Privy Council Appeal No. 23 of 1936

The Indian Radio and Cable Communications Company, Limited - - - - - - - *Appellants*

v.

The Commissioner of Income Tax, Bombay Presidency and Aden - - - - - - - *Respondent*

FROM

THE HIGH COURT OF JUDICATURE AT BOMBAY

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL, DELIVERED THE 8TH APRIL, 1937.

Present at the Hearing:

LORD MAUGHAM.
SIR SHADI LAL.
SIR GEORGE RANKIN.

[*Delivered by* LORD MAUGHAM.]

This is an appeal from a judgment and order of the High Court of Judicature at Bombay, dated the 28th March, 1935, whereby the High Court, upon the hearing of a Case referred to it by the respondent under the provisions of section 66 (2) of the Indian Income-tax Act, 1922 (XI of 1922) (referred to below as "the Act"), answered the question of law raised thereby adversely to the contention of the appellant company.

The question of law referred to the High Court arose in the course of the assessment of the income of the appellant company chargeable with income tax and super tax for the year of assessment ending on the 31st March, 1934, and was as follows:—

> "Whether the half share of the net profits, payable by the Assessee company" (meaning the appellant company) "under clause 5 of the Agreement dated the 19th day of February, 1932, viz. Rs.3,35,861 is a proper deduction to be allowed for the purposes of arriving at the amount on which this company should be assessed for the purposes of income tax and super tax, within the meaning of section 10 (2) (ix)."

It should be added that the material subsection of the Indian Income-tax Act, 1922, is section 12 (2) which, after providing that the tax shall be payable under the head "other sources" in respect of income, profits and gains of every kind, enacts as follows:—

> "Such income, profits and gains shall be computed after making allowance for any expenditure (not being in the nature of capital expenditure) incurred solely for the purpose of making or earning such income, profits or gains, provided that no allowance shall be made on account of any personal expenses of the assessee."

The appellant company is incorporated and registered in Bombay under the Indian Companies Act, 1913. Prior to the date of the agreement of 1932, out of which the present problem arises, the appellant company carried on in India the business of communication by wireless, whilst a company known as the Imperial and International Communications, Ltd. (whom it will be convenient to call the Communications Company), owned or controlled two companies called the Eastern Telegraph Company, Ltd., and the Eastern Extension Australasia and China Telegraph Company, Ltd., which carried on the business and undertaking in India of communication by cable. The radio business of the appellant company and the cable business in India of the undertakings of the two companies controlled by the Communications Company (called below the combined undertaking) were to a certain extent competitive, a circumstance which led to the agreement next to be stated. The Communications Company held not less than half the issued share capital of the appellant company, which no doubt facilitated the negotiation of the terms.

By the agreement which was dated the 19th February, 1932, and made between the Communications Company and the appellants, it was recited that the parties had agreed that the future operation and control of the business in India of the combined undertaking could be conducted more conveniently and to their mutual advantage if possession of the combined undertaking was given to the appellants and the business was conducted by the appellants in connection with their wireless undertaking.

By clause 3 it was provided that (subject to certain conditions precedent which were satisfied) the Communications Company should on a date to be appointed deliver to or otherwise place the appellants in possession for the purposes of the agreement of all plant, machinery, instruments and apparatus, fittings, furniture, stationery and stores (thereinafter referred to as "the plant") at Bombay and Madras owned or held by the Communications Company in connection with the business in India of the combined undertaking, and from the appointed date the appellants were authorised to use the plant for the purpose of carrying on and conducting for the period of the agreement the business in India of the combined undertaking (exclusive of the Karachi business as defined in the agreement) in conjunction with the wireless undertaking of the appellants.

Clause 4 provided that the agreement should determine on the 31st December, 1944, or earlier on notice given by either party that they were ceasing to carry on business.

The consideration to be paid by the appellants under the agreement was set out in clause 5 in the following terms:—

> "The Radio Company shall as and from the appointed date pay to the Communications Company:—
>
> (*a*) The sum of Pounds ninety thousand sterling which represents an assessment of the expenses proportionate to the

traffic of the combined undertaking emanating in India exclusive of the Karachi business, of the maintenance by the Communications Company of its communications system throughout the world exclusive of India. The said sum shall be payable by four equal quarterly instalments on the thirty-first March, the thirtieth June, the thirtieth September and the thirty-first December in each year and each instalment shall be remitted to London by and at the expense of the Radio Company within six weeks after the date on which the same shall become payable.

(*b*) One-half of the net profits of the Radio Company for each of its financial years which shall be payable to or at the direction of the Communications Company and paid in Rupees in Bombay as follows:—

(1) As to eighty per cent. thereof by such payments on account from time to time as the Board of Directors of the Radio Company shall consider that the finances of the Radio Company justify.

(2) As to the balance thereof within fourteen days after the date on which the Balance Sheet and Profit and Loss Account of the Radio Company for such financial year shall have been passed and adopted by the Shareholders of the Radio Company at their Annual General Meeting. Provided that if the aggregate of such payments on account shall exceed the actual amount of the half share in the net profits of the Radio Company as finally ascertained for such financial year the excess paid shall be refunded by the Communications Company to the Radio Company on demand.

For the purpose of sub-clause (*b*) of this clause the expression ' net profits ' means the profits for each year remaining after deducting from the gross revenue of the Radio Company from all sources (except as hereinafter mentioned) the aggregate amount of all terminal and transit charges payable to Government and other administrations and Telegraph Companies, Royalty payable to the Government of India, and all ordinary expenses in connection with the entire undertaking properly chargeable to revenue and depreciation at the usual rates hitherto adopted by the Radio Company but before making any allowance for Income Tax and before placing any sum to Reserve.

Provided—

(1) That the sum of Pounds ninety thousand sterling payable under sub-clause (*a*) of this clause shall be treated for the purpose of this clause as an ordinary expense in connection with the undertaking properly chargeable to Revenue.

(2) That if Government shall levy from the Radio Company Income Tax on the half share of the net profits payable to the Communications Company under sub-clause (*b*) of this clause the Radio Company shall be entitled to deduct the amount of the tax so levied and paid from the share of the Communications Company in the net profits of the Radio Company before payment of that share to the Communications Company.

(3) That in ascertaining the annual gross revenue of the Radio Company from all sources income derived from investments made by the Radio Company by way of Reserve Fund or any other fund established out of profits shall be excluded from such Revenue.

(4) That all accounts shall be kept and payments made in Rupees except the said sum of Pounds ninety thousand which shall be payable and paid in sterling."

There were a number of other provisions of which the following are the most important for the present purpose.

By clause 6 the Communications Company guaranteed that the plant referred to in clause 3 thereof should be handed over in good working order to the satisfaction of the chief engineer of the appellant company.

By clause 7 (*a*) the Communications Company undertook

> " so to uphold and maintain the Communications including cables, land lines and radio services from time to time belonging to it outside India, and shore ends and cable connections therefrom to the cable offices in Bombay and Madras, as to keep its system in good working order and up to the standard of efficiency required for fast communications, Act of God, Governments and peoples, civil commotions, strikes and lockouts alone excepted."

(*b*) The Communications Company were

> " to permit [the appellant Company] to receive and retain the total receipts derived from the cable and wireless traffic emanating in India, less rebates and outpayments to other administrations and companies, save and except receipts derived from cable traffic for the Persian Gulf and Iraq only, entrusted to the Communications Company by the Indian Government Telegraph Department at Karachi."

By (*d*) the parties agreed that during the period of the agreement there should be the closest co-operation between them in the conduct of the business of their respective undertakings in so far as they related to communications with and through India and so also that the control of the said business of wireless in India and of the combined undertaking in India (exclusive as aforesaid) should be conducted by the appellant company free from interference by the Communications Company.

By (*e*) if during the period of this agreement the appellant company should duly perform and observe the stipulations on its part herein contained the Communications Company would allow the appellant company for the purposes of the agreement to use, hold and enjoy the plant and other premises delivered and transferred to it by the Communications Company free from any interference or disturbance by or on behalf of the Communications Company: provided however that if any of the said plant or premises should become unnecessary for the purpose of the cable business to be carried on by the appellant company, that company would hold and dispose of the same under the directions and on behalf of the Communications Company.

There followed provisions imposing on the appellant company obligations to carry on the business in India of the combined undertaking to the best possible advantage, to maintain the plant transferred to it in satisfactory condition and repair, to renew the plant when necessary, to insure, and to hand over the same and any renewals to the Communications Company in satisfactory condition and repair at the determination of the agreement. The appellant company was to permit the Communications Company to

receive and retain the total receipts derived from the cable and wireless traffic of the Communications Company and its subsidiaries, including the combined undertaking, emanating at any place outside of India and also the receipts derived from cable and wireless traffic for the Persian Gulf and Iraq entrusted to the Communications Company by the Indian Government Telegraph Department at Karachi, less refunds, rebates to Governments and out-payments to other administrations and companies.

Clause 11 provided that the Communications Company should forthwith after the appointed date execute in favour of the appellant company (*a*) an underlease of certain premises whereof the Communications Company were the lessees, for a term expiring on the 31st December, 1944, and at a rent equal to that payable under the lease held by the Communications Company, and (*b*) a lease of certain premises at Madras whereof the Communications Company were the owners for a term expiring on the said 31st December, 1944, at a nominal rent, the said underlease and lease to contain clauses enabling the Communications Company to re-enter upon the premises the subject thereof upon the termination of the said agreement.

In pursuance of the agreement possession of the plant and premises of the combined undertaking was given to the appellants.

For the year 1933-34 ended the 31st March, 1934, the appellants were assessed by the Income-tax Officer of the Companies Circle, Bombay, to income-tax on a total income of Rs.18,86,366 derived from business and securities. The only question now in dispute with regard to the assessment is whether in computing the profits of the appellants' business the appellants were entitled to deduct the sum payable to the Communications Company under clause 5 (*b*) of the agreement, namely one-half of the net profits of the appellants for the financial year in question, which was stated to amount to Rs.3,35,861. (The deduction of the £90,000 payable under clause 5 (*a*) was allowed.)

The Income-tax Officer having refused to allow the said payment as a deduction, the appellants appealed to the Assistant Commissioner of Income-tax, who by his order dated the 22nd February, 1934, held that the said deduction had been correctly disallowed.

The appellants thereupon required the Commissioner of Income-tax to draw up a statement of the Case and refer it with his opinion thereon to the High Court of Judicature at Bombay. The question above set out was accordingly referred to the High Court. The learned Judges held that the question so referred must be answered in the negative. In that Court as before their Lordships, the contention was that the one-half of the net profits of the appellants for the year in question was in the nature of rent payable under the agreement for the right to use the plant of the Communications Company in connexion with the cable business in India of the combined undertaking. The Chief Justice and Ragnekar J. declined to accept that contention.

Their Lordships have had the advantage of a learned argument on behalf of the appellants; but they have found themselves unable to come to a conclusion different from that of the High Court. It may be admitted that, as Mr. Latter contended, it is not universally true to say that a payment the making of which is conditional on profits being earned cannot properly be described as an expenditure incurred for the purpose of earning such profits. The typical exception is that of a payment to a director or a manager of a commission on the profits of a company. It may, however, be worth pointing out that an apparent difficulty here is really caused by using the word "profits" in more than one sense. If a company having made an apparent net profit of £10,000 has then to pay £1,000 to directors or managers as the contractual recompense for their services during the year, it is plain that the real net profit is only £9,000. A contract to pay a commission at 10 per cent. on the net profits of the year must necessarily be held to mean on the net profits before the deduction of the commission, that is, in the case supposed, a commission on the £10,000.

Their Lordships do not think that there is in the present case any sufficient ground for holding that the sum in question is of the nature of a rent. It is neither described as a rent, nor does the agreement contain several of the clauses which a lease of plant of such a character would naturally contain. Circumstances of greater importance are that the sum payable may be small or great or nothing—a most unusual feature in the case of rent—and that it is impossible to presume or infer that the half share of profits is being paid only as rent, or as a similar payment, in consideration merely of the use of the plant the subject of the licence in clause 3 of the agreement. The sum is in truth made payable as part of the consideration in respect of a number of different advantages which the appellants derive from the agreement and not all of them can be shown to be of a purely temporary character. The agreement as a whole is much more like one for a joint adventure for a term of years between the appellant company and the Communications Company than one for a lease for that period. Speaking generally, receipts in respect of business emanating from abroad are to be retained by the Communications Company while receipts arising in India are to be retained by the appellants and that irrespective of whether the messages are sent by cable or by wireless; and the net profits of the appellant company are to be divided. Nor is it wholly immaterial to note that at the date of the agreement the appellant company was, and that it apparently still is, in some measure controlled by the Communications Company.

Their Lordships recognise the difficulty which may often exist in deciding whether expenditure not in the nature of capital expenditure has been incurred solely for the purpose of making or earning "income, profits or gains," and they agree that it may be impossible to formulate a test

which will always suffice to discriminate between the expenditure which is and which is not allowable for the purpose of income tax; but in the present case they have little hesitation in coming to the conclusion that the proposed deduction is not allowable. To avoid misconception it is proper to say that in coming to this conclusion they have not taken the view that the case is governed by the decision in the *Pondicherry Railway Co., Ltd.* v. *Commissioner of Income Tax, Madras* (1931) L.R. 58, I.A. 239, though that case no doubt throws light on the nature of the problem which has to be solved in the present case. It should perhaps be added that a sentence in the judgment in that case has been explained, if explanation was necessary, by Lord Macmillan in the subsequent case of *W. H. E. Adamson* v. *The Union Cold Storage Company,* 16 Tax Cas. 293, at pp. 331-2.

For the reasons above stated their Lordships will humbly advise His Majesty that the appeal should be dismissed with costs.

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In the Privy Council

THE INDIAN RADIO AND CABLE COMMUNICATIONS COMPANY, LIMITED

v.

THE COMMISSIONER OF INCOME TAX, BOMBAY PRESIDENCY AND ADEN

DELIVERED BY LORD MAUGHAM

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