

NONSUCH ESTATE LTD.

v.

THE COMMISSIONER OF INCOME-TAX, MADRAS

November 21, 1974

[H. R. KHANNA AND A. C. GUPTA, JJ.]

Income-tax Act, 1922—Assessee followed mercantile system of accounting—Debited in books each year managing agency remuneration for three years—Claimed deduction in the third year on receipt of approval from Central Government for reappointment of managing agents as required under s. 326 Companies Act—Whether assessee should have claimed deduction in each assessment year.

The assessee who followed the mercantile system of accounting debited in its account books certain sums of money as remuneration of the managing agents for the assessment years 1957-58 to 1959-60. For the purpose of income-tax the company added back the sum to its taxable income and claimed the whole sum as a deductible expenditure in the assessment year 1959-60 on the ground that the sum became payable only during that year when the Government accorded its approval to the new managing agency agreement. The Income-tax Officer rejected the claim holding that the approval of the Central Government was necessary only for actual payment and the assessee should have ascertained the liability for each year and claimed it since he followed the mercantile system of accounting. This view was upheld by the Appellate Assistant Commissioner and the Income-tax Appellate Tribunal.

The High Court held that although at the time the debit entries were made in the account books of the assessee, approval of the Central Government had not been received, when it came later, it gave legal effect to the debit entries with retrospective effect from April 1, 1956 and that the refusal of deduction by the Income-tax Officer was right.

Allowing the appeal to this Court,

HELD: The High Court was in error in answering the question against the assessee. Even an assessee following the mercantile system of accounting is not entitled to claim a deduction until liability for the sum for which deduction is claimed has accrued. The High Court overlooked the plain terms of s.326 of the Companies Act, 1956 under which it could not be assumed that the Central Government would approve every proposed appointment or re-appointment of managing agent. [809A; D; 810A]

In the instant case it is only when the Central Government conveyed its approval to the appointment of managing agents by its letter dated September 2, 1957 that the appointment became effective and the Company's liability to pay the remuneration of the managing agents accrued. The liability became effective from April 1, 1956 because the Central Government chose to give its approval retrospective operation. The liability could not be said to have arisen from any date prior to September 2, 1957 when the approval was given. Section 326 of the Companies Act contains an absolute prohibition against the appointment or re-appointment of a managing agent before the approval of Central Government was obtained. [810B-C]

CIVIL APPELLATE JURISDICTION : Civil Appeal No. 1554 of 1970.

Appeal by Special Leave from the Judgment & Order dated the 19th Augut, 1968 of the Madras High Court in Tax Case No. 18 of 1965.

G. B. Pai, A. G. Manessea, D. C. Mathur and K. K. John, for the appellant.

B. B. Ahuja and S. P. Nayar, for the respondent.

A The Judgment of the Court was delivered by

B GUPTA, J. This is an appeal by special leave from a judgment of the Madras High Court in a reference under section 60(1) of the Income Tax Act, 1922. The appellant, Nonsuch Estate Limited, is a public limited company incorporated in the year 1924 under the Indian Companies Act, 1913. The appellant, referred to hereinafter as the Company, derives its income from tea grown in its estate for which it is assessed to income-tax. M/s. Harrisons and Crosfield Limited have been the managing agents of the Company from the beginning. The following question relating to the assessment year 1959-60 was referred to the High Court :

C "Whether on the facts and in the circumstances of the case, the sum of Rs. 97,188/- representing the Managing Agency remuneration for the period 1-4-1956 to 30-6-1957 was deductible in the computation of the income of previous year ending on 30th June 1958, relevant for the assessment year 1959-60."

The relevant facts leading to the reference are these. The managing agents of the Company were entitled to commission at the rate of 1½ per cent on all sales of tea and other produces of the Company and a further sum of Rs. 12,000/- per annum for secretarial work. There was, however, no written agreement embodying the terms. After the Companies Act, 1956 came into force on April 1, 1956 it was decided that there should be a fresh managing agency agreement between the Company and its managing agents in conformity with the provisions of the said Act. A fresh agreement drawn up and submitted by the managing agents was approved by the Company. The new agreement proposed the reappointment of M/s. Harrisons & Crosfield Limited as the managing agents of the Company for a period of 10 years on a remuneration of 5 per cent commission on the net profits of the Company computed in the manner laid down in sections 349 to 351 of the Companies Act, 1956 subject to a minimum remuneration of Rs. 12,000/- per annum. The revised terms were to take effect from April 1, 1956. As required by sec. 326 of the Companies Act, the new agreement was sent to the Central Government for approval by a communication dated August 3, 1957 enclosing a formal application for the purpose in Form 25, On September 2, 1957 by a letter addressed to the Company the Government conveyed its approval to "the appointment of M/s. Harrisons & Crosfields Ltd. as the Managing agents. for a period of 10 years with effect from 1st April 1956, on a remuneration of 5 per cent commission on the net profits of the Company computed in the manner as laid down in Sections 349 to 351 of the Companies Act, 1956 subject to a minimum remuneration of Rs. 12,000/- (Rupees twelve thousand only) per annum payable to the Managing Agents, in the event of absence or inadequacy of profits in any financial year." On receipt of the approval, the Company by a resolution adopted at an extraordinary general meeting of its shareholders held on October 4, 1957 reappointed M/s. Harrisons & Crosfield Limited on the terms stated above. In terms of the new agreement the existing agency agreement between the parties stood cancelled with the expiry of March 31, 1956.

The Company follows the mercantile system of accounting. For the period April 1, 1956 to June 30, 1956, the Company credited a sum of Rs. 9320/- to the account of the managing agents as their remuneration in accordance with the terms of the proposed new agreement. This was disclosed in the published accounts of the Company for the year July 1, 1955 to June 30, 1956 relevant to the assessment year 1957-58. For the purpose of assessment of income-tax, however, the Company added back the said sum of Rs. 9,320/- to its taxable income. In the next accounting year ending on June 30, 1957 relevant to the assessment year 1958-59 the same process was followed with regard to the remuneration payable to the managing agents. For the assessment year 1959-60 for which the previous year was July 1, 1957 to June 30, 1958, a total sum of Rs. 97,188/- was shown as managing agents' remuneration payable during that year. This amount was made up as under :

	Amount
"Proportionate remuneration for 3 months at 5 per cent on the net profits for the period ending on 30-6-1956 paid during the year ending on 30-6-1958	9,320
Remuneration at 5 per cent on the net profit of the year ending on 30th June 1957 paid during the year ending on 30-6-1958	71,368
Managing Agents expenses for the year ending 30th June 1957 recouped during the year ending on 30th June 1958	13,200
Proportionate Managing Agent's expenses for the year ending on 30th June 1956 recouped during the year ending on 30-6-1958	3,300
	<hr/> 97,188 <hr/>

Though this sum did not pertain to the previous year relevant to the assessment year 1959 60, the Company claimed it as deductible expenditure for that year on the ground that the sum became payable only during that year when the Government accorded its approval to the new agreement. The Income-tax Officer rejected this claim on the view that the approval of the Central Government was necessary only for actual payment and "the assessee should have ascertained the liability for each year and claimed it on the mercantile basis which was the system adopted by the assessee company." The Appellate Assistant Commissioner and the Tribunal also took the same view. The High Court answered the question referred to it against the assessee on the following reasoning :

" There was undoubtedly an understanding between the managing agency and the assessee as to the new terms of remuneration which actually were given effect to by making debit entries in the remuneration account then and there. It is true that at the time the debit entries were made, approval of the Central Government had not come. But when it came actually later, it gave legal effect to the debit

- A entries, not from the date of the approval but from April 1, 1956. That being the case, the refusal of the deduction, in our opinion was right."

- B In our judgment the High Court was in error in answering the question referred to it against the assessee. It appears that the Income-tax authorities, the Tribunal and the High Court all laid special emphasis on the fact that the Company followed the mercantile system of accounting. The distinction between the two methods of accounting, one on the cash basis and the other on the mercantile basis is well-known. In *Commissioner of Income-tax, Madras v. A. Gajapathy Naidu*⁽¹⁾, this Court explained the difference between the two methods quoting with approval an extract from a Judgment of the Allahabad High Court in *Commissioner of Income-tax v. Singari Bai*⁽²⁾. In
- C *Gajapathy Naidu's*⁽¹⁾ case this Court said :

- D "It is commonplace that there are two principal methods of accounting for the income, profits and gains of a business one is the cash basis and the other, the mercantile basis. The latter system of accountancy "brings into credit what is due immediately it becomes legally due and before it is actually received; and it brings into debit expenditure the amount for which a legal liability has been incurred before it is actually disbursed"."

- E However, even an assessee following the mercantile system of accounting is not entitled to claim a deduction until liability for the sum for which deduction is claimed has accrued. The reasons given by the High Court overlook the plain terms of sec. 326 of the Companies Act, 1956. Sec. 326 so far it is material for the question involved in this case, is in these terms :

"Sec. 326.(1) In respect of any company.....

- (a)
- F (b) unless the approval of the Central Government has been obtained for such appointment or re-appointment.
- (2) The Central Government shall not accord its approval under sub-section (1) in any case, unless it is satisfied—
- G (a) that it is not against the public interest to allow the company to have a managing agent;
- (b) that the managing agent proposed is, in the opinion, a fit and proper person to be appointed or re-appointed as such, and that the conditions of the managing agency agreement proposed are fair and reasonable; and
- H (c) that the managing agent proposed has fulfilled any conditions which the Central Government requires him to fulfil."

(1) 53 I.T.R. 114.

(2) 13 I.T.R. 224.

Section 326 prohibits the appointment or re-appointment of a managing agent unless the Central Government approved such appointment or re-appointment. The Central Government would not accord its approval unless the requirements specified in clauses (a), (b) and (c) of sub-section (2) of the section have been fulfilled. Therefore, it cannot be assumed that the Central Government will approve every proposed appointment or re-appointment of a managing agent. Thus in the instant case it is only when the Central Government conveyed its approval to the appointment of M/s. Harrisons and Crosfield Limited as managing agents by its letter dated September 2, 1957 that the appointment became effective and the Company's liability to pay the remuneration of the managing agents accrued. The position here is not that the liability had arisen earlier and its quantification only depended on the approval of the Central Government. It is true that the liability became effective from April 1, 1956, a date anterior to the relevant previous year, but that is because the Central Government chose to give its approval retrospective operation. The liability in these circumstances cannot be said to have arisen from any date prior to September, 2, 1957 when the approval was given as sec. 326 contains an absolute prohibition against the appointment or re-appointment of a managing agent before the approval of the Central Government was obtained. In our opinion, the position is quite clear from the terms of sec. 326 and we do not consider it necessary to refer to the authorities cited by the learned counsel for either side.

The appeal is accordingly allowed, the answer given by the High Court to the question referred to it is discharged and the question is answered in the affirmative and in favour of the assessee. The appellant will be entitled to its costs in this Court and in the High Court.

P.E.R.

Appeal allowed.