
(1984) 07 AP CK 0022

In the Andhra Pradesh High Court

Case No : Reference Case No. 244 of 1978

Commissioner of Income Tax

APPELLANT

Vs

Balaji Chitra Mandir

RESPONDENT

Date of Decision : 23-07-1984

Acts Referred:

Income Tax Act, 1961 — Section 256(1), 261, 28(ii)

Citation : (1985) 22 TAXMAN 539

Hon'ble Judges : Y.V. Anjaneyulu, J;B.P. Jeevan Reddy, J

Bench : Division Bench

Advocate : M.S.N. Murthy, for the Appellant; M.J. Swamy, for the Respondent

Final Decision : Dismissed

Judgement

Y.V. Anjaneyulu, J.—The Tribunal referred the following question of law u/s 256(1) of the income tax Act, 1961 ("the Act") for the opinion of this Court : "Whether, on the facts and in the circumstances of the case, the amount of Rs. 40,000 received by the assessee as a forfeiture of security deposit is a revenue receipt ?"

The assessee is a partnership firm and the assessment relates to the year 1973-74. The assessee was carrying on business in the exhibition of cinema films. On 25-8-1968, the assessee-firm leased the cinema hall to K. Bhakthavatsalam ("the lessee") for a period of 151 weeks subject to the payment of weekly rent of Rs. 3,521. A sum of Rs. 40,000 was deposited by the lessee with the assessee as security under the agreement. Under clause 6 of the agreement, the amount of Rs. 40,000 shall be returned to the lessee one week before the date of termination of the agreement. If the assessee fails to repay the same, the lessee shall be entitled to continue the agreement till the amount of Rs. 40,000 is repaid. Clause 4 of the agreement provided that the lessee shall pay the weekly hire of each week in advance of the running week. Clause 18 of the agreement, which is relevant for the purpose of this reference, provides that, if the lessee should fail to pay the weekly hire, as agreed, for any week, the

agreement shall stand cancelled and the advance (security deposit) of Rs. 40,000 shall be forfeited. It appears, the lessee committed a default in payment on the weekly lease amount for three weeks continuously commencing from 7-2-1979. The assessee served a notice on the lessee calling for payment of the weekly rent in arrear. The assessee also gave a notice to the lessee that, pursuant to the default committed in the payment of the weekly rent, the agreement stood cancelled and the security deposit of Rs. 40,000 was forfeited. It appears, later on, the assessee filed a suit before the Fourth Additional Judge, City Civil Court, Hyderabad, contending that the agreement, which should have been, in the normal course, continued for 132 weeks more, was terminated on account of the default committed by the lessee and pursuant to such termination, the assessee suffered loss of Rs. 1,25,000. It may be mentioned that, subsequent to the termination of the lease, the assessee leased the cinema hall to Usha Films on 20-3-1969. In the plaint, the assessee seems to have stated that, in view of the forfeiture of security deposit of Rs. 40,000, no claim for any damages was being made apart from the claim for reimbursement of loss of Rs. 1,25,000 said to have been suffered by the assessee on account of the premature termination of the lease. Eventually, there was a compromise as a result of which the assessee received from the lessee an amount of Rs. 7,771 on account of unpaid weekly hire charges and it was further agreed that the amount of Rs. 40,000 kept with the assessee by the lessee as security deposit shall be forfeited.

2. In the income tax return filed by the assessee for the assessment year 1973-74, the assessee included in its income the sum of Rs. 7,771 received from the lessee on account of the unpaid weekly hire charges under the compromise, but did not include in its income the sum of Rs. 40,000 being security deposit forfeited. The assessee claimed before the ITO that the sum of Rs. 40,000 did not represent income receipt in its hands but was a capital receipt not liable to be taxed under the Act. The ITO declined to accept the assessee's contention and held that the sum of Rs. 40,000 represented damages for breach of contract and, therefore, constituted income in the assessee's hands. In that view, he included the sum of Rs. 40,000 in the total income of the assessee. The assessee appealed against the assessment of Rs. 40,000 in its hands to the AAC. The AAC held that, since the termination of the lease agreement did not result in discontinuance of the assessee's business and the profit-making machinery of the assessee continued thereafter, the amount of Rs. 40,000 formed part of the income of the assessee. The AAC, accordingly, upheld the assessment of the sum of Rs. 40,000.

3. The assessee carried the matter in second appeal to the Tribunal. The learned Accountant Member and the learned Judicial Member wrote separate but concurring judgments reversing the order of the AAC and accepting the assessee's contention that the sum of Rs. 40,000 was not income liable to be taxed under the Act. The learned Accountant Member observed that the security deposit of Rs. 40,000 has no relevancy to the income which the assessee was

receiving week after week in the form of lease hire. He observed that the security deposit was made with the assessee with the sole idea of compelling the lessee to pay the weekly hire charges in time. Referring to the lease deed as well as the subsequent compromise between the assessee and the lessee, the learned Accountant Member held that there was no element of profit on account of loss of profit included in the sum of Rs. 40,000 forfeited by the assessee. It was, therefore, held that the sum of Rs. 40,000 representing the security deposit forfeited was not in the nature of income in the hands of the assessee liable to tax. The learned Judicial Member held that the forfeiture of the security deposit cannot be said to be compensation received by the assessee for loss of profit. In that view, it was held that the sum of Rs. 40,000 received by the assessee by forfeiting the security deposit did not partake the nature of income liable to be assessed under the Act. The assessee's appeal was, accordingly, allowed by the Tribunal. The Commissioner asked for and obtained the present reference u/s 256(1).

4. Two questions fall for consideration in the present case and they are : (1) whether the assessee entered into the lease agreement dated 25-8-1968 in the course of its regular business; and (2) whether the sum of Rs. 40,000 being the security deposit forfeited is a capital receipt or a revenue receipt. As far as the first question is concerned, we have no difficulty in coming to the conclusion that the lease agreement was entered into by the assessee-firm in the course of its business, namely, exhibition of cinema films.

It is not the assessee's case that the assessee discontinued the business and gave the cinema hall on lease. On the contrary, the authorities throughout proceeded on the basis that the lease of the cinema hall constituted the assessee's business and the income arising therefrom to the assessee on the lease of the cinema hall fell to be assessed under the head "Profits and gains of business or profession". The assessability of the sum of Rs. 40,000 in the assessee's hands was also examined by the authorities below on the same basis. It must, therefore, be held that the lease agreement dated 25-8-1968 was entered into by the assessee with the lessee in the course of its business and the assessability or otherwise of the sum of Rs. 40,000 falls to be examined with reference to the undisputed position that the forfeiture was made under the agreement entered into in the normal course of the assessee's business. The question whether a particular receipt is a capital receipt or a revenue receipt is the subject-matter of consideration in a number of cases. The Courts have held that the distinction between these two is well marked although the decision in each case will turn upon its own facts. As observed by the Supreme Court in *Commissioner of Income Tax, Nagpur Vs. Rai Bahadur Jairam Valji and Others*, various rules have been enunciated by the Courts as furnishing a key to the solution of the question although it is not possible to lay down any single test as infallible or any single criterion as decisive in the determination of the question, which must ultimately depend on the facts of the particular case and the authorities bearing on the question are valuable only as indicating the matters

that have to be taken into account in reaching a decision. The observations of the Supreme Court in the above case indicate that generally payments made in the settlement of rights under a trading contract are trading receipts and are assessable to revenue. Where the circumstances of any case indicate that compensation is paid to a person for cancellation of a contract, which does not affect the trading structure of his business nor deprive him of what, in substance, is his source of income, termination of the contract being a normal incident of the business, and such cancellation leaves him free to carry on his trade, the receipt is revenue. Where, however, by the cancellation of an agreement, the trading structure of the assessee is impaired or such cancellation results in loss of what may be regarded as the source of the assessee's income, the payment made to compensate for cancellation of the agreement is normally a capital receipt [see the decision of the Supreme Court in *Kettlewell Bullen and Co. Vs. Commissioner of Income Tax, Calcutta*, . Obviously realising this clear distinction, the learned counsel for the assessee, Shri M.J. Swamy, contended that the agreement dated 25-8-1968 entered into by the assessee with the lessee in the present case constituted the source or the profit-making apparatus and by the cancellation of such an agreement, the trading structure of the assessee is impaired. The learned counsel contended that the termination of the agreement resulted in loss of the source of the assessee's income and the sum of Rs. 40,000 forfeited by the assessee must be regarded as compensation for the termination of such agreement and should, therefore, be held to be capital receipt. The learned counsel relied on a number of decisions. We shall refer to some of these decisions; but we must observe that all the cases referred to by the learned counsel relate to the agency contracts providing the source and the profit-making apparatus from which income was derived. In all those cases, compensation received by the assessee on account of termination of contracts was held by the Courts to be capital in nature, because the termination of the contracts resulted in the destruction of the very source of producing income. In our opinion, cases touching on this aspect do not provide any assistance in the present case, although the capital asset producing the income is not, in our opinion, the agreement entered into by the assessee, but the cinema hall, which is the capital asset. The agreement is not the real source of the income derived by the assessee, but the source is the cinema theatre itself. The agreement did not constitute the profit-making apparatus; the cinema hall is the profit-making apparatus. The agreement is only a means to manage the cinema hall producing the income and providing the profit-making apparatus. In agency contracts, there is no other capital asset de hors the agreement. The agreement itself was the source from which income, profits and gains spring up and if compensation is paid to a person on account of the termination of the agency contract producing income, it could be legitimately said that the receipt of compensation related to the extinction of the source and the profit-making apparatus and, in that sense, is a capital receipt. In the present case, it is not possible to accept the contention that the termination of the agreement dated 25-8-1968 resulted in the destruction of the source producing the income or that there was any injury to

the profit-making apparatus and, consequently, the sum of Rs. 40,000 forfeited by the assessee is relatable to a capital asset. As we observed earlier, the capital asset is the cinema theatre itself which continued to exist as it was prior to the termination of the contract and also continued to produce income even after the termination of the agreement. Basically, therefore, we are unable to appreciate the contention of the learned counsel that the agreement itself constituted the source of the profit-making apparatus and it must, therefore, be held that the sum of Rs. 40,000 appropriated by the assessee by forfeiting the security deposit was capital in nature. We shall briefly refer to the decisions relied on by the learned counsel for the assessee. Our attention has been invited to a decision of this Court in *J.R. Kimtee and Sons Vs. Commissioner of Income Tax*, . That was a case of managing agency agreement. On account of the premature resignation of the managing agent, which was demanded, the arbitrators determined that the assessee in that case should be paid damages of Rs. 93,515 towards compensation for the loss of managing agency commission. This Court held that the sum of Rs. 93,515 was not income in character but was capital and all the same held that the provisions of section 28(ii) of the Act applied and the compensation received for the loss of managing agency had to be deemed to be profits or gains from the business and was, therefore, liable to income tax. As pointed out earlier, this is a case where the agreement of managing agency constituted the source and when that source was destroyed, compensation was paid. We are unable to accept the contention of the learned counsel that, based on the principles enunciated by this Court in the above case, the agreement between the assessee and the lessee must be viewed as the apparatus which leads to the business rather than the business itself. Indeed, the apparatus in the cinema hall and the business carried on by the assessee in working the cinema hall led to the assessee entering into the agreement. Reference may be made to the decision of the Bombay High Court in *Commissioner of Income Tax, Bombay City-III Vs. Kantilal Shah and Another*, . This again is a case of an agreement to finance a manufacturing firm and there was no independent capital asset. In the particular facts of that case, the Bombay High Court held that the assessee, who was a lady, had no income from business and had income only from other sources. She had not entered into such agreement previously. The financing agreement possessed some unusual feature. On a cumulative consideration of all the facts and circumstances of the case, the Bombay High Court came to the conclusion that the financing agreement was not a contract or arrangement in the course of the regular business of the assessee and, in that view, held that the termination of the contract amounted to premature determination of a capital asset which had been a source of income for the assessee and any amount received for such premature determination must be regarded as a capital receipt. This case is totally distinguishable. We have already found that the agreement was entered into by the assessee in the course of its business. The learned counsel also invited our attention to the decision of the Bombay High Court in *Commissioner of Income Tax, Bombay City-III Vs. Khushalbai Patel and Sons*, The assessee in that case entered into two finance contracts with the Western

India Oil Distributing Co. Ltd. Under these agreements, the assessee-firm agreed to finance the company such sum or sums of money as the company from time to time required for purposes of its business. In the meantime, some differences and difficulties arose between the assessee-firm and the company. The assessee did not accept the suggestions of the company for variation of the contracts with regard to payment of interest, etc., and, consequently, the company filed a suit for certain reliefs. Ultimately, a consent decree was passed whereunder the company paid the assessee as and by way of compensation for termination of the agreements a sum of Rs. 3 lakhs. The question was whether the sum of Rs. 3 lakhs, was income or not. The Bombay High Court held that it was a capital receipt because compensation was paid for the loss of source producing the income. We do not see how the above decision could be of any assistance to the present case. The learned counsel also relied on the decisions in *Gooptu Estates Ltd. v. CIT* 4 ITC 146 (Cal.), *Sabine (H.M. Inspector of Taxes) v. Lockers Ltd.* 38 TC 120, *Burmah Steamship Co. Ltd. v. IRC* 16 TC 67, *CIT v. Motiram Nandram* [1940] 8 ITR 132 (PC) and *Ukhara Estate Zamindaries (Pvt.) Ltd. Vs. Commissioner of Income Tax, West Bengal*, . We do not consider it necessary to deal with those cases in detail as, in our opinion, the facts of those cases were clearly distinguishable from the facts of the present case. In all those cases, the agreements, which constituted the source and profit-making apparatus, were terminated and compensations were received by the assessees which were held to be capital receipts. Besides the agreements, there was no other capital asset producing the income in those cases. We have already observed that, in the present case, the compensation was quite different in that part from the agreement, the real capital asset was the cinema hall and it was that capital that was producing the income. That capital asset remained intact. It is, therefore, not possible to accept the contention that, in the termination of the agreement dated 25-8-1968, the assessee lost the source of producing income or that the profit-making apparatus was destroyed.

5. On the other hand, we have a decision of the Madhya Pradesh High Court in *Thackers H.P. and Company Vs. Commissioner of Income Tax*, That was a converse case. The assessee in that case was carrying on business in the purchase and sale of tendu leaves. He entered into a contract for the purchase of tendu leaves from the Orissa Forest Corporation Ltd. and deposited a sum of Rs. 39,350 as security with the corporation. As the contract was not fulfilled, the Corporation forfeited the security. The assessee claimed the security deposit forfeited as a business loss and the claim was disallowed by the ITO. The Tribunal affirmed the disallowance holding that the deposit of the amount of Rs. 39,350 for the contract with the Corporation was in the nature of a capital expenditure for commencing the venture and was not deductible as a business loss. The assessee carried the matter on reference to the High Court. The High Court held that the business carried on by the assessee was purchase and sale of tendu leaves and the contract with the Orissa Forest Corporation Ltd. being in the course of the same business, which was then carried on by the assessee, it could

not be said to be the commencement of a new business. The deposit of the security amount was made as a business expenditure in the course of the business and was not for acquiring a new business and, therefore, the loss incurred by the assessee on the forfeiture of the security deposit was a business loss. We are in respectful agreement with this principle. The contract was admittedly entered into by the assessee in the regular course of its business and the security deposit was forfeited by the assessee for its benefit on account of the termination of such a contract. The amount forfeited by the assessee has reference only to its business and did not represent any compensation for loss of source producing income or any injury to or destruction of the profit-making apparatus. We may also refer to the decision of the Supreme Court in COMMISSIONER OF Income Tax AND EXCESS PROFITS TAX MADRAS Vs. SOUTH INDIA PICTURES LTD., That was a case of an assessee who was carrying on business of distribution of films. He entered into three agreements for advancing monies to certain motion picture producers towards the production of three films and acquiring the rights of distribution thereof.

The agreements, inter alia, provided that the assessee would advance certain sums of money in instalments for the production of the films, the assessee acquiring the sole right to distribute the films for a period of five years from the date of release of each film. After the assessee had exploited to a certain extent its right of distribution of the three films, the agreements were cancelled and the producers paid an aggregate sum of Rs. 26,000 to the assessee towards compensation as a result of the termination of the contracts. The Supreme Court held that the sum paid by the producers to the assessee was not compensation for not carrying on its business but was a sum paid in the ordinary course of business to adjust the relation between the assessee and the producers : the termination of the agreements did not radically or at all affect or alter the structure of the assessee's business. The Supreme Court held that the amount received by the assessee in that case was income liable to be taxed. In our opinion, this principle wholly applies to the present case.

6. For the aforesaid reasons, we hold that the Tribunal was in error in coming to the conclusion that the sum of Rs. 40,000, being security deposit forfeited by the assessee under the agreement dated 25-8-1968 entered into with the lessee, did not represent income liable to be taxed under the head "Profits and gains of business or profession".

7. We answer the question referred to us in the affirmative, i.e., in favour of the revenue and against the assessee. No costs. The learned counsel for the assessee makes an oral application for leave to appeal to the Supreme Court. In our opinion, the principle is fairly well settled and we do not think this is a fit case for grant of leave to appeal to the Supreme Court u/s 261 of the Act. The oral application is, accordingly, rejected.