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view of the circumstances of the case, there will be no order as to costs.

G. D. KHOSLA, C.J.—I agree.

SHAMSHER BAHADUR, J.—I also agree.

B. R. T.

CIVIL MISCELLANEOUS

Before G. D. Khosla, C.J., and Tek Chand, J.

THE COMMISSIONER OF INCOME-TAX, SIMLA,—*Appellant*

versus

M/s KASHMIRI MAL-VASDEV, SIMLA,—*Respondent.*

Income Tax Reference No. 28 of 1953.

1959

Dec., 24th

Indian Income Tax Act (XI of 1922)—Sections 3 and 4(3)(vii)—Compensation received on account of cancellation of liquor contract—Whether revenue receipt or capital receipt—tests to determine.

The assessee-firm had advanced Rs. 1,25,000 to Koti Darbar out of which Rs. 80,000 had been repaid. With a view to liquidate its liability for the balance amount, Koti Darbar gave two liquor contracts for two years to the assessee. These contracts were, however, soon after cancelled by the Political Department of the Government of India. The assessee filed a suit for the balance amount of Rs. 48,000 and damages amounting to Rs. 50,000 resulting from the cancellation of the contracts. Koti Darbar paid Rs. 48,000 on account of the balance and the claim for damages including interest and costs was compromised at Rs. 40,000 which amount was paid in full settlement of the claim of the assessee. The Appellate Assistant Commissioner held that Rs. 15,040 out of Rs. 40,000 were on account of compensation for cancellation of the contracts and that this amount was assessable as revenue receipt. The Income-tax Appellate Tribunal held that the amount of Rs. 15,040 on account of compensation was in the

nature of capital receipt and not assessable. At the instance of the Commissioner of Income-tax, the Tribunal referred the following point of law to the High Court:—

> "On the facts and in the circumstances of the case, was the Tribunal right in holding that the amount of Rs. 15,040 represented compensation for loss of business and was a receipt of capital nature?"

Held, that the test for determining on which side of the line a receipt is to fall is whether the sum in question was paid to the assessee in *the ordinary course of business.* The other test is whether on the cancellation of an agreement the whole trade of the assessee had for all practical purposes become extinct and the payment to the assessee represented the loss of a fundamental asset.

Held, that in the present case the sum received by the assessee was not in the ordinary course of business. The assessee's business of liquor contracts, if it had materialized, would have been in the nature of an apparatus leading to business rather than as the business itself. If, however, taking of a liquor contract had been in the ordinary course of business of the assessee, then the receipt would have formed a part of the business itself and would have been in the nature of a trading receipt. The emphasis, therefore, is to be laid on the fact whether the contract was entered into in the ordinary course of business and if so then alone the termination of such a contract could be termed a revenue receipt. Whether such a contract has the character of a capital asset in the hands of an assessee would, therefore, depend on the test whether it was in the nature of a capital asset in the hands of the assessee or it was only a part of his stock-in-trade. The assessee in this case was prevented from carrying on the business of liquor contract by an external authority in the exercise of a paramount power and the injury inflicted was on the capital asset itself and not on any stock-in-trade. A capital receipt is not taxable as the compensation is received "for sterilising the asset from which otherwise profit might have been obtained." In this case the compensation which was paid by Koti Darbar and received

by the assessee, was owing to the destruction of the assets which formed a fixed, as opposed to circulating capital. The liquor contracts were the vehicles by means of which the assessee could enter into that business. The compensation recevied by the assessee was for loss of business and was a receipt of capital nature.

Question referred answered in the affirmative.

Income-tax reference under section 66(2) of the Income-Tax Act, made by Mr. Sahgal and Mr. Bhavnani, Income-tax Appellate Tribunal, Delhi Bench, on 14th October, 1953, for decision of the following question of law:—

> *"On the facts and in the circumstances of the case, was the Tribunal right in holding that the amount of Rs. 15,040, represented compensation for loss of business and was a receipt of capital nature ?"*

S. M. SIKRI, ADVOCATE-GENERAL, AND H. R. MAHAJAN, for Appellant.

B. R. TULI, GANGA PARSHAD JAIN AND PREM CHAND JAIN, for Respondent.

JUDGMENT

k Chand, J. TEK CHAND, J.—This is a reference under section 66(2) of the Income-tax Act and the question of law formulated by this Court which arises from the order of the Income-tax Appellate Tribunal, Delhi Bench, is as under:—

> "On the facts and in the circumstances of the case, was the Tribunal right in holding that the amount of Rs. 15,040 represented compensation for loss of business and was a receipt of capital nature?"

The relevant facts leading to this reference are that the assessee-firm had advanced a sum of Rs. 1,25,000 to Koti Darbar in 1938. The assessee

had recovered a sum of Rs. 80,000 and in September, 1943, when the accounts were gone into a balance of Rs. 48,000 was still due from Koti Darbar. Koti Darbar, with a view to liquidate its liability, gave two liquor contracts for two years to the assessee-firm in full settlement of its claim, but soon after these contracts were cancelled by the Political Department of the Government of India. The assessee, in 1945, filed a suit for the recovery of the balance of the debt amounting to Rs. 48,000 and further for the recovery of Rs. 50,000 on account of damages resulting from the cancellation of the liquor contracts. The last claim included interest on the loan advanced. In the meanwhile, a sum of Rs. 48,000 had been realised by the assessee. On 10th of April, 1948, the suit as compromised and the Rana of Koti agreed to pay a sum of Rs. 40,000 in full settlement of the assessee's claim on account of interest, litigation expenses and compensation for the cancellation of the contracts.

The Income-tax Officer, Simla, when scrutinising the accounts of the assessee firm for the year 1949-50, held that out of Rs. 40,000 received by the assessee, Rs. 28,000 were taxable, being compensation for cancellation of the liquor contracts. On appeal, the Appellate Assistant Commissioner found that only Rs. 15,040 should be treated as compensation and not the balance. The Income tax Appellate Tribunal, while allowing the appeal *pro tanto* observed—

> "It seems to us that upon the findings recorded by the Appellate Assistant Commissioner, the sum of Rs. 15,040 cannot be considered to be income, profits and gains taxable under the provisions of the Income-tax Act. This sum

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represents compensation pure and simple for loss of business by running which the assessee expected to make huge profits. Since the business itself went out of existence, any amount received as compensation for the loss thereof, is a receipt in the nature of a capital receipt."

Feeling dissatisfied from the order of the Tribunal the Commissioner of Income-tax, Punjab made an application to the High Court under section 66(2) of the Income-tax Act and in compliance with the order of the High Court, the question of law referred to above was formulated.

The sole question that arises in this case is whether Rs. 15,040 was a capital receipt or a revenue receipt for purposes of taxibility, the controversy between the parties being whether this amount which was received as a compensation on account of cancellation of the liquor contracts, was liable to suffer taxation.

Mr Sikri, on behalf of the Commissioner of Income-tax, has placed reliance in the main upon two decisions of the Supreme Court reported in *Commissioner of Income-tax, Nagpur* v. *Rai Bahadur Jairam Valji and others* (1), and *Commissioner of Income-tax and Excess Profits Tax, Madras* v. *South India Pictures Ltd.* (2), in which the case law was reviewed. The facts of the former decision are, that in 1935, Bengal Iron Company had entered into an agreement with the respondent (assessee) who had been supplying limestone and dolomite to the company since 1920. The B. I. Company had gone into liquidation and its assets and liabilities were taken over by another

(1) (1959) 35 I.T.R. 148
(2) (1956) 29 I.T.R. 910

company called the Indian Iron and Steel Company which continued to purchase limestone and dolomite from the respondent for some time but later on informed the respondent of its decision to purchase its requirements from elsewhere. The respondent instituted a suit against the I.I.S. Company for the specific performance of the contract and for an injunction restraining the company from purchasing limestone and dolomite from any other person than the respondent. In 1940, the respondent and the company compromised their dispute. Owing to difficulties in the enforcement of this agreement, a fresh agreement was entered into in 1941 and according to one of its terms the company undertook to pay a sum of Rs. 2,50,000 to the respondent as solatium besides monthly instalments of Rs. 40,000. Pursuant to this agreement, the respondent received a sum of Rs. 2,50,000 as well as the balance due towards the monthly instalments. The question which was raised in that case was whether the sum of Rs. 2,50,000 received by the respondent was capital or revenue in his hands. The Supreme Court held that this was a revenue receipt and was, therefore, chargeable to tax, and could not be held to be a capital receipt. The Supreme Court observed that the sum of Rs. 2,50,000 which was admittedly paid as solatium for cancellation of the contract, represented the profit which the respondent could have made had the contract been performed and for this reason it was a revenue receipt. The following observations of Rowlatt., J., made in the case of *Commissioner of Inland Revenue* v. *Northfleet Coal and Ballast Co. Ltd.* (1), were cited with approval.

> "If the contract had gone forward those sums would have come into profits

(1) (1927) 12 Tax Cas. 1102

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every year and now that they are represented by a commutation, so far as that is concerned, the point seems to be concluded by *Short's* case. * * *

These contracts are not being sold. They are not being even extinguished really for this purpese. What is happening is that the profits under them are being taken; something is being taken in respect of the profits of them. That is the position. This sum represents the profits of the company on the contracts, treating them as contracts which notionally have earned or are going to earn a profit."

The Supreme Court also relied upon observations made in *Jesse Robinson and Sons* v. *Commissioner of Inland Revenue* (1). In that case, the appellant had entered into two contracts for the sale of yarn. The purchaser had cancelled the contract and had paid £ 12,500 in settlement of the claims. The contention of the appellant was that this payment was not a trading receipt or profit arising from his trade. In rejecting this contention, Rowlatt, J., had said—

"It seems to me that there is no reason why the sum received in that respect for breach of contract is not a sum which is part of the receipts of the business for which that contract was made."

In the case of *Short Brothers Limited* v. *Commissioner of Inland Revenue* (2), the appellant company was carrying on the business of shipbuilders and had entered into a contract to build two steamers and later on this contract was cancelled and the appellant company was paid by way

(1) (1929) 12 Tax Cas. 1241
(2) (1927) 12 Tax Cas. 955

of compensation as sum of £ 100,000. The question was whether this was a capital or a revenue receipt. It was held that being a receipt in a going concern, it was not a capital receipt and the assessee was liable to be taxed. The Court of appeal affirmed this view on the ground that the payment of £ 100,000 in settlement of the rights under the contract was an adjustment made between the parties in the ordinary course of business. The following observations of the Supreme Court are to the point for purposes of finding an answer to the question referred:—

> "In our opinion, therefore, when once it is found that a contract was entered into in the ordinary course of business, any compensation received for its termination would be a revenue receipt, irrespective of whether its performance was to consist of a single act or a series of acts spread over a period, and in this respect, it differs from an agency agreement. (page 163). * * *
>
> It is, however, unnecessary to further elaborate this point, as we are concerned in this appeal, not with an agency agreement but with a contract entered into in the ordinary course of business, and, in our judgment, compensation received on account of such a contract must be held to be a revenue receipt. (page 164)."

In the other case decided by the Supreme Court, *Commissioner of Income-tax and Excess Profits Tax, Madras* v. *South India Pictures Ltd.* (1), certain agreements which had been entered into by the assessee who was carrying on the business of distribution of films, were cancelled

(1) (1956) 29 I.T.R. 910

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by the producers who were the other contracting party and in lieu thereof an aggregate sum of Rs. 26,000 was paid to the assessee as compensation towards commission. It was held by majority that the sum paid to the assessee was not compensation for not carrying on its business but was a sum paid in the ordinary course of business, and the amount paid to the assessee was by way of compensation for the loss of commission which would have been earned had the agreements not been terminated. As the sum received by the assessee was not towards the price of any capital assets sold or surrendered or destroyed but in the course of its going distributing agency business it was held to be an income receipt.

In *Vaughan* v. *Archie Parnell and Alfred Zeitlin Ltd.* (1), the assessee had brought an action for damages for breach of the agreement and was awarded £ 5,000as damages. It was held that the measure of the damages was really the loss of profit which the assessee company suffered by the breach of contract and accordingly it was rightly included in its assessable income.

Mr. Sikri for the appellant argues that the assessee had not set up any profit-making apparatus, apart from the business which he was to carry on under the the two liquor contracts, and that the payment in question was made towards adjustment of the rights under the two liquor contracts and, therefore, must be deemed to be a *quid pro quo* for the loss of profits which were expected to be made in carrying out the liquor business if the liquor contracts had not been cancelled and the assessee had been permitted to carry on the business. In such a case if any profits had been made, they would have been liable to be taxed. The next argument was that if the compromise had not been

(1) (1942) 10 I.T.R. 17 (Supp.)

arrived at between the assessee and Rana of Koti, and the assessee's suit had been decreed, the sum of Rs. 50,000 which he would have recovered on account of compensation, could not have escaped the tax. It was also urged that the payment was not in consideration of the sterilization or extinction of the capital which would have yielded profit, but it was profit itself and therefore it could not be treated as a capital accretion.

Before commenting on these arguments, the points made on behalf of the assessee may also be summarised. Mr. B. R. Tuli, learned counsel for the assessee, while relying upon observations made in *The Commissioner of Income-tax, Hyderabad Deccan* v.*Messrs. Vazir Sultan and Sons* (1), and also in the two decisions of the Supreme Court which were cited by Mr. Sikri, *Commissioner of Income-tax Nagpur* v. *Rai Bahadur Jairam Valji and others* (2), and *Commissioner of Income-tax and Excess Profits Tax, Madras* v. *South India Pictures Ltd.* (3), and upon decisions of other Courts referred to in those judgments, has argued that the amount in question was in the nature of a capital accretion and not subject to tax. He contended that the cancellation of liquor contracts was tantamount to destruction of capital making apparatus whereby the entire business came to an end and, therefore, it was loss of capital. He also argued that the liquor contracts were not entered into—in the ordinary course of business—and therefore could not be in the nature of revenue receipt. Whether a particular amount falls in the category of a capital receipt or in that of a revenue receipt, depends on whether it was fixed or a circulating capital.

(1) A.I.R. 1959 S.C. 814
(2) (1959) 35 I.T.R. 148
(3) (1956) 29 I.T.R. 910

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The facts in the case of *The Commissioner of Income-tax, Hyderabad, Deccan* v. *Messrs. Vazir Sultan and Sons* (1), were that the assessee firm had the sole selling agency in respect of certain cigarettes in the Hyderabad State. By a subsequent agreement in 1939 the territory was extended to an area outside the Hyderabad State but by a resolution of the manufacturing company passed in 1950, the second agency in respect of the territory outside the State was cancelled and the assessee firm received a little over rupees two lacs by way of compensation for the termination of the agency. The question arose whether the amount was a revenue receipt and was taxable as such or it was a capital receipt. The majority view was that the agency agreements formed a capital asset of the assessee's business worked or exploited by the assessee by entering into contracts for the sale of the cigarettes manufactured by the company to the various customers and dealers in the respective territories. This asset really formed part of the fixed capital of the assessee's business. It did not constitute the business of the assessee but was the means by which the assessee entered into the business transactions by way of distributing those cigarettes within the respective territories it formed. It, therefore, formed the profit-making apparatus of the assessee's business of distribution of cigarettes and was neither circulating capital nor the assessee's stock-in-trade. Any payment made by way of compensation for terminating or cancelling the business would be in the nature of capital receipt in the hands of the assessee.

The minority Judgment per Kapur, J., was to the effect that compensation for the loss of an agency would be for the loss of a capital asset if the termination of the agency was a damage to the

(1) A.I.R. 1959 S.C. 814

recipient's business structure such as to destroy or materially cripple the whole structure involving serious dislocation of the normal commercial organisation but not if it was merely compensation for the loss of trading profit.

Mr. Tuli has submitted that so far as the bearing of the observations of their Lordships of the Supreme Court are concerned, the principles he is contending for found favour not only with the Hon'ble Judges in majority but also with the Hon'ble Judge who expressed the minority view.

The test for determining on which side of the line a receipt is to fall is whether the sum in question was paid to the assessee in *the ordinary course of business.* The other test is whether on the cancellation of an agreement the whole trade of the assessee had for all practical purposes become extinct and the payment to the assessee represented the loss of a fundamental asset. These two criteria were taken into consideration in the case of *Barr Crombie and Co. Ltd.* v. *Commissioner of Inland Revenue* (1), and in the case of *Van Den Berghas Ltd.* v. *Clark* (2). According to their Lordships of the Supreme Court, if the true character of the agreement was that it brought into existence an arrangement which would enable the assessee to carry on a business and was not itself any business, any payment made for the termination of such an agreement would be a capital receipt. It was argued with justification by Mr. Tuli that the sum received by the assessee on account of the termination of the liquor contracts was not in the ordinary course of business. The assessee's business of liquor contract if it had materialised would have been in the nature of an apparatus leading to business rather than as the business itself. If,

(1) (1945) 26 T.C. 406
(2) (1935) 19 T.C. 390

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however, taking of a liquor contract had been in the ordinary course of business of the assessee, then the receipt would have formed a part of the business itself and would have been in the nature of a trading receipt. The emphasis, therefore, is to be laid on the fact whether the contract was entered into in the ordinary course of business and if so then alone the termination of such a contract could be termed a revenue receipt. Whether such a contract has the character of a capital asset in the hands of an assessee would, therefore, depend on the test whether it was in the nature of a capital esset in the hands of the assessee or it was only a part of his stock-in-trade. The assessee in this case was prevented from carrying on the business of liquor contract by an external authority in the exercise of a paramount power and the injury inflicted was on the capital asset itself and not on any stock-in-trade. A capital receipt is not taxable as the compensation is received, in the words of the House of Lords in the *Glenboig Union Fireclay Co. Ltd.* v. *The Commissioners of Inland Revenue* (1), "for sterilising the asset from which otherwise profit might have been obtained".

In our case, the injury has been inflicted not on any stock-in-trade but on entire capital itself. Taking of liquor contract was no part of the business of the assessee before us. In the earlier Supreme Court case, *Commissioner of Income-tax and Excess Profits Tax, Madras* v. *South India Pictures Ltd.* (2), the distinguishing feature was that the assessee had entered into agency agreements, which had been cancelled, as a part of his ordinary business and therefore the payment in lieu of cancellation could not be constituted a capital but a revenue receipt. The Supreme Court in *The Commissioner of Income-tax, Hyderabad,*

(1) 12 T.C. 427 (465)
(2) (1956) 29 I.T.R. 910=A.I.R. 1956 S.C. 492

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Deccan v. *Messrs. Vazir Sultan and Sons* (1), also pointed out that one has really got to look to the nature of the receipt in the hands of the assessee irrespective of any consideration as to what was actuating the mind of the other party.

There is no doubt that in this case the compensation which was paid by Koti Darbar and received by the assessee, was owing to the destruction of the assets which formed a fixed, as opposed to circulating, capital. The liquor contracts were the vehicles by means of which the assessee could enter into that business. As the entire field has been covered by the above decisions of the Supreme Court, it is not necessary, in order to find an answer to the question referred to us, to review the English decisions which have been considered in great detail by their Lordships. Applying the tests laid down by their Lordships of the Supreme Court, this question must be answered in the affirmative.

We are, therefore, of the view that on the facts and in the circumstances of the case, the Tribunal was right in holding that the amount of Rs. 15,040/ represented compensation for loss of business and was receipt of a capital nature. The contention of the assessee, therefore, prevails and he is entitled to his costs which we assess at Rs. 250.

G. D. Khosla, C. J.— I agree.

G. D. Khosla, C. J.

R.S.

APPELLATE CIVIL

Before G. D. Khosla, C. J., and Tek Chand, J.

JARNAIL SINGH AND ANOTHER,—*Appellants*

versus

BAKHSHI SINGH AND ANOTHER,—*Respondents.*

Letters Patent Appeal No. 132/A of 1958.

1959

Dec., 24th

Companies Act (I of 1956)—Section 3(I)(iii)—Private Company—Article prohibiting transfer of shares except to

(1) A.I.R. 1959 S.C. 814