1964

April 17

THE COMMISSIONER OF INCOME-TAX, MADHYA PRADESH, NAGPUR

v.

SWADESHI COTTON AND FLOUR MILLS

[K. SUBBA RAO, J.C. SHAH AND S. M. SIKRI, JJ.]

Income Tax—Deduction of bonus—Bonus relating to 1947 *paid in* 1949*—Claim for deduction for account year* 1949*—System of accounting by assessee—Principle of reopening of accounts—If applicable—Indian Income-tax Act*, 1922 (11 *of* 1922), *ss.* 10(2)(x), 10(5).

The respondent company paid to its employees Rs. 1,08,325/- as bonus for the year 1947 in the calendar year 1949, as a result of the award of the Industrial Tribunal dated January 13, 1949. This amount was debited by the company in its profit and loss account for the year 1948 and the corresponding credit was given to the bonus payable account. The books for 1948 were not closed till the date of the award of the Industrial Tribunal. For the relevant assessment year, 1950-51, the company claimed that under s. 10(2)(x) of the Indian Income-tax Act, 1922, it was entitled to an allowance in respect of the amount paid as bonus, but the claim was rejected by the Income-tax authorities on the ground that according to the mercantile system of accounting which was followed by the assessee the year to which the liability was properly attributable was the calendar year 1947 and not 1949. It was the case of the Income-tax authorities that it was a legal liability of the assessee which arose in 1947 and should have been estimated and put into the accounts for 1947, and that, if necessary, the amounts for the year 1947 should be reopened. It was admitted that the bonus in the instant case was a profit bonus.

Held: (i) It was only when the claim to profit bonus, if made, was settled amicably or by industrial adjudication that a liability was incurred by the employer, who followed the mercantile system, within s. 10(2)(x), read with s. 10(5), of the Indian Income-tax Act, 1922; and as it was only in 1949 that the claim to profit bonus was settled by an award of the Industrial Tribunal, the only year the liability could be properly attributed to was 1949.

(ii) The system of reopening accounts was not applicable under the scheme of the Indian Income-tax Act.

(iii) The words "year in question" in proviso (b) to s. 10 (2)(x) of the Act meant "year in respect of which bonus was paid".

CIVIL APPELLATE JURISDICTION: Civil Appeal No. 587 of 1963. Appeal by special leave from the judgment and order dated November 30, 1960 of the Madhya Pradesh High Court, in Miscellaneous Civil Case No. 73 of 1960.

K. N. Rajagopal Sastri and *R. N. Sachthey*, for the appellant.

S. K. Kapoor, S. Murty and *K. K. Jain*, for the respondent.

April 17, 1964. The judgment of the Court was delivered by

SIKRI, J.—The respondent, Swadeshi Cotton & Flour Mills, hereinafter referred to as the assessee, is a limited company which owns and runs a textile mill at Indore. For the assessment year 1950-51 (accounting year calendar year 1949), which was its first year of assessment under the Indian Income-tax Act, 1922 (hereinafter referred to as the Act) it claimed that under s. 10(2)(x) of the Act it was entitled to an allowance in respect of the sum of Rs. 1,08,325/- which it had paid as bonus for the year 1947 in the calendar year 1949, as a result of the award of the Industrial Tribunal, dated January 13, 1949. The claim of the assessee was not accepted by the Income Tax authorities. The Appellate Tribunal held that it was a liability relating to an earlier year and not the year 1949. However, on an application by the assessee it stated a case and referred two questions. We are concerned only with one which reads thus:

> "Whether on the facts and in the circumstances of the case the assessee is entitled to claim a deduction of bonus of Rs. 1,08,325/- relating to the calendar year 1947 in the assessment year 1950-51?

The High Court of Madhya Pradesh answered the question in the affirmative. The appellant, having failed to get a certificate under s. 66A(2) of the Act, obtained special leave from this Court, and that is how the appeal is before us.

The facts and circumstances referred to in the question have been set out in the statement of the case. Unfortunately, the facts are meagre, but since the appellant is content to base his case on a few facts, which will be referred to shortly, it is not necessary to call for a further statement of the case.

The facts, in brief, are as follows. The assessee paid as bonus to its employees the sum of Rs. 1,08,325/9/3 for the calendar year 1947 in terms of an award made on January 13, 1949 under the Industrial Disputes Act. This amount was debited by the assessee in its profit and loss account for the year 1948 and the corresponding credit was given to the bonus payable account. The books for 1948 had not been closed till the date of order of the Industrial Tribunal, January 13, 1949. This bonus was in fact paid to the employees in the calendar year 1949. the relevant assessment year being 1950-51.

The Appellate Assistant Commissioner had further found that upto 1946 when the order for payment of bonus used to be received before the company's accounts for the year were finalised, the amount of bonus used to be in fact

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debited to the profit and loss account of the respective year. This finding is repeated by the Appellate Tribunal in its appellate order.

On these facts the learned counsel for the appellant, Mr. Sastri, contends that according to the mercantile system of accounting, which is followed by the assessee, and on which its profits have been computed for the accounting calendar year 1949, the year to which the liability is properly attributable is the calendar year 1947 and not 1949. He says that it was a legal liability of the assessee which arose in 1947 and should have been estimated and put into the accounts for 1947. In the alternative he has invited us to reopen the accounts for the year 1947, following the practice which, according to him, obtains in England.

In our opinion, the answer to the question must depend on the proper interpretation of s. 10(2)(x), read with s. 10(5), of the Act. These provisions read as follows:—

> "s. 10(2)(x)—Any sum paid to an employee as bonus or commission for services rendered, where such sum would not have been payable to him as profits or dividend if it had not been paid as bonus or commission;
>
> Provided that the amount of the bonus or commission is of a reasonable amount with reference to—
>
> (a) the pay of the employee and the conditions of his service;
>
> (b) the profits of the business, profession or vocation for the year in question; and
>
> (c) the general practice in similar businesses, professions or vocations."
>
> "s. 10(5)—In sub-section (2), "paid" means actually paid or incurred according to the method of accounting upon the basis of which the profits or gains are computed under this section;..."

If we insert the definition of the word 'paid' in sub-cl. (x), it would read as follows:

> "any sum actually paid or incurred according to the method of accounting upon the basis of which the profits or gains are computed under this section, to an employee as bonus..."

As the assessee's profits and gains have been computed according to the mercantile system, the question, using for the time being the terms of the clauses, comes to this:—

> "Has this sum of Rs. 1,08,325/- been incurred by the assessee according to the mercantile system in the calendar year 1947 or 1949?"

At first sight the sentence does not read well, but the meaning of the word 'incur' includes 'to become liable to'. Therefore, the question boils down to:

> "In what year did the liability of this sum of Rs. 1,08,325/- arise, according to the mercantile system?"

The mercantile system of accounting was explained in a judgment of this Court in *Keshav Mills Ltd.* vs. *Commissioner of Income Tax, Bombay*(1) thus:—

> "That system 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."

These observations were quoted with approval in *Calcutta Co. Ltd.* vs. *Commissioner of Income Tax, West Bengal*(2).

On the facts of this case, when did the legal liability arise in respect of the bonus? This depends on the facts of the case and the nature of the bonus awarded in this case. This Court has examined the nature of profit bonus—it is common ground that the bonus with which we are concerned with was a profit bonus—in various cases. It is explained in *Muir Mills* v. *Suti Mills Mazdoor Union*(3) that "there are two conditions which have to be satisfied before a demand for bonus can be justified and they are (1) when wages fall short of the living standard, and (2) the industry makes huge profits part of which are due to the contribution which the workmen make in increasing production. The demand for bonus becomes an industrial claim when either or both these conditions are satisfied."

This matter was again considered in the case of *Associated Cement Co.* v. *Their Workmen*(4). This Court observed:—

> "It is relevant to add that in dealing with the concept of bonus this Court ruled that bonus is neither a gratuitous payment made by the employer to his workmen nor can it be regarded as a deferred wage. According to this decision, where wages fall short of the living standard and the industry makes profit part of which is due to the contribution of labour, a claim for bonus can be legitimately made."

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(1) [1953] S.C.R. 950. (2) [1960] 1 S.C.R. 185.
(3) [1955] 1 S.C.R. 991. (4) [1959] S.C.R. 925.

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In 1961, this Court was able to say that "the right to claim bonus which has been universally recognised by industrial adjudication in cases of employment falling under the said Act has now attained the status of a legal right. Bonus can be claimed as a matter of right provided of course by the application of the Full Bench formula it is shown that for the relevant year the employer has sufficient available surplus in hand." (Vide Gajendragadkar, J., as he then was, in *Workmen* v. *Hercules Insurance Co.*(1).

The *Indian Tea Association* v. *Workmen*(2) this Court held that "the profit bonus can be awarded only by reference to a relevant year and a claim for such bonus has therefore to be made from year to year and has to be settled either amicably between the parties or if a reference is made, it has to be determined by Industrial adjudication. A general claim for the introduction of profit bonus cannot be made or entertained in the form in which it has been done in the present proceedings."

It follows from the above decisions of this Court that:—

(a) workmen are entitled to make a claim to profit bonus if certain conditions are satisfied;

(b) the workmen have to make a claim from year to year;

(c) this claim has either to be settled amicably or by industrial adjudication; and

(d) if there is a loss or if no claim is made, no bonus will be permissible.

In our opinion it is only when the claim to profit bonus, if made, is settled amicably or by industrial adjudication that a liability is incurred by the employer, who follows the mercantile system of accounting, within s. 10(2)(x), read with s. 10(5) of the Act.

On the facts of this case, it is clear that it was only in 1940 that the claim to profit bonus was settled by an award of the Industrial Tribunal. Therefore, the only year the liability can be properly attributed to is 1949, and hence we are of the opinion that the High Court was right in answering the question in favour of the assessee.

The second contention of the learned counsel does not appeal to us. We are of the opinion that this system of reopening accounts does not fit in with the scheme of the Indian Income Tax Act. We have already held in *Commissioner of Income Tax, Madras* v. *A. Gajapathy Naidu, Madras*(3) that as far as receipts are concerned, there can be no reopening

(1) [1961] 2 S.C.R. 995. (2) [1962] Supp. (1) S.C.R. 557.
(3) A.I.R. 1964 S.C. 1653.

of accounts. The same would be the position in respect of expenses. But even in England accounts are not opened in every case. Halsbury gives various instances in footnote (m) at p. 148, Vol. 20. Mr. Sastri has relied on various English cases but it is unnecessary to refer to them as Lord Radcliffe explains the position in England, in *Southern Railway of Peru Ltd.* v. *Owen*[1] thus:

> "The courts have not found it impossible hitherto to make considerable adjustments in the actual fall of receipts or payments in order to arrive at a truer statement of the profits of successive years. After all, that is why income and expenditure accounting is preferred to cash accounting for this purpose. As I understand the matter, the principle that justified the attribution of something that was in fact, received in one year to the profits of an earlier year, as in such cases as *Isaac Holden and Sons* v. *Inland Revenue Comrs.* (1924) 12 Tax Cas. 758 and *Newcastle Breweries Ltd.* v. *Inland Revenue Comrs.* (1927) 12 Tax Cas. 927 was just this, that the payment had been earned by services given in earlier year and, therefore, a true statement of profit required that the year which had borne the burden of the cost should have appropriated to it the benefit of the receipt."

The principle mentioned by Lord Radcliffe would not apply to a profit bonus. As stated above, a profit bonus is strictly not wages, at least not for the purpose of computing liability to income tax; it is not an expense, in the ordinary sense of the term, incurred for the purpose of earning profits. *A fortiori* profits have already been made. It is more like sharing of profits on the basis of a certain formula.

One other point raised by Mr. Sastri remains. He urged that the word "for the year in question" in the proviso to sub-s. 10(2)(x) mean "for the year in which allowance is claimed." We are unable to agree with him. The words 'for the year in question' mean the year in respect which bonus is paid.

In the result, the appeal fails and is dismissed with costs.

Appeal dismissed.

(1) [1957] A.C. 334.