INCOME-TAX REFERENCE

Before D. K. Mahajan and S. K. Kapur, JJ.

THE COMMISSIONER OF INCOME-TAX, DELHI AND RAJASTHAN—*Petitioner*

versus

M/S MOTOR AND GENERAL FINANCE LTD., DELHI AND ANOTHER—*Respondents*

I. T. Reference No. 33-D of 1960.

Income-tax Act (XI of 1922)—S. 10(2)(XV)—Capital and Revenue Receipts—Financing Company entering into agreement with a producer and obtaining distribution rights of the pictures produced by it—Compensation received for earlier termination of the agreement by the company—Whether capital receipt or revenue receipt and whether liable to tax.

1965

March, 15th.

Held, that the main business of the company was financing and financiers naturally enter into different kinds of contracts in the course of carrying on their business. The contracts entered into by the company with Kardar Productions were not other than contracts in the course of its carrying on financing business. Elaborate provisions were made in the financing agreement for securing the return of monies advanced by the company. Termination of such contracts would be necessary incidents of the trade itself carried on by the company. The termination of the agreement in the circumstances of this case could well be said to have been brought about in the ordinary course of business and the money received by the company would certainly be regarded as also having been received in the ordinary course of business and, therefore, a trading receipt. If the test of fixed capital versus circulating capital is applied, there is no doubt that the payment was related to the circulating capital of the assessee and consequently not a capital receipt. The cancelled contract must be held, in these circumstances, to be an ordinary commercial contract made in the course of carrying on the company's trade and not such as can be said to affect the whole structure of the profit-making apparatus of the company. The ordinary conduct of business of financing must necessarily include not only making of the contract but also the modification or alteration thereof. It would be apt to describe that even if there was a sterilisation of any asset, it was a trading asset, and not a capital one. The compensation received by the assessee company for earlier termination of the contract, being a trading receipt, was liable to be assessed to income-tax.

Reference under section 66(2) of the Indian Income-tax Act, 1922 (XI of 1922) made by the Income-tax Appellate Tribunal Delhi Bench, New Delhi, wherein the following question of law have been referred for the opinion of their Lordships of the Punjab High Court—

"(i) *Whether on the facts and circumstances of the case the sum of Rs 2,75,000 (net) received by the assessee (the Motor and General Finance Limited) and the sum of Rs 75,000 received by the assessee (the Goodwill Pictures Limited), was a trading receipt or partook of the nature of a capital receipt ?*"

"(ii) *Whether there was material on which the Tribunal could find that the business structure or an entire activity or organisation of the assessee had disappeared ?*"

H. Hardy and D. K. Kapur, Advocates, for the Petitioner.

K. R. Bajaj, J. L. Bhatia, P. N. Monga, and Yash Paul Mehta, Advocates, for the Respondents.

ORDER

The following judgment of the Court was delivered by:—

Kapur, J.

KAPUR, J.—The reference in this case made under section 66(2) of the Indian Income-tax Act is with respect to two assessees, namely, Messrs. Motor & General Finance Ltd. (hereinafter referred to as the Company) and Messrs Goodwill Pictures Ltd., Delhi (hereinafter referred to as Goodwill Pictures. The relevant assessment years are 1950-51 for Motor and General Finance Ltd. and 1949-50 in the case of Goodwill Pictures Ltd. The following two questions of law have been referred to this Court:—

(1) Whether on the facts and circumstances of the case the sum of Rs. 2,75,000 (net received by the assessee (the Motor and General Finance Ltd.) and the sum of Rs. 75,000 received by the assessee (the Goodwill Pictures Limited) was a trading receipt or partook of the nature of a capital receipt?

(2) Whether there was material on which the Tribunal could find that the business structure

or an entire activity or organisation of the assessee had disappeared?

Till 1946, the Memorandum of Association of the Company did not authorise it to engage in the business of distribution or production of motion pictures. Till then the said company was carrying on business of general financing. In 1947, however, the Memorandum of Association was amended and a new clause, which reads as under, was inserted—

> "To carry on the business of film finance whether by system of hire-purchase, co-partnership, profit-sharing, royalty and/or on percentage commission or any other form, and to act as producers, distributors, exhibitors of cinema films and to carry on business of cinematograph trade and industry in all its branches."

After the aforementioned amendment in the Memorandum of Association, the said company entered into a contract with Kardar Productions of Bombay and undertook to finance the production of films by them. The agreement contemplated three groups of pictures, that is, groups (A), (B), and (C). At the time of agreement the pictures to be produced in groups (A) and (B) were ascertained while the pictures in group (C) were still under contemplation. The company was, however, to provide a finance of Rs. 12 lacs for each group. The first picture in group (A) was "Shahjahan" and in group (B) "Keemat" and the said company financed to the extent of Rs. 12 lacs for the production of "Shahjahan" and Rs. 4 lacs for the production of "Keemat". The agreement *inter alia* provided that the company will act as the sole film distributing agent on commission basis for Delhi, U.P. and East Punjab. In consideration of financial assistance, management and control over the territorial agents, the company was to receive commission at the rate of 10 per cent on all realisations over and above the commission that was to be paid to the territorial distributors appointed for the purpose. The agreement did not provide for any payment of interest to the company. The full responsibility for the recoupments of bad debts was of the company who had also to bear the entire distribution expenses. The distribution receipts, in the first instance, were to be received by the said company from the distributors and the company was

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to deduct 10 per cent commission on distribution receipts plus the commission payable to the sub-distributors and was thereafter to retain the balance towards reimbursement of the advance for production of pictures. Balances over and above the aforesaid amounts were to be paid to the distributors. In normal course of business the Company entered into an agreement with sub-distributors. Some other important terms of the contract were—

(a) The agents have no responsibility in regard to the financial results arising from the success or failure of any picture, such responsibility rests solely on the producer;

(b) The producer shall at his own cost incur all pre-release and release publicity expenses and give publicity contribution to the various territorial agents in accordance with their agreement;

(c) The picture which shall be supplied to the agents by the producer shall always remain the property of the producer subject to the first and foremost lien of the agents for the amount advanced by the agents thereto.

The first picture in group (A) and the first picture in group (B) "Shahjahan" and "Keemat", respectively, were not successful and there being no provision under the agreement of 31st of August, 1946 for the application of the receipts from pictures in one group towards the short recoveries of the advances in another group, a supplementary agreement was entered into between the parties on the 7th of February, 1948. The effect of this agreement was that unrecovererd amount against "Shahjahan" and "Keemat" along with the commission were treated as separate block account and the said company could recover these amounts out of future realisations of "Shahjahan" and "Keemat" and from excess realisations of other group of pictures. Two pictures in group (B) viz., "Natak" and "Dard" proved very successful and the parties expected that the exhibition receipts may amount to nearly Rs. 40 lacs. At this stage Kardar Productions were approached by other distributors with more attractive terms with the

result that they declined to hand over to the company their first picture in group (C) named "Dil-lagi" which was expected to be a box-office hit. The said company filed a suit for specific performance against Kardar Productions and it was compromised by a consent decree on the 30th December, 1948. Under the terms of the decree Kardar agreed to pay to the said company a sum of Rs. 5,43,812-5-6 "in respect of the amounts of advances and other moneys due and payable". The said company also accepted a sum of Rs. 3,50,000 in full settlement of commission in respect of pictures already delivered by the producers as well as in respect of pictures not so delivered, compensation for early termination of the company's agency agreement and damages, if any, which may be claimed by Goodwill Pictures. This amount also included compensation for termination of the agency in respect of pictures "Natak" and "Dard" for Delhi, U.P. and East Punjab. It may be mentioned here that immediately after the agreement of August, 1946, the company had entered into a sub-agency agreement with Goodwill Pictures. In view of the termination of the agreement between the producer and the company the latter was not in a position to carry out its obligations under the contract with Goodwill Pictures and consequently with a view to settle the matter with Goodwill Pictures, the company had to pay compensation to the tune of Rs. 75,000 for release from its obligation. The Goodwill Pictures agreed to receive the said sum of Rs. 75,000 as compensation for early termination of the agency.

After making the payment of Rs. 75,000 to Goodwill Pictures the company credited a sum of Rs. 2,75,000 (Rs. 3,50,000 minus Rs. 75,000) to the reserve account and not to the profit and loss account. On these facts the Income-tax Officer repelled the contention that the amounts of Rs. 2,75,000 and of Rs. 75,000 were capital receipts and not assessable to income-tax. The Appellate Assistant Commissioner by his judgment dated the 25th of March, 1952 in appeals Nos. 48 and 122 upheld the order of the Income-tax Officer Aggrieved by the said orders both the assessees filed appeals before the Income-tax Appellate Tribunal. The Tribunal allowed the appeals and held that—

> "By receiving the net sum of Rs. 2,75,000. The Motor and General Finance Ltd. divested itself of the

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right to distribute films produced by A.R. Kardar of Bombay, and the Goodwill Pictures Ltd. in its turn divested itself of the right to sub-distribute the above-mentioned productions. The result in each case was the disappearance of a business structure. It is a case of an entire activity or an entire organisation disappearing."

In the result the Tribunal came to the conclusion that both these receipts were of capital nature and, therefore, not liable to tax.

Whether a payment or receipt is revenue or capital is one of the most vexed questions in the field of taxation laws that judges are called upon to determine. There is, so far as we are aware, no single infallible test for settling the question and each case must depend on its particular facts. What may have weight in one set of circumstances may have little weight in another. Many cases have arisen on this point and this case raises once more the same troublesome question, namely, whether the receipt in the circumstances is a capital receipt. A number of cases have been referred to and we shall advert to some of them as providing illustrations of treatment given to particular set of facts. Some of the most eminent judges are still of the view that the best test, though not affording an answer in all cases, is whether or not the sum has been paid or has been received in respect of fixed or circulating capital. To determine that question, particularly in case of payments received on termination of agency contracts, the enquiry to be made is, were the cancelled contracts ordinary commercial contracts made in the course of carrying on the tax-payer's trade or were they such as affected the whole structure of the profit-making apparatus of the tax-payer. In *Vanden Bergh's Ltd.* v. *Clark* (*Inspector of Taxes*) (1), the appellant company had entered into three successive agreements with a Dutch company for carrying on their business in co-operation and *inter alia* to share the profits of their respective businesses in specified proportions. The sum in question was received on the compromise of a dispute arising out of the said agreements, whereunder the agreements were also determined. The House of Lords held the cancellation moneys to be capital receipts, since contracts cancelled were not commercial contracts made in the course of

(1) 19 T.C. 390. [H.L.].

carrying on trade, but related to the whole structure of the assessee's profit-making apparatus. Lord MacMillan also invoked the criterion afforded by the differentiation between fixed and circulating capital relied upon by the Court of Appeal and held that "the agreements formed the fixed framework within which their circulating capital operated; they were not incidental to the working of their profit-making machine but were essential part of mechanism itself. They provided the means of making profits, but they themselves did not yield profits." On the other side of the border is the decision in *Kelsall, Parsons & Co.* v. *Inland Revenue Commissioner* (2), where the nature of payment was distinguished from that in *Vanden Bergh's case* on the ground that the agreement was a temporary and variable element in appellant's business. In this case the appellants were working on commission basis for the sale of the products of various manufactures and entered into several agency agreements for the purpose. One of the agreements which was for a period of three years was terminated at the end of the second year in consideration of payment of compensation. It was held that the compensation money was taxable, since the contract itself was incidental to the normal course of the appellant's business. Lord President observed—

> "It was a normal incident of a business such as that of the appellants that the contracts might be modified, altered or discharged from time to time, and it was quite normal that the business carried on by the appellants should be adjustable to variations in the number and importance of the agencies held by them, and to modifications of agency agreements, including modifications of their durations, which might be made from time to time."

Another case which must be noticed is *Glenboig Union Fireclay Co. Ltd.* v. *Inland Revenue Commissioners* (3). It is one of the most frequently quoted cases though under Excess Profit duty legislation the principles to be applied for determining the issue were the same. The appellants were carrying on business *inter alia* of fireclay merchants. They were lessees of some fireclay fields over a part of which ran the line of the Calendonian Railway. Railway Company brought an action to prevent the appellants from

(2) 21 T.C. 608.
(3) 12 T.C. 427.

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working the fields which was eventually unsuccessful. From the years 1908—1911 during which the action was proceeding, the appellant company charged on its trading account the expenditure incurred in keeping open the fireclay field which formed the subject of the proceeding and in the year 1913 it received from the Railway Company an agreed sum as damages in settlement of claims in respect of loss, injury, damages or expenses competent to the appellant in connection with the interdict granted against the appellant during the pendency of the proceedings. After the House of Lords decided against the Railway Company, it exercised its statutory powers to require part of the fireclay field to be left unworked on payment of compensation, which was settled by arbitration and paid. The payment of statutory compensation was held to be a capital receipt since it was the price paid for sterlising the asset from which otherwise profit might have been obtained. In *Short Bros. Ltd.* v. *Inland Revenue Commissioner* (4), a sum paid to a company engaged in the business of building ships in respect of the cancellation of a contract to build two ships was held to be a trading receipt. In *Glenboig's case* fireclay was treated as a capital asset but the decision in *Johnson* (*Inspector of Taxes*) v. *Try* (W.S.) Lt. (5), indicated that the result in the case of an assessee in whose hands the asset sterilised was a trading asset would have been different. In *Kettle Well Bullen & Co.* vs. *C.I.T.* (6), the appellant company was formed with the object *inter alia* of carrying on the Managing Agencies. It was working as Managing Agent of six companies including the Fort William Jute Co. The Jute company had agreed to pay remuneration at the rate of Rs. 3,000 per month, commission at the rate of 10 per cent on the profits of the company's working, additional commission at 3 per cent on the cost price of all new machinery and stores purchased by the managing agent outside India on account of the company and interest on all advances made by the Managing Agent to the company on the security of the company's stocks, raw materials and manufactured goods. The payment in question was a sum of Rs. 3,50,000 paid to the Managing Agents as compensation for voluntary resignation from the Managing Agency. The question was whether the amount received by the

(4) 12 T.C. 955.
(5) 27 T.C. 167.
(6) 53 I.T.R. 261.

appellant to relinquish the Managing Agency was a revenue receipt liable to tax. It was held by their Lordship of the Supreme Court that the payment made to the assessee was to compensate it for loss of capital asset and was not, therefore, in the nature of a revenue receipt. The principal of the decisions as epitomised by Shah, J., is in the following words:—

> "On an analysis of these cases which fall on two sides of the dividing line, a satisfactory measure of consistency in principle is disclosed. Where on a consideration of the circumstances, payment is made to compensate a person for cancellation of a contract which does not affect the trading structure of his business, nor deprive him of what in substance is his source of income, termination of the contract being a normal incident of the business, and such cancellation leaves him free to carry on his trade (freed from the contract terminated) the receipt is revenue. Where by the cancellation of an agency the trading structure of the assessee is impaired, or such cancellation results in loss of what may be regarded as the source of the assessee's income, the payment made to compensate for cancellation of the agency agreement is normally a capital receipt."

Based on the same principle is the decision of the Supreme Court in *Gillanders Arbuthnot and Co. Ltd.* v. *Commissioner of Income-tax, Calcutta* (7). There it was held that the termination of an agency agreement was in the normal course of business and determination of individual agencies a normal incident not affecting or impairing its trading structure. Other decisions of the Supreme Court wherein the compensation was held to be a capital receipt are *Commissioner of Income-tax* v. *Wazir Sultan and Sons* (8), and *Godrej and Co.* v. *Commissioner of Income-tax* (9). In *Wazir Sultan's case* their Lordships of the Supreme Court held by majority that compensation paid for restricting the area in which previous agency agreement operated was a capital receipt, not assessable to income-tax. In that case the decision was based on the fact that the agency agreements were not entered into by the assessee in the carrying

(7) 53 I.T.R. 283.
(8) 36 I.T.R. 175.
(9) 37 I.T.R. 381.

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on of their business, but formed the capital asset of the assessee's business which was exploited by the assessee by entering into contracts with various customers and dealers in the respective territories and it formed part of the fixed capital of the assessee's business. In this case again the principal test applied was whether the payment related to the fixed or circulating capital. In *Godrej and Co.'s case* the managing agency agreement in favour of the assessee which was originally for a period of 30 years was modified and remuneration payable to the managing agents was reduced. As compensation for agreeing to this reduction the assessee received Rs. 7,50,000. It was held that the payment was in truth a compensation for releasing the company from the onerous terms as to remuneration as it was in terms expressed to be: so far as the assessee-firm was concerned it was received as compensation for the deterioration or injury to the managing agency by reason of the release of its rights to get higher remuneration and, therefore, a capital receipt. On the other hand of the thin edge stand the decisions of the Supreme Court in *Commissioner of Income-tax and Excess Profits Tax* v. *South India Pictures Ltd.* (10), and *Commissioner of Income-tax* vs. *R. B. Jairam Valji* (11). In *South India Pictures Ltd.'s case*, the compensation received for determination of the distribution rights of films was held taxable. In that case the assessee had exploited partially its rights of distribution of cinematographic films to which it was entitled in the terms of the agreement under which it had advanced money to the producer. The agreements were cancelled and the producers paid an aggregate sum of Rs. 26,000 to the assessee towards commission. It was held by their Lordships of the Supreme Court that the sum paid to the assessee was not compensation for not carrying on its business but was a sum paid in the ordinary course of the business to adjust the relations between the assessees and the producers and was taxable. In *R. B. Jairam Valji's case* a contract for supply of limestone and dolomite was terminated when the purchaser, the Bangal Iron Co. Ltd., found the rates uneconomical. A suit for specific performance and an injunction was filed restraining the company from purchasing limestone and dolomite from any other person. A fresh agreement between the respondent and the company fell through

(10) 29 I.T.R. 910.
(11) 38 I.T.R. 148.

because of circumstances beyond the control of the parties. The company agreed to pay Rs. 2,50,000 as solatium besides the monthly instalments of Rs. 4,000 remaining unpaid, under the earlier contract. It was held by their Lordships of the Supreme Court that the sum of Rs. 2,50,000 was not paid as compensation for expenses laid out for works at the quarry of a capital nature and could not be held to be a capital receipt on that account, the agreements were merely adjustments made in the ordinary course of business. Venkatarama Aiyer, J., at page 161 observed—

> "It will be seen that the receipts, the chargeability of which was in question in the decisions cited for the respondent, were all payments made as compensation for the termination of agency contracts whereas we are concerned with an amount paid as solatium for the cancellation of a contract entered into by a businessman in the ordinary course of his business, and that, in our judgment, makes all the difference in the character of the receipt. In an agency contract, the actual business consists in the dealings between the principal and his customers, and the work of the agent is only to bring about the business. In other words, what he does is not the business itself but something which is intimately and directly linked up with it. It is, therefore, possible to view the agency as the apparatus which leads to business rather than as the business itself on the analogy of the agreements in *Van Den Berghs Ltd.* v. *Clarks* (12). Considered in this light, the agency right can be held to be of the nature of a capital asset invested in business. But this cannot be said of a contract entered into in the ordinary course of business. Such a contract is part of the business itself, not anything outside it as is the agency, and any receipt on account of such a contract can only be a trading receipt."

What are the facts of this case. The main business of the company was financing and financiers would naturally enter into different kinds of contracts in the course of contracts in the course of its carrying on financing business.

(12) [1935]3 I.T.R. [Eng. Case]17.

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Elaborate provisions were made in the financing agreement for securing the return of monies advanced by the company. Termination of such contracts would be necessary incidents of the trade itself carried on by the company. The termination of the agreement in the circumstances of this case could well be said to have been brought about in the ordinary course of business and the money received by the company would certainly be regarded as also having been received in the ordinary course of business and, therefore, a trading receipt. If we apply the test of fixed capital *versus* circulating capital we are left with no doubt in our minds that the payment was related to the circulating capital of the assessee and consequently not a capital receipt. The cancelled contract must be held, in these circumstances, to be an ordinary commercial contract made in the course of carrying on the company's trade and not such as can be said to affect the whole structure of the profit-making apparatus of the company. The ordinary conduct of business of financing must necessarily include not only making of the contract but also the modification or alteration thereof. It would, in our view, be apt to describe that even if there was a sterilisation of any asset it was a trading asset, and not a capital one. In the result the first question must be answered in favour of the Commissioner of Income-tax. We accordingly hold that the two sums of Rs. 2,75,000 received by the company and Rs. 75,000 received by Goodwill Pictures were trading receipts. In view of this answer to the first question, the second question really does not arise for consideration. We answer the question accordingly. Having regard to the circumstances of the case, however, there will be no order as to costs.

Mahajan, J.

D. K. MAHAJAN.—I agree.

B.R.T.

APPELLATE CIVIL

Before S. K. Kapur, J.

MUNICIPAL CORPORATION OF DELHI,—*Appellant*

versus

SAT NARAIN GURWALA,—*Respondent*

Regular Second Appeal No. 38—D of 1959.

Punjab Municipal Act (III of 1911)—S. 3(13)(a)—Street—Vacant space—Whether a street or not—How to be determined—"Accessible to the public"—Meaning of—Street and private passage—Distinction between.