# K. M. S. LAKSHMANIER AND SONS
*v.*
# COMMISSIONER OF INCOME TAX AND EXCESS PROFITS TAX, MADRAS.

*1953*

*January 23.*

[PATANJALI SASTRI C.J., MUKHERJEA, CHANDRASEKHARA AIYAR, VIVIAN BOSE and GHULAM HASAN JJ.]

*Excess Profits Tax Act (XV of 1940)—Rules under Schedule II, R. 2-A—Computation of average capital—Security deposit received from customers—Whether "borrowed capital"—"Deposit" and "Loan"—Essentials of.*

The assessees, who were the sole selling agents of a yarn manufacturing company and who distributed yarn to several constituents under forward contracts, kept two accounts for each constituent, *viz.*, a "contract deposit account" and a "current yarn account", crediting the moneys which they received in advance from the constituents in the former account and transferring them to the current yarn account in adjustment of the price of the bales supplied then and there, that is to say, when deliveries were made under the contract. On the 5th May, 1944, they decided to keep the advance amounts under a new heading "Contracts Advance Fixed Deposit Account" and to return the advance amounts in full after the completion of each contract and payment of the full value of the bales supplied. On the 5th December, 1944, they changed the name of this account into "Security Deposit" account, and on the 14th February, 1945, the assessees decided to modify the arrangement further and demand a certain sum from each customer towards Security Deposit and keep the same with the assessees so long as the business connection with the customer under the forward contracts continued. Interest was also allowed on the amount of the deposit. The question being whether the advance amounts received by the assessees as deposit were "borrowed money," within the meaning of Rule 2-A of the Rules in the Second Schedule to the Excess Profits Tax Act, 1940, and should not be deducted in computing the average capital used for the purposes of the business:

*Held*, (i) that the advance amounts received before the 5th May, 1944, were only advance payments of the price, to be adjusted on delivery, and could in no sense be regarded as borrowed money;

(ii) the amounts received after the 5th May, 1944, up to 14th February, 1945, were also, having regard to the terms of

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the arrangement then in force, more in the nature of trading receipts than of security deposits as they were really advance payments in regard to each contract, and the transaction provided in substance and effect for the adjustment of the mutual obligations on the completion of each contract;

(iii) the method of dealing adopted after the 14th February, 1945, had all the essential elements of a transaction of loan, and the deposits received after that date were "borrowed money" for the purposes of Rule 2-A, as the amount of deposit had no relation to the price of the goods to be delivered under each contract, the price of the goods supplied was to be paid by the customer in full, the assessees were allowed to use the money for their own business paying interest to the customers, and the amounts were returnable only at the end of the business connection.

The terms "loan" and "deposit" are not mutually exclusive, and the fact that a deposit is made with the object of inducing the person with whom the deposit is made to have dealing with the depositor and for the specific purpose of being held as security for the due performance by the depositor of his part of the contract, would not prevent a deposit from being really in the nature of a loan.

*Nawab Major Sir Mohamed Akbar Khan* v. *Attar Singh* (L. R. 63 I.A. 279) relied on. *Inland Revenue Commissioners* v. *Port of London Authority* (L.R. [1923] A.C. 507) and *Inland Revenue Commissioners* v. *Rowntree* ([1948] 1 All E.R. 482) distinguished. *Davies* v. *The Shell Co. of China* (32 Tax Cas. 133) applied.

CIVIL APPELLATE JURISDICTION: Civil Appeal No. 71 of 1952.

Appeal from the Judgment dated 9th January, 1950, of the High Court of Judicature at Madras (Satyanarayana Rao and Viswanatha Sastri JJ.) in Case Referred No. 67 of 1947.

*G. S. Pathak* (*G. R. Jagadisan*, with him) for the appellants.

*M. C. Setalvad, Attorney-General for India* (*G. N. Joshi*, with him) for the respondent.

1953. January 23. The Judgment of the Court was delivered by

PATANJALI SASTRI C.J.—This appeal arises out of a reference made by the Income-tax Appellate Tribunal, Madras Bench, under section 21 of the Excess Profits Tax Act, 1940 (hereinafter referred to as the Act).

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The appellants are merchants carrying on business in yarn in Madura and are the sole selling agents for yarn manufactured by the Madura Mills Co., Ltd., distributing yarn to several constituents under forward contracts in respect of which they obtained advances of moneys from their constituents. During the chargeable accounting period (13th May, 1944, to 12th April, 1945) the appellants received from their customers sums amounting to Rs. 7,69,569 and they claimed before the Excess Profits Tax Officer that the said sum should be treated as "borrowed money" within the meaning of Rule 2-A of the Rules in the Second Schedule to the Act and, on that footing, no excess profits tax was payable by them for the chargeable accounting period. The Excess Profits Tax Officer rejected the claim and assessed them to excess profits tax of Rs. 25,404, holding that, having regard to the terms of the agreement under which the amounts were received, they could not in law be regarded as "borrowed money" within the meaning of that Rule. Appeals to the Appellate Assistant Commissioner and the Income-tax Appellate Tribunal having failed, the appellants applied to the Tribunal for reference of the question of law arising in the case to the High Court at Madras for its determination, and the Tribunal accordingly referred the following question:

"Whether in the circumstances of this case, the moneys deposited by customers with the assessee firm as security deposits were "borrowed money" within the meaning of Rule 2-A of the Second Schedule to the Excess Profits Tax Act, 1940, either throughout the chargeable accounting period ended 12th April, 1945, or during any part of that chargeable accounting period ? "

The reference was heard by a Division Bench of the Court (Satyanarayana Rao and Viswanatha Sastri JJ.) and the learned judges by their judgment dated 9th June, 1950, decided the question against the appellants but granted them leave to appeal to this Court.

As is well known, during the period of the war, profits arising from a trade or business were much higher

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than the pre-war standard of profits and the State wanted to catch a portion of such profits which it deemed to be in excess of the normal or "standard" profits. The Act accordingly charges a tax on the "excess profits" earned under war conditions and makes provision, *inter alia*, for cases where, as here, there is an increase of capital used for purposes of the business in the chargeable accounting period. In such cases the standard profits are to the increased by an amount calculated by applying the "statutory percentage" (varying from 8 to 12 per cent. in different classes of cases) to the increase in capital. Thus, with the increase in the capital employed in the chargeable accounting period, there would be an increase in the standard profits and a decrease in the excess profits. Where the increase in the capital is brought about with borrowed money, it is but fair that such money, which plays its part in earning the larger profits, of which the State claims a substantial share, should not be deducted in computing the average capital used for the purposes of the business. Rule 2-A of the Rules in the Second Schedule to the Act accordingly provides that in computing the average capital during the chargeable accounting period and the relative standard period "no deduction shall be made in respect of borrowed money". In the present case, the appellants having admittedly received no security deposits during the standard period, the increase in the average capital employed in the chargeable accounting period would be much greater than what it has been computed to be, if the security deposits received, which were all used for the appellants' business, were treated as borrowed money and part of the average capital of their business for the chargeable accounting period, and that, as stated above, would result in a considerable reduction of the excess profits as now assessed. What then is the true legal character of these security deposits?

The sums in question were received by the appellants under three different arrangements with their

customers evidenced by the circulars issued to them. The first of these circulars issued on 5th May, 1944, was in the following terms :

" You are quite aware of the fact that we are and will be, so long as the existing contracts of bales are closed, transferring the Contract Advance Deposit amounts to the credit of current yarn account for the bales supplied to you then and there.

Now, what we have decided in this connection is not to do so as stated above, but to keep such advance amounts under the new heading " Contracts Advance Fixed Deposit Account " and return in cash or by bank's cheque or by insured post the advance amount of the bales booked and supplied in full under certain contract number only after completion of that contract with the bank's commission etc. expenses that may be incurred therein on your account.

The value of the bales delivered or to be delivered for each and every time should be paid in full and this system is applicable to our future booking of contracts only."

This was followed by another issued on 5th December, 1944, which runs thus :

" This is to inform you that we have changed the heading of your " Contracts Advance Fixed Deposit " account into " Security Deposit " account. As such, we have transferred the amount which is to your credit in the former to the credit of your latter account. This is with effect from 1st November, 1944. Kindly note."

The arrangement was further modified by the last circular dated 14th February, 1945, which was in these terms :

"Instead of calling for amounts from you towards 'Security Deposit' due to bales for which we are entering into forward contracts with you and returning the same to you from the said deposit then and there, as we are doing now, and in order to make it feasible, we have decided to demand from you a certain sum towards Security Deposit and keep the

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same with us so long as our business connection under forward contracts will continue with you.

In your case, we have fixed a sum of Rs.....for the said deposit, which amount we have to keep with us on your approval. Against the said amount, a sum of Rs.....stands credit with us now in the said deposit. Therefore, the balance of Rs.....due by you/to you, is to be remitted/will be returned. Kindly let us have your reply immediately in this connection.

Please note that interest of 3 per cent. per annum will be allowed as usual to the said deposit amounts until further notice."

It will be seen that before the 5th May, 1944, which covers the first seven weeks of the chargeable accounting period, the appellants had two accounts for each constituent, namely, a "contract deposit account" and a "current yarn account", crediting the moneys received from the customers in the former account and transferring them to the yarn account in adjustment of the price of the bales supplied "then and there", that is, as and when deliveries were made under a contract either in instalments or in full. It is clear that the amounts received from the customers under this arrangement were merely advance payments of the price which were to be adjusted against the value of the bales supplied from time to time under the forward contracts and they can in no sense be regarded as borrowed money. This indeed was not disputed by Mr. Pathak. It was also conceded by him that the circular of 5th December, 1944, which merely changed the heading of the account in which the moneys received were credited, did not alter the legal position as it then stood. Accordingly, the question arises only with reference to the amounts received between 5th May, 1944, and 14th February, 1945, which covers the major part of the chargeable accounting period and those received thereafter till the end of that period.

It will be convenient to deal first with the amounts received during the last part of that period, for, if we

accept the view of the learned judges below that those amounts were not borrowed money, then *a fortiori* must amounts received during the second part be held not to be borrowed money.

The circular of the 14th February, 1945, marks a clear departure from the mode of dealing followed by the parties before the 5th May, 1944. The amount deposited by a customer was no longer to have any relation to the price fixed for the goods to be delivered under a forward contract—either in instalments or otherwise. Such price was to be paid by the customer in full against delivery in respect of each contract without any adjustment out of the deposit, which was to be held by the appellants as security for the due performance of his contracts by the customer so long as his dealings with the appellants by way of forward contracts continued, the appellants paying interest at 3 per cent. in the meanwhile, and having, as appears from the course of dealings between the parties, the use of the money for their own business. It was only at the end of the "business connection" with the appellants that an adjustment was to be made towards any possible liability arising out of the customer's default. Apart from such a contingency arising, the appellants undertook to repay an equivalent amount at the termination of the dealings. The transaction had thus all the essential elements of a contract of loan, and we accordingly hold that the deposits received under the final arrangement constitute borrowed money for the purpose of Rule 2-A.

The learned Attorney-General laid great stress on the fact that the amounts were deposited with the object of inducing the appellants to have dealings with the customers and for the specific purpose of being held as security for the due performance by the customers of their forward contracts, and that the appellants themselves fixed the amount to be deposited in each case. These features, according to him, distinguished these transactions from a real borrowing or a real lending which the expression "borrowed money" in Rule 2-A must be taken to connote. We are unable to see how

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the object which the customers had in view in making the deposits can affect the essential character of the transaction. If A pays money to B who agrees to return not the identical currency in specie but an equivalent sum subsequently, no bailment arises but simply a loan owing by B to A. The fact that it is called a "deposit" can make no difference. As pointed out by the Judicial Committee of the Privy Council in *Nawab Major Sir Mohammad Akbar Khan* v. *Attar Singh* (1), the two terms are not mutually exclusive. "A deposit of money is not confined to a bailment of specific currency to be returned in specie. As in the case of a deposit with a banker, it does not necessarily involve the creation of a trust but may involve only the creation of the relation of debtor and creditor, a loan under conditions". The fact that one of the conditions is that it is to be adjusted against a claim arising out of a possible default of the depositor cannot alter the character of the transaction. Nor can the fact that the purpose for which the deposit is made is to provide a security for the due performance of a collateral contract invest the deposit with a different character. It remains a loan of which the repayment in full is conditioned by the due fulfilment of the obligations under the collateral contract.

The Attorney-General placed strong reliance, as did the learned judges in the High Court, on the English decisions in *Inland Revenue Commissioners* v. *Port of London Authority* (2) and *Inland Revenue Commissioners* v. *Rowntree & Co. Ltd.* (3). In the first case it was held that the stock issued by the Port of London Authority as consideration for the acquisition of the property of certain dock companies of London, which carried interest and was redeemable after twenty years, could not be regarded as representing "borrowed money" under Rule 2 of Part III of Schedule IV of the Finance (No. 2) Act, 1915, as that expression referred to "a real borrowing and a real lending". The transaction was held to be a purchase of assets for consideration in the shape of the stock issued, though it was attended

(1) (1936) L.R. 63 I.A. 279.
(2) L.R. [1923] A.C. 507.
(3) [1948] 1 All E.R. 482.

with incidents in some respects similar to those which would have ensued if there had been a borrowing. It may well be conceded that the term "borrowed money" must be construed in its natural and ordinary meaning and implies a real borrowing and a real lending. But the holding that "there was nothing of the kind" in the issue of stock as consideration for the purchase of certain assets, where "no money passed directly or indirectly between the parties to the transaction" is not of much assistance in determining the issue whether the security deposits now in question involved a real borrowing and a real lending. For the reasons already indicated, we are satisfied that they do answer to that description and constitute borrowed money within the meaning of Rule 2-A.

The other case cited is still less helpful. Under certain arrangements for financial facilities, A drew bills on B who accepted them and then, as an agent of A, discounted them with C and paid over the proceeds to A, who agreed to put him in funds before the maturity of the bills for paying them off. The Court of Appeal held that the money thus raised was not "borrowed money" within the meaning of paragraph 2 (1) of Part II of the Seventh Schedule to the Finance (No. 2) Act, 1939, which provided that "any borrowed money shall be deducted" (for the purpose of Excess Profits Duty). After referring to the Port of London case (*supra*) as authority for the view that the words "borrowed money" require the existence of a borrower and a lender and that there must be a real borrowing in the legal sense of the word, the learned judges proceeded to inquire who could be the lender, if any, in the circumstances of the case and found there was none—not B, for an acceptor of a bill need not have any money in his hands at all to lend, not C who was only acquiring certain rights in the bill under the law merchant but was not lending money. They accordingly found it "impossible to discover that there was such a relationship" (of lender and borrower) either between A and B or between A and C. In the

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present case, the relationship of lender and borrower in all its essential features is plainly recognisable between the depositors and the appellants, and that decision does not affect the matter one way or the other.

On the other hand, a more recent decision of the English Court of Appeal in *Davies* v. *The Shell Company of China* (1), which Mr. Pathak brought to our notice, is more in point. A British Company, which sold petroleum products in China through Chinese agents, required the latter to deposit with the company a sum of money in Chinese dollars to be held as security against possible default by the agent in payment for the products consigned to them and to be repaid when the agency came to an end. These deposits were, during the war, transferred to the United Kingdom for reasons of safety and were there held in sterling. Subsequently, when the Chinese dollar depreciated in relation to sterling, the amounts required to repay the deposits in Chinese dollars were much less than the sums held by the company as sterling equivalents of the deposits, and the question arose whether such deposits were trading receipts or receipts of a capital nature. In holding that they were capital receipts and the profit was therefore a capital gain, Jenkins L.J., who delivered the leading judgment, observed :

"If the agent's deposit had in truth been a payment in advance to be applied by the company in discharging the sums from time to time due from the agent in respect of petroleum products transferred to the agent and sold by him, the case might well be difficult and might well fall within the *ratio decidendi* of *Landes Bros.* v. *Simpson*(2) and *Imperial Tobacco Co.* v. *Kelley*.(3) But that is not the character of the deposits here in question. The intention manifested by the terms of the agreement is that the deposit should be retained by the company, carrying interest for the benefit of the depositor throughout the terms of the agency. It is to be available during the

(1) (1951) 32 Tax Cas. 133.
(2) (1934) 19 Tax Cas. 62.
(3) (1943) 25 Tax Cas. 292.

deriod of the agency for making good the agent's pefaults in the event of any default by him; but otherwise it remains, as I see it, simply as a loan owing by the company to the agent and repayable on the termination of the agency; and I do not see how the fact that the purpose for which it is given is to provide a security against any possible default by the agent can invest it with the character of a trading receipt."

The Attorney-General relied also upon certain decisions holding that security deposits received from employees were impressed with a fiduciary character so that the depositors were entitled to preferential payments from the assignee in bankruptcy of the depositee. He admitted, however, that there were decisions holding the other way, and we do not think it necessary to discuss that class of cases, as the manner in which such sums have to be dealt with under the Insolvency Acts has no direct bearing on the question now under consideration.

Turning now to the deposits received by the appellants from 5th May, 1944, to 14th February, 1945, we are of opinion that, having regard to the terms of the arrangement then in force, they partake more of the nature of trading receipts than of security deposits. It will be seen that the amounts received were treated as advance payments in relation to each "contract number" and though the agreement provided for the payment of the price in full by the customer and for the deposit being returned to him on the completion of delivery under the contract, the transaction is one providing in substance and effect for the adjustment of the mutual obligations on the completion of the contract. We hold accordingly that the sums received during this period cannot be regarded as borrowed money for the purposes of Rule 2-A.

Lastly, Mr. Pathak suggested that the case having proceeded both before the Excess Profits Tax authorities and the High Court on the footing that if the sums received from the customers during any part of the chargeable accounting period were held to be borrowed

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money, they must be included in the computation of the average profits for the whole of the chargeable accounting period, no distinction should now be made between one part of the period and another for this purpose. We cannot accept that view. It is true to say that no such distinction was in fact made at any stage so far, but that is because it was held that none of the sums received under any of the arrangements was borrowed money within the meaning of Rule 2-A. But, if it be held that the amounts received under one or more, but not all, of the agreements are borrowed moneys, then, obviously, the computation of average capital in accordance with Rule 2-A must take into account the different character of the sums received under each of the agreements which was in force during a part only of the chargeable accounting period. The form of the question referred to the court clearly recognises this and admits of a distinction being made, if necessary, between parts of the chargeable accounting period.

In the result we set aside the order of the court below and answer the question referred in the affirmative with reference to the last part of the chargeable accounting period, namely, 14th February, 1945, to 12th April, 1945, and in the negative with reference to the rest of that period. We make to order as to costs.

*Order set aside.*

Agent for the appellants : *Naunit Lal.*

Agent for the respondent : *G. H. Rajadhyaksha.*