Provided that no such notice shall be neces- sary if the retrenchment is under an agreement which specifies a date for the termination of service;
>
> (b) the workman has been paid, at the time of retrenchment, compensation which shall be equivalent to fifteen days' average pay for every completed year of service or any part thereof in excess of six months; and

(c) notice in the prescribed manner is served on the appropriate Government."

Section 25FF, as substituted by Act 18 of 1957 with effect from November 28, 1956, provides :

"Where the ownership or management of an undertaking is transferred, whether by agreement or by operation of law, from the employer in relation to that undertaking to a new employer, every workman who 73 0 has been in continuous service for not less than one year in that undertaking immediately before such transfer shall be entitled to notice and compensation in accordance with the provisions of Section 25F, as if the workman had been retrenched :

Provided that nothing in this section shall apply to a workman in any case where there has been a change of employers by reason of the transfer, if-

(a) the service of the workman has not been interrupted by such transfer;

(b) the terms and conditions of service applicable to the workman after such transfer are not in any way less favourable to the workman than those applicable to him immediately before the transfer; and

(c) the new employer is, under the terms of such transfer or otherwise, legally liable to pay to the workman, in the event of his retrenchment, compensation on the basis that his service has been continuous and has not been interrupted by the transfer."

Under S. 25FF the right of the workmen to retrenchment com- pensation arises on transfer of ownerships or management from the employer in relation to the undertaking to a new employer. But in the conditions set out in the proviso no such right accrues. It is common ground that the first and the second conditions in the proviso are satisfied. Counsel for the Commissioner contended that the third condition of the proviso was also satisfied, and no right to retrenchment compensation arose in favour of the workmen under s. 25FF of the Industrial Disputes Act. Counsel for the Commissioner contended that the liability of the partners in a firm to pay retrenchment compensation being joint and several, when the undertaking carried on by a firm is continued by one of the partners after its dissolution, and the services of the workmen are not terminated and the terms and conditions of the service are not made less favourable, the partner continuing the business may appropriately be held liable to pay to the workmen retrenchment compensation on the footing that the service of the workmen had been continuous. Counsel relied upon the view expressed by the Calcutta High Court in Alex A. Apcar (Jr.) & Company v. M. N. Gan and Others(1) in which it was observed that a change of partnership by inclusion or retirement of partner, which legally changes the constitution of the firm, does not result (1) A.I.R. 1960 Cal. 14 in, a "change of business or employer within the meaning of ss. 25F and 25FF".

Counsel for the assessee relied upon a judgment of this Court in Anakapalia Co-operative Agricultural and Industrial Society v. Its Workmen & Others(1) in support of the contention that on a bona fide transfer of an undertaking the workmen employed in the undertaking are entitled to

retrenchment compensation under s. 25FF against the transferor. That however was a case in which the transferee had declined to re-employ the workmen of the transferor and the first condition of the proviso was not fulfilled. That case can have no application to the present case. In the view we take, that the allowance claimed is not a proper outgoing, or allowance in computing the profits of the assessee, we do not express any opinion on the question whether the workmen of the undertaking became entitled to retrenchment compensation on the transfer of the undertaking to Walter.

Liability to pay retrenchment compensation arises under s. 25FF when there is a transfer of the ownership or management of an undertaking : it arises on the transfer of the undertaking and not before. Transfer of ownership or management of an undertaking in law operates, except in the conditions Set out in the proviso, as retrenchment of the workmen. But until there is a transfer of the undertaking resulting in determination of employment the workmen do not become entitled to retrenchment compensation. So long as the ownership of the business continues with the employer, the right of the workmen to claim compensation remains contingent. A workman may, before the transfer of ownership of the business, himself terminate the employment: he may die or he may become superannuated: in none of these cases the owner of the business is under any obligation to pay retrenchment compensation to the workman. The obligation to pay compensation becomes definite only when there, is retrenchment by the employer, or when the ownership or management of the undertaking is, except in the cases contemplated by the proviso, transferred to a new employer, and not till then. The right therefore arises from determination of employment, or from transfer of the undertaking : it has no existence before these events take place.

The judgment of this Court in Calcutta Company Ltd v. Com- missioner of Income-tax, West Bengal (2) on which reliance was placed by counsel for the assessee has no bearing on the present case, for in that case, expenditure which it was estimated had to be incurred to discharge an existing and definite obligation enforceable against the assessee in praesenti was held a permissible (1) [962] 2 L.L.J. 621.

(2) 37 I.T.R. 1.

deduction in the computation of income. The Calcutta Com- pany Ltd had sold plots of land for building purposes undertaking to develop them within six months by laying out roads, providing drainage and installing lights, etc. In the accounts of the Company maintained according to the mercantile system, the Company had credited the full sale price of the. plots agreed to be paid by the purchasers, but not actually received, and against the price it debited an estimated sum as expenditure for the development it had undertaken to carry out, even though no part of the amount was actually spent. By the terms of sale, the Company had undertaken an unconditional obligation which was enforceable against it : the liability was not contingent upon the happening of a future event. It was held by this Court that the outgoing debited was properly admissible. The decision of the House of Lords in Owen (H. M. Inspector of Taxes) v. Southern Railway of Peru Ltd.(1) on which counsel for the assessee relied also does not assist the the assessee. In that case under the Peruvian law the Southern Railway of Peru Ltd. was bound to pay its employees in Peru prescribed compensation payments upon termination of their services, subject to the fulfilment by the employee of certain conditions. The amount to be paid depended on the length of service and rate of

pay at the end of the period of service. The Company set apart from the gross profits of each year sums prospectively payable under the Peruvian law as compensation on the termination of employment. In proceedings for assessment to tax of the Company made under Case 1 of Sch. D of the Income Tax Act, 1918 (8 & 9 Geo. 5, Ch. 40), it was contended on behalf of the Company that upon proper principles of commercial accountancy compensation calculated to have accrued due to each employee from year to year as deferred remuneration was properly allowable as a deduction. The Special Commissioners upheld the claim of the Company on the (,round that it was a matter of correct accountancy practice to make provision in the accounts for the sums in question. The matter reached the House of Lords in appeal from an order on a reference under s. 64 of the Income-Tax Act, 1952. The House held that where a number of similar contingent obligations arise from trading, there is no rule of law which prevents the deduction of a provision for them in ascertaining annual profits, if a sufficiently accurate estimate can be made. But a majority of the House held that the "provision claimed by the Company throughout the proceedings was not permissible by reason of the absence of discount and other factors". Lord MacDermott observed at p. 635 :

".....as a general proposition it is, I think, right to say that in computing his taxable profits for a (1) 36 T.C. 602.

particular year a trader who is under a definite obligation to pay his employees for their services in that year an immediate payment and also a future payment in some subsequent year, may properly deduct not only the immediate payment but the present value of the future payment provided such present value can be satisfactorily determined or fairly estimated. Apart from special circumstances, such a procedure, if practicable, is justified because it brings the true costs of trading in the particular year into account for that year and thus promotes the ascertainment of the "annual profits or gains arising or accruing fro in" the trade."

Lord MacDermott was of the view that the provision made by the Company led to anomalies, and was not admissible as made, and the case should be remitted to the Special Commissioners whether it is practicable to arrive at satisfactory deductions. Lord Radcliffe with whom the Lord Chancellor and Lord Tucker agreed was of the view that there is no rule of law which forbids the introduction of a provision for future payments in or payments out, if the right to receive them or the liability to make them, is in legal terms contingent at the closing of the relevant year. The question which arises in the present case is not about the admissibility of a provision made by a trader by the adoption of it reasonably satisfactory method estimating the present value of an obligation which may arise in future to pay a sum of money to his employees. The question that falls to be determined is whether the liability which arises on transfer of the, business is to be regarded as a permissible outgoing in the account of the business which is transferred. Broadly stated, the present value on commercial valuation of money to become due in future, under a definite obligation, will be a permissible outgoing or deduction in computing the taxable profits of a trader, even if in certain conditions the obligation may cease to exist because of forfeiture of the right. Where, however, the obligation of the trader is purely contingent, no question of estimating its present value may arise, for to be a permissible outgoing or allowance, there must in the year of account be a present obligation capable of commercial valuation.

As already observed, the liability to pay retrenchment com- pensation arose for the first time after the closure of the business and not before. It arose not in the carrying on of the business, but on account of the transfer of the business. During the entire period that the business was continuing, there was no liability to pay retrenchment compensation. The liability which arose on transfer of the business was not of a revenue nature. Profits of a business involve comparison between the state of the business at two specific dates. Normally the liability which occurs after the last date, unless its source is in a pre-existing definite obligation, cannot be regarded as a part of the outgoing of the. business debit-able in the profit & loss account. A deduction which is proper and necessary for ascertaining the balance of profits and gains of the business is undoubtedly properly allowable, but where a liability to make a payment arises not in the course of the business, not for the purpose of carrying on the business, but springs from the transfer of the business, it is not, in our judgment, a properly debatable item in its profit & loss account as a revenue outgoing. The claim of the firm to treat it as an item in the determination of the profits of the firm under s. 10(1) of the Income-tax Act can.not, therefore,. be sustained.

Under s. 10(2) (xv) of the Indian Income-tax Act in the computation of taxable profits (omitting parts of the clause not material) "any expenditure laid out or expended wholly and exclusively for the purpose of such business, profession or vocation", i.e. business, profession or vocation carried on by the assessee, is a permissible allowance. But to be a permissible allowance the expenditure must be for the purpose of carrying on the business. Where accounts are maintained on the the mercantile system, if liability to make the payment has arisen during the time the business is carried on, it May appropriately be regarded as expenditure. But where the liability is, during the whole of the period that the business is carried on, wholly contingent and does not raise any definite obligation during the time that the business is carried on, it cannot fall within the expression "expenditure laid not or expended wholly and exclusively" for the purpose of the business.

Two cases illustrative of the principle may be noticed. It was held by the Madras High Court in Commissioner of Income- tax, Madras v. Indian Metal and Metallurgical Corporation(1) that a provision made in the annual accounts maintained by an employer setting apart by way of a reserve to meet the liability, if any, to which the employer may become subject in the event of retrenching workmen because of the necessity of retrenchment of the services of the staff, was not a liability in praesenti in the year of account, but was only a contingent liability which may arise on the happening of a particular contingency and was not allowable as a ,deduction in assessment of tax. This- Court in dealing with a case under the Wealth Tax Act in Standard Mills Company Ltd. V. ,Commissioner of Wealth-tax, Bombay(1) held that a liability under the award of the Industrial Court to pay gratuity to its ,employees at certain rates on death while in service, or on voluntary retirement or resignation after fifteen years' continuous (1) 51 I.T.R. 240.

(2) 63 I.T.R. 470.

service, or on termination of service after certain specified periods, but not if the employee was dismissed for dishonesty or misconduct, was a mere contingent liability which arose only when the employment of the employee was determined by death, incapacity, retirement or resignation : the liability did not exist its praesenti. The amount of Rs. 1,41,506/- claimed as a permissible allow-

ance by the assessee in its profit & loss account cannot, in our judgment, be regarded as properly admissible either under s. 10 (1) or s. 10 (2) (xv) of the Income-tax Act. The answer to the question must, therefore, be in the negative.

The appeal is allowed and the order passed by the High Court is set aside. The Commissioner will be entitled to his costs in this Court.

R.K.P.S. Appeal allowed.