
(1960) 10 AHC CK 0008

In the Allahabad High Court

Case No : Income-tax Miscellaneous Case No. 145 of 1952

COMMISSIONER OF Income Tax

APPELLANT

Vs

MATHULAL BALDEO PRASAD.

RESPONDENT

Date of Decision : 05-10-1960

Acts Referred:

Income Tax Act, 1922 — Section 66(1)

Citation : (1961) 42 ITR 517

Hon'ble Judges : Mootham, C.J.;Upadhya, J;Gurtu, J

Bench : Full Bench

Judgement

GURTU, J. - This is a reference u/s 66(1) of the Indian Income Tax Act, 1922, read with section 21 of the Excess Profits Tax Act, 1940, made by the Income Tax Appellate Tribunal at the instance of the assessee Messrs. Mathulal Baldeo Prasad, Kanpur.

The facts stated by the Appellate Tribunal in the statement of the case drawn up and referred to this court are as follows :

"The assessee is a registered firm. The assessment year is 1946-47 and the accounting year is from July 7, 1944, to July 14, 1945. It carried on speculative transactions in cotton. Three such transactions were entered into with a firm Chaturbhuj Piramal and in these three transactions the date of settlement in the first one was January, 1944, the second in March, 1944, and the third in May, 1944. In other words these dates of settlement were all in the accounting year ending on July 6, 1944, relevant to the assessment year 1945-46. The first one resulted in a profit of Rs. 297-8-0, the second in a loss of Rs. 4,655-13-0, and the third in a loss of Rs. 11,138; the aggregate being a loss of Rs. 14,994. The said firm of Chaturbhuj Piramal submitted an account to the assessee but the assessee firm having failed to pay, claimed a sum of Rs. 15,561-8-0 inclusive of interest of Rs. 65-2-6. The assessee disputed the correctness of the account and the matter was referred to two arbitrators appointed by each of the parties but the arbitrators having failed to give their award new arbitrators were appointed

by the East India Cotton Association Ltd. according to the terms of the association of which both the assessee and Chaturbul Piramal were members. The arbitrators so appointed gave their award on August 29, 1944. Copy of the award is made annexure "A" of the statement of the case. By this award the assessee was made liable to pay a sum of Rs. 14,994 with interest at the rate of 4 1/2% per annum from May 25, 1944, till date of payment. The assessee wrote off this amount of Rs. 14,994 as loss in the year of account relevant to the assessment year 1946-47. It is contended that since the loss was determined upon the award of the arbitrators it can only be said to have been incurred in the assessment year 1946-47. The Tribunal held by its order which is made a part of this case as annexure "B" that the loss claimed was incurred in the assessment year 1945-46. In its opinion the assessee's claim was fictitious in order to put off the payment as would be clear from the award of the arbitrators. It, therefore, held that there was no ground to claim the loss in 1946-47 assessment year only on the point that the award was passed in the said assessment years."

The additional facts found stated in annexures "A" and "B" will also be referred to later in the course of this order.

The question formulated for our consideration and referred to us with the statement of the case is as follows :

"Whether the loss amounting to Rs. 14,994 was loss pertaining to the assessment year 1945-46 or to the assessment year 1946-47 ?"

The question is whether this loss of Rs. 14,993 odd was an ascertained liability in and a loss pertaining to the assessment year 1945-46 or to the assessment year 1946-47. The system of accounting being mercantile, the answer to this question would depend upon whether an enforceable liability had arisen in the assessment year 1945-46 or whether it could be said that the liability had arisen in the year 1946-47.

It was contended before us on behalf of the assessee that the liability arose when the award of the arbitrator was given, and that before that date the liability was at best only a contingent liability. Alternatively, it was contended that there existed a mere possibility of a liability coming into existence before the award was given and that it was when the award was given that an actual liability came into existence, inasmuch as there was no admission by the assessee of the claim put forward by the constituents but a denial of the same. It was said that until acceptance by admission or determination by an award the amount claimed could only be debited as an ascertained liability when the award was given and the liability came to be fixed and quantified.

In support of this contention several cases were cited before us.

The case of Kanpur Tannery Ltd. v. Commissioner of Income Tax was a case where the assessee was required to insure his stock-in-trade with the Central Government u/s 7 of the War Risks (Goods) Insurance Ordinance, 1940, and to

pay the proper insurance premium. It was found that he had not paid the proper premium in the accounting year in which it was said to have become exigible by virtue of section 7. The High Court referred to section 7A introduced by the Amending Ordinance, which enacted that if any person evaded payment of the premium either by not insuring the goods under the Ordinance of 1940 at all or not insuring the goods to the full amount of their value, then an officer authorised in that behalf would determine the amount of premium which had been evaded and this amount could be recovered from the person concerned; and it held that in the circumstances until the evaded premium was determined as aforesaid it could not be said under the mercantile system of accounting that a liability had been incurred which could be entered in the books as an expenditure, for that could only be done when the liability had become an ascertained sum of money and that until ascertained the liability no doubt existed but proceedings had to be taken in some way or other to determine the exact amount. The High Court relied for its view upon the principle enunciated in the cases of *Senthikumara Nadar & Sons v. Commissioner of Income Tax and Calcutta Co. Ltd. v. Commissioner of Income Tax*.

The next case cited was *Ford & Co. Ltd. v. Commissioners of Inland Revenue*. That was a case where the assessee carried on business of grain merchants and for the period in question bought grain in the Argentine and sold it to the Royal Commission for wheat supplies, hereinafter to be referred to as the Commission. The assessee had apparently undertaken to cover the liability for demurrage for detention of the carrying ships, the Wheat Commission itself chartered the ships upon terms which include liability by the Commission to pay demurrage to the shipowners except in certain circumstances. In terms of the agreement the Commission claimed against the assessee a sum totalling pound 33,847 as demurrage for the period April to July, 1920. Immediately the claims were made the company protested against them and at no time admitted them. Eventually, the Commission agreed to refund the sums they had deducted in respect of demurrage from the company's invoices and to hold over the claims until the relevant facts had been fully ascertained. The company, however, included the amount of pound 33,847 as an ascertained liability in its account for the year to September 30, 1920. Ultimately after negotiations the Commission on March 7, 1922, agreed to make no claim for demurrage on the appellant-company subject to certain conditions. The conditions being fulfilled the appellant was excused the payment of pound 33,847 in question and that sum was credited in the assessee's account for the year to September 30, 1920.

The company contended that the Commission had in law an irrefutable claim against them for the payment of pound 33,847 and that sum was a liability subsequently satisfied by services rendered, and claimed that the sum in question was a proper deduction in computing the profits of the company for the accounting period of twelve months ending on September 30, 1920.

The Special Commissioners refused the claim holding that the appellant company

had never admitted its liability for the sum of pound 33,847, which was no more than a contingent liability, and that what the Commission gave up for services rendered was not an ascertained debt due to them of pound 33,847 but merely their right to prosecute their claim further for that sum.

It was held in the High Court that the sum in question was not an admissible deduction in computing the profits for the accounting period ending on September 30, 1920, being a contingent liability only, and that even if it had been an ascertained liability on that date the accounts might properly be reopened on the subsequent abandonment of the claim by the Wheat Commission so as to disallow any deduction made.

James Spencer & Co. v. Commissioners of Inland Revenue is a case in which the facts were that the assessee were a firm of Clyde Stevedores, who at the material time carried on their employers liability risk instead of insuring claims under the Workmens Compensation Act or at common law. For the purposes of the firms excess profits tax the relevant chargeable accounting period was a period of nine months ending December 31, 1945. The assessees debited against the profits of the chargeable accounting period a sum of pound 38,161 made up of (1) the capitalized value of claims admitted for weekly payments even where the capitalised value had not been paid within the chargeable accounting period and (2) claims which had not been admitted nor discerned for within the accounting period, but which were subsequently, admitted or found by a competent court to be due. The Commissioners disallowed that debit on the ground that it was a reserve against future liabilities.

On appeal the Special Commissioners were "invited only to determine the legal principle involved" and they did so by a finding that "no liability in respect of an accident arose until it was either admitted or if disputed until determined by the decision of a competent court." The assessees appealed and the question of law to be decided was whether liability in respect of an accident arises (a) when the accident occurs or (b) when liability is admitted or determined by a court.

After examining the numerous cases the Lord President Cooper opined as follows :

".... it seems to follow that, if in the earlier period there is only a provisional or contingent liability it is not until it has been subsequently determined to by an actual liability by admission or decision that it can properly be brought into computation, and it should then be debited even if it is not until a still later period that the exact quantum can be inserted...."

Applying this rule to the facts of the case, the Lord President considered that the Special Commissioners were right in holding that no liability arose in respect of an accident until the fact of liability was either admitted or determined. Until then the liability was only provisional or contingent for the purposes of tax computation; that the contingency was purified and the provisional liability became actual when the fact of liability was so ascertained and it was then that

the debit should appear in the accounts.

In *Rajarathina Nadar v. Commissioner of Income Tax* it was indicated that as the assessee maintained his accounts on the mercantile basis a mere ascertained liability with a corresponding entry in his accounts was sufficient for claiming revenue expenditure; an ascertained liability was there and was legally enforceable against the assessee; that the assessee intended not to discharge his liability did not affect his legal liability or his legal rights under the Income Tax Act and the Excess Profits Tax Act.

On behalf of the revenue authorities the case of *Sassoon & Co. Ltd. v. Commissioner of Income Tax* was cited. The passages relied upon deal with the question of the character of income, and when it may be said to accrue, arise or be received or earned. The case does not seem to be directly to the point.

Having indicated the trend of the authorities, let me consider what exactly is the situation in this case. From the facts stated in the case or annexures "A" and "B" the following matters are clear. The transactions in question were speculative transactions in cotton. They had to be settled in the months of January, March and May. The constituent of the assessee submitted an account, and the assessee disputed the correctness of the rate and asserted that the constituent had not rendered a true and correct account of the transactions. The dispute was then referred to the arbitration of two persons. One representative of each party, and then under the membership rules of the East India Cotton Association Ltd., both the assessee and his constituent being members, thereof, it was referred to an arbitrator who gave an award.

It appears, therefore, that the contracts were of a wagering character where no goods were delivered. Secondly, there was an agreement to refer disputes to arbitration. Thirdly, that nomination was made by each of the parties of two arbitrators. It was when they refused to continue to act that an arbitrator was appointed under the rules. It would therefore appear that from the very outset, having regard to the speculative nature of the transactions, it was apprehended that disputes would arise involving, in whole or in part, repudiation of the claim of one party or the other and, therefore, provisions were agreed to for determining by arbitration whether any liability had come into existence and if so to what extent. In speculative contracts with rates varying from minute to minute or hour by hour, there was undoubtedly scope for over-reaching by one party or the other and it is clear that it is for this reason that by the fact of membership of the Cotton Association it was agreed that the machinery of arbitration would be used for determining whether or not a liability had come into existence at all and, if so, to what extent. The parties, therefore, clearly contemplated repudiation of each others claim and in agreeing to a machinery of arbitration agreed that immediately a claim was made it would not be considered to be enforceable in a court of law unless the existence or otherwise of the liability was determined by arbitration. Of course if the claim was admitted and it was debited in the books of the assessee then there was no question that the

assessee accepted the liability. On the other hand, if it was repudiated then even though the repudiation may not subsequently have been found to be justified or even if there was a repudiation mala fide, the claim could not be said to be established and the liability would have to be determined by arbitration. In this case, inasmuch as both parties agreed in the first instance to nominate an arbitrator each, it must be taken, that they were also both agreeable to set the machinery of arbitration in motion after the repudiation. What exactly then was the right of the constituent of the assessee after he had presented his accounts for payment and the correctness of those accounts was disputed ? Was the right merely to have the question of liability determined in the first instance by arbitration and then such right being determined to go to the civil court thereafter to have the award made a decree of the court so that the amount awarded could be recovered, or was there a right to enforce the claim straightway on the basis that a liability had come into existence the very moment the transactions were completed ? In my view it was clearly in the contemplation of the parties that in the first instance their only right would be to get a determination by arbitration as to whether or not liability had come into existence under the contract and it was only after such ascertainment that the so-called liability could be said to have ceased to be a mere claim and to have become an actual liability with a right of enforcement in a court of law. The arbitration clause is a matter of agreement between the parties. In these circumstances since the assessee's books were not debited with the amount claimed and since there was a repudiation of the same immediately the claim was made, I think that it cannot be said that in the first instance there was anything more than a mere assertion of a claim. It could only be said at that stage that if that claim was found correct by the arbitrators, the claim would then become an actual enforceable liability against the assessee.

In every case whether a debit should be made in one accounting year or another must depend upon the facts of the case. It is not right or proper to give an answer in vacuo and the answer must be given having regard to the facts of each case. The nature of the transaction in the instant case, the fact of repudiation and the acceptance of the machinery of arbitration and the setting of it in motion voluntarily by the parties would all go to show that it was clearly in the contemplation of the parties that an enforceable liability would only be deemed to have come into existence when and only when it was determined and fixed by the arbitrators. The conclusion at which I have arrived seems to be in accord with the approach in the cases to which reference has already been made. I would, therefore, answer the question propounded in this way that the loss amounting to Rs. 14,993 and odd was a loss not pertaining to the assessment year 1945-46 but to the assessment year 1946-47. Reference should be answered accordingly.

UPADHYA, J. - I have had the advantage of reading the order proposed by my learned brother and respectfully agree that the loss amounting to Rs. 14,994 was a loss pertaining to the assessment year 1946-47 as contended by the assessee.

All that happened during the previous year relevant to 1945-46 assessment was that the assessee entered into three speculative transactions in cotton in which the dates of settlement fell in January, March and May, 1944. The assessee did not accept the claim of Messrs. Chaturbhuj Piramal and the matter was referred to arbitration. As mentioned by my learned brother the transactions were entered into between members of the East India Cotton Association Ltd. In accordance with the rules of the association which bound the parties the dispute between them had to be settled by arbitration. Having regard to the nature of the transactions and the provisions relating to arbitration and the fact that the claim was not admitted by the assessee it could not be said to be an ascertained liability of the assessee until the arbitrators decided the matter. In the circumstances the assessee cannot be said to be in the wrong in not claiming the adjustment of the loss in the assessment for the year 1945-46. It may be noticed that the ascertained liability fixed by the arbitrators could not be known to the assessee at all during the accounting period relevant to 1945-46 assessment and no debit entry in respect of Rs. 14,994, which is the item in dispute, could possibly be made in the accounts of that period.

Learned counsel for the Department invited our attention to the provisions of section 10(2A) of the Income Tax Act which reads as follows :

"10. (2A) Where for the purpose of computing profits or gains under this section, an allowance or deduction has been made in the assessment for any year in respect of any loss, expenditure or trading liability incurred by the assessee and, subsequently during any previous year, the assessee has received, whether in cash or in any other manner whatsoever, any amount in respect of such loss or expenditure, or has obtained some benefit in respect of such trading liability by way of remission or cessation thereof, the amount received by him or the value of the benefit accruing to him shall be deemed to be profits and gains of business, profession or vocation and to have accrued or arisen during that previous year."

This provision was introduced by the Indian Finance Act 1955 and is not applicable to assessments for the years 1945-46 and 1946-47. It provides for the inclusion of such amount as is received by an assessee during a previous year which he has claimed as a reduction in computing profits or gains u/s 10 in the assessment for an earlier year. Strictly speaking this provision is inapplicable to the instant case for no loss, expenditure or trading liability has been already allowed or deducted and none may be said to have been recovered during the relevant previous year. It is, however, urged that this provision implies that the liability should be deducted when incurred. This would be correct if the accounts are kept according to the mercantile system of accountancy and it is found that the loss, expenditure or trading liability was incurred during the previous year in question. As observed by my learned brother the amount had not been determined and the parties when entering into speculative transactions contemplated disputes being settled by arbitration. It is also found that the

assessee became liable for the precise amount of Rs. 14,994 only after the close of the previous year relevant to 1945-46 assessment. It cannot be, therefore, said that there was any trading liability for an ascertained amount which could be entered in the accounts earlier.

A question relating to expenditure provided for but not actually made during the accounting period came up before the Supreme Court in *Indian Molasses Co. (Private) Ltd. v. Commissioner of Income Tax*. Hidayatullah, J., observed :

"Expenditure which is deductible for Income Tax purposes is one which is towards a liability actually existing at the time, but the putting aside of money which may become expenditure on the happening of an event is not expenditure."

Adopting the argument with respect it may be said that the loss deductible for Income Tax purposes is one actually existing at the time and debiting an amount which may in whole or in part be subsequently found to be due as a result of an arbitration agreed to between the parties is not a loss.

BY THE COURT. - Our answer to the question referred is that the loss amounting to Rs. 14,994 was a loss pertaining to the assessment year 1946-47 and the relevant chargeable accounting period. The assessee will have his costs which we assess at Rs. 200. Fee of the learned counsel for the Department is fixed at the same amount.

[MOOTHAM, C.J. - Judgment pronounced by me today under Chapter VII, rule 1 (2), of the rules of Court.]

Reference answered accordingly.