
(1978) 02 AP CK 0031

In the Andhra Pradesh High Court

Case No : Case Referred No. 106 of 1976

P. Satyanarayana

APPELLANT

Vs

Commissioner of Income Tax

RESPONDENT

Date of Decision : 23-02-1978

Acts Referred:

Income Tax Act, 1961 — Section 28

Citation : (1979) 116 ITR 803

Hon'ble Judges : S. Obul Reddi, C.J.;Amareswari, J

Bench : Division Bench

Advocate : Y.V. Anjaneyulu, for the Appellant; P. Rama Rao, for the Respondent

Judgement

Obul Reddi, C.J.—The following question is referred for the opinion of this court:

"Whether, on the facts and in the circumstances of the case, the assessee is entitled to claim the sum of Rs. 39,449 as loss arising in the course of business allowable u/s 28 of the I.T. Act, 1961, or in the alternative as a bad debt deductible u/s 36(2) of the said Act ?"

2. The facts leading to the reference are these : The assessee (P. Satyanarayana) is an individual carrying on business as a film distributor. His accounting year was the calendar year. The assessment year with which we are now concerned is 1969-70. He entered into an agreement with a firm of film producers, Messrs. Sri Sambhu Films, Madras. That agreement was on June 4, 1965, for acquisition of distribution rights of a film "Andhra Maha Vishnu" which was under production at that time. In pursuance of that agreement, he advanced a total amount of Rs. 1,68,000. After the film was produced, the assessee, as distributor, realised only Rs. 90,000 towards the advance of Rs. 1,68,000. That picture proved a failure. The agreement did not provide for any security against the advance amount. All that the assessee was entitled to under the agreement was to recover the total sum advanced by him by exercising his rights as a distributor. As there was no scope of recovering any amount more than Rs.

90,000, the assessee and the producer entered into an agreement. By that agreement, a settlement was reached between the parties, under which the assessee received a sum of Rs. 50,000 in full satisfaction of the outstanding amount of Rs. 76,637 and wrote off the balance of Rs. 26,637. That settlement was on May 31, 1968. The assessee had yet another agreement with another film producer, Messrs. Swati Films, for the distribution rights of a film "Siva Leelalu". Under that agreement dated March 4, 1967, he advanced Rs. 43,000 up to May 31, 1967. That picture also proved a failure, and a sum of Rs. 25,311 remained outstanding. As there was no other means of recovering the amount of Rs. 25,311, he entered into a similar agreement and settled by receiving a sum of Rs. 12,500 in full satisfaction of the amount due from the producer. The total amount thus written off under the two settlements was Rs. 39,448, and for this amount the assessee claimed deduction as loss in business. His claim for deduction was not allowed by the ITO. But, on appeal, the AAC allowed his claim on the ground that they were bad debts. The revenue then went up in appeal before the Tribunal contending that the AAC was in error in holding that the debts were bad debts arising out of the business. The revenue also contended that no deduction could be claimed in respect of the amount of Rs. 39,448 as revenue loss because the advances were not of a business or trading nature. According to the revenue, it was an investment of capital made by the assessee in order to secure distribution rights of the films and, therefore, should be treated as capital loss. The case of the assessee before the Tribunal was that the loss was in the course of his business, and entering into such agreements and settlements is an accepted commercial practice and, therefore, it was trading loss. He also contended that it was a bad debt deductible u/s 36(2) of the I.T. Act.

3. The Tribunal, relying upon a decision of the Madras High Court in Commissioner of Income Tax Vs. Coimbatore Pictures (P.) Ltd., , held that the facts of the case do not show that it was a trading loss and that this is not a case where the assessee carried on money-lending business and, as such, the advances given by him were not in the course of or part of money-lending business.

4. What constitutes a trading loss has been explained by the Supreme Court in a series of decisions. In COMMISSIONER OF Income Tax AND EXCESS PROFITS TAX MADRAS Vs. SOUTH INDIA PICTURES LTD., the Supreme Court was considering the case of a film distributor who had entered into an agreement with a producer for distribution rights of films. The agreements entered into by the film distributor, inter alia, provided for advance of certain sums of money to the purchaser for the production of the films, and for the sums advanced, the assessee acquired the sole rights to distribute the films for a period of five years from the date of release of each film. The assessee was to pay itself from the money realised by the distribution of the films its commission and the amount advanced to the producer. The assessee had also a charge by way of security on the negative and positive copies of the films for amounts due on account of advance. The assessee, after exploiting its rights under the agreement to some

extent, entered into a settlement with the producers under which the producers paid a sum of Rs. 26,000 to the assessee towards commission. In regard to the amount received by the assessee on account of settlement, both the Tribunal and the High Court held that the amount was a capital receipt. The learned judges, referring to the agreements entered into by the distributors and the producers, observed at page 917 of the report:

"Here were three agreements entered into by the assessee in the ordinary course of his business along with several similar agreements. These three agreements were by mutual consent put an end to. The termination of these three agreements did not radically or at all affect or alter the structure of the assessee's business. Indeed, the assessee's business of distribution of films proceeded apace notwithstanding the cancellation of these three agreements."

5. The learned judge ultimately concluded (p. 919):

"In our opinion, in the events that had happened, the amount was not received by the assessee as the price of any capital assets sold or surrendered or destroyed or sterilized but in the language of Rowlatt J. in *Short Bros.*" case [1927] 12 TC 955 the amount was simply received by the assessee in the course of its going distributing agency business from that going business."

6. The Supreme Court in *Badridas Daga Vs. The Commissioner of Income Tax*, elaborately discussed the question whether the loss sustained by a business by reason of embezzlement by an employee or agent is an admissible deduction u/s 10(2)(xi) of the 1922 Act. That was a case where deduction was claimed on the ground that the employee misappropriated the moneys belonging to the assessee. The learned judges, dealing with the controversy whether deduction is permissible or not, observed at page 14 of the report:

"The controversy, therefore, narrows itself to the question whether amounts lost through embezzlement by an employee are a trading loss which could be deducted in computing the profits of a business u/s 10(1)."

7. After referring to some of the decisions which they noticed, the learned judges held (p. 15):

"The result is that when a claim is made for a 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. It is the case of the assessee here that it is an accepted commercial practice which accords with the trading principles that distributors do enter into agreements with producers and advance moneys for production of a picture or pictures and to be paid out of the rights that were given to the distributors under the agreement by screening the pictures in specified areas or districts. The loss

sustained by the distributor is, therefore, one which arose out of the carrying on of the business of distribution and is incidental to it.

9. The Supreme Court again in *Commissioner of Income Tax, Nagpur Vs. Rai Bahadur Jairam Valji and Others*, , dealing with the question whether a receipt is capital or income, observed that the question 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 learned judge clearly stated that, when once it is found that a contract was entered into in the ordinary course of business, any compensation received for its termination would be a revenue receipt, irrespective of whether its performance was to consist of a single act or a series of acts spread over a period.

10. In *Indore Malwa United Mills Ltd., Indore Vs. State of Madhya Bharat and Others*, , the question arose whether the deduction claimed was in respect of a trading loss. That was a case where a company was carrying on business of manufacturing cloth. Under the memorandum of association of the company, for the purpose of its business, it was authorised to raise or borrow money from time to time to invest its funds, inter alia, in loans to others. The company entered into an agreement with another company whereunder they were appointed as its managing agents in the place of another company. The former managing agents of the company had borrowed moneys from outsiders and entered them in the appellant-company's accounts and invested large sums with themselves in current account with the company. The managing agents of the company subsequently went into liquidation. The appellant-company then submitted its return of income and claimed deduction under the head "bad debt and trading loss", as the loss was written off in the profit and loss account of the appellant-company. Subba Rao J. (as he then was), following the decision in *Badridas Daga Vs. The Commissioner of Income Tax*, :

"Under the memorandum of association as well as under the express power conferred by the said resolution, the company, through the managing agents, could invest its funds by way of loans. If there was no mishap the managing agents would have paid the entire amount and if they did not, the company could have recovered the entire amount from them. The result, therefore, was that both the borrowing by the managing agents on behalf of the company from third parties and the lending to themselves created legal obligations. They were obligations created in the course of the business. The money lent would be a debit item in the accounts of the company in accordance with the accepted commercial practice and if the amount was realized it would be a credit item. Both would be proper items of accounts for ascertaining the profit and loss of the company. If the debt became irrecoverable, it would be a bad debt.

We, therefore, find no difficulty in holding that the said debt which had become irrecoverable was a trading loss deductible in computing the profit of the appellant-company in the assessment year. It was a loss incidental to the

appellant's business and is certainly sanctioned by commercial practice and trading principles."

11. In *B.D. Bharucha, Bombay Vs. Commissioner of Income Tax, Central Bombay*, the question cropped up whether the money advanced by a distributor to a producer, which could not ultimately be recovered and was written off as a bad debt, was a trading loss. The learned judges of the Supreme Court found that the picture, which was to be released by the firm to which moneys were advanced, was not released within the stipulated time and that resulted in the distributor suffering a loss. The question was whether it was a loss of capital or a revenue loss. The learned judges held that the debt was in respect of and incidental to the business which was carried on by the appellant in the relevant accounting year ; that it was found that it had become irrecoverable in the relevant accounting year and that the amount had actually been written off as irrecoverable in the books of the appellant; and that, therefore, all the conditions for the grant of the allowance u/s 10(2)(xi) were satisfied. The learned judges also made it clear that it is not correct to consider loss as amounting to a loss of capital, since all payments reduce capital in the ultimate analysis and that losses in the running of a business cannot be said to be of capital.

12. In *Devi Films Private Ltd. Vs. Commissioner of Income Tax*, a Division Bench of the Madras High Court observed (headnote):

"A trading loss has a wider connotation than a bad debt. There may be a bad debt which may not fall within the purview of Section 10(2)(xi) but may well be regarded as one eligible to deduction in the computation of the net profits chargeable to tax because such bad debts will have to be taken into account on the side of debit which will reduce the net profits. But whether allowance can be given in that way may sometimes depend on whether the outgoing, or what is regarded as bad debt resulting in a loss, is on the capital or revenue account. Most trading losses incurred in the course of carrying on of business in a particular year will also come under that category and will naturally enter into computing the net total income as the real profits chargeable to tax cannot be arrived at without setting off of legitimate trading loss."

13. *Devi Films Private Ltd. Vs. Commissioner of Income Tax*, was not noticed by the Madras High Court in *Commissioner of Income Tax Vs. Coimbatore Pictures (P.) Ltd.*, . The Madras High Court disagreed with the view of the Mysore High Court in *Commissioner of Income Tax, Mysore Vs. Y.V. Sreenivasa Murthy*, . According to the Madras High Court, the advances made by distributors to film producers, while entering into agreements for distribution rights of pictures, need not necessarily be an advance on revenue account incurred in the course of business. The view expressed by the Madras High Court in *Commissioner of Income Tax Vs. Coimbatore Pictures (P.) Ltd.*, does not commend to us in view of what the Supreme Court has been saying since the case of *COMMISSIONER OF Income Tax AND EXCESS PROFITS TAX MADRAS Vs. SOUTH INDIA PICTURES LTD.*, . *South India Pictures Ltd.*'s case was also one where the assessee had

entered into three agreements for advancing moneys to the producers towards the production of three films and acquiring the rights of distribution thereof. The learned judges clearly held that such agreements are agreements in the ordinary course of business.

14. The assessee's business here too is a business of distribution of films, a right which he acquired by advancing moneys to the producers. It is an accepted commercial practice. The distributors generally advance moneys to the producers in order to enable them to complete the pictures and thus purchase distribution rights and exploit those rights. In other words, the distributor has to pay himself from the moneys realised by him by exploiting his distribution rights.

15. The Supreme Court in *Ramchandrar Shivnarayan Vs. The Commissioner of Income Tax, Andhra Pradesh*, after an elaborate review of the cases, reversing the decision of this court in *Commissioner of Income Tax Vs. Ramchandrar Shivnarayan*, , observed that the loss of Rs. 30,000 was directly connected with the business operation and was incidental to the carrying on of the business of purchase of Government securities to earn profit and, in such a situation, it was part of the trading loss and deductible as such in arriving at the true profits of the appellant. That was a case where a firm, carrying on business in gold, silver and gunnies, etc., derived income from investment in Government securities. A sum of Rs. 50,000 borrowed from a creditor for the purpose of purchasing Government securities was brought in cash to Rajahmundry by its employee and was handed over to its cashier. At a time when the cashier had turned his back to take out some books, a stranger suddenly arrived at the place of the assessee's business and committed theft of Rs. 30,000. In spite of lodging a complaint with the police, the amount could not be recovered. The assessee then claimed deduction of that amount as a business loss in computing its profits and the Tribunal allowed the claim on the ground that the loss was incidental to the carrying on of its business. On a reference at the instance of the revenue, the High Court held that the loss was not allowable as a deduction as the loss was not incidental to the assessee's business. The Supreme court reversed the decision of this court and held that the loss of Rs. 30,000 was directly connected with the business operation and ,was incidental to the carrying on of the business of purchase of Government securities to earn profit.

16. The loss here too is in the course of the film distribution business. The assessee, as a film distributor, advanced moneys to the producers and when he found that the distribution rights given to him under the agreement did not fetch sufficient moneys even to cover the advances given by him, he entered into a settlement with the producers, accepted a portion of the balance due to him and wrote off the remaining as irrecoverable. It is, therefore, a trading loss occasioned in the course of film distribution business and is incidental thereto. It is an accepted commercial practice between the distributors and the producers to enter into such agreements. We, therefore, hold that the loss sustained was one in the course of business and incidental thereto and is, therefore, a trading loss.

Mr, Anjaneyulu, however, conceded before us that he is not putting his case u/s 36(2) of the Act.

17. We, therefore, answer the first part of the question in the affirmative and in favour of the assessee. There will be no order as to costs. Advocate's fee Rs. 250.