THE

INDIAN LAW REPORTS

PUNJAB SERIES

CIVIL REFERENCE

Before Eric Weston, C.J., and Khosla, J.

MESSRS NARAIN SWADESHI WEAVING MILLS, CHHEHARTA (AMRITSAR),—*Petitioner.*

1950

Sept 8th

versus

THE COMMISSIONER OF EXCESS PROFITS TAX, EAST PUNJAB AND DELHI PROVINCES, DELHI,—*Respondent.*

Civil Reference No. 3 of 1949

Excess Profits Tax Act (XV of 1940), sections 2 (5) and 5—Definition of business in section 2 (5), whether exhaustive—Receipts of hire by the assessee firm by leasing its machinery to the Company in which the assessee firm had interest—whether such receipts are profits from business within the meaning of section 5.

Held, that the definition of business in section 2 (5) including the proviso is not exhaustive of all instances in which income derived from property can be income from business.

Held further, that if the sole concern of the assessee firm was to receive hire of machinery from the Company in which it had no interest, such receipts would not be profits from business within the meaning of section 5. But in the present case the assessee firm and the Company which had taken the machinery on hire from it were really one and the same firm and such receipts, therefore, were profits from that business diverted into the pockets of the assessee firm, and were liable to excess profits tax.

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Case referred by the Income-tax Appellate Tribunal, Bombay, under section 66 (1) of the Indian Income-tax Act of 1922, read with section 21 of the Excess Profits Tax Act, for orders of the Hon'ble Judges of the High Court.

G. S. PATHAK and R. P. KHOSLA, for Petitioner.

S. M. SIKRI and H. R. MAHAJAN, for Respondent.

JUDGMENT

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E. WESTON, C. J. This is a reference or rather four references consolidated into one made under section 66(1) of the Indian Income-tax Act by the Income-tax Appellate Tribunal, Madras Bench. There were four applications for reference referring each to one accounting year, but the questions raised by each application were identical.

The reference relates to a liability under the Excess Profits Tax Act of 1940. The assessee firm, known as Narain Swadeshi Weaving Mills, Chheharta, was constituted in the year 1935, having three partners, Narain Singh and his two sons, Gurudayal Singh and Ram Singh, their shares in the partnership being six annas, five annas, and five annas respectively. There is no doubt that this partnership was a business partnership. A factory with plant and machinery at Chheharta was owned by the firm which carried on the business of manufacture of ribbons and laces. On the 7th of April 1940, a public limited liability company was incorporated under the name of Hindustan Embroidery Mills, Ltd., the object of which was to take over from the assessee firm the buildings, leasehold rights, plant and machinery and all other assets in the factory. About 41,000 shares were subscribed to this company each of Rs 10 of which Rs. 5 were to be paid up. Of these 23,000 shares were allotted to the assessee firm and the partners of the assessee firm also held shares on their individual accounts. In all, of the 41,000 shares 33,340 were held by the assessee

firm and its partners. As the capital subscribed was not sufficient to cover the price of both the factory and machinery, the arrangement arrived at was that the Company purchased the factory but the machinery was taken on hire from the assessee firm at an annual rental of Rs 40,000. The Directors of the Company were the partners of the assessee firm, one Dr. Surmukh Singh, another son of Narain Singh who, however, lives in South Africa, and N. D. Nanda, a brother-in-law of Gurudayal Singh.

On the 28th of July 1940 an agreement was entered into by the Company by which they purported to appoint a firm Uppal and Company as managing agents, and this firm Uppal and Company is said to have consisted of two partners, Ram Singh and Gurudayal Singh, the two sons of Narain Singh, the partners having equal shares. The partnership deed of this firm was not executed until the 21st of April 1941. Under the terms of the managing agency agreement Uppal and Company were to receive 10 per cent of the net profits of the Company and also salary and allowances. On the 25th of January 1941 the Company entered into another agreement with a firm styled Ram Singh and Company, which is said to have been constituted on that day having partners Ram Singh, Gurudayal Singh and Surmukh Singh, the three sons of Narain Singh, each having one-third share in that firm. By this agreement Ram Singh and Company were appointed selling agents and were to receive a certain commission on sales and a certain percentage of the gross income of the Company. The partnership deed of this firm was not executed until the 17th of March 1941. On the 21st of April 1941, the same day as the partnership deed of Uppal and Company was executed, a new partnership deed of the assessee firm was executed modifying the shares of the partners therein. The lengthy agreement sets out the partnership deed of the 24th of November 1935, the sale to Hindustan Embroidery Mills, Ltd., of the buildings, and states that the income of the

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firm has been reduced to the hire of the machinery and dividends on shares held in the Hindustan Embroidery Mills, Ltd. The agreement then recites the appointment of Uppal and Company as managing agents of Ram Singh and Company as selling agents, and states that Narain Singh has no interest either in Uppal and Company or in Ram Singh and Company and as such has disadvantages both financial and others arising out of these contracts of Managing and Selling Agency, and proceeds to revoke the partnership deed of the 24th of November 1935, and constitute another agreement providing that the shares of each partner in the profit and loss of the firm as on and after the 1st of April 1941 shall be three-fourths in the case of Narain Singh and one-eighth each in the case of Gurudayal Singh and Ram Singh. Then follow a number of provisions for division of profits, maintenance of books, place of business of the firm and so on.

The Excess Profits Tax Officer after consideration of the facts set out above came to the conclusion that the main purpose of the formation of the firms Uppal and Company and Ram Singh and Company was the avoidance of liability to Excess Profits Tax; and under section 10A of the Excess Profits Tax Act he held that the three firms were really one, amalgamated the income of all three, and proceeded to assess the assessee firm the Excess Profits Tax on this basis. Under clause (3) of section 10A of the Act the assessee firm preferred an appeal to the Income-tax Appellate Tribunal. Before the Tribunal it was contended that the amount of Rs 40,000 received by the assessee firm as rent of the machinery could not be treated as business profits liable to Excess Profits Tax. The basis of this contention was that the assessee firm did not carry on any business and in any event the receipt of this rent was not a receipt from business. The Tribunal held that the assessee firm carried on business in letting out machinery on hire and that the rent obtained thereby was a business profit liable to Excess Profits Tax.

It was also contended that the Excess Profits Tax Officer was not justified in treating as one the three firms, the assessee firm, Uppal and Company and Ram Singh and Company. This contention also was repelled by the Tribunal. On this finding the contention that the share of Surmukh Singh, the son of Narain Singh living in South Africa, should be excluded before amalgamating the profits of Ram Singh and Company with the assessee firm also was rejected. The only other question before the Tribunal was whether proper notices had been given to the assessee firm.

The assessee firm then filed four applications under section 66 (1) of the Income-tax Act read with section 21 of the Excess Profits Tax Act requiring the Tribunal to refer to this Court five questions. The Tribunal has referred three questions in the following terms :—

"1. Whether there is any evidence before the Tribunal to support the conclusion that the main purpose of the transactions was the avoidance of Excess Profits Tax?

2. Whether on the facts admitted or proved, the share of income of Dr Surmukh Singh in the firm of Ram Singh and Company can be legally included along with the shares of income of Ram Singh and Gurudayal Singh?

3. Whether on the facts and circumstances of the case the leasing of machinery, etc., by the assessee firm to the company was a business within the meaning of section 2 (5) of the Excess Profits Tax Act?"

The Tribunal declined to refer two other questions. The first of these was the question of notice

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and proper opportunity under section 10A of the Excess Profits Tax Act. The Tribunal considered this a question of fact and their refusal to refer this matter to us has not been challenged before us. The second question which the Tribunal declined to refer was propounded by the assessee firm in the following terms :—

> "Whether the proceedings under section 10A were not null and void, *ab initio,* for want of necessary previous sanction from the Inspecting Assistant Commissioner of Excess Profits Tax, the fact of such previous sanction having been obtained being neither mentioned in the order nor proved before the Appellate Tribunal at the time of hearing although expressly required by the Court."

The refusal of the Tribunal to refer this question has been the subject of complaint before us and it is convenient to dispose of this matter at this stage. It appears that although the previous approval of the Inspecting Assistant Commissioner required by clause (1) of section 10A was not made a matter of evidence before the Excess Profits Tax Officer, no contention alleging that in fact this approval had not been obtained was raised before this Officer or in the grounds of appeal preferred to the Tribunal. The application for reference to this court, it appears, came before a Bench, the members of which had not heard the original appeal, and before the referring Tribunal it was represented that the Tribunal hearing the appeal had permitted argument to be raised before it on the question whether previous approval of the Inspecting Assistant Commissioner had been given. No reference to this appeared in the judgment of the Appellate Tribunal and the Tribunal hearing the reference held that it must be presumed that "the question was not properly raised before the Tribunal."

The question as to whether previous approval of the Inspecting Assistant Commissioner had or had not

been given is a question of fact, and it is quite impossible for us to require any reference based on this question to be made to us. The point that the approval was challenged by the assessee should have been raised expressly in the memorandum of appeal to the Appellate Tribunal, or, in the absence of such express reference, if it was desired that the Appellate Tribunal should consider the matter, it was incumbent upon the assessee to make their application for such consideration a matter of record. There is nothing on the record, and the presumption made by the Tribunal, which I understand to mean that the question was not raised at all, seems justified. We are, therefore, concerned only with the three questions which have been referred to us.

Mr Pathak for the assessee firm preferred to argue first the third of the three questions, but it seems to me that decision of the first is a necessary preliminary to consideration of the third. Taking, therefore, the first question, what we have to consider is whether there was evidence upon which the Tribunal could base its conclusion that the main purpose of the formation of the firms, Uppal and Company and Ram Singh and Company, was the avoidance of Excess Profits Tax; and amalgamation of the income of these firms with that of the assessee firm should, therefore, be made. The dates of formation of these firms and the constitution of these firms have already been set out. There is naturally no direct evidence upon which the Tribunal could base its conclusion. The evidence necessarily was circumstantial. It seems to me, however, that evidence was also substantial. It is perfectly clear that the assessee firm and the Company were closely connected. The Company was little more than an expansion of the assessee firm and was under the complete control of the partners of the assessee firm. The Excess Profits Tax Act came into force on the 16th of April 1940. The Company was incorporated on the following day. While it is true that promoters and directors of public companies not infrequently arrange managing or

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selling agencies to be obtained for their benefit in their own or other names, the creation of both Uppal and Company and Ram Singh and Company shows some indication of haste, for their formal partnership deeds were not drawn up until some months after the agreement of managing and selling agencies were made with the Company. This is evident that it was thought necessary to divert part of the profits of the Company, and therefore of the assessee firm, to other firms which could be urged to be entities separate from the parent assessee firm. The assessee firm and its partners held more than three-quarters of the shares of the Company and as such they were entitled to more than three-quarters of the profits of the Company. Apart from advantage under the Excess Profits Tax Act which had just come into force, the advantage to be gained by the manoeuvres of formation of a managing and a selling agency was slight. Lastly there is the readjustment of shares of the assessee firm made after the formation of Uppal and Company and Ram Singh and Company, for which it may be said there was no necessity unless in fact the three firms were considered to be one and the same. In all these circumstances it cannot be said that there was not evidence upon which the Tribunal was justified in coming to the conclusion that the formation of the firms Uppal and Company and Ram Singh and Company was mainly for the purpose of avoidance or reduction of liability to Excess Profits Tax. I think, therefore, we must proceed on the basis that the three firms, the assessee firm, Uppal and Company and Ram Singh and Company, were in fact one and the same. On this conclusion the second question referred to us needs no discussion. The answer must be that profits of the three firms under section 10A can legally be amalgamated for the purpose of assessment to Excess Profits Tax.

I now come to the third question upon which the major argument before us has been led. The learned Advocate for the assessee firm has strenuously contended that the annual rent of Rs 40,000 received or drawn from the Company is in no way profits from

business within the meaning of section 5 of the Excess Profits Tax Act. He claims that the function of the assessee firm has been merely to receive rent and dividends, and he relies upon the proviso to clause (5) of section 2 of the Excess Profits Tax Act. Clause (5) so far as is material is in the following terms :—

> " (5) 'business' includes any trade, commerce or manufacture or any adventure in the nature of trade, commerce or manufacture or any profession or vocation, but does not include a profession carried on by an individual or by individuals in partnership if the profits of the profession depend wholly or mainly on his or their personal qualifications unless such profession consists wholly or mainly in the making of contracts on behalf of other persons or the giving to other persons of advice of a commercial nature in connection with the making of contracts :
>
> Provided that where the functions of a company or of a society incorporated by or under any enactment consist wholly or mainly in the holding of investments or other property, the holding of the investments or property shall be deemed for the purpose of this definition to be a business carried on by such company or society. "

Mr Pathak's argument is that as by the proviso the holding of investments or property is deemed to be a business in the case of a company or society incorporated, the clear implication is that the true nature of the holding of investments or property is not business, and in any case the holding of investments or property by an individual or partnership cannot be held to be business. He relies largely upon a decision of the Calcutta High Court, *Bengal Jute Mills Co.* v. *Commissioner of Income Tax* (1).

(1) (1949) 17 I. T. R. 308.

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The facts of that case were that the assessee company was limited liability company carrying on business as manufacturers of jute products. The company had let a part of its business premises to a firm doing the business of dehydrating potatoes. The question was whether the rent received by the company from the tenant firm was rightly treated as income from business for the purposes of excess profits tax. It was held that it was not.

The decision in this case may be said to be in accord with other decisions both in England and in India. In *Inland Revenue Commissioners* v. *Broadway Car Co.* (1), a company carrying on business of motor car agents and repairers on land held under lease sublet part of this land. Owing to war conditions the motor business had dwindled and the whole land was not required for it. The rent received under the sub-lease exceeded that payable under the lease by £ 400. The Court of appeal upheld the findings of the Commissioners (1) that the income of £ 400 did not arise in the ordinary course of the company's business, and (2) that the income was income from an investment and was not liable to excess profits. *Shri Laxmi Silk Mills, Bombay* v. *Commissioner of Excess Profits Tax Bombay City* (2) was a case where the assessee's business was to manufacture silk cloth and also to dye silk yarn. By reason of difficulty of obtaining silk yarn on account of the war the assessee could not work the dyeing plant, and after it had remained idle for some time, it was let by the assessee on a monthly rent to a company, which, it would seem, was able to use it for dyeing other material. The question was whether the rent received by the assessee was profit from business within the meaning of section 2(5) of the Excess Profits Tax. This was answered in the negative. It was held that although the dyeing plant was a commercial asset of the assessee, it had ceased to be a commercial asset with the assessee because of the war, and the income which

(1) 1946 (2) A. E. R. 609.
(2) (1948) 16 I. T. R. 98.

the assessee derived by letting it could not be considered to be income of the assessee's business within the meaning of section 2(5).

The expression " commercial asset " is taken from *Sutherland* v. *Commissioners of Inland Revenue* (1) where hire received from the owner of a steam drifter commandeered by the Admiralty was held to be the owner's income from business.

Mr Pathak claims that in the present case the annual receipt of Rs 40,000 as rent of the machinery cannot be regarded as a profit or gain from business, that it is simply a rent received from property held, that the letting of property is a method and natural consequence of holding ownership, and is in no sense a business. He relies upon the *Bengal Jute Mills Case* (2) not so much for the decision but for observations made by Trevor Harries, C. J., which, he claims, lay down that in no circumstances income of the nature of rent can be a profit of business for the purpose of Excess Profits Tax unless it is covered by the deeming proviso to section 2(5) of the Excess Profits Tax.

The learned Chief Justice held himself bound by an earlier decision of the Calcutta High Court, *in re Commercial Properities, Ltd* (3). This was a case under the Income-tax Act. It was held that owning property and carrying on the business of letting houses is not a business within the meaning of that term as used in the Income-tax Act. In this Act business is shortly defined as including any trade, commerce or manufacture, or any adventure or concern in the nature of trade, commerce or manufacture. The question was whether tax was payable under section 9 (property) or under section 10 (business) of the Income-tax Act. Rankin, C. J., rejected the argument that because the owner of a property was a company which had been incorporated for the pur-

(1) 12 Tax. Cases 63
(2) (1949) 17 I. T. R. 308.
(3) I. L. R. (1928) 55 Cal. 1057.

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pose of owning such property, therefore the income derived from the property must be regarded as income derived from "business", and said—

> "In my judgment, income derived from 'property' is a more specific category, applicable to the present case."

Harries, C. J., considered that the proviso in section 2 (5) of the Excess Profits Tax Act of 1940 should be taken to admit the correctness and application to that Act of the observations of Rankin, C. J., in the *Commercial Properties case* (1), and held that under the terms of section 2 (5) the holding of property could not be held to be a business unless it is the whole or main function of a company or society incorporated under any Act. He considered rule 4, subrule (4), Schedule I of the Excess Profits Tax Act. This reads as follows :—

> "In the case of a business which consists wholly or partly in the letting out of property on hire, the income from the property shall be included in the profits of the business whether or not it has been charged to income-tax under section 9 of the Indian Income-tax Act, 1922, or under any other section of that Act."

but held that the word "partly" appearing in this rule could not make the rule at variance with the substantive provisions of the Act.

With great respect it seems to me unnecessary to hold that the deeming clause in the proviso to section 2 (5) must be exhaustive of all instances in which income derived from property can be income from business. In *Inland Revenue Commissioners* v. *Desoutter Brothers, Ltd.* (2), the question was whether royalties,

(1) I.L.R. (1928) 55 Cal. 1057.
(2) 1946 (1) A. E. R. 58.

received by a British company under a license granted to an American company to manufacture drills on patents held by the assessee British company, ought to be included in the profits of the assessee company for the purposes of Excess Profits Tax. The argument of the assessee was based upon section 12 (4) of the Finance (No. 2) Act, 1939, which subsection is identical with the proviso to section 2(5) of the Indian Act. Dealing with this section 12 (4) Lord Greene M. R. said :—

> " I should have thought that the objects of that subsection were manifest. In my view, it was intended, and quite clearly intended, to bring into the net a type of corporation which otherwise would or might have escaped it. The commonest type of corporation with which the subsection is dealing is what may be called a trust investment company, whose business is the holding of investments and deriving income from them. Such a corporation would not be said to be carrying on a ' trade or business ' within the meaning of subsection (1). Anyhow, if it were not absolutely clear, subsection (4) makes it quite certain that that type of corporation is to be included, and its operations are to be regarded as the carrying on of a trade on business. That seems to me to be the real and sole object of subsection (4). The argument really amounted to this : by implication the profits from investments or property held by any other type of corporation are excluded. I cannot begin to see the shadow of a foundation for any such argument. In my opinion it breaks down completely, once the real significance of subsection (4) is appreciated. "

If then the definition of " business " in section 2 (5) including the proviso is not taken as necessarily exhaustive, it is open to us to consider each case on its

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particular facts. A person who makes profit by buying and selling motor vehicles undoubtedly would be doing business within the definition. Would not a person also do business who makes profit from an extensive motor vehicle hiring undertaking? I should have thought so. Yet on the view expressed by the Calcutta High Court it would seem that the answer would be in the negative.

The argument of Mr. Pathak when applied to the present case would have force were it a fact that the sole concern of the assessee firm was the receipt of hire of machinery from a company or firm in which the assessee firm had no interest. But this is not the state of affairs. On the finding under the first question referred, the assessee firm, the firm of managing agents and the firm of selling agents are really one and the same firm. This firm and its partners hold the majority of shares in the company. The agreement for payment of Rs 40,000 as rent of machinery is an agreement between the assessee firm and the company which the assessee firm controls. The business of the assessee firm was, and in effect, still is the manufacture of ribbons and laces, and the receipt of Rs. 40,000 is a profit from that business diverted into the pockets of the assessee firm.

In my opinion, therefore, the third question must be answered in the affirmative. I would, therefore, answer the three questions in the manner indicated above and would direct that the assessee firm bear the costs of the Commissioner and would assess those costs at the total fees deposited under section 66(2) of the Income-tax Act.

Khosla J.

KHOSLA, J. I agree.