

COMMISSIONER OF INCOME TAX, MADRAS

v.

MESSRS. BEST & CO.

November 2, 1965

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

*Income-tax Act (11 of 1922), s. 10—Assessee a multi-agency concern—One of the agencies terminated with a restrictive covenant not to carry on business—Compensation, whether capital or revenue receipt.*

The respondent was a multi-agency concern. The principal of one of the agencies terminated that agency and paid the respondent certain amounts. When the amounts were sought to be assessed to income-tax, the respondent objected on the ground that the amounts represented only compensation received for termination of the agency business and as consideration for the restrictive covenant not to do business in the same line for a prescribed period. The Income-tax Officer, the Appellate Assistant Commissioner and the Appellate Tribunal held against the respondent, but the High Court on a reference, held that by the termination of the agency, the respondent lost an earning asset and that the compensation paid for the destruction of such an asset was a capital receipt not liable to tax.

In appeal to this Court,

HELD : While the income-tax authorities have to gather the relevant material to establish that the compensation given for the loss of the agency was a taxable income, an adverse inference could be drawn against the assessee if he had not produced evidence which was in his exclusive knowledge and keeping. The respondent gave up one of its innumerable agencies in different lines without any protest presumably because it was in the normal course of its business, and continued to do business without any mishap. It did not place any material before the Department to establish the relative importance of the said agency in the frame work of the earning apparatus of its business. The loss of the agency would therefore only be a normal trading loss, and the amount of compensation attributable to it would be a revenue receipt assessable under s. 10 of the Income-tax Act, 1922. [486 H; 487 A, C; 488 B-C]

The restrictive covenant was one of the terms of the agreement relating to consideration, and therefore the compensation paid, was not only in lieu of the giving up of the agency but also for the respondent accepting a restrictive covenant for a specific period. Since the covenant was an independent obligation which came into operation only after the agency was terminated and was wholly unconnected with it, that part of the compensation attributable to the restrictive covenant was a capital receipt not assessable to tax. [491 B, C, H; 492 A]

*Gillanders Arbuthnot & Co. Ltd. v. Commissioner of Income-tax, Calcutta*, [1964] 8 S.C.R. 121 and *Commissioner of Income-tax, Madras v. Chari and Chari* [1965] 3 S.C.R. 692, followed.

The apportionment of the compensation has to be made on a reasonable basis between the loss of the agency in the usual course of business and the restrictive covenant by the assessing authority. The compensation was severable and any difficulty in apportionment cannot be a

A ground for rejecting the claim by the revenue and the assessee for apportionment. [492 B-D]

*Wales (H. M. Inspector of Taxes) v. Tilley*, (1942) 25 T.C. 136  
*Carter v. Wadman (H. M. Inspector of Taxes)* (1946) 28 T.C. 41 and  
*T. Sadasivam v. Commissioner of Income-tax*, (1954) 28 I.T.R. 435, referred to.

B CIVIL APPELLATE JURISDICTION ; Civil Appeals Nos. 682 and 683 of 1964.

Appeals from the judgment and order dated July 24, 1961 of the Madras High Court in Case Referred No. 29 of 1957.

C *A. V. Viswanatha Sastri, R. Ganapathy Iyer, R. H. Dhebar* and *R. N. Sachthey*, for the appellant.

*K. N. Rajagopala Sastri, G. C. Sanghi, B. R. Narwala* and *H. K. Puri*, for the respondent.

The Judgment of the Court was delivered by

D **Subba Rao, J.** Messrs. Best & Co., Ltd., Madras, the respondent herein, hereinafter called the Agency Company, is a private limited company carrying on business in innumerable lines. It is doing the business of importers, exporters, agents and sub-agents of various shipping, insurance, and manufacturing companies, in the course of which it acquired numerous agencies from manufacturers both in India and outside for sale in India of textiles, dairy products, engineering equipments, soaps, paints, toilet goods, etc. One of such agencies was from the Imperial Chemical Industries (Exports) Limited, Glasgow, hereinafter called the "Principal", for distribution and marketing in certain territories in South India of its ammunition, blasting explosives and accessories. The said agency came into existence in 1900. The terms of the agency were not reduced to writing. The rates of commission were paid on terms agreed upon from time to time. The agency was terminable at will; but, because of their mutual confidence, it continued without break till the year 1947 when the Principal decided to transfer all its agencies in India and Ceylon to Imperial Chemical Industries (India) Limited. By its letter dated March 11, 1947, the Principal gave notice to the Agency Company terminating its agency from April 1, 1948. After some correspondence, the agency was terminated on March 31, 1948, and the Principal paid certain amounts in three instalments calculated on the basis of the income earned by the Imperial Chemical Industries (India) Limited, which took over the business from that date. Pursuant to that agreement, the Prin-

cipal paid on September 30, 1949, a sum of Rs. 34,100 as commission on sales during the year ended March 31, 1949, on September 30, 1950, a commission of Rs. 66,790 on sales during the year ended March 31, 1950, and on September 30, 1951, a commission of Rs. 3,35,371 on sales during the year ended March 31, 1951. During the assessment year 1950-51, the first amount was brought to tax and the assessment had become final and nothing turns upon it in these appeals. But in respect of the other two assessment years, namely, 1951-52 and 1952-53, the Agency Company objected to the inclusion of the said amounts in its taxable income on the ground that the said amounts represented only compensation received for termination of the agency business and also as consideration for the restrictive covenant not to do business in the same line for a prescribed period. The Income-tax Officer, in the first instance, and, on appeals, the Appellate Assistant Commissioner held that the termination of the said agency did not alter the structure of the respondent's business and that they represented only remuneration paid voluntarily by the Principal to the agent in appreciation of its past services. On further appeals by the Agency Company, the Income-tax Appellate Tribunal held that, as the three annual instalments were based on future sales in the same territory as before, they were of the same nature as the normal commission receipts of the respondent. On that ground, both the appeals were dismissed. At the instance of the assessee, the following question was referred by the Tribunal to the High Court of Judicature at Madras for its opinion under s. 66(1) of the Indian Income-tax Act, 1922, hereinafter called the Act :

"Whether the aforesaid sum of Rs. 66,790 and Rs. 3,35,371 are assessable under Section 10 for the assessment years 1951-52 and 1952-53."

A Division Bench of the said High Court, having regard to the circumstances of the case, came to the conclusion that by the termination of the agency the assessee lost an earning asset and the compensation paid for the destruction of such an asset was a capital receipt and, therefore, not liable to tax. The Revenue, on obtaining the necessary certificate from the High Court, has preferred the present two appeals to this Court.

Mr. A. V. Viswanatha Sastri, learned counsel for the Revenue, contended that the assessee had innumerable agencies, that it was a normal incident in the course of its business to give up agencies and acquire new ones, that the termination of the agency in question was a normal occurrence in the course of its

A business, that it had no impact on the earning assets or the structure of the business, that the alleged restrictive covenant was only an act of grace on the part of the agent in view of the long standing relationship between the parties and that it did not enter into the calculation of the compensation paid to the assessee. In short, his argument was that the said compensation  
B only represented the taxable income of the assessee. Should the Court hold that the compensation was in part capital and in part revenue income, the argument proceeded, the said compensation would have to be apportioned reasonably between the said parts.

C Mr. Rajagopala Sastri, learned counsel for the assessee, advanced the argument that on a true construction of the agreement disclosed by the correspondence it should be held that the amount received by the assessee was wholly as a consideration for the restrictive covenant and, therefore, was of a capital nature. Alternatively, he contended that even if the amount was  
D wholly paid as compensation for the loss of the agency, it was a capital receipt, as the assessee lost a substantial source of income in relation to the totality of its business. On the assumption that the payment partook of a composite character, the learned counsel would say that an apportionment should be made in  
E proportion of the value to the assessee of the loss incurred under both the heads, namely, the loss of the agency and the restrictive covenant not to do business for a specified period in the same field.

These appeals raise the familiar question, namely, whether a particular income arising from the termination of one of the  
F agencies of a multi-agency concern is a capital receipt or a revenue receipt. The decisions on this question are legion. Eminent judges in India as well as in England expressed their inability to lay down a precise principle of universal application, but were able to evolve some workable rules of guidance. The difficulty is inherent in the problem itself. This Court in a  
G recent decision has surveyed the entire field and, therefore, no useful purpose will be served to cover the ground over again. That case is *Kettlewell Bullen & Co. Ltd. v. Commissioner of Income-tax, Calcutta*<sup>(1)</sup>. There, this Court, speaking through Shah, J., expressed its conclusion thus :

H "Where, on a consideration of the circumstances, payment is made to compensate a person for cancel-

(1) [1964] 8 S.C.R. 93

lation of a contract which does not affect the trading structure of his business, nor deprive him of what in substance is his source of income, termination of the contract being a normal incident of the business, and such cancellation leaves him free to carry on his trade (freed from the contract terminated) the receipt is revenue: where by the cancellation of an agency the trading structure of the assessee is impaired, or such cancellation results in loss of what may be regarded as the source of the assessee's income, the payment made to compensate for cancellation of the agency agreement is normally a capital receipt."

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But the difficulty still remains in the application of the said principle to the facts of each case. In *Gillanders Arbuthnot and Co. Ltd. v. Commissioner of Income-tax, Calcutta*<sup>(1)</sup> this Court applied the said rules to the facts of that case, which, by and large, are similar to the facts in the present case. It would, therefore, be useful to notice briefly the facts of that case. There, the appellant company carried on business in diverse lines: acting as managing agents, shipping agents, purchasing agents, and secretaries, the company also acted as importers and distributors on behalf of foreign principals and bought and sold on its own account. Under an unwritten agreement which was terminable at will the appellant acted as sole agents and distributors of explosives manufactured by the Imperial Chemical Industries (Export) Ltd. That agency was terminated and by way of compensation the Imperial Chemical Industries (Export) Ltd. paid for the first three years after the termination of the agency two-fifths of the commission accrued on its sales in the territory of the appellant's agency computed at the rates at which the appellant had formerly been paid and in addition in the third year full commission for the sales effected in that year at the same rates. The Imperial Chemical Industries (Exports) Ltd. had intended to take a formal undertaking from the appellant to refrain from selling or accepting any agency for explosives or other competitive commodities, but no such agreement in writing was taken or insisted upon. The question was whether the amounts received by the appellant for those three years were of the nature of capital or revenue. This Court held that the amounts paid were of the nature of income and, therefore, assessable to tax. The reason given for that conclusion was that, having regard to the vast array of business done

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(1) [1964] 8 S.C.R. 121

- A by the appellant as agents, the acquisition of agencies was in the normal course of business and determination of individual agencies a normal incident not affecting or impairing its trading structure. The material facts of that case are on all fours with the present case. Indeed, the Principal in both the cases was the same and the agency terminated was also a similar one.
- B The compensation given was worked out on the same lines. The only difference is that in that case it was not found that the restrictive covenant entered into the bargain.

- This Court again reiterated the same principle in *Commissioner of Income-tax, Madras v. Chari & Chari Ltd.*<sup>(1)</sup>. But, on the facts of that case, it came to the conclusion that the compensation paid for the loss of agency was a capital asset. There, Shah, J., speaking for the Court, said :
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- “In *Kettlewell Bullen and Co.'s case*<sup>(2)</sup> this Court pointed out that ordinarily compensation for loss of office or agency is regarded as a capital receipt, but the rule is subject to an exception that payment received even for termination of an agency agreement, where the agency is one of many which the assessee holds, and the termination of the agency does not impair the profit-making structure of the assessee, but is within the framework of the business, it being a necessary incident of the business that existing agencies may be terminated, and fresh agencies may be taken, is revenue and not capital, *Kelsall Parson and Co.'s case*<sup>(3)</sup> falls within the exception to the ordinary rule, and circumstances which brought the case of the respondent within the exception must be clearly established.”
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- As we have observed earlier, in view of the judgments of this Court, no further citation is called for. Whether the compensation received by an assessee for the loss of agency is a capital receipt or a revenue receipt depends upon the circumstances of each case. Before coming to a conclusion one way or the other, many questions have to be asked and answered : what was the scope of the earning apparatus or structure, from physical, financial, commercial and administrative standpoints ? If it was a business of taking agencies, how many agencies it had, what was their nature and variety ? How were they acquired, how one or some of them were lost and what was the total income they were
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(1) [1965] 3 S.C.R. 692

(2) [1964] 8 S.C.R. 93

(3) [1938] 21 T.C. 608

yielding? If one of them was given up, what was the average income of the agency lost? What was its proportion in relation to the total income of the company? What was the impact of giving it up on the structure of the entire business? Did it amount to a loss of enduring asset causing an unabsorbed shock dislocating the entire or a part of the earning apparatus or structure? or was it a loss due to an ordinary incident in the course of the business? The answers to these questions would enable one to come to a conclusion whether the loss of a particular agency was incidental to the business or whether it amounted to a loss of an enduring asset. If it was the former, the compensation paid would be a revenue receipt; if it was the latter, it would be a capital receipt. But these questions can only be answered satisfactorily if the relevant material is available to the income-tax authorities. The evidence of witnesses in charge of the business, the relevant accounts and balance sheets of the assessee before and after the loss, other evidence disclosing the previous history of the total business and the relative importance of the agency lost and the present position of the business after the loss of the said agency have to be scrutinized by the Department.

At this stage the question of burden of proof raised at the Bar may be noted. In *Commissioner of Income-tax v. Chari & Chari Ltd.*(<sup>1</sup>), this Court observed :

“.....it must *in the first instance* be observed that it is for the revenue to establish that a particular receipt is income liable to tax.....”.

We may point out, as some argument was advanced on the question of burden of proof, that this Court did not lay down that the burden to establish that an income was taxable was on the Revenue was immutable in the sense that it never shifted to the assessee. The expression “in the first instance” clearly indicates that it did not say so. When sufficient evidence, either direct or circumstantial, in respect of its contention was disclosed by the Revenue, adverse inference could be drawn against the assessee if he failed to put before the Department material which was in his exclusive possession. The process is described in the law of evidence as shifting of the onus in the course of a proceeding from one party to the other. There is no reason why the said doctrine is not applicable to income-tax proceedings. While the Income-tax authorities have to gather the relevant material to establish that the compensation given for the loss of agency was

(1) [1965] 3 S.C.R. 692

- A by the appellant as agents, the acquisition of agencies was in the normal course of business and determination of individual agencies a normal incident not affecting or impairing its trading structure. The material facts of that case are on all fours with the present case. Indeed, the Principal in both the cases was the same and the agency terminated was also a similar one.
- B The compensation given was worked out on the same lines. The only difference is that in that case it was not found that the restrictive covenant entered into the bargain.

C This Court again reiterated the same principle in *Commissioner of Income-tax, Madras v. Chari & Chari Ltd.*<sup>(1)</sup>. But, on the facts of that case, it came to the conclusion that the compensation paid for the loss of agency was a capital asset. There, Shah, J., speaking for the Court, said :

D "In *Kettlewell Bullen and Co.'s case*<sup>(2)</sup> this Court pointed out that ordinarily compensation for loss of office or agency is regarded as a capital receipt, but the rule is subject to an exception that payment received even for termination of an agency agreement, where the agency is one of many which the assessee holds, and the termination of the agency does not impair the profit-making structure of the assessee, but is within the framework of the business, it being a necessary incident of the business that existing agencies may be terminated, and fresh agencies may be taken, is revenue and not capital, *Kelsall Parson and Co.'s case*<sup>(3)</sup> falls within the exception to the ordinary rule, and circumstances which brought the case of the respondent within the exception must be clearly established."

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As we have observed earlier, in view of the judgments of this Court, no further citation is called for. Whether the compensation received by an assessee for the loss of agency is a capital receipt or a revenue receipt depends upon the circumstances of each case. Before coming to a conclusion one way or the other, many questions have to be asked and answered : what was the scope of the earning apparatus or structure, from physical, financial, commercial and administrative standpoints? If it was a business of taking agencies, how many agencies it had, what was their nature and variety? How were they acquired, how one or some of them were lost and what was the total income they were

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(1) [1965] 3 S.C.R. 692

(2) [1964] 8 S.C.R. 93

(3) [1938] 21 T.C. 608

could have been brought out if only the average total commission earned by the assessee for a reasonable period of time before the transfer was disclosed. In the absence of such material it is not possible to arrive at any conclusion one way or the other, on the line of enquiry pursued by the High Court. What remains, therefore, is only the fact that the assessee had innumerable agencies in different lines and that it only gave up one of them and continued to do business without any apparent mishap. The correspondence between the parties shows that the assessee gave up the agency without any protest presumably because such termination of agencies was part of the normal course of its business. We, therefore, hold on the facts of the present case that the loss of the said agency by the assessee was only a normal trading loss and that the income it received was a revenue receipt.

Mr. Rajagopala Sastri's next contention is that on a fair reading of the correspondence that passed between the parties it should be held that the compensation given to the assessee was only in lieu of a restrictive covenant and, therefore, it was a capital receipt.

To appreciate this contention it is necessary to read the relevant correspondence. On March 11, 1947, the Principal wrote a letter to the assessee. As the argument mainly turned upon the contents of this letter, it is necessary to extract it in full. It reads :

IMPERIAL CHEMICAL INDUSTRIES (EXPORT)  
LIMITED

Explosives Branch,  
Nobel House,  
25, Bothwell Street,  
Glasgow C-2.  
11th March 1947.

Our Ref. : Export sales Section GKL/NR.

Messrs. Best and Company Limited,  
P.O. Box 63,  
Madras, India.

Dear Sirs,

*Agency arrangements.*

We refer to the interview which Mr. J. W. Donaldson had with your Mr. Ruddle in May 1945, when it

A was intimated that as a matter of long term policy, our agencies in India and Ceylon would ultimately be taken over by Imperial Chemical Industries (India), Limited. It was indicated at that time that a period of two to three years might elapse before any steps were taken as regards this transfer. We now have to advise you that the matter has been receiving further consideration, and Imperial Chemical Industries (India), Limited desire to take over the various agencies as from the first April 1948.

C It is with regret, therefore, that we have to intimate our intention of transferring your agency, as from the above date, to Imperial Chemical Industries (India), Limited, and would take this opportunity of expressing to you our sincere appreciation of the valuable services you have rendered to us over a period of many years.

D As a result of the transfer of your agency to Imperial Chemical Industries (India) Limited, we propose that compensation should be paid to you on the following basis :—

E (1) For the first three post-transfer years, we shall pay you two-fifths of the commission accruing on annual sales in the territory of your Agency taken over by Imperial Chemical Industries (India) Limited, such commission to be computed at the commission rates formerly paid to you.

F (2) In the third post-transfer year we shall pay you, in addition, a sum equivalent to the full commission on sales for that year effected by Imperial Chemical Industries (India) Limited in your territory, calculated at the same rates.

G (3) Payment will be made to you after the end of each year as soon as the amount is ascertained.

H For the purposes of calculating the commission due to you, the post-transfer years will be deemed to run as from the date of the transfer of your agency to Imperial Chemical Industries (India) Limited. We trust that you will find these proposals acceptable.

H As a condition of our paying compensation on the basis outlined above, we would request you to be good enough to give us a formal undertaking to refrain from

selling or accepting any agency for explosives or other commodities competitive with those covered by the agency agreement now being terminated. A

In this connection, we are asking our legal department to prepare a formal agreement which we will submit to you for your signature as soon as possible. B

Yours faithfully,

*for* Imperial Chemical Industries  
(Export) Limited.

Mr. Rajagopala Sastri contended that for the past valuable services the Principal expressed only sincere appreciation and for the termination of the agency and thus putting an end to the assessee's future benefits it proposed to give the assessee compensation measured by the sales effected by the new agent. But his main argument is that whatever terminology was used, commission or compensation, the amount agreed to be paid was wholly as compensation for the assessee agreeing to refrain from selling or accepting any agency for selling explosives. That conclusion was sought to be arrived at on the ground that the said restrictive covenant was a condition for the payment of compensation. We find it difficult to accept this construction of the document. The scope of this document cannot be appreciated ignoring the circumstances under which it came into existence. As we have stated earlier, the agency, which is the subject-matter of this agreement, was only one of many other agencies the assessee had. C  
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We cannot agree with the learned counsel that the compensation was given wholly for the restrictive covenant. Indeed, the compensation was given expressly for giving up the agency. In the last paragraph of the letter a request was made to the assessee to agree to a restrictive covenant as a condition for paying compensation. The letter dated April 8, 1947, written by the Principal to the Agency Company makes the position clear. Therein it was stated : F  
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"With regard to the point you raise concernig the period during which you would undertake not to take any competitive agency, we would like you to understand that it was never our intention that you should be tied down on this point for all time. We had felt that the limiting period should be one of five years and we are pleased to note from your letter that this appa- H

A       rently is in accordance with your own ideas. It is suggested that the five years should date from the termination of the agency, namely, 1st April, 1948.”

The letter written by the assessee to the Principal is not on the file. But it is clear from this letter that the restrictive covenant was one of the terms of the agreement relating to consideration.

B       It was a part of the consideration that passed from the assessee for receiving the compensation. We cannot also agree with Mr. Viswanatha Sastri, who went to the other extreme and contended that the restrictive covenant was only an act of grace on the part of the Agent and that it did not enter into the bargain.

C       We, therefore, hold that the compensation agreed to be paid was not only in lieu of the giving up of the agency but also for the assessee accepting a restrictive covenant for a specific period.

The next question is whether that part of the compensation attributable to the restrictive covenant is a capital receipt or a revenue receipt.

D       The House of Lords in *Beak (H.M. Inspector of Taxes) v. Robson*<sup>(1)</sup>, had to consider, whether compensation paid for a restrictive covenant was a capital receipt or a revenue receipt. Under a service agreement the respondent therein covenanted in consideration of the payment to him of £7,000 on the execution of the agreement, that if the agreement were determined by notice given by him or by his breach of its provisions he would not compete directly or indirectly with the company within a radius of fifty miles of its place of business until the five years had expired. The House of Lords held that the said amount was a payment for giving up a right wholly unconnected with his office and operative only after he ceased to hold that office and, therefore, it was not taxable under Schedule E of the Income-tax Acts.

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This Court in *Gillanders Arbuthnot and Co. Ltd. v. Commissioner of Income-tax, Calcutta*<sup>(2)</sup> accepted the said principle and held that the compensation paid for agreeing to refrain from carrying on competitive business in the commodities in respect of the agency terminated or for loss of goodwill was *prima facie* of the nature of a capital receipt.

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In the present case, the covenant was an independent obligation undertaken by the assessee not to compete with the new agents in the same field for a specified period. It came into operation only after the agency was terminated. It was wholly un-

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(1) [1942] 25 T.C. 33.

(2) [1964] 8 S.C.R. 121

connected with the assessee's agency terminated. We, therefore, hold that that part of the compensation attributable to the restrictive covenant was a capital receipt and hence not assessable to tax. A

The next question is whether the compensation paid is severable. If the compensation paid was in respect of two distinct matters, one taking the character of a capital receipt and the other of a revenue receipt, we do not see any principle which prevents the apportionment of the income between the two matters. The difficulty in apportionment cannot be a ground for rejecting the claim either of the Revenue or of the assessee. Such an apportionment was sanctioned by courts in *Wales (H.M. Inspector of Taxes v. Tilley)*<sup>(1)</sup>, *Carter v. Wadman (H.M. Inspector of Taxes)*<sup>(2)</sup>, and *T. Sadasivam v. Commissioner of Income-tax, Madras*<sup>(3)</sup>. In the present case apportionment of the compensation has to be made on a reasonable basis between the loss of the agency in the usual course of business and the restrictive covenant. The manner of such apportionment has perforce to be left to the assessing authorities. B  
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The answer to the question referred to the High Court is that only such part of the sums of Rs. 66,790 and Rs. 3,35,371 as is attributable to the loss of the agency is assessable under s. 10 of the Act for the assessment years 1951-52 and 1952-53. We accordingly modify the answer given by the High Court in that regard. E

In the result, the appeals are partly allowed. As both the parties failed in part and succeeded in part, they will bear their respective costs here and in the High Court. F

*Appeals allowed in part.*

(1) [1942] 25 T.C. 136

(2) [1946] 28 T.C. 41

(3) [1955] 28 I.T.R. 435