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INDORE MALWA UNITED MILLS LTD., INDORE

v.

STATE OF MADHYA BHARAT AND OTHERS

October 1, 1964

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(K. SUBBA RAO, J. C. SHAH AND S. M. SIKRI, JJ.)

Indore Industrial Tax Rules, 1927, *s.* 3—*Large amounts borrowed by Managing Agents from outsiders on behalf of the company and invested with themselves—Managing Agents authorised by company resolution to do so—Debt not paid back by Managing Agents claimed as bad debt by company—Whether allowable as trade loss—Indian Income-tax Act*, 1922, *s.* 10(2).

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The appellant company which carried on the business of manufacturing textiles was allowed by its Memorandum of Association to borrow money for the purpose of its business and to invest it *inter alia* in loans to others. Its Board of Directors passed a resolution to the effect that the company would invest its surplus funds in current account with the Managing Agents on interest. The Managing Agents borrowed large sums from outsiders, entered the borrowings in the books of the company and invested large

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sum with themselves in current account. Before the Annual General Meeting they would bring back the money into the company's accounts to satisfy the General Body that they had paid off their debts, and afterwards would again withdraw large sums for their own purposes. In 1933 the Managing Agents' company went into liquidation and a large debt was due from them to the company. In 1941 the debt having been found to be irrecoverable, the appellant company claimed it as a bad debt and

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trading loss for the purpose of computing its income under the Indore Industrial Tax Rules, 1927, the provisions of which, in this regard, were similar to those of the Indian Income-tax Act, 1922. The assessing authority did not allow the claim, nor did the Appellate Authority. The High Court also held that the losses incurred by the company were really *dehors* the business of the company. The company thereupon appealed to the Supreme Court.

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It was contended on behalf of the appellant that the employment of the Managing Agents was incidental to the carrying on of the appellant's business, that, as the Managing Agents had the power to borrow funds for the appellant company and invest the surplus in loans to themselves, the loss caused by such investment was also incidental to the carrying on the appellant's business, and therefore the said loss was deductible in arriving at the trading profits of the company.

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HELD : The appeal must be allowed.

The Managing Agents had borrowed the money from outsiders and invested it with themselves in accordance with the company's resolution. The money borrowed from outsiders became part of the funds of the company, and the creditors could have sued the company for it. Similarly the company could have sued the Managing Agents for the sums invested with them. Both the borrowing by the company and the investment with the Managing Agents created legal obligations. Appropriate entries were

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made in the company's accounts in accordance with commercial practice. The amounts invested with the Managing Agents were entered as debts which became bad debts on becoming irrecoverable. In the circumstances the loss arising from the bad debts was incidental to the appellant's business

and deductible in computing the profits of the appellant company for the assessment year in question. [563 F-H; 564 B-E]. A

Badridas Daga v. *Commissioner of Income-tax*, [1959] S.C.R. 690 and *Commissioner of Income-tax, U.P.* v. *M/s. Nainital Bank Ltd.*, [1965] 1 S.C.R. 340.

CIVIL APPELLATE JURISDICTION : Civil Appeal No. 1013 of 1963. B

Appeal from the judgment dated November 9, 1960, of the Madhya Pradesh High Court in Civil Miscellaneous Appeal No. 40 of 1955.

A. V. Viswanatha Sastri and *Rameshwar Nath*, for the appellant. C

B. Sen, Balwan Singh Johar and *I. N. Shroff*, for the respondents.

The Judgment of the Court was delivered by

Subba Rao J. This appeal by certificate preferred against D the order of the High Court of Madhya Pradesh, Indore Bench, raises the question whether an item of Rs. 42,63,090-14-7 should have been allowed as a trading loss in computing the profits of the appellant-company under s. 3 of the Indore Industrial Tax Rules, 1927.

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The facts may be briefly stated. The appellant, Indore Malwa United Mills Ltd., is a public limited company incorporated and registered under the Indore Companies Act, 1914. Since the incorporation it has been carrying on business of manufacturing cloth. Under the Memorandum of Association of the said company, for the purpose of the textile business it was authorized to F raise or borrow money from time to time and to invest its funds, *inter alia*, in loans to others. For the purpose of carrying on the business, the appellant-company originally appointed M/s. Karimbhai Ibrahim & Co. Ltd. as its Managing Agents. On June 8, 1926, the Board of Directors of the appellant-company passed a resolution to the following effect : G

> "Resolved that Surplus Fund of the company be invested with the agents in current account with the company at the same rate of interest *viz.*, 6% "

On November 28, 1929, the appellant-company entered into an agreement with M/s. Karimbhai Ibrahim & Sons Ltd. where- H under they were appointed as the Managing Agents of the appellant-company in place of M/s. Karimbhai Ibrahim & Co. Ltd.

A On July 19, 1932, the Board of Directors reaffirmed the resolution of June 8, 1926. Pursuant to the power conferred on the Managing Agents under the said agency agreement and the said resolution, Karimbhai Ibrahim & Sons Ltd. borrowed large sums of money from outsiders, entered them in the appellant-company's accounts and invested large sums with themselves "in current B account with the company" in terms of the said resolution and utilized the same for their own purposes. Before the Annual General Body Meeting they used to bring large amounts into the accounts of the company and show that they had paid off their debts. After satisfying the General Body they would again withdraw large sums for their purposes. The General Body C was also aware of the loans and indeed it approved the said transactions. In the year 1933 the Managing Agency company went into liquidation. For the assessment year 1941, the appellant-company submitted its return of income and claimed thereunder a deduction, among other items, a sum of Rs. 49,13,316 under the head of bad debt and trading loss written off in the D profits and loss account of the appellant-company—we are only concerned in this appeal with this item and, therefore, it is not necessary to notice any other particulars of the assessment. The Assessing Authority allowed only Rs. 6,41,913-2-0 as bad debt and disallowed the amount due from Karimbhai Ibrahim & Sons E Ltd. on the ground that the said borrowings were not made for the purpose of the business of the company. On appeal the Appellate Authority also took the same view. On further appeal, the High Court confirmed the finding of the Appellate Authority on the ground that the losses incurred by the company were really *dehors* the business of the company, though they might F involve fraudulent conduct of the Managing Agents. Hence the present appeal.

Mr. A. V. Viswanatha Sastri, learned counsel for the appellant, contended that the employment of the Managing Agents was incidental to the carrying on of the appellant's business, that, G as the Managing Agents had the power to borrow funds for the appellant-company and invest the surplus in loans to themselves the loss caused by such investment was also incidental to the carrying on of the appellant's business and, therefore, the said loss was deductible in arriving at the trading profits of the appellant-company.

H Mr. Sen, learned counsel for the respondents, raised before us two contentions, namely, (1) the assessment in question was made under the Indore Industrial Tax Rules, 1927, that under

the said Rules tax was payable only in respect of the profits or gains of any cotton mill industry and that profits or loss pertaining to the money-lending activity of the appellant-company could not possibly be subject to tax or deduction under the said Rules; and (2) the debt due by the Managing Agents was not a trading debt inasmuch as the Managing Agents borrowed moneys not necessary for the business of the appellant-company and lent to themselves the said amount and, therefore, it was a loss incurred by the appellant *dehors* the business of the company.

The first question raised by Mr. Sen is based upon the distinction between the Indore Industrial Tax Rules and the corresponding provisions of the Indian Income-tax Act. It is said that the Indore Industrial Tax Rules are only concerned with the cotton mill industry and the tax payable thereunder is in respect of the said industry, while under the Income-tax Act the tax is payable in respect of the income of the business of the assessee. But a perusal of the proceedings during all the stages does not disclose that any such argument was advanced at any time. Assuming that the contention was correct, if it had been raised before, the assessee might have been in a position to establish by relevant evidence that the particular amount borrowed by the Managing Agents was from and out of the amounts borrowed for the purpose of the said industry. We cannot allow a question which at its best is a mixed question of fact and law to be raised for the first time before us. We do not propose to express our opinion on the same one way or other. We shall proceed with the appeal on the basis that for the purpose of deducting trading losses in computing trading profits there is no difference between the Income-tax Act and the relevant Indore Industrial Tax Rules.

The only question, therefore, is whether the loss claimed in the present case was a trading loss which is deductible in computing the profits of the company. The relevant principle of law has been laid down by this Court in *Badridas Daga* v. *Commissioner of Income-tax*(1). There, after considering the relevant decisions on the subject, this Court laid down the following test:

> "The result is that when a claim is made for a deduction for which there is no specific provision in s. 10(2), whether it is admissible or not will depend on whether, having regard to accepted commercial practice and trading principles, it can be said to arise out of the carrying on of the business and to be incidental.

(1) [1959] S.C.R. 690, 695.

A to it. If that is established, then the deduction must be allowed, provided of course there is no prohibition against it, express or implied, in the Act."

Where an agent employed by the appellant for the purpose of carrying on his business in exercise of the powers conferred on him operated on the bank accounts, withdrew moneys from it B and used them for discharging his personal debts, this Court in the said decision found no difficulty in holding that the amount misappropriated and found irrecoverable was an allowable deduction under the Income-tax Act. The only difference between that case and the present one is that the Agent misappropriated C the amount in that case, whereas in the present case the Managing Agents in exercise of the powers conferred by the appellant borrowed the moneys, but failed to return the same. If embezzlement of moneys entrusted to an agent is incidental to a business, by the same token moneys legally utilized by the agent must more appropriately be incidental to the business. In a D recent decision in *The Commissioner of Income-tax, U.P.* v. *M/s. Nainital Bank Ltd.*(1) this Court held that an amount lost to the bank by dacoity was a loss incidental to the business of banking. There, in the course of the business large amounts were kept in the bank premises, and this Court held that the risk of loss by dacoity was incidental to a banking business. If E that be so, the fact that the Managing Agents brought into the company's till larger amounts than the company's business demanded at a particular point of time would not make the borrowings or the lending of money to themselves any the less incidental to the sanctioned business operations.

F The question is not whether the Managing Agents committed a fraud on the company, but whether the amounts borrowed were the funds of the company. If the creditors had filed a suit against the company, could it have resisted the suit on the ground that the Managing Agents had no power to borrow the amounts for the reason that at the time they borrowed, the amounts were G in excess of the requirements of the business? Decidedly not. There would not have been any defence to such a suit. After the borrowing the money became the company's money. That apart, there was no question of fraud in this case, for the profit and loss account and the balance sheet placed before the General Body Meeting of the Company every year brought to its notice H the total amount the company borrowed through the Managing Agents and the General Body approved of it. The only fraud,

(1) [1965] 1 S.C.R. 340.

if any, consisted in the practice followed by the Managing Agents in bringing into the accounts of the company the entire amount lent to them in order to satisfy the shareholders that nothing was going wrong. A

The next step is the borrowing of money by the Managing Agents from the company. Under the memorandum of association as well as under the express power conferred by the said resolution, the company, through the Managing Agents, could invest its funds by way of loans. If there was no mishap the Managing Agents would have paid the entire amount and if they did not, the company could have recovered the entire amount from them. The result, therefore, was that both the borrowing by the Managing Agents on behalf of the company from third parties and the lending to themselves created legal obligations. They were obligations created in the course of the business. The money lent would be a debit item in the accounts of the company in accordance with the accepted commercial practice and if the amount was realized it would be a credit item. Both would be proper items of accounts for ascertaining the profit and loss of the company. If the debt became irrecoverable, it would be a bad debt. B C D

We, therefore, find no difficulty in holding that the said debt which had become irrecoverable was a trading loss deductible in computing the profit of the appellant-company in the assessment year. It was a loss incidental to the appellant's business and is certainly sanctioned by commercial practice and trading principles. We, therefore, hold that the High Court went wrong in holding that the said amount represented loss incurred by the appellant *dehors* its business. E F

In the result, the appeal is allowed. The appellant will have its costs here and in the High Court.

Appeal allowed.