
(1962) 10 MAD CK 0005

In the Madras High Court

Case No : Tax Case No. 136 of 1960 (Reference No. 54 of 1960)

COMMISSIONER OF Income Tax, MADRAS

APPELLANT

Vs

ESSEN PRIVATE LTD.

RESPONDENT

Date of Decision : 29-10-1962

Acts Referred:

Income Tax Act, 1961 — Section 66

Citation : (1963) 50 ITR 569

Hon'ble Judges : Jagadisan, J

Bench : Division Bench

Judgement

JAGADISAN J. - At the instance of the Commissioner of Income Tax, Madras, the following question has been referred to us u/s 66 of the Indian

Income Tax Act : ""Whether there are materials for the Tribunal to hold that the debt in question was incurred in the course of the business so as to

make its loss deductible u/s 10(2)(xi) ?

The assessee is a private limited company incorporated under the Indian Companies Act. It is carrying on business as managing agent of several

concerns. It is the managing agent of the India Cements Ltd., and it is also having an insurance agency. Another company called Amer Hind

Manufactures Ltd., hereinafter called as the managed company or the company, was formed for the manufacture and sale of typewriters, carbon

papers, typewriting ribbons, stencil papers and other articles. This company was managed by a company called American Agencies Ltd. The

managing agency of the American Agencies Ltd. was, however, terminated on and from July 16, 1950. The shareholders of the company (Amer

Hind Manufactures Ltd.) passed a resolution on June 17, 1950, terminating the managing agency of American Agencies Ltd., and appointing the

assessee as their managing agents on and from July 16, 1950. It appears that the managed company was in need of funds and the assessee

advanced moneys from time to time on what is stated to be a "current account". The fact of this advance is not disputed. The assessee also

guaranteed the loan of about Rs. 2 lakhs obtained by the managed company from the Indian Overseas Bank Ltd. A guarantee letter was passed

on June 23, 1953. On October 22, 1954, the Indian Overseas Bank claimed payment of their dues in full and the assessee paid in fulfilment of the

terms of the guarantee the sum of Rs. 81,599-8-0. The fortunes of the managed company steadily declined and the result was that the assessee not

merely lost the expected earning from the managing agency business, but also failed to recoup the advance made on current account and the

amount paid to the Indian Overseas Bank as guarantors. The assessee had apparently not much hopes of recovering these sums of money even in

1954. In the balance-sheet of the assessee published for the calender year 1954, these loans and advances were described as doubtful. In the

accounting year ended December 31, 1955, the previous year for the assessment year 1956-57, the assessee wrote off in its books of account Rs.

4,03,203 consisting of the amounts advanced on "current account" and payment made to the Indian Overseas Bank as guarantors and claimed it as

allowance in computing its business income u/s 10(2) (xi) of the Indian Income Tax Act.

The Income Tax Officer disallowed the claim of bad debt mainly on the ground that the debts were not connected with the business of the

managing agency, that the advances by the assessee were of a capital nature, that they were not in any event trade debts admissible to be written

off u/s 10(2) (xi) as, if recovered, they would not swell the profits of the assessee's business. The assessee went up on appeal to the Appellate

Assistant Commissioner and he affirmed the decision of the Income Tax Officer. He observed that he was not much impressed with the reasons

given by the Income Tax Officer in disallowing the assessee's claim but however upheld the officer's decision on the ground that the expenditure or

loss partakes the character of a capital expenditure or loss. There was a further appeal by the assessee to the Income Tax Appellate Tribunal. The

assessee confined its claim for allowance before the Tribunal to a sum of Rs. 3,59,302-14-7. Of this the amount advanced on current account was

Rs. 3,40,956-1-1. The balance of Rs. 18,346-13-6 represented the amount of loss incurred out of the guarantee given to the Indian Overseas

Bank in respect of the companys borrowing. We have already stated that the assessee paid the Overseas Bank the sum of Rs. 81,593-8-0. Out of

this the assessee recovered or realised a sum of Rs. 44,905-13-0 by sale of the manufactured goods of the company and the balance that

remained un recouped on this account was Rs. 36,693-11-0. As the guarantee to the Overseas Bank was given jointly by the assessee and one S.

N. N. Sankaralinga Iyer, the assessee claimed by way of deduction only half of Rs. 36,693-11-0, that is, Rs. 18,346-13-6. The total of the claim

of the assessee u/s 10(2) (xi) was arrived at by adding this Rs. 18,346-13-6 to Rs. 3,40,956-1-1 advanced on ""current account"".

The Tribunal upheld the assessees claim on grounds which are not clear and which are of course not self-explanatory. The view of the Tribunal

seems to be that the loans and advances which admittedly became irrecoverable constitute trading expenses within the purview of section 10(2)

(xi) of the Act. It is against this decision of the Tribunal that the Commissioner applied for a reference to this court, and as stated already, the

question set out above stands referred to us.

Learned counsel for the department raises the following contentions : (1) The written off debt is not a business debt of the assessee which arose in

the course of its managing agency business. (2) The alleged bad debt is really in the nature of a capital loss. (3) The debt even if it is an admissible

bad debt u/s 10(2) (xi) became bad not in the year of account but in the years prior to the ""previous year"". (4) The particular managing agency

business in respect of which the claim is made became extinct by termination of the agency on November 27, 1954, and was not carried on in the

accounting year, and that, therefore, the claim for deduction is inadmissible.

We shall first consider the question of the nature of the loss sustained by the assessee, whether it was of a capital or a revenue nature, as the

answer to that question would practically decide the admissibility or otherwise of the assessees claim u/s 10(2) (xi). Is it a trade or business debt

that is written off is really the crucial question. The purpose for which the assessee lent or advanced moneys from time to time to the managed

company is not known and has not been divulged by the assessee. We gather

from the statement of the case by the Tribunal that large sums of money were advanced on "current account" to the managed company. Of course we know that the assessee guaranteed the borrowing from the Indian Overseas Bank Ltd. by the company and sustained loss by fulfilling the terms of the guarantee. It is however clear that the company was needy and the assessee put them in funds. This, in our opinion, is a very slender foundation to constitute a trade liability of the assessee incurred in relation to the managing agency business. The terms of the managing agency agreement do not compel or make it obligatory on the part of the assessee to finance the company with a view to continue its effective existence. Clause 14 which has been referred to in the order of the Appellate

Assistant Commissioner is only permissive. It provides :

That the agents may, at their option, lend and advance to and for the use of the company, moneys to the extent that may be necessary for the needs of the company from time to time, the same to run at a rate of interest to be fixed by the board of directors of the company from time to time.

We must point out that actually the assessee did not charge any interest for the advance on current account and also waived its right for allowance

for deduction for interest paid by it on its borrowal for the purpose of making the advance. We are unable to find anything in clause 14 set out

above which would throw light on the character of the payments, whether they would be capital or revenue if and when made. Nothing turns upon

the fact that this clause does not create an obligation on the part of the assessee to lend money to the company. This clause is really unhelpful, if not

irrelevant, to determine the true character of the periodical advances that were made. The claim of the assessee that the managing agency

relationship is sufficient to constitute the sums lent or advanced as business debt is in our opinion too broadly stated. We do not subscribe to the

view that it is part of the managing agents business, necessarily or incidentally, to lend money to the managed company, and that every such

lending, whatsoever be its nature or purpose, would amount to a trade or business debt. Nor can we agree to treat it as a business debt by merely

calling it a scheme of financing. Mere words cannot afford any solution to the question of the real character of the payment. A close scrutiny of the

facts is essential, as appearance and stock phrases are often deceptive.

We shall now refer to the findings recorded by the department and the Tribunal. The Income Tax Officer found that it was not necessary for the

assessee to advance moneys for obtaining or earning the managing agency remuneration, and that therefore the expenditure could not be regarded

as relating to the assessee's business, and that the advances were merely capital advances which even if recovered would not go to the credit side

of the assessee's profit and loss account to enhance its profits. The Appellate Assistant Commissioner recorded the following finding : ""Therefore

the expenditure having been incurred, in a way, to acquire a business partakes the character of capital expenditure. Moreover the object of the

advances appears also to be to stabilise the managed company and in that even the advances must be held to be by way of capital. This may also

be the reason why the appellant not only did not charge interest on its advances but even agreed to the exclusion of the interest paid by it on its

borrowals from the deduction claimed."" The Tribunal has observed in its order that the managed company was financially in strained

circumstances, and the old managing agents, namely, the American Agencies Ltd., were sent out only because they were not in a position to hold

the company with finances. This is what the Tribunal states : ""It was notorious that the old managing agents could not deliver the goods, they having

no funds, and the managed company was placed in a strait jacket as regards finance."" The Tribunal refers to the further fact that under the

memorandum of association the assessee was entitled to lend moneys and to guarantee the performance of contracts. In this connection the

Tribunal States, ""as per sub-clause (19) of clause 13 of the memorandum of association, the assessee is entitled to lend moneys and to guarantee

the performance of contracts. There is no doubt that the making of advances and the payment of moneys on guarantees was made in the course of

business.

The findings of the Tribunal are very hazy and indecisive. It seems to find that the assessee came to be appointed as the managing agents displacing

the previous managing agents only because the company wanted money to carry on business, and that the assessee was ready and resourceful to

satisfy the need. This finding necessarily implies that the assessee acquired the

managing agency on condition of giving loans and making advances.

If this is the true state of affairs the loss arising out of the loans and advances would only be a capital loss as it relates to the structure or framework

of the managing agency business. In one sense it would even be an acquisition cost of the profit yielding apparatus, namely, the agency business.

The Tribunal states that it is within the scope of the assessee's business as provided in sub-clause (19) of clause 13 of the memorandum of

association to lend moneys and to stand as guarantors to secure third parties "debts". The inference drawn is that the debts in question were

incurred in the course of business. Which business the Tribunal does not say. If it meant the agency business then the reference to the particular

clause in the memorandum is misleading. If it had in mind some other business besides the agency business like money-lending business or the

business or guaranteeing, then it decided a point not urged by the assessee and not supported by a title of evidence. The Tribunal failed to take a

proper perspective of the real question in issue in the case, and has clearly misdirected itself in upholding the assessee's claim disregarding the

findings recorded by the department which appear to be amply borne out by the evidence on record.

We are not concerned in this case directly with the question whether the payments made by the assessee would be a proper allowance u/s 10(2)

(xv) of the Act. The question now before us is whether the assessee's claim to write off these debts as bad debts is legitimate and proper. It is

indisputable that if the loss suffered by the assessee by reason of the irrecoverability of the debts is a capital loss, the claim is unsustainable u/s

10(2) (xi). In Commissioner of Income Tax v. S. R. Subramanya Pillai, it has been held that capital losses cannot be treated as bad debts. At page

92, Viswanatha Sastri J. observes thus :

Except in the case, therefore, of a money-lending or banking business, where the entire money invested or lent out is regarded as stock-in-trade

or circulating capital, capital losses cannot be treated as bad debts and deducted from the receipts of a particular year.

With respect we agree with this observation. We therefore come back again to the question, whether the advances made by the assessee were

really of a capital nature or not. In our opinion, the proper test to be applied is

that which was formulated by Lord Clyde in *Robert Addie & Sons*

Collieries Ltd. v. Inland Revenue Commissioners and that is :

Is it a part of the company's working expenses ? - is it expenditure laid out as part of the process of profit-earning ? - or, on the other hand, is it a

capital outlay ? - is it expenditure necessary for the acquisition of property or of rights of a permanent character, the possession of which is a

condition of carrying on its trade at all ?

There is no proof in this case that the assessee made the advances as part of the working expenses of the managing agency business. Nor is there

proof that they were laid out as part of the process of profit-earning. There is nothing to show, and we say this because there is no evidence before

us, that the remuneration of the managing agents was based upon the percentage of the profits of the company. There is utter paucity of evidence in

regard to the nature, object and purpose of the periodical advances made on current account or for the giving of the guarantee to the Indian

Overseas Bank Ltd. On the other hand, it seems to be fairly clear that the assessee made the advance only as an outlay for the strengthening of the

capital structure of his managing agency business, to put it on a firm and stable foundation vis-a-vis the managed company, so that the machinery of

the profit apparatus might be an effective and remunerative operation.

In a recent decision reported in *Commissioner of Income Tax v. Mysore Sugar Co. Ltd.*, the Supreme Court has laid down the test to discriminate

between a capital outlay and a revenue expense. At page 653, Hidayatullah J. observes :

To find out whether an expenditure is on the capital account or on revenue, one must consider the expenditure in relation to the business. Since all

payments reduce capital in the ultimate analysis, one is apt to consider a loss as amounting to a loss of capital. But this is not true of all losses,

because losses in the running of the business cannot be said to be of capital. The questions to consider in this connection are : for what was the

money laid out ? Was it to acquire an asset of an enduring nature for the benefit of the business, or was it an outgoing in the doing of the business ?

If money be lost in the first circumstance, it is a loss of capital, but if lost in the second circumstance, it is a revenue loss. In the first, it bears the

character of an investment, but in the second, to use a commonly understood

phrase, it bears the character of current expenses.

Applying this test, which we would respectfully adopt, the nature of the payment in the present case is quite clearly of a capital kind.

Though the above conclusion reached by us would be sufficient to answer the question referred to us in favour of the department, we wish to refer

to another aspect of the matter, which seems to be equally decisive against the assessee. It is now well settled that the assessee cannot claim to

write off the debt as a bad debt or trading loss unless he adopts the mercantile system of accounting and unless he is in a position to show that the

debts, had they been good, would have come in on the credit side of his profit and loss account. This is the position where the business of the

assessee is other than that of money-lending or banking. Money is the stock-in-trade of a money-lender or a banker, and therefore every debt

which is lost can be claimed as a bad debt for allowance. The essential criterion therefore is that the debt in question must come in for computation

in the profit and loss account. The principle governing the applicability of section 10(2) (xi) in respect of a business other than money-lending or

banking business has been thus succinctly stated by Viswanatha Sastri J. in Commissioner of Income Tax v. S. R. Subramanya Pillai :

Except in the case of a banking or money-lending business, there could be no allowance for bad debts where the accounts of the business were

kept on a cash basis. Under the mercantile accountancy system referred to in section 10(2) (xi), an entry is made on the receipt side of the account

when a sale is concluded although the money on account of such sale has not been paid in. In making up the account at the end of the year such

entries are treated as receipts and the tax is levied on what has sometimes been called as book profits. It may later on be found that some of these

book profits are in fact irrecoverable. They are then written off as bad debts and since such book profits have been included in the income assessed

to tax, the bad debts have been allowed to be written off against the book profits in the year in which they are found to be irrecoverable.

Again at page 93 :

When section 10(2) (xi) speaks of a bad debt, it means a debt which would have come into the balance-sheet as a trading debt in the business or

trade that is in question in this case - the booksellers trade - and which has

become a bad debt. It does not refer to any debt due to the trader

which, when it was good, would not have come to swell the profits of the bookselling trade.

More recently the Supreme Court has considered the question in Commissioner of Income Tax v. Abdullabhai Abdulkadar. The principle is laid

down in these terms at page 551 :

Under clause (xi) also a debt is only allowable when it is a debt and arises out of and as an incident to the trade. Except in money-lending trade,

debts can only be so described if they are due from customers for goods supplied or loans to constituents or transactions of a similar kind. In every

case the test is, was the debt due as an incident to the business; if it is not of that character it will be a capital loss.

On the facts of the present case these loans and outstanding were shown as outstandings to the assessee in its balance-sheet as doubtful asset in

the year 1954. It is true it was treated as an asset but it was not at any time brought into the profit and loss account. It cannot be pretended that if

the moneys had been recovered by the assessee from the managed company it would have in any way augmented its income or, to use the familiar

expression, "'gone to swell its profits of the business.'" We are, therefore, of the opinion that the claim of the assessee cannot be sustained u/s 10(2)

(xi) of the Act. It is unnecessary to refer to the other contentions raised by the learned counsel for the department urging that the debt became bad

even prior to the accounting year, and that there was no carrying on of the managing agency business in the year of account.

The question is answered against the assessee and in favour of the department. The department will get its costs from the assessee. Counsels fee

Rs. 250.