

COMMISSIONER OF INCOME-TAX U.P. LUCKNOW

v.

M/S. GANGADHAR BAIJNATH GENERAL GANG, KANPUR

August 23, 1972

[K. S. HEGDE, P. JAGANMOHAN REDDY AND H. R. KHANNA, JJ.]

Income-tax Act (11 of 1922), s.10—Partners of two partnerships joining to form a third partnership—Partners of one partnership going out of new firm—Receipt of payments as compensation—If capital or revenue.

Six persons, three of whom were partners of B-firm having a selling agency of S-company, and three others who were partners of J-firm having quota rights in the S-company, formed a partnership the BJ-firm. There was no deed of partnership and the partnership of the BJ-firm was terminable at will. The B-firm continued to exist carrying on various other business activities. The BJ-firm was appointed as managing agents of the S-company. Later, the three persons belonging to B-firm went out of the BJ-firm and for doing so, they were paid a sum of money which included compensation as per the terms of an agreement between the B and J groups. The BJ-firm continued as the managing agents of the S-company. The appellant, B-firm, in appeal to this Court, while admitting that the portion of the compensation which represented profits was a revenue receipt, contended, that the remaining portion purporting to be made up of compensation for giving up (a) its managing agency rights, (b) its selling agency rights, and (c) its goodwill, was not a revenue receipt but a capital receipt.

HELD: The entire sum received by the appellant was a revenue receipt assessable under s. 10 of the Income Tax Act, 1922. [938F-G].

(1) The question whether a particular receipt is capital or revenue is largely a question of fact. [935A]

(2) (a) The BJ-firm was not a partnership of two firms because two firms cannot join in a partnership, but was really a partnership consisting of six partners. The appellant-firm had various business activities one of which was to join the BJ-firm to carry on certain business activities. The appellant's representatives by entering into the partnership were merely carrying on a trading activity. [935F-G; 937D-E]

(b) The managing agency rights as well as any goodwill vested with the BJ-firm. By going out of the BJ-firm the partners representing the appellant-firm had surrendered their rights in the partnership to the remaining partners and obtained payments for surrendering their rights. It was a case of cancellation of a contract which had been entered into the ordinary course of business, and not one of parting with any managing agency right. The payment received in settlement as a result of the termination of the contract represents the profits which the assessee would have made had the contract been performed.

[936G-H; 937A-B, D-E]

Commissioner of Income-tax, Nagpur v. R. B. Jairam Valji and Ors.
35 I.T.R. 148, followed.

A (c) It was not a case of the only trading activity of the appellant-firm coming to an end. Only one of its trading activities had been put an end to and hence, the amount received could not be considered as compensation for stopping its business. [937E-F]

Therefore, the compensation paid for the termination of the contract is not a capital receipt. [937F]

B (3) (a) The selling agency of the appellant firm had been transferred to the BJ-firm even at the time when the BJ-firm was formed. On the day when the partners of the B-firm left the BJ-firm it was an asset of the BJ-firm and hence the compensation paid could only relate to the termination of the contract of partnership and not to the transfer of selling agency. [937F-G]

C (b) Assuming that indirectly the selling agency right of the appellant firm was affected, it was only one of several trading activities of the appellant firm and the trading structure of the assessee-firm was not at all affected. The appellant-firm merely replaced one trading activity by another by utilising the compensation for acquiring controlling shares in two other companies. In such cases, the amount received for the cancellation of an agency, does not represent the price paid for the loss of a capital asset, but is in the nature of income. [937G-H; 938A]

D *Gillanders Arbuthnot and Co. Ltd. v. Commissioner of Income-tax, Calcutta*, 53 I.T.R. 28B, and *Kettlewell Bullen and Co. Ltd. v. Commissioner of Income-tax Calcutta*, 53 I.T.R. 261, followed.

CIVIL APPELLATE JURISDICTION : C. A. Nos. 1746 and 2022 of 1968.

E Appeal by certificate from the judgment and order dated October 22, 1965 of the Allahabad High Court in Income-tax Reference No. 286 of 1960.

S. T. Desai and *S. Mitra*, *B. B. Ahuja* and *B. D. Sharma* for the appellant. (in C.A. No. 1746 of 1968.)

H. K. Puri, for the respondent (in C.A. No. 1746 of 1968.)

F *H. K. Puri* and *S. K. Dhingra*, for the appellant (in C.A. No. 2022 of 1968).

S. T. Desai, *S. Mitra*, *O. P. Malhotra* and *B. B. Ahuja* and *B. D. Sharma*, for the respondent (in C.A. No. 2022/68).

The Judgment of the Court was delivered by

G *Hegde, J.* These are appeals by certificate from the decision of the High Court of Allahabad in a Reference under s. 66(1) of the Income-tax Act, 1922 (to be hereinafter referred to as the Act).

The Income-tax Appellate Tribunal (Allahabad bench) referred to the High Court for its opinion the following questions :

H “(1) whether on the facts and in the circumstances of the case, the receipt of Rs. 35,01,000/- constituted income liable to tax under section 10 of the Income-tax Act ?

- (2) Whether it was competent to the Appellate Assistant Commissioner to invoke the provisions of section 12-B for the assessment of Rs. 35,01,000/- when the Income-tax Officer had assessed the amount under Section 10 of the Income-tax Act ? A
- (3) Whether on the facts and in the circumstances of the case the receipt of Rs. 35,01,000/- was taxable under section 12-B of the Income-tax Act ?” B

The High Court answered the first and the second question in favour of the Revenue and on the third question it recorded its opinion that on the facts and in the circumstances of the case, the receipt in question was not taxable under s. 12-B of the Act. C

Aggrieved by the decision of the High Court the Commissioner of Income-tax has brought Civil Appeal No. 1746 of 1968 and the assessee Civil Appeal No. 2022 of 1968. D

The material facts of the case as could be gathered from the statement of case are these : The assessee is a partnership firm carrying on business of financing, moneylending, selling agencies and the like pursuits. The relevant assessment year is 1948-49, the concerned accounting year ending October, 1947. On April 29, 1946 the three partners of the assessee firm entered into an agreement with Gajadhar Jaipuria, R. S. Puran Mal Jaipuria and Mangloo Ram Jaipuria. The terms of the agreement as found by the Tribunal, were : E

- (1) That the partners should acquire on joint account, the shares of the Swadeshi Cotton Mills Co. Ltd. and Eland Ltd. F
- (2) The partners of the assessee firm (who will hereinafter be referred to as the 'Bagla Group') and the remaining three partners (who will hereinafter be referred to as the "Jaipuria Group") were to invest the amount required to acquire the shares in question equally and all benefits including the managing agency, selling agency, quota rights should be enjoyed in joint account but the selling agency which was in the hands of the assessee firm should continue to be in its hands till the Dussehra of that year. Similarly the quota rights which were in the hands of the Jaipuria Group should continue in the hands of that Group till the Dussehra of that year. G
- H

- A** (3) Neither party should acquire any share in his separate account or have any interest directly or indirectly to the exclusion of the other.

B Till the date of the formation of this partnership, the assessee firm consisting of "Bagla Group" were the selling agents of the Swadeshi Cotton Mills Co., Ltd. The "Jaipuria Group" which was a different firm were enjoying some quota rights in that mill. In pursuance of the agreement above referred to the new partnership "Bagla-Jaipuria and Co." purchased shares of the Swadeshi Cotton Mills Co. Ltd. For that purpose both the groups contributed equally. But no partnership deed as such was entered into by the partners. On July 16, 1946, an agreement was entered into between the Swadeshi Cotton Mills Co., Ltd. and the Bagla Jaipuria and Co. appointing the latter as the managing agents of the Company for a period of twenty years. On October 7, 1946, another agreement was entered into by the partners of the Bagla Jaipuria and Co. whereby it was decided that one of the two **D** Groups would retire from the business with effect from October 6, 1946 subject to the terms and conditions specified in that agreement. The relevant clauses of that agreement read thus :

E "It is agreed that one or other of the Bagla or Jaipuria groups shall retire from the said partnership with effect from 6th October, 1946. The continuing group shall pay to the retiring group their shares of the capital and interest thereon and compensation which shall include the price of goodwill and the share of the retiring partner in the profits of the firm upto 5th October 1946. The question as to which of the said two groups shall retire and what amount of compensation shall be paid by the continuing group to the retiring group shall be determined by auction held in the manner set out hereinafter. Such auction shall be held forthwith. The auction shall be conducted by Dr. Brijendra Swarup, Advocate of Kanpur and Mr. B. P. Khaitan, Solicitor of Calcutta. Only partners shall be entitled to attend auction. Rai Bahadur Rameshwar Prasad Bagla and Sjt. Mangtoram Jaipuria will give bids on behalf of their respective groups and the respective groups shall be bound by bids so given by their aforesaid respective nominee. The group offering to pay the highest compensation shall continue as partners in the firm and the other group shall retire as herein provided."

H The continuing group shall pay to the retiring group within 10 days from the date of the auction the following :

- (a) The amount of capital contributed by the retiring group with interest calculated at the rate of $4\frac{1}{2}\%$.
- (b) And compensation money ascertained as aforesaid."

In the auction held in pursuance of this agreement the Jaipuria Group outbid the Bagla Group. Consequently the Bagla Group retired from the business on receipt of the following amounts :

- Rs. 97,11,699—on account of capital investment
- Rs. 1,77,232—on account of interest on capital investment and
- Rs. 35,01,000—on account of compensation as provided in the agreement.

The Jaipuria Group paid those amounts to the Bagla Group on October 7, 1946. A separate receipt was executed by the Bagla Group in respect of the receipt of Rs. 35,01,000/-. That receipt recites :

"Received from Seth Gajadhar Jaipuria, Rai Sahib Puranmull Jaipuria and Seth Mungturam Jaipuria the sum of Rs. 35,01,000/- as solatium and compensation for surrendering to the Jaipuria group our right, title and interest in running concern of Bagla Jaipuria & Co. who *inter alia* were appointed the Managing agents of the Swadeshi Cotton Mills Co., Ltd. for a period of twenty years under an agreement dated 16th July, 1946 and, with expectation of further renewals of like period."

The assessee firm resigned as selling agents with effect from October 5, 1946. Jaipuria group continued in the name and style of Bagla Jaipuria and Co.

In the course of the assessment for the assessment year 1948-49, the Income-tax Officer brought to tax the sum of Rs. 35,01,000/- as income. He overruled the objection of the assessee that it was a compensation for giving up the managing agency right. Aggrieved by the decision, the assessee took up the matter in appeal to the Appellate Assistant Commissioner. The Appellate Assistant Commissioner affirmed the decision of the Income-tax Officer. He further held that the case also fell within the scope of s. 12-B of the Act. Thereafter the assessee took up the matter in appeal to the Income-tax Appellate Tribunal. It was contended before the Tribunal that the receipt in question cannot be considered as income coming within s. 10 of the Act as the same was a capital receipt. It was further contended that the Appellate Assistant

A Commissioner had no competence to convert the assessment made under s. 10 into one under s. 12-B and at any rate the receipt in question does not come within the scope of s. 12-B. The Tribunal rejected the first two contentions. But it agreed with the assessee that the receipt in question cannot be brought to tax under s. 12-B. At the instance of the assessee, the Tribunal submitted for the opinion of the High Court questions 1 and 2 referred to earlier and at the instance of the Commissioner of Income-tax, it referred to the High Court Question No. 3.

C This case came up for hearing before this Court on an earlier occasion. By our order dated August 12, 1971, we called upon the Tribunal to submit a supplementary statement of case on certain points viz. :

- D (1) Was any compensation payable under the agreement either directly or by implication in respect of the assessee's surrender of its share in the managing agency. If so, what is the amount of compensation payable in that regard.
- E (2) Was any compensation payable under the agreement directly or by implication in lieu of the assessee giving up its selling agency. If so, what is the amount of compensation payable in respect of that right.
- F (3) Did the assessee give up any other rights under the agreement. If so, what are those rights and what is the value of those rights ?
- G (4) The agreement says that the compensation includes "the price of goodwill and the share of the retiring partner in the profits of the firm upto 5th October, 1946".
- (a) was there any goodwill, if so what was its value and
- (b) What part of the compensation received by the assessee as can be attributed towards the profits earned by the association of persons calling itself M/s. Bagla Jaipuria Company uptill 5th October, 1946.

The Tribunal submitted the supplementary statement of case called for on November 24, 1971. Dealing with the first question, the Tribunal observed :

H "It will thus be seen that compensation was paid by the Jaipuria Group to the Bagla Group (a) partly for the surrender of its share in the Managing Agency

right, (b) partly for giving up its selling agency right and (c) partly for the profits earned by the Bagla Group upto 5th October, 1946. There is, however, no material on the record on the basis of which it may be possible to split up the quantum of compensation in respect of each of the above three items at (a), (b) and (c). Therefore, our answer to query No. (1) is that the compensation was payable under the agreement dated 7-10-1946 not directly but by implication in respect of the assessee's surrender of its share in the Managing Agency right but it is not possible to determine the quantum for want of material on the point."

Dealing with point No. 2, the Tribunal's answer is the same as of point No. 1. Dealing with point No. 3, the Tribunal observed that the only other right given up by the assessee under the agreement was the goodwill but there is no material on record on the basis of which its value could be ascertained. On point No. 4(a), the Tribunal observed :

"Regarding query No. (iv)(a), made by the Supreme Court, there was certainly, in our opinion goodwill of the partnership firm M/s. Bagla Jaipuria & Co. as it was appointed not only the Managing Agents of a very big cotton mill for a period of 20 years in 1946, at a time when there was Government control over cloth and textile Mills and their managing agents were making huge profits, but had also the sole-selling agency of the Co. viz. Swadeshi Cotton Mills Ltd. The goodwill of M/s. Bagla Jaipuria & Co., also included besides, right to managing agency commission etc. the selling agency of the Baglas, which they were holding since 1911 and the quota rights of the Jaipurias, which they had been holding since the quota system was introduced by the Central Government, during the Second World War: There is, however, no material to value the goodwill separately."

On point No. 4(b), this is what the Tribunal has observed :

"Regarding query No. (iv)(b) the compensation of Rs. 35,01,000/- no doubt includes payment towards the share of its profit in the partnership firm of M/s. Bagla Jaipuria & Co. from 29-4-1946 to 5-10-1946 but it is again regretted that there is no material on the basis of which the compensation can be computed as attributable to this aspect of the matter."

The question for decision is whether the receipt of Rs. 35,01,000/- is a capital receipt or a revenue receipt. The ques-

A tion whether a particular receipt is a capital or revenue is largely a question of fact but often we come across border line cases which do present difficulties in arriving at a conclusion. As observed by this Court in *Commissioner of Income-tax, Nagpur v. R. B. Jairam Valji and Ors.*⁽¹⁾.—

B “The question whether a receipt is capital or income has frequently come up for determination before the courts. Various rules have been enunciated as furnishing a key to the solution of the question, but as often observed by the highest authorities, it is not possible to lay down any single test as infallible or any single criterion as decisive in the determination of the question, which must ultimately depend on the facts of the particular case, and the authorities bearing on the question are valuable only as indicating the matters that have to be taken into account in reaching a decision. Vide *Van Den Berghs Ltd. v. Clark*⁽²⁾. That, however, is not to say that the question is one of fact, for, as observed in *Davies (H. M. Inspector of Taxes) v. Shell Company of China Ltd.*⁽³⁾.

C “these questions between capital and income, trading profit or no trading profit, are questions which, though they may depend no doubt to a very great extent on the particular facts of each case, do involve a conclusion of law to be drawn from those facts.”

E As we are of opinion, for the reasons to be presently stated, that the receipt of Rs. 35,01,000/- is an income from business and as such was liable to be brought to tax under s. 10, we have not thought it necessary to go into other two questions.

F Before examining the legal position, it is necessary to emphasise certain salient features of this case. The new partnership named Bagla Jaipuria and Co. is not a partnership of two firms. Two firms cannot join in a partnership. Really it was a partnership consisting of six partners; three of whom were partners of one firm and the other three partners of another firm. This new partnership came into existence on April 29, 1946. These partners did not enter into a deed of partnership. This partnership took over as managing agents of the Swadeshi Cotton Mills Co. Ltd. on July 16, 1946. Three of the partners belonging to Bagla Group went out of the partnership on October 6, 1946.

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H Though the three named members of the Bagla Group were partners of the new firm, the benefit of the new partnership was to enure to the old firm of which those three persons were partners.

(1) 35 I.T.R. 148.

(2) [1935] 3 I.T.R. (Eng. Cas.) 17.

(3) [1952] 22 I.T.R. (Supp.) 1.

That old firm not only continued to be in existence but continued to carry on various business activities. It may be noted that the firm Bagla Jaipuria & Co. continued to be in existence. It continued to be the managing agents of Swadeshi Cotton Mills Co. Ltd. Its goodwill, if any, was not parted with. What really happened was that three of the partners of that firm went out of the partnership and for doing so they were paid Rs. 35,01,000/- which sum also included the profits earned by the Bagla Jaipuria & Co. from the date it came into existence, till the three partners belonging to the Bagla Group went out of the partnership leaving the partnership firm intact. There is no dispute that the portion of the compensation which represents past profits is a revenue receipt. The only question is whether the remaining portion was a Revenue receipt or Capital receipt. The remaining portion of the receipt purports to be compensation given to the three partners for giving up what are called (i) the managing agency rights (ii) the selling agency rights and (iii) the goodwill. We shall first take up the question relating to the goodwill and the managing agency rights.

It was urged on behalf of the assessee that as a result of the agreement dated October 7, 1946, the assessee firm parted with its managing agency rights which but for that agreement would have continued for a period of twenty years with a possibility of renewal. The managing agency right given up under that agreement is a capital asset of the firm and therefore any compensation paid for the extinguishment of that right is a capital receipt. It was also argued that one of the rights that the assessee firm parted with under that agreement was the goodwill of the company which is also a capital asset. Consequently compensation paid in respect of the same must also be considered as capital receipt.

In our opinion the aforementioned arguments are fallacious. The managing agency rights vested with the Bagla Jaipuria & Co. Similar is the case so far as the goodwill is concerned assuming that any goodwill had been built up by that time, Bagla Jaipuria & Co. continues to be in existence. It had not parted with managing agency rights nor its goodwill taken away. What has happened is that the partners representing the assessee firm in Bagla Jaipuria & Co. had surrendered their rights in the partnership to the remaining partners and obtained certain payments for surrendering their rights. This is not a case of parting with any agency rights. This is really a case of cancellation of a contract which had been entered into in the ordinary course of business. Such contracts are liable, in the ordinary course of business, to be altered or terminated on terms and any payment received in settlement of the rights as a result of the termination of the contract really repre-

A sends the profits which the assessee would have made had the contract been performed. As observed by this Court in *Jairam Valji's* case (supra) :

B “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.”

C As seen earlier no deed of partnership had been entered into. Therefore the same was terminable at will. Any of the partners of the firm could have brought the partnership to an end. Consequently the possibility of termination of a partnership of the type with which we are concerned is inherent in the very course of business.

D The facts set out in the statement of case show that the assessee firm had various business activities; one of its business activity was to join Bagla Jaipuria & Co. to carry on certain business activities. The assessee's representatives by entering into that agreement were merely carrying on a trading activity. Such being the case, it is not possible to hold that the compensation paid for the termination of the contract is a capital receipt.

E It is not the case of the assessee that its only trading activity had come to an end. It had several activities. Just one of its trading activity had been put an end to. Hence the amount received cannot be considered as compensation for stopping its business.

F Now we come to the transfer of the selling agency to Bagla Jaipuria & Co. This is not a right transferred under the agreement dated October 7, 1946. That right had been transferred to Bagla Jaipuria & Co. even at the time the partnership was formed. On October 7, 1946, the assessee was no more the owner of that selling agency. On that day it was an asset of Bagla Jaipuria & Co. Hence the compensation paid can only relate to the termination of the contract of partnership and not to the transfer of the selling agency. Assuming that agreement of October 7, 1946 has indirectly affected the selling agency right of the assessee, the same was one of the several trading activities of the assessee firm. On the basis of the material on record, the High Court held that after the Bagla Group gave up its interest in the Bagla Jaipuria & Co., the assessee firm with the aid of Rs. 35,01,000/- received as compensation acquired controlling shares in two other companies namely the India United Mills Ltd. and the Muir Mills Ltd. From this it is clear that the trading

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structure of the assessee firm was not affected. It merely replaced one trading activity by another. In *Gillanders Arbuthnot and Co. Ltd. v. Commissioner of Income-tax, Calcutta*⁽¹⁾, this Court held in the case of an assessee having vast array of business including acquisition of agencies in the normal course of business, the determination of an individual agency is a normal incident not affecting or impairing its trading structure. In such cases the amount received for the cancellation of an agency does not represent the price paid for the loss of a capital asset; they were of the nature of income.

In *Kettlewell Bulleun and Co. Ltd. v. Commissioner of Income-tax Calcutta*⁽²⁾, this Court after considering, various decisions rendered by the courts in U.K. and in this country about the principles which govern the determination of the nature of compensation received on the termination of an agency observed :

“On an analysis of these cases which fall on two sides of the dividing line, a satisfactory measure of consistency in principle is disclosed. Where, on a consideration of the circumstances payment is made to compensate a person for cancellation 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.”

For the reasons mentioned above we hold that the entire sum of Rs. 35,01,000/- received by the assessee was a revenue receipt assessable under s. 10.

In the result Civil Appeal No. 2022 of 1966 is dismissed with costs. On our indicating our tentative conclusion on the first question referred to the High Court the learned Solicitor-General appearing for the revenue did not press Civil Appeal No. 1746 of 1968. It is accordingly dismissed with no order as to costs.

V.P.S.