

(1991) 02 KAR CK 0083

In the Karnataka High Court

Case No : Income-tax Referred Case No. 191 of 1984

Hotel Broadway Complex, Bangalore

APPELLANT

Vs

Commissioner of Income Tax

RESPONDENT

Date of Decision : 21-02-1991

Acts Referred:

Income Tax Act, 1961 — Section 163, 37, 37 (1)

Citation : (1992) 102 CTR 309 : (1992) 198 ITR 361

Hon'ble Judges : R. Ramakrishna, J;K. Shivashankar Bhat, J

Bench : Division Bench

Advocate : G. Sarangan, for the Appellant; G. Chanderkumar, for the Respondent

Judgement

K. Shivashankar Bhat, J.—The question referred to us under the provisions of the Income Tax Act, 1961, reads thus :

"Whether, on the facts and in the circumstances of the case, the assessee is entitled to deduction of municipal taxes paid by it in respect of the business premises ?"

2. The assessee firm commenced the business with effect from June 1, 1973, and its first accounting year ended on March 31, 1974. A portion of the property in the possession of the firm was let out earlier and the income therefrom was being assessed under the head "Income from house property" though a substantial portion of the building is used for the business of boarding and lodging of the assessee. During the earlier years, the same business was being carried on by a firm called "Messrs. Chidambaram Brothers" (hereinafter referred to as the "earlier firm"). This earlier firm came into existence in the year 1959 with five partners out of whom Ananthasivan was one of the partners. The building which belonged to this firm was sought to be levied with property tax by the Corporation of the City of Bangalore; the matter was pending thereafter in litigation. During the pendency of this litigation, the earlier firm was dissolved. The earlier firm had incurred several debts. As per the deed of dissolution, the

entire assets and liabilities were taken over by Ananthasivan including the goodwill of the business. This dissolution was effected under a deed dated May 27, 1973. Within a few days, the assessee firm was reconstituted under a deed dated June 1, 1973. The property tax which was the subject matter of litigation in the High Court went in favour of the Corporation of the City of Bangalore. Therefore, the Bangalore City Corporation proceeded to recover the arrears of property tax from the assessee-firm which was occupying the property in question. A demand notice was issued and coercive steps were sought to be taken. Therefore, the assessee firm paid the arrears of tax.

3. The assessee sought deduction of this payment as a revenue expenditure. The Appellate Tribunal did not accept the claim of the assessee. Hence, this reference.

4. The short question is whether the assessee firm is entitled to have the payments made towards the arrears of property tax deducted as part of its revenue expenditure.

5. Originally, the business was being carried on by a firm called "Chidambaram Brothers". It was dissolved on May 27, 1973. One of the partners of this dissolved firm was Ananthasivan. As per the deed of dissolution, Ananthasivan was entitled to the rights and liabilities of the business and it was his sole responsibility to discharge the debts of the firm; goodwill of the firm was also given to him.

6. Property tax which were in arrears during the period the said dissolved firm was carrying on the business naturally formed the part of the liabilities taken over by Ananthasivan.

7. By a deed dated June 1, 1973, a new firm came into existence with Ananthasivan as one of the four partners. After reciting the history of the previous firm and its dissolution, this deed recites that three other persons desired to join him as partners for carrying on the business of Hotel Broadway. Though the newly joined partners contributed various sums stated therein, Ananthasivan was not to contribute any capital "as the business carried on at present by him in partnership" was treated as his capital. Ananthasivan was to attend to the business of the firm. Clause 10 states that the partnership shall be in force "till the entire debts mentioned supra, which the business owes to several secured and unsecured creditors are fully discharged". No specific debts were specified at "supra", but earlier the deed had referred to the fact that Ananthasivan was liable to discharge all the debts of the earlier firm. The liability towards Bangalore City Corporation in respect of arrears of property tax would be comprised within the scope of this clause 10.

8. The question referred to us has to be considered in the background of the above facts. The municipal taxes referred to in the question are the arrears of property tax payable to the Bangalore City Corporation; this would not include the current taxes payable for the period after the new firm was constituted.

9. Mr. Sarangan, learned counsel for the assessee, contended that an occupant of premises is bound to discharge the tax liability and, as such, the assessee, in order to safeguard its business interest and as a matter of commercial expediency, paid the arrears of tax when coerced by the City Corporation (by the issuance of a distraint warrant) and so the said payment will be a business expenditure and not a capital expenditure. The Appellate Tribunal found that there was nothing on record to show that the assessee (the new firm) took over all the debts of the dissolved firm and the matter was remanded to the Commissioner (Appeals) to decide whether the liabilities were of Ananthasivan or of the new firm. The Appellate Tribunal observed that if it was the liability of Ananthasivan, then the assessee will not be entitled to the deductions claimed in respect of the arrears of tax; for this, the Appellate Tribunal relied on the decision of the Supreme Court in Commissioner of Income Tax, Kerala Vs. Malayalam Plantation Ltd.,

10. Mr. Sarangan contended that the question whether the liability for arrears was of Ananthasivan or of the assessee was not very relevant, and the approach ought to be to examine whether the payments were made by the assessee as a matter of commercial expediency.

11. Mr. Chanderkumar, learned counsel for the Revenue, however, contended that the tax arrears were part of the burden to be borne by the premises which were taken over the assessee and this burden is part of the capital of the new firm; in other words, while the firm is constituted and its capital would be computed necessarily after deducting the liabilities having a charge on the premises; whether the liability was of Ananthasivan or of the firm may not be very relevant, because, even if the liability is of the firm, it is a liability in the nature of a capital liability.

12. The tests applied to find out the nature of an outgoing is mainly from the principle that a deductible expenditure must be incidental to the business and must be necessitated or justified by commercial expediency; it must be directly and intimately connected with the business and must be laid out by the taxpayer in his character as a trader; there must be a direct and intimate connection between the expenditure and the business i.e., between the expenditure and the character of the assessee as a trader, and not as owner of assets, even if they are assets of the business (vide Law of Income tax by Sampath Iyengar, VII Edn., Vol. 2, page 1632).

13. The expression "for the purpose of the business" refers to a business that is being carried on by the assessee. Thus the expenditure incurred before the setting up of a business cannot be deducted but is treated as part of the capital expenditure for the setting up of the business.

14. Section 37 of the Income tax Act, 1961, provides for the deduction of an expenditure which is not in the nature of capital expenditure, etc. Therefore, the deductibility depends on the expenditure being a revenue expenditure, in

contradistinction to a capital expenditure.

15. In a few decisions cited before us, the Supreme Court had pointed out that discharge of the tax liabilities of others would not be an admissible deduction.

16. While Mr. Sarangan stressed the point of commercial expediency. Mr. Chanderkumar emphasised the nature of the payment as being arrears of tax due from the previous firm.

17. Property tax is a charge on the property in question. The occupant of the property is obliged to pay the arrears to save the occupant from the embarrassment and the inconvenience of eviction; the discharge of such a liability is not because of the nature of the business nor the liability arises out of the trading activity as such. May be, the premises in question are necessary to carry on the business, just as investment on machinery is necessary to carry on an industrial activity. The discharge of the liability which is fastened as a charge on the property releases the property from the burden of the charge and goes into the augmentation of the capital value of the property. Thus viewed, there can be no doubt that the payment by the assessee towards the arrears of tax is nothing but an expenditure in the nature of capital expenditure.

18. The existence of arrears of property tax should be presumed to be known to the assessee when it was constituted because any prudent person who transacts any dealing in relation to an immovable property is expected to verify the tax liability in relation to the said property; arrears of property tax attach themselves as a burden on the property by operation of law. The nature of property tax is quite different from other taxes like sales tax or income tax; property tax due to a municipal body is reflected in the municipal property registers. It is not possible to hold that the partners who joined Ananthasivan should be assumed to be ignorant about property tax arrears. If knowledge of the tax arrears is attributed to them, then, necessarily the said liability would go into the computation of the firm's capital. The assessee cannot take advantage of the fact that these were not reflected in the books of the previous firm, since a prudent businessman is expected to probe into the tax liabilities attached to a business premises. In these circumstances, the payments made towards property tax arrears cannot be held to be in the nature of non-capital expenditure at all.

19. Learned counsel appearing for both sets of parties took us on the vast beach, covered by case law; we walked around with the utmost attention to pick up the right pebble, still we are not certain whether the right pebble has been picked up by us.

20. The starting point was the Indian Molasses Co. (Private) Ltd. Vs. Commissioner of Income Tax, West Bengal, . Every test formulated has to be applied with caution, because the Supreme Court has pointed out that each of the tests necessarily does not lead to a particular conclusion. The Supreme Court was actually concerned with the setting aside of a certain sum of money by way

of trust to satisfy a possible claim which was held to be non-deductible.

21. In *Commissioner of Income Tax, Bombay Vs. Abdullahbhai Abdulkadar*, the question was whether the payment made by the assessee under the section 43 of the earlier Income tax Act (similar to the present section 163) was a deductible expenditure. The assessee therein was the agent of a non resident principal; the payments made by the assessee could not be recovered by the assessee from its non-resident principal. Since the liability arose in view of the nature of the business, the assessee claimed the payment to be a business expenditure. This contention of the assessee was not accepted by the Supreme Court, though the High Court had allowed the deduction holding that, as the law imposed an obligation upon the respondent firm to discharge the liability and it was incidental to the business of the respondent, the amount was a deductible loss; and even if it was not a debt, then also the amount could be claimed by the assessee as a business or trading loss, because in arriving at the true profit of the respondent's business that loss had to be deducted. The Supreme Court held (at page 549) :

"In order that a loss may be deductible it must be a loss in the business of the assessee and not payment relating to the business of somebody else which under the provisions of the Act is deemed to be and becomes the liability of the assessee. The loss becomes allowable if it "springs directly from and is incidental" to the business of the assessee. The decision therefore, mainly depends upon whether the loss claimed is a business loss of that nature. In our opinion, the amount which became payable by the respondent firm cannot be called its business loss. In order to be deductible the loss must be in the nature of a commercial loss and, as has been said above, must spring directly out of it and must really be incidental to the business itself. It is not sufficient that it falls on the trader in some other capacity or is merely connected with his business."

22. It was further pointed out that the liability arose in the said case, not because of the business of another person. The Supreme Court negated the contention that the expenditure was in respect of the assessee's business.

23. A notable feature of the case is that the agency of the assessee was incidental to its business since it was carrying on the business of commission agent; therefore, the liability fastened on the assessee towards the tax had a nexus with the assessee's business. In spite of this connection, the Supreme Court held that the expenditure incurred, i.e. the payment of tax on behalf of the non resident principal, resulting in a debt in favour of the assessee which could not be recovered by the assessee was not a deductible expenditure; a "mere connection" between the business of the assessee and the expenditure incurred or loss caused, is not sufficient to confer on it the status of a business loss or expenditure.

24. *Commissioner of Income Tax, Kerala Vs. Malayalam Plantation Ltd.*, was referred to by the Appellate Tribunal also. The estate duty paid by the assessee

company consequent on the death of a certain non resident shareholder was the subject of the assessee's claim for deduction as incurred for the purpose of business. Section 10(2)(XV) of the earlier Act, corresponding to the present section 37, was relied upon.

25. The assessee's claim was disallowed. After tracing the law by reference to several earlier decisions, the Supreme Court concluded at page AIR 1964 SC 1728 thus (page 150 of 53 ITR) :

"The expression "for the purpose of the business" is wider in scope than the expression "for the purpose of earning profits". Its range is wider : it may take in not only the day to day running of a business but also the rationalisation of its administration and modernisation of its machinery; it may include measures for the preservation of the business and for the protection of its assets and property from expropriation, coercive process or assertion of hostile title; it may also comprehend payment of statutory dues and taxes imposed as a precondition to commence on for carrying on of a business; it may comprehend many other acts incidental to the carrying on of a business. However wide the meaning of the expression may be, its limits are implicit in it. The purpose shall be for the purpose of the business, that is to say, the expenditure incurred shall be for the carrying on of the business and the assessee shall incur it in his capacity as a person carrying on the business. It cannot include sums spent by the assessee as agent of a third party, whether the origin of the agency is voluntary or statutory; in that event, he pays the amount on behalf of another and for a purpose unconnected with the business. In the present case, the company, as a statutory agent of the deceased owners of the shares, paid the sums payable by the legal representatives of the deceased shareholders. The payments have nothing to do with the conduct of the business. The fact that on his default, if any, in the payment of the dues the Revenue may realise the amounts from the business assets is a consequence of the default of the assessee in not discharging his statutory obligation, but it does not make the expenditure any the more expenditure incurred in the conduct of the business."

26. Therefore, a possibility of the business assets being sold, if the liability is not met and expenditure incurred, is not a reason to hold, it as business expenditure. In the instant case before us, the assessee's claim is basically on the ground that, if property tax arrears had not been paid, the business premises would have been lost to the assessee. The payment is not made in the course of business and as incidental to the said business it had nothing to do with the conduct of the business. The liability had arisen, earlier to the assessee's business, and the prior liability attached to the premises was being cleared by the payments made by the assessee.

27. In *Travancore Titanium Products Ltd. Vs. Commissioner of Income Tax, Kerala*, it was pointed out that the deductible expenditure must be incidental to the business and must be necessitated or justified by commercial expediency and there must be a direct and intimate connection between the expenditure and the

business, i.e., between the expenditure and the character of the assessee as a trader and not as owner of assets, even if they are assets of business. Therefore, the amount of wealth tax paid on the assets comprising business assets was held to be non deductible u/s 10(2)(xiv) of the old Income tax Act. The above principle is applicable to the facts of the case before us because the tax arrears were paid by the assessee not in its capacity as a trader but as the "occupier" of the premises charged to the said tax.

28. The two decisions - (i) Commissioner of Income Tax, Kerala Vs. Gemini Cashew Sales Corporation, Quilon, and (ii) Commissioner of Income Tax, West Bengal Vs. Indian Molasses (Private) Ltd., need not be discussed.

29. Indian Aluminium Co. Ltd. Vs. Commissioner of Income Tax, West Bengal I, , has some bearing on the facts of the case before us. There, the assessee company incurred a statutory liability to pay income tax by deducting u/s 18(7) of the old Act; this was not reimbursed by the non resident; hence the assessee company claimed it as a deduction, either as a bad debt or as an expenditure laid out for the purposes of the assessee's business. At page 2287, the Supreme Court held Navayuga Traders Gunnies Firm, Rajahmundry Vs. The Commissioner of Income Tax , Andhra Pradesh, Hyderabad,

"The assessee was presumed to know the relevant provisions of the Act at the time when it entered into an agreement with the Montreal company. There was no provision in the agreement with the Montreal company which created a contractual obligation on the assessee to make payment of the taxes deductible u/s 18(3B). At any rate, it is difficult to understand how a payment made under a statutory obligation, because the assessee was in default, could constitute expenditure laid out for the purpose of the assessee's business."

30. It is thus clear that the fact that liability was fastened on the assessee by statute is no ground to grant the deductions u/s 37(1).

31. Now, a few High Court decisions. In Commissioner of Income Tax, Bombay City-I Vs. Desmet (India) Pvt. Ltd., the Bombay High Court was concerned with the claim of an assessee regarding expenditure (commission paid) incurred in connection with the completion of the unfinished contract taken over by the assessee; the claim was allowed. The business of the assessee and the commission paid therein were closely interlinked with each other.

32. In Commissioner of Income Tax, Central Vs. Georgepolous, the Madras High Court observed that an unforeseen liability which had to be met by the assessee is not a capital expenditure, because, such liability never went into the making of the consideration for obtaining the business. This decision is distinguishable on the very facts stated therein.

33. In Commissioner of Income Tax Vs. Shriram Prayagdas and Mahadeo Prasad, , the Madhya Pradesh High Court held that payment of arrears of taxes by the present owner of the vehicles to save the vehicle from attachment was an

expenditure incurred out of commercial expediency. Similarly, Commissioner of Income Tax Vs. Hind Motor Cycle Works, of the Allahabad High Court was cited in support of the principle that, when the transferee-firm had taken over the liability of the old firm, it is a trading liability. As to this decision, we have our own reservations because the nature of the liability taken over by the transferee of the business has to be examined before arriving at its status. If the liability taken over is part of the bargain, in the sense that it goes into the making up of the consideration towards capital, then, it cannot be a trading liability at all. Regarding the former decision also, we have our reservations; the arrears of tax therein, if paid in the capacity as the owner of the vehicles, and not as the operator of the vehicles, then the payments cannot be deducted as revenue expenditure. In this regard, the relevant test formulated by the Supreme Court has already been noticed by us.

34. The decision of the Calcutta High Court in Emerald Paints and Colour Products (P.) Ltd. Vs. Commissioner of Income Tax, rested on its own facts.

35. In Dashmesh Transport Co. (P.) Ltd. Vs. Commissioner of Income Tax, the Punjab and Haryana High Court held that payment of arrears of tax was part of the consideration towards the acquisition of capital and, therefore, not deductible as revenue expenditure.

36. Facts of the case in Shankar Theatres Vs. Commissioner of Income Tax, Vidarbha and Marathwada, decided by the Bombay High Court are very apposite. The municipal taxes were in arrears which, after getting accumulated, were paid by the assessee after a few years. This was claimed as a business expenditure but the High Court disallowed the claim, holding that only the current year's municipal taxes on the business premises could be claimed as deductible expenditure and not the arrears.

37. In Industrial Credit and Development Syndicate Ltd. Vs. Commissioner of Income Tax, (I.T.R.C. No. 11 of 1983, dated February 7, 1990), the Income Tax and surtax liabilities of the old company paid by the amalgamated company were held as inadmissible deductions, by a Bench of this court.

38. The deed of partnership under which the present assessee-firm was constituted indicates that the firm's duration was until all the debts were discharged and, therefore, payment of such debts is one of the purposes for which the business was agreed to be carried on by the partners. Ananthasivan who had taken over the assets and liabilities of the old firm, instead of contributing any capital in money, contributed the very business for the firm to carry it on; therefore, it cannot be said that the tax liability did not go into the making of the consideration; it must have been part of the consideration in the formation of the firm's capital for business. The partners of the new firm cannot be permitted to feign ignorance of such a statutory liability. If, for any reason, the said liability is to be held as the liability of Ananthasivan or of the old firm, then again, the assessee herein cannot claim it as a revenue expenditure by

discharging the liability fastened statutorily on the business assets, since the said act of payment was in the assessee's capacity as an occupier of the premises and not in its capacity as a trader.

39. For the reasons stated above, we are of the view that the assessee is not entitled to claim the deduction in question as a business expenditure u/s 37(1) of the Act.

40. The question referred to us is, accordingly, answered in the negative and against the assessee.