

INCOME-TAX REFERENCE.

Before Rankin C.J., C. C. Ghose and Buckland JJ.

In re N. S. MUNDY.*

1930

Jan. 27.

Income-tax—Income—Profits—Gains—Capital—Withdrawal—Liability—Money compensation—Income-tax Act (XI of 1922), ss. 4(3) (vii), 10, 12, 34.

If a man claimed an interest in the capital of a business, whether he had or had not a right to it, and in the end received Rs. 60,000 in satisfaction of the *bona fide* claim he may have in the capital of that business, the money so received is not liable to income-tax, not being "income, profits or gains" within the meaning of section 4(3) (vii) of the Income-tax Act, and for the same reason withdrawal of capital from a firm would not be liable to income-tax.

In re Turner Morrison and Co., Ltd. (1) distinguished.

INCOME-TAX REFERENCE, at the instance of the assessee.

The facts of the case, out of which this Reference arose, appear fully in the judgment, as well as in the subjoined extracts from the Letter of Reference by the Commissioner of Income-tax, Assam:—

During the course of 1925, differences arose between Mr. Trotman, proprietor of Messrs. John Smeal & Co., of Silchar, and his manager, Mr. Mundy, who was in receipt of a salary of Rs. 600 *per mensem* plus 25 per cent. of the net annual profits. Finally, after taking Mr. Trotman to court, it was settled between them "that Mr. Trotman should pay Mr. Mundy Rs. 60,000, whereupon Mr. Mundy should cease connection with the business. In April, 1926, the sum of Rs. 55,000 was, accordingly, paid to Mr. Mundy, who gave a receipt for Rs. 60,000 'as full settlement of my claim to a partnership in the firm of John Smeal and Company, Silchar'."

The receipt of this money was not entered by Mr. Mundy in his income-tax return in 1927-28 and the sum was not assessed in that year. In 1928-29, the payment came to the knowledge of the income-tax authorities, who, acting under section 34 of the Act, made a supplementary assessment on Mr. Mundy. Against this supplementary assessment, Mr. Mundy appealed to the Deputy Commissioner, Cachar, as Assistant Commissioner of Income-tax; the appeal was rejected, the judgment being attached herewith as Appendix No. 3. Mr. Mundy now applies for a revision of the assessment or for a reference to the High Court. I am not prepared to revise the order and accordingly submit to the High Court the question put in detail below.

Mr. Bagram and *Mr. Stuart-Smith*, for the assessee.

Mr. Satindra Nath Mukerji, for the Income-tax Commissioner, Assam.

*Income-tax Reference No. 12 of 1929, under section 66(2) of the Indian Income-tax Act (XI of 1922).

RANKIN C. J. This is a Reference by the Commissioner of Income-tax, Assam, and the question arises whether or not, a certain sum, amounting to Rs. 55,000, paid in April, 1926, by a Mr. Trotman to the assessee is liable to Income-tax.

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It appears that Mr. Trotman, in 1924, was the owner of a business, which he carried on under the style of John Smeal & Co. Mr. Mundy, the assessee, was engaged by Trotman as an assistant in the business. It may be that the word "assistant" is not a quite sufficient description and that Mr. Mundy might be described as manager; but Mr. Mundy began as a servant of Mr. Trotman and he had to begin with no interest save that of an employee in his master's business. It appears that, by the 21st May, 1924, Mr. Mundy had been serving his employer so well that, for a good many years past, it had been understood between them that, although there was no formal partnership, he had the position, which Mr. Trotman described as "virtually that of a quarter share-holder in the business." The reason of this was that Mr. Mundy was being remunerated, it would seem, by 25 *per cent.* of the profits, and Mr. Trotman held out to Mr. Mundy that he was going to make a will, that he wished to convert the business into a limited liability company and to give Mr. Mundy a share. As to his intention to give Mr. Mundy this interest in this way, there is evidence of a letter of the 21st May, 1924, Trotman saying that he is putting his intention into writing so that Mundy might have a tangible guarantee of his position. Later on, it appears that Mr. Mundy was taking up the position that he had been given a right to a quarter interest in the capital of this business, that he was a partner or, at the worst, was a person, who had an enforcible agreement with Trotman to give him the interest of a partner to the extent of one-fourth share. Trotman was taking up the attitude "you are not a partner in fact. It is true that I did promise that I was going to convert the business into a limited company and give you a quarter of the shares. That has not been

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“done and you, Mundy, are not desirous any longer “that I should do it.” Mundy was maintaining that he had an even higher right, namely, a right to a quarter interest in the business apart from any question of limited company. In that position, Mundy, made an offer to Trotman that he was willing to take Rs. 70,000 for his quarter share of the business; and there is no doubt, on the terms of the letter, that he was claiming this, not as an *ex gratia* payment, but as a sum of money which he would take in lieu of what he alleged to be his right. Now, Trotman in reply, did not admit that Mundy had the right he claimed, but he said that just as he was willing to convert the business into a limited company and give Mundy one quarter of the shares, so in lieu of that he was willing to let Mundy have Rs. 60,000—to give in cash what he had expressed willingness to give in kind. This offer was accepted in a letter, in which Mundy said “I am willing to accept your offer of Rs. 60,000 in “payment of my quarter share of the business.”

Now, the Commissioner of Income-tax, Assam, was, in the first instance, the authority to find all necessary questions of fact. It is quite true that he has found that Mr. Trotman's letters only amounted to an agreement that, if the business was converted into a limited company, Mundy would have a quarter of the shares. He says: The agreement might have been enforceable; but as Mundy did not in the end accept the offer of a quarter share in the company that matter ended there. Accordingly, says the Income-tax Commissioner, there is no partnership proved. We are thrown back on the letter in which Trotman speaks of Mundy as having the position virtually of a quarter share-holder in the business. Thereupon, the Income-tax Commissioner goes on to say: “In my opinion, “this does not constitute a saleable interest; and the “payment by Mr. Trotman was an *ex gratia* payment “to Mr. Mundy in consideration of the fact that the “latter had served him long and well.”

Now, in my judgment, the Income-tax Commissioner misdirected himself in law in holding that,

upon these findings of fact, this payment was an *ex gratia* payment to Mr. Mundy in consideration of the fact that the latter had served him long and well. It may be quite true that Mr. Mundy had no right of a partner; but he certainly was claiming to have that right and he was claiming upon grounds which, as I can see, may well have had very good foundation. The letter accepting Rs. 60,000 was a letter accepting it "in payment of my quarter share of the business." So that, it is plain to me that, apart altogether from any question of *ex gratia* payment, the payment was made by way of buying out a claim to a partnership, which claim was no doubt fairly formidable, or the sum of Rs. 60,000 would not have been given in exchange therefor. It seems to me that, on the correspondence, the Income-tax Commissioner thought himself obliged to hold this to be an *ex gratia* payment in consideration of the fact that Mr. Mundy had served Mr. Trotman long and well, merely because he could not find that, in point of fact, there was a right of a partner in Mr. Mundy. In so doing, I think the Income-tax Commissioner has misdirected himself and I am clear that, on this correspondence alone, Mr. Mundy took this money in satisfaction of his claim to be entitled to a quarter share in the business. It seems that there was a suit between the parties in which an issue was framed "Did the plaintiff, Mundy, "become partner with the defendant from April, "1924."

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Now, this payment of Rs. 60,000 was in settlement of Mundy's claim. That being so, it appears to me that we have to consider whether such a payment is "income, profits or gains" at all within the meaning of the Indian Income-tax Act. If a man claims an interest in the capital of a business and in the end receives Rs. 60,000 in satisfaction of all claims he may have in the capital of the business, is that income liable to income-tax? In my opinion, it is not liable to income-tax and for the same reason for which withdrawal of capital from a firm would not be liable

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to income-tax. We have not had the matter argued by learned counsel for the assessee at any length; but I may say that if the assessee's case had depended upon his showing that the payment was within clause (vii) of sub-section (3) of section 4, as at present advised, I should have thought that the payment, being one arising out of a business, that clause did not apply. I am of opinion that the sum of money here concerned is not "income, profits or gains" within the meaning of that clause at all.

A recent case, *In re Turner, Morrison & Co., Ltd.*, (1) has been cited to us on behalf of the Commissioner of Income-tax. That case appears to have been decided under clause (vii) of sub-section (3) of section 4 and other arguments appear to have been addressed to the Court upon the question, whether the sum of money there fell within section 10 or section 12 of the Income-tax Act. I do not observe that the case was argued upon the footing that the payment in that case was of a character such as would prevent it from being "income, profits or gains" at all within the meaning of the Income-tax Act. I think the special circumstances of that case probably account for the fact that this aspect of the question was not dealt with in the judgment. It appears from the terms of the articles of association of the company that the managing agents had to take whatever remuneration the company would agree to in its annual meeting. In the course of a year, the company went into voluntary liquidation and, in these circumstances, assuming that there was no other reason why the managing agents should not make a claim for wrongful dismissal, it is obvious that they would have some difficulty in recovering much by way of damages for wrongful dismissal, if their remuneration after doing the work was entirely in the hands of their employers. It would seem that, as the company was being wound up, a large sum of money was paid to the managing agents—a sum considerably in excess

(1) (1928) I. L. R. 56 Calc. 211.

even of the remuneration, which had been paid for a whole year in either of the preceding years, and, in these circumstances, it is perhaps not altogether to be wondered at that the sum of money in that case was dealt with as a question of *ex gratia* payment made to the managing agents in consideration of the fact that they were losing their expectation of continuing to do business as the managing agents of the company. In any case, that matter is not on all fours with the question with which we are here concerned. If I am right in thinking, upon the correspondence in the present case, that Rs. 60,000 was paid and received in satisfaction of a *bona fide* claim on the part of the assessee to be entitled to an interest in the capital of a certain business, it does not seem to me that that is liable to income-tax.

Accordingly, the question propounded to us should, in my opinion, be answered in favour of the assessee. The question is not perhaps very happily worded—“Was the Income-tax Officer correct in holding that “the applicant’s interest in the business did not “amount to a partnership or to such an interest as “would entitle the income-tax department to regard “money received in exchange for it as a capital receipt “and not income.” In my judgment, as to the latter part of that question, the Income-tax Officer was not correct. Whether Mr. Mundy had or had not a right to a quarter interest in this business, if he received the Rs. 60,000 in satisfaction of a *bona fide* claim that he would be entitled to a quarter interest in the capital, the money so received is not taxable.

The assessee will have his costs of this Reference.

GHOSE J. I agree.

BUCKLAND J. I agree.

Attorney for the assessee: *S. N. Mukerji.*

Attorneys for Assam Income-tax Dept.: *C. R. Ker & Co., G. C. Gooding.*

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