

RAJA MOHAN RAJA BAHADUR

v.

THE COMMISSIONER OF INCOME-TAX, U.P.

April 6, 1967

[J. C. SHAH, S. M. SIKRI AND V. RAMASWAMI, JJ.]

Income-tax—Assessee maintaining accounts on cash basis—Obtaining decree for repayment of loan made to debtor to whom U.P. Encumbered Estates Act, 1934 applied—Receiving interest in loan in U.P. Encumbered Bonds—Whether amounting to receipt of income on date when bonds received.

The appellant, a Hindu undivided family, carried on the business of money-lending and maintained its accounts on cash basis. After the appellant had obtained a decree for the recovery of a loan made to a debtor, the latter obtained an order under the U.P. Encumbered Estates Act 25 of 1934, applying the provisions of the Act to him. The Special Judge, Sultanpur, thereafter passed an order for payment of the principal sum and interest to the appellant. Pursuant to this order the appellant received in 1946 an amount in cash from the debtor and for the balance the State Government gave to the appellant U.P. Encumbered Estates Bonds. While the cash amount received in 1946 was appropriated by the appellant towards the principal due, he split up the amount of the face value of the bonds into two sums and credited one amount in the books of account towards the balance of principal and the other amount to an account styled as "interest accrued". In submitting the return of the taxable income for the assessment year 1948-49, the appellant did not disclose any receipt of income from interest due on the loans advanced to the debtor and was duly assessed to tax on the income disclosed by him. In October 1948 the appellant sold the bonds and disclosed in the return for the assessment year 1949-50 as interest received during the year of account the difference between the amount realised by sale of the bonds and the amount due as principal. The Income-tax Officer issued a notice under s. 34(1)(a) of the Income-tax Act, 1922 and brought to tax the amount disclosed by the appellant as escaped income of the previous year relevant to the assessment year 1948-49.

This order was confirmed by the Appellant Assistant Commissioner as well as by the Tribunal. The High Court, upon a reference, also held in favour of the respondent.

In appeal to this Court it was contended on behalf of the appellant that the accounts maintained by the appellant being on cash basis, until the appellant realised the value of the bonds, no interest was received by him; that when a trader maintains accounts on cash basis, the receipt of money alone can be taken into account in determining the taxable income. It was contended in the alternative that the bonds issued by the Government merely amounted to a fresh promise by an agent of the debtor to pay the amount of the bonds in instalments and by receiving the bonds incorporating such a promise, no money or money's worth was received by the creditor.

HELD : Dismissing the appeal; the Encumbered Estates Bonds were by operation of the statute received by the appellant in satisfaction *pro tanto* of the liability of the debtor. They were a fresh security. The liability of the original debtor was substituted by an obligation undertaken

A by the State : the bonds were convertible in terms of money : income was therefore received by the appellant when the bonds were received.

Where the accounts are maintained on cash basis receipt of money or money's worth and not accrual of the right to receive is the determining factor. Therefore, if commercial assets are received by a trader maintaining accounts on cash basis in satisfaction of an obligation, income which is embedded in the value of the assets is deemed to be received; the receipt of income is not deferred till the asset is realised in terms of cash or money. It makes no difference whether the receipt of assets is in pursuance of an agreement or that the trader is compelled by law to accept the assets from the debtor. Once title of the trader to an asset received is complete whether by consensual arrangement or by operation of law, he receives the income embedded in the value of the assets. [486D-F]

C *Californian Copper Syndicate (Limited and Reduced) v. Harris (Surveyor of Taxes)*, 5 T.C. 159, referred to.

Although the Government had the right to recover the amount due under the bonds from the land-holder, it did not, on that account, become the agent of the land-holder for payment of his dues. Even if the Government was unable to recover the money from the land-holder, the liability undertaken by it under the bond remained unimpaired. [487C-D]

D *Cross (H. M. Inspector of Taxes) v. London and Provincial Trust Ltd.* 21 T.C. 705, distinguished.

What was taxable was only that income which represented the difference between the amount due as principal and the market value of the bonds at the date of receipt. [488E-F]

CIVIL APPELLATE JURISDICTION : Civil Appeal No. 1395 of 1966.

E Appeal from the judgment and decree dated July 10, 1962 of the Allahabad High Court in Income-tax Reference No. 445 of 1959.

Bishan Narain and Govind Saran Singh, for the appellant.

F *T. V. Viswanath Iyer, R. Ganapathy Iyer, S. P. Nayyar* for *R. N. Sachthey*, for the respondent.

The Judgment of the Court was delivered by

G **Shah, J.** The appellant, a Hindu undivided family, carries on the business of money-lending, and maintains its accounts on cash basis. The appellant commenced an action in the Civil Court for a decree for recovery of Rs. 2,58,000/- due by Nisar Ahmad Khan, Taluqdar of Mohana Estate. The action was carried to the Judicial Committee of the Privy Council and was ultimately decreed in favour of the appellant. Nisar Ahmad Khan then obtained under the U.P. Encumbered Estates Act 25 of 1934 an order applying the provisions of the Act to him. The Special Judge, Sultanpur, passed an order for payment of Rs. 5,00,992/- to the appellant. Pursuant to the order the appellant received in 1946 H Rs. 1,54,692/- from the debtor and for the balance the Government of the United Provinces gave to the appellant Encumbered Estates bonds of the face value of Rs. 3,46,300/-. The amount

received in the year 1946 was appropriated by the appellant towards the principal due. The appellant split up the amount of the face value of the bonds into two sums of Rs. 2,22,097/9/11 and Rs. 1,24,202/6/1, and credited the first amount in the books of account towards the balance of principal and the second amount to an account styled "Interest Accrued". In submitting the return of his taxable income for the assessment year 1948-49 the appellant did not disclose any receipt of income from interest due on the loans advanced to Nisar Ahmad Khan. The appellant was duly assessed to tax on the income disclosed by him. In October 1948 the appellant sold the Encumbered Estates bonds and realized a total sum of Rs. 3,21,600/-, and disclosed in the return for the assessment year 1949-50 as interest received during the year of account the difference between the amount realized by sale of the bonds and the amount due as principal. The Income-tax Officer issued a notice under s. 34(1)(a) of the Indian Income-tax Act and brought to tax the difference between the face value of the bonds and the amount due as principal as escaped income of the previous year relevant to the assessment year 1948-49. The order was confirmed by the Appellate Assistant Commissioner and the Income-tax Appellate Tribunal. The Tribunal then submitted three questions to the High Court of Judicature at Allahabad of which the following were canvassed before us :

"(2) Whether, the receipt of Encumbered Estate Bonds during the previous year 1947-48 amounted to receipt of cash during that previous year and not during the previous year 1948-49 when the Bonds were in fact sold at less than their face value ?

(3) Whether in the circumstances of the case, the mere receipt of the Encumbered Estate Bonds was tantamount to receipt of income assessable in the year 1948-49 ?"

The High Court answered the questions in the affirmative. Against the order passed by the High Court, with certificate, the appellant has appealed to this Court.

The scheme of the U.P. Encumbered Estates Act 25 of 1934 and the form of the bonds issued in satisfaction of the liability of the debtors may be briefly summarised. Under the U.P. Act a "landlord" may apply to the Collector stating the amount of his debts and requesting that the provisions of the Act be applied to him. The Collector entertains the petition and transfers it to the Special Judge. The landlord then submits a written statement giving the list of his creditors and the list of his assets. Notices are published by the Special Judge and the creditors are called upon to submit their written claims. On the claims for debts secured or unsecured duly proved, simple money decrees are passed in

- A** favour of the creditors. The Special Judge then determines the properties belonging to the landlord and prepares a list of the properties and a list of the debts adjudged to be due by the landlord ranking the same in order of priority and then sends the decrees to the Collector for execution. If the amount due by the debtor is less than the instalment value of his proprietary rights in land, the
- B** Collector is enjoined to direct the landlord to pay with land revenue dues such amount to the Provincial Government in instalments with future interest at a rate determined by the Provincial Government. If the Collector has proceeded under s. 27 he has to give to each creditor a bond or bonds bearing interest at the prescribed rate for the amount due to him payable in instalments within a period not exceeding 20 years. The form of the bond is as follows :

- C** "The Governor of the United Provinces hereby promises to pay to or order at any Treasury- in the United Provinces or at the General Treasury at Fort William or at Bombay on the day of 19 on the application of the holder, or earlier
- D** at the entire option of the Government of the United Provinces, the sum of and in the meantime to pay at the said Treasury interest on such sum at the rate of three and one-quarter per cent, per annum, such interest to be paid half yearly on the 20th day of February and the 20th day of August in every year, commencing
- E** from the 20th day of 19 on which date the whole interest due from the date hereof shall be paid."

- On February 26, 1948 the appellant received Encumbered Estates Bonds of the face value of Rs. 3,46,300/-. The appellant appropriated bonds of the face value of Rs. 2,22,097/9/11 towards the principal and costs due, and appropriated the remaining bonds of the value of Rs. 1,24,202/6/1 towards "interest accrued due" in
- F** the debtor's account. The departmental authorities and the Tribunal held that the receipt by the appellant of bonds of the face value exceeding the principal amount of the debt due constituted receipt of interest. The High Court agreed with that view.

- G** Counsel for the appellant submitted that the accounts maintained by the appellant being on cash basis, until the appellant realised the value of the bonds no interest was received by the appellant. Counsel asserted that when a trader maintains account on cash basis receipt of money alone may be taken into account in determining the taxable income. In the alternative Counsel urged that the bond issued by the Government under the U.P. Encumbered
- H** Estates Act merely amounted to promise by an agent of the debtor to pay the amount of the bond in instalments and by receiving the bonds incorporating such a promise no money or money's worth is received by the creditor.

Under s. 4 of the Income-tax Act, 1922, the total income of any previous year of a resident assessee includes all income, profits and gains from whatever sources derived which are received or are deemed to be received in the taxable territories in such year by or on behalf of such person, or accrue or arise or are deemed to accrue or arise to him in the taxable territories during such year, or accrue or arise to him without the taxable territories during such year, or having accrued or arisen to him without the taxable territories before the beginning of such year and after the 1st day of April, 1933, are brought into or received in the taxable territories by him during such year. The Act does not contain much guidance as to cases in which tax is to be levied on income received, and cases in which tax is to be levied on income accrued or arisen. Section 13 however requires that income, profits and gains for the purposes of ss. 10 and 12 shall be computed in accordance with the method of accounting regularly employed by the assessee. If accounts are maintained according to the mercantile system, whenever the right to receive money in the course of a trading transaction accrues or arises, even though income is not realised, income embedded in the receipt is deemed to arise or accrue. Where the accounts are maintained on cash basis receipt of money or money's worth and not the accrual of the right to receive is the determining factor. Therefore, if commercial assets are received by a trader maintaining accounts on cash basis in satisfaction of an obligation, income which is embedded in the value of the assets is deemed to be received: the receipt of income is not deferred till the asset is realized in terms of cash or money. It makes no difference whether the receipt of assets is in pursuance of an agreement or that the trader is compelled by law to accept the assets from the debtor. Once title of the trader to an asset received is complete, whether by a consensual arrangement or by operation of law, he receives the income embedded in the value of the asset. In *Californian Copper Syndicate (Limited and Reduced) v. Harris (Surveyor of Taxes)*⁽¹⁾ Lord Trayner in dealing with a case of assessment to income tax of a Company formed for the purpose, *inter alia*, of acquiring and reselling mining property resold the whole of its assets to a second Company and received payment in fully paid shares of the purchasing Company, observed:

"A profit is realised when the seller gets the price he has bargained for. No doubt here the price took the form of fully paid shares in another company, but, if there can be no realised profit, except when that is paid in cash, the shares were realisable and could have been turned into cash, if the Appellants had been pleased to do so. I cannot think that Income Tax is due or not

(1) 5 T.C. 159

A according to the manner in which the person making the profit pleases to deal with it.”

B Counsel for the appellant contended that the bonds were intended to renew the promise to pay the amount due by the debtor through his agent, and by the renewal of the promise even if the original liability was extinguished and a fresh liability was substituted, no income was received by the appellant.

C We are unable to agree with that contention. The Government of the State undertook to pay the amount of the bonds in satisfaction of the liability of the debtor. The liability of the original debtor was extinguished and a fresh obligation was undertaken by the State Government in substitution of the original liability. The Government had the right to recover the amount due under the bonds from the landholder, but on that account the Government did not become the agent of the landholder for payment of his debts. Even if the Government was unable to recover the money from the landholder, the liability undertaken by the Government under the bond remained unimpaired. The bond was a security for payment of the debt which completely replaced the original liability of the debtor.

E The decision in *Cross (H.M. Inspector of Taxes) v. London and Provincial Trust Ltd.*⁽¹⁾ on which counsel for the appellant relied has, in our judgment, no application to this case. In 1932 the Brazilian Government suspended payment of interest on Government bonds for a period of three years and issued interest-bearing funding bonds in exchange for the interest coupons. The London and Provincial Trust Ltd. which held among its investments Brazilian bonds received funding bonds which it sold from time to time. It was held that by issuing the funding bonds the Government of Brazil did not pay interest and the assessee Bank received no interest when it received the funding bonds. Sir Wilfrid Greene, M.R. observed :

G “It is not open to question that income can be in the form of money's worth. Nor is it open to question that if the holder of a security, the contractual income from which is money, receives from the person liable to pay that money some thing of money's worth (*e.g.*, goods) instead of the money, such goods are income arising from the security. . . . On the other hand, where there is a mere substitution of a promise to pay at a later date for the obligation to make an interest payment presently due, the owner of security cannot be said to have received income from it. In such a case, . . . the payment

(1) 21 T.C. 705.

has been postponed instead of being made on its due date. Nor do I see how it can make any difference if upon the true reading of the transaction the original obligation is extinguished and the promise to pay at a later date is accepted in its place.”

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MacKinnon, L.J., observed at p. 721 :

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“It is quite true that income may arise by the receipt of money’s worth as well as by the receipt of money. And it is equally true that a debtor may pay his debt by giving the promise of a third party to pay : But I am satisfied that there can never be payment of his debt by a debtor by giving his own promise to pay at a future date. And I am equally satisfied that, though income arises to a creditor from a debtor’s paying his debt income does not arise by the debtor’s promising that he will pay his debt later on.”

C

But the Encumbered Estates Bonds were by operation of the statute received by the appellant in satisfaction *pro tanto* of the liability of the debtor. They were a fresh security. The liability of the original debtor was substituted by an obligation undertaken by the State : the bonds were convertible in terms of money. Income was therefore received by the appellant when the bonds were received.

D

It is necessary to state that the income-tax authorities have brought to tax the difference between the face value of the bonds and the principal which remained due in the relevant previous year. But what was taxable was only that income which represented the difference between the amount due as principal and the market value of the bonds (which were payable in twenty instalments) at the date of receipt. It is true that before the Income-tax Appellate Tribunal this question was not expressly pressed. The appellant did however contend that no part of the difference between the face value of the bonds and the principal amount due was taxable and the third question referred by the Tribunal was sufficiently comprehensive to justify consideration of the plea that a part of the difference only was taxable. Having regard to the argument presented before the Tribunal and the amplitude of the question referred, the High Court was in error in refusing to consider whether only a part of the difference between the face value of the bonds and the principal amount due to the appellant was taxable. Counsel appearing on behalf of the Department concedes that what was taxable was only the difference between the principal amount due and the market value of the bonds when received in the year of account, and he has agreed that the necessary adjustments will be made by the Department in that behalf.

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- A In that view, we do not think it necessary to modify the answer recorded by the High Court on the third question.

- It is also necessary to observe that in the year 1949-50 the appellant had submitted a return disclosing the difference between the amount received by sale of the bonds and the principal amount due as income received in the previous relevant year. Whether that income was brought to tax pursuant to the return cannot be ascertained from the record. Counsel for the Department has stated that it is not the object of the Department to levy tax in respect of the same income twice. He has agreed that if tax has been levied in respect of the difference between the principal and the realized value of the bonds disclosed in the return for the assessment year 1949-50, appropriate adjustments will be made in that behalf. In view of the statements made at the Bar we do not think it necessary to give any directions in that behalf also.
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- C

The appeal is dismissed. There will be no order as to costs in this Court.

R.K.P.S.

Appeal dismissed.