

(1972) 09 MAD CK 0028

In the Madras High Court

Case No : Tax Case No. 43 of 1967 (Reference No. 15 of 1967)

Commissioner of Income Tax (Central)

APPELLANT

Vs

Inden Biselers

RESPONDENT

Date of Decision : 20-09-1972

Acts Referred:

Income Tax Act, 1922 — Section 10(1), 10(2)

Citation : (1973) ILR (Mad) 660 : (1973) 91 ITR 427

Hon'ble Judges : V. Ramaswami, J;G. Ramanujam, J

Bench : Division Bench

Advocate : V. Balasubrahmanyam and J. Jayaraman, for the Appellant; S. Swaminathan and K. Ramagopal, for the Respondent

Judgement

Ramaswami, J.—The following two questions have been referred for decision:

1. Whether, on the facts and in the circumstances of the case, the Appellate Tribunal was right in law in holding that the sum of Rs. 1,18,875 was

a trading loss deductible u/s 10(1) of the Indian Income Tax Act, 1922, in order to arrive at the profits of the assessee's business for the

assessment year 1957-58 ?

2. Whether, on the facts and in the circumstances of the case, the Tribunal was right in law in holding that the assessee's claim was not

entertainable u/s 10(2)(xv) of the Indian Income Tax Act, 1922?

2. The assessee is a registered firm carrying on business in export of manganese and iron ore. It entered into four contracts with M/s. M. Golodetz

& Co., New York, undertaking to supply certain quantities of manganese ore of a specified quality within a specified period. After supplying

certain quantity of ore as per the agreement, due to the nonavailability of the specified quality either in the mines or in the market, the assessee

could not supply the balance of the quantity and quality of ore to the said American firm. The assessee-firm, therefore wrote to the American company expressing its inability to fulfil the contracts and requesting the company to cancel the contracts in respect of the balance of the quantity of ore yet to be supplied. The American firm declined to accede to the request, but instead proposed certain modifications in the terms of the original contracts, both with regard to the quality and quantity of the ore to be supplied and also offered to extend the time for fulfilling the contracts, subject however to the assessee executing promissory notes of the value of \$32,500 in its favour as security for the faithful performance of the contracts by the assessee under the modified terms. This was accepted by the assessee and three promissory notes were executed by the assessee as required by the American firm. Even as per the terms of the modified contracts, the assessee could not supply the required quantity and quality of ore in spite of its best efforts and, therefore, the American firm forfeited an amount of \$25,000 equivalent to Rs. 1,18,875 as per the terms of the contracts. The assessee-firm paid the amount during the accounting year relevant to the assessment year 1957-58 and claimed "this amount as a business loss in that year.

3. The Income Tax Officer rejected the claim on the ground that as it was beyond the control of the assessee to perform the contract, the assessee was not under an obligation either to perform the contract or to pay any damages to the American firm for the breach of contract and that the assessee paid the sum of \$25,000 to the American firm only with a view to safeguard its good business relationship with the foreign firm, that the payment resulted in an enduring benefit to the assessee-firm and, therefore, it could not be allowed as a business loss.

4. In the appeal, as required by the Appellate Assistant Commissioner, the assessee also filed a statement containing various particulars relating to the transaction with the American firm and also similar transactions with other persons. After consideration of the material placed before the Appellate Assistant Commissioner, he held that the contracts with the American firm were not genuine and in that view confirmed the disallowance of the assessee's claim. On a further appeal to the Tribunal, the Tribunal came to the conclusion that there were no reasons at all to doubt the

genuineness of the original contracts or to think that these contracts were not entered into in the usual course of the assessee's business and that

there was no material to show either that the quantity of manganese ore stipulated in the contracts was not available in the mines or in the market at

any time prior to the date of these contracts or that the stipulated price was too low compared to the price prevailing in the market at the time of

the contracts. The Tribunal was also of the view that the assessee's failure to fulfil these contracts was due to the non-availability of the quality of

ore during the relevant period and was not mala fide and that the Assessee-firm acted wisely in accepting the modified terms and also in agreeing

to execute the promissory notes. The Tribunal further held that the payment of \$25,000 by the assessee to the American firm was in discharge of

the legal obligations of the assessee under the contracts and that the payment did not come under the category of capital expenditure. The Tribunal

then proceeded to consider the assessee's claim for allowance of this amount u/s 10(2)(xv) of the Indian Income Tax Act, 1922. (hereinafter

called "the Act"). In the view that the promissory note amounts were not paid by the assessee in order to earn any profits from the fulfilment of the

contracts, but were paid by way of damages for the breach of contract, the Tribunal held that the assessee's claim cannot be allowed u/s 10(2)(xv)

of the Act. The assessee's claim u/s 10(1) of the Act for deduction of the amount was then considered. Relying on the decision in Narandas

Mathuradas & Co. v. Commissioner of Income Tax, [1959] 33 ITR 461 and Hind Mercantile Corporation Ltd. Vs. Commissioner of Income

Tax, Madras, the Tribunal held that the assessee was entitled to a deduction of a sum of Rs. 1,18,875 in computing its business income u/s 10(1)

of the Act.

5. The Commissioner of Income Tax filed an application u/s 66(1) requiring the Tribunal to refer the first question of law set out above. In its reply

the assessee objected to the reference of the question suggested by the Commissioner and requested that in case the Appellate Tribunal decided to

refer the question the assessee required the Tribunal to refer the second question set out above. Though the departmental representative objected

to the reference of the second question, the Tribunal has referred both the questions for our opinion.

6. We are of opinion that the learned counsel for the revenue is well founded in his contention that the second question referred to above had not

come up for consideration on proper reference and that, therefore, we cannot answer that question. An identical point came up for consideration in

COMMISSIONER OF Income Tax, MADRAS Vs. K. RATHNAM NADAR., and it was held therein that where either the Commissioner or

the assessee had made an application u/s 66(1) of the Indian Income Tax Act, 1922, for a reference to the High Court., it is not open to the other

party in reply to the application filed by the opposite party to ask for a reference of a question which it wants to be referred and that the only way

by which a party can ask for a reference of any question to the High Court is by filing an application u/s 66(1) and if that is refused, to apply to the

High Court u/s 66(2) of the Act. The jurisdiction of the High Court is dependent upon a proper reference. In the absence of a separate application

u/s 66(1) by the assessee, therefore, the reference was incompetent. We accordingly return the reference of the second question unanswered.

7. It is now well settled that the list of allowances u/s 10(2) of the Act is not exhaustive of all allowances which could be made in ascertaining

profits taxable u/s 10(1) and that if there was any loss which, from the commercial point of view, can be considered a trading loss that loss ought to

be deducted u/s 10(1) before the true profits of the business are ascertained. In this connection, reference may be made to the decision of the

Supreme Court in Calcutta Company Ltd. Vs. The Commissioner of Income Tax, West Bengal, wherein their Lordships, held that the expression

profits or gains "" in Section 10(1) of the Act has to be understood in its commercial sense and there can be no computation of such profits and

gains until the expenditure which is necessary for the purpose of earning the receipts is deducted therefrom. In this decision, the following passage

in Badridas Daga Vs. The Commissioner of Income Tax, has also been quoted:

The result is that when a claim is made for deduction for which there is no specific provision in Section 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.

8. The argument of Thiru Balasubrahmanian, the learned counsel for the revenue, was that the three promissory notes in question were not executed by the assessee for the purpose of earning profits, but they were executed for the purpose of securing the business itself. It was for the purpose of ensuring the contract which is the very source of the assessee's export business. The execution of the promissory notes is antecedent to and de hors the export business which the assessee carried on and not incidental to its business of export and that the loss, if any, incurred by the forfeiture and payment was, therefore, not incurred in the course of business and, hence, it could not be deducted u/s 10(1) of the Act. This, in short, is the argument for the revenue. On the other hand, the learned counsel for the assessee contended that the original contracts and the subsequent contracts were entered into in the course of and for the purpose of the business, that the promissory notes were executed for the due fulfilment of the terms of the contract and the amount of the promissory notes represented liquidated damages and that, therefore, the claim was deductible as a trading loss u/s 10(1).

9. It is seen from the correspondence and the statement of the assessee given before the Appellate Assistant Commissioner that the sum of \$ 25,000 covered by the promissory note-securities represented the difference between the agreed price and the expected market rate on the date of delivery in respect of these contracts and it was actually found at the time of breach that the amount covered by the securities represented the difference between the agreed price and the market rate. The promissory notes were executed for the due performance of the obligations under the amended contracts. The finding of the Tribunal is that both the original contracts and the modified contracts were genuine and bona fide and that the execution of the promissory notes was, therefore, incidental to the carrying on of the business. The Tribunal also found that the breach of the modified contracts was also bona fide, that the assessee was unable to supply the required quantity of ore as per the terms of the contract and that the assessee could not have escaped its liability under the promissory notes and that, therefore, the discharge of the promissory notes was a legal obligation of the assessee incurred in the course of and incidental to the

business. We are also of the view that this is a normal thing that happens in any business and to any businessman. On the facts and findings of the Tribunal, we are of the view that the damages paid by the assessee is a revenue loss incurred in the course of carrying on of the business and, therefore, liable to be deducted u/s 10(1) of the Act.

10. Some of the decisions which considered similar claims u/s 10(1) of the Act also support our conclusion. In *Narandas Mathuradas & Co. v. Commissioner of Income Tax* the facts were these : The assessee-firm carried on business in several commodities and in the course of its business

it submitted tenders to the B.B. & C.I. Railway and undertook to supply certain commodities. In accordance with the terms of the tender, it had

deposited a sum of Rs. 4,419 as security for carrying out the contract. This amount was forfeited, due to non-fulfilment of the contract, by the

railways. The assessee claimed this sum as a trading loss. It was held that submitting of tenders was in the course of its business and that, therefore,

the making of the deposit was incidental to the business which the assessee was carrying on. The forfeiture was, therefore, a trading loss deductible

u/s 10(1) of the Act.

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11. *Hind Mercantile Corporation Ltd. v. Commissioner of Income Tax* was a case in which the assessee entered into a contract with a Belgium

company for export of groundnut oil. The contract could not be fulfilled due to change in the policy of the Government with regard to export of

groundnut oil. When a demand was made for damages for breach of contract by, the Belgium company, the matter was referred to arbitration and,

as per the award of the arbitrator, the assessee had to pay a sum of Rs. 2,35,758 as damages and incurred a sum of Rs. 10,303 as legal expenses

and this court held that these amounts are allowable deductions in computing the profits and gains of the assessee's business u/s 10 of the Act.

12. *Calcutta Co. Ltd. v. Commissioner of Income Tax* was a case in which the assessee bought lands and sold them in plots for building purposes

undertaking to develop them by laying out roads, providing drainage system and installing lights. It was held that the estimated amount which would

have to be expended by the assessee for laying out roads, providing drainage system and installing lights, etc., was in the course of carrying on its

business and was incidental to the business and, having regard to the accepted

commercial practice and trading principles, was an allowable deduction in arriving at the profits and gains of the business u/s 10(1) of the Act.

13. In Commissioner of Income Tax Vs. Prafulla Kumar Mallik, the facts were these : The assessee was a paddy procuring agent under the Government of Orissa on the basis of an agreement entered into by him. Under that agreement the assessee was required to supply paddy and rice of certain standard quality known as "fair average quality". Under one of the clauses the Collector was authorised to levy a penalty and deduct the same from the pending or future bills in case the supply of foodgrains was not in conformity with the "fair average quality". In exercise of that power, during the course of the year, penalties amounting to Rs. 25,700 were imposed on the assessee and realised by deduction from the bills.

The question for consideration was whether this penalty was an admissible deduction u/s 10(1) of the Indian Income Tax Act, 1922. It was held :

It is an inevitable consequence of the assessee's business as a paddy procuring agent that, as a result of the goods delivered not being of contract quality, breach of warranty, with the risk of liability to pay damages, should at times be committed and payment of such damages as a result of the breach of warranty in the course of or as a consequence of earning profits and gains of the business is incidental to the carrying out of the assessee's business as a paddy procuring agent; it was an unavoidable loss arising as one of the consequences of carrying On such business.

14. In The Commissioner of Income Tax Vs. The Mysore Sugar Co., Ltd., it was held that when the assessee-company makes a forward arrangement for the next year's sugarcane crops and pays some amount in advance out of the price, there was no capital investment in making the advance and the loss incurred due to the sugarcane growers' inability to grow sugarcane due to drought was a loss incurred by the assessee on the revenue side and, therefore, was deductible. As observed by the Supreme Court in Commissioner of Income Tax U.P. Vs. Nainital Bank Ltd., a loss or payment is not deductible unless it is incurred in carrying out the operation of the business and is incidental to the operation. Again, the question whether the loss was incidental to the operation of the business is a question to be decided on the facts of each case having regard to the nature of the business carried on and the nature of risk involved in carrying them

out. The degree of the risk or its frequency is not of much relevance, but its nexus to the nature of the business is material.

15. In the present case, the Tribunal has found that the breach of the contract was bona fide. Therefore, the damages paid in consequence of the breach is loss incurred in carrying on the business of export. The amount would, therefore, have to be deducted in order to determine the true profits and gains of the assessee u/s 10(1) of the Act. We, therefore, answer the question in the affirmative and against the revenue with costs.

Counsel's fee Rs. 250.