INCOME-TAX REFERENCE.

Before Sir Lionel Leach, Chief Justice, Mr. Justice King and Mr. Justice Krishnaswami Ayyangar.

THE COMMISSIONER OF INCOME-TAX, MADRAS, PETITIONER,

1940, March 14.

v.

MADRAS AND SOUTHERN MAHRATTA RAILWAY COMPANY, LIMITED, MADRAS, RESPONDENTS.*

Indian Income-Tax Act (XI of 1922), sec. 4—Guaranteed interest paid in London to r ilway company by Secretary of State for India—Subsequent reimbursement by him out of the profits of the company working in British India—Assessability of the amount to income-tax in British India.

Where, in pursuance of a contract between a railway company working in British India and the Secretary of State for India, the Secretary of State for India paid guaranteed interest half-yearly in sterling in London to the company on the capital provided by it and at the end of the year reimbursed himself out of the profits of the undertaking in British India, the surplus profits being distributed between the company and the Secretary of State in proportion to their respective shares in the capital, the company contended that the payment of guaranteed interest in London cannot be regarded as profits accruing or arising in British India within the meaning of section 4 of the Indian Income-Tax Act, 1922,

held, negativing the contention, that the payment by the Secretary of State in London is merely a provisional payment which he recovers out of the profits in British India and the sum of money representing the equivalent in rupees of the amount so paid is consequently liable to assessment in the hands of the company in British India.

Madras and Southern Mahratta Railway Co., Ltd. v. *The Commissioners of Inland Revenue*(1) applied and followed.

* Original Petition No. 225 of 1939.

(1) (1926) 12 T.C. 1111.

COMMISSIONER OF INCOME-TAX, MADRAS v. M. & S. M. Ry. Co., Ltd.

Bengal-Nagpur Railway Company, Ltd. v. *The Secretary of State for India*(1) not followed.

In the matter of the Indian Income-Tax Act XI of 1922.

Nugent Grant (with him *C. Krishnaswami Ayyar*) for respondents.—The assessee is a company incorporated in England working a railway in British India. The company has contributed a portion of the capital of the undertaking and, under the terms of a contract with the Secretary of State for India, the latter has agreed to pay every half-year to the company in London interest at the rate of three and a half per cent on the capital contributed by the company. The amount of such guaranteed interest paid to the company in London is the subject-matter of dispute in the present case. The Income-tax authorities claim that this amount paid to the company in England is liable to income-tax in British India while the company contends that it is not so liable. Construing a similar contract between the Bengal-Nagpur Railway Company and the Secretary of State for India, the Calcutta High Court held in *Bengal Nagpur Railway Company, Ltd.* v. *The Secretary of State for India*(1) that such amount of guaranteed interest received by that company in England was not profit and that no income-tax could be levied on that amount in British India. This decision is, no doubt, in conflict with the decision of ROWLATT J. in *Madras and Southern Mahratta Railway Co., Ltd.* v. *The Commissioners of Inland Revenue*(2). But the Income-tax authorities have for a long time accepted the Calcutta decision as correct and even after the decision of ROWLATT J., no attempt has been made to set matters right by legislative amendments. Several amendments have been introduced in the Indian Income-Tax Act on many other points but no amendment has been sought to be made in regard to this matter. I shall, however, proceed on the basis that the view of the Calcutta High Court is erroneous and that the decision of ROWLATT J. must be accepted as correct. ROWLATT J. held that the guaranteed interest received by the company in England formed part of the profits of the company, and that it must be taken into account in assessing the company to corporation profits tax

(1) (1922) I.L.R. 49 Cal. 815 (S.B.). (2)-(1926) 12 T.C. 1111.

in England. It may be that the amount of guaranteed interest paid in England is profit of the company; but it is not profit or income accruing or arising in British India within the meaning of section 4 of the Indian Income-Tax Act. Under the contract with the Secretary of State the amount is payable to the company in London on 1st January and 1st July every year and when it is so paid in London it is not paid out of any profits earned in British India. The fact that the amount is shown in the balance sheet of the railway undertaking in British India does not affect the question and the amount cannot be deemed to be income arising or accruing in British India on this ground. Moreover, the amount is liable to income-tax in England, see *Foulsham* v. *Pickles*(1) and *Hall (H.M. Inspector of Taxes)* v. *Marians*(2); and the profit must be deemed to arise in England.

K. V. Sesha Ayyangar for petitioner.—The decision in *Madras and Southern Mahratta Railway Co., Ltd.* v. *The Commissioners of Inland Revenue*(3) is clear. ROWLATT J. held that the total profits of the company, and not the profits of the company minus the amount of guaranteed interest, was liable for the corporation profits tax. Under the terms of the contract the profits are divided at the end of the year between the Secretary of State and the company and the share of the company is paid to it, only after the Secretary of State reimburses himself the amount which he has paid by way of guaranteed interest. This amount is paid in anticipation of profits and is traceable to the profits earned in British India. The company is paid this amount because it manages the railway in British India and carries on business there. The fact that the Secretary of State guarantees a definite percentage of interest on the capital contributed by the company and pays the same in advance in England does not alter the character of the profits when they are earned. All that the guarantee means is that the Secretary of State assures a minimum percentage of interest even if profits are not made in the undertaking. That the amount is paid in England does not make any difference. The amount is paid to the company in respect of business carried on by it in British India and consequently it is income arising to the company

(1) [1925] A.C. 458. (2) (1935) 19 T.C. 581.
(3) (1926) 12 T.C. 1111, 1123.

COMMISSIONER OF INCOME-TAX, MADRAS v. M. & S. M. Ry. Co., Ltd.

in British India. Even though money is paid under agreement in a place outside British India for business done in British India, it is assessable to tax in British India; vide *Commissioner of Income-tax, Bombay Presidency* v. *Sarupchand Hukamchand*(1), which was approved by the Privy Council in *Commissioner of Income-tax, Bombay* v. *Chunilal B. Mehta*(2). In *In the matter of the Bishop of Lucknow*(3) the Allahabad High Court held that an honorarium paid in London to the Bishop of Lucknow for holding the Lucknow See was income accruing in British India. Commission paid outside British India for services rendered within British India was held to be income arising within British India; see *In the matter of V. G. Eve y*(4). The fact that the amount paid in England is liable to income-tax assessment in England has also no bearing on the question whether it is income arising or accruing within British India. There is provision for relief against double taxation, both in the British and the Indian Statutes.

Nugent Grant in reply.—The question that arose in *Madras and Southern Mahratta Railway Co., Ltd.* v. *The Commissioners of Inland Revenue*(5) was entirely different from the one that arises here. Distinction ought to be made between the amount of guaranteed interest and the amount of surplus profits paid to the company. The nature and scope of the two payments are different. If the amount of guaranteed interest is subject to assessment in England it cannot be deemed to be income arising in British India. Income cannot be considered to accrue in two places at the same time in regard to the same transaction.

Cur. adv. vult.

JUDGMENT.

LEACH C.J.

LEACH C.J.—The assessee in this case is the Madras and Southern Mahratta Railway Company, Limited, which was incorporated in England in 1882. The main object of the incorporation of the company was the fulfilment of a contract with the Secretary of State for India in Council for the construction and

(1) (1930) I.L.R. 55 Bom. 231. (2) I.L.R. [1938] Bom. 752 (P.C.).
(3) (1931) I.L.R. 54 All. 223. (4) I.L.R. [1937] 2 Cal. 327.
(5) (1926) 12 T.C. 1111, 1123.

carrying on of a railway in India. After the incorporation, the contract was duly entered into and in accordance therewith the company constructed, equipped and maintained the railway to which the contract related and supplied the necessary staff for its working. The Secretary of State provided the land required for the railway and also the moneys necessary for its construction and working. All the assets of the undertaking including the rails, plant, machinery and rolling stock were to be and are his property. The company manages the railway under the supervision and control of the Secretary of State, who is empowered to appoint one member of the board of directors. The Court has been informed that the director appointed by the Secretary of State possesses a power of veto.

By virtue of the contract of 1882 the company undertook to pay into the Bank of England to the credit of the Secretary of State a sum of £3,000,000, and the Secretary of State undertook during the continuance of the contract to pay half-yearly to the company out of the revenues of India interest at the rate of 3½ per cent per annum on the amount. The £3,000,000 was duly paid by the company into the Bank of England to the credit of the Secretary of State, who has paid to the company in London half-yearly the amount required to meet the interest due but the Secretary of State has reimbursed himself at the end of the year out of the profits of the undertaking. The £3,000,000 represented the company's capital and the Secretary of State guaranteed interest on it at the rate mentioned. The contract also provided for division of the surplus profits between the Secretary of State and the company according to their respective shares in the capital of the undertaking.

COMMISSIONER OF INCOME-TAX, MADRAS v. M. & S. M. Ry. Co., Ltd.

LEACH C.J.

The contract of 1882 continued to govern the relations between the company and the Secretary of State until 26th June 1908 when a further contract, expressed to be supplemental to the contract of 1882, was entered into. The contract of 1908 provided for the continuance of the original contract subject to certain variations and modifications. It was agreed that the capital of the undertaking should be taken to be the sum of £16,250,000 of which £12,750,000 was to be the capital of the Secretary of State, and £3,500,000 to be the capital of the company. The Secretary of State was given the right to require the company to issue new capital stock not exceeding £1,500,000 to be allotted as fully paid up to such share-holders as he might direct. This new stock was issued in the same year with the result that the amount of the company's capital became £5,000,000 the figure at which it now stands. After the issue of this new stock the capital of the Secretary of State was deemed to be £11,250,000 for the purpose of determining the proportion in which the profits should be distributed.

All moneys received by the company in the course of the working of the railway have to be paid over to the Secretary of State. The company is not entitled to use any of the receipts of the undertaking for the purposes of meeting working expenses. These expenses are met from a grant made each year by the Secretary of State. As I have indicated the net receipts of the undertaking are divided at the end of each year between the Secretary of State and the company in proportion to their respective shares in the capital. The distribution of the profits rests with the Secretary of State, who is entitled in calculating the surplus to deduct the equivalent in rupees of the amount he has paid to the company by way of

guaranteed interest in the course of the year. The surplus has always been more than sufficient to enable the Secretary of State to reimburse himself.

The reference arises out of the assessment of the company for the year 1937–38. The company returned an income of Rs. 24,36,479 for 1936–37. In arriving at this figure the company deducted Rs. 23,33,333 which it had received from the Secretary of State as interest under his guarantee. This deduction was in accordance with the practice which had been previously allowed, a practice which received the approval of the Calcutta High Court in *Bengal-Nagpur Railway Company, Ltd.* v. *The Secretary of State for India*(1). This decision however conflicts with a later decision in England affecting the company, *Madras and Southern Mahratta Railway Co., Ltd.* v. *The Commissioners of Inland Revenue*(2), and it is this conflict which has given rise to the reference. The Income-tax authorities say that the Calcutta decision is wrong and that the company in calculating its annual profits must include the amount of guaranteed interest received in London. In order that the question may be decided, the Commissioner of Income-tax, in agreement with the company, has referred to this Court under the provisions of section 66 (1) of the Indian Income-Tax Act, 1922, the following question :

"Whether the said sum of Rs. 23,33,333 being the equivalent in rupees of the guaranteed interest paid by the Secretary of State for India under the terms of the contracts, dated 1st June 1882 and 26th June 1908 between the Secretary of State and the company which was deducted for the purpose of the company's return for the accounting year 1936–37 is liable to assessment in the hands of the company ? "

(1) (1922) I.L.R. 49 Cal. 815 (S.B.). (2) (1926) 12 T.C. 1111.

COMMISSIONER OF INCOME-TAX, MADRAS v. M. & S. M. RY. CO., LTD.

LEACH C.J.

In *Bengal-Nagpur Railway Company, Ltd.* v. *The Secretary of State for India*(1) that company was called upon to pay tax on an income of Rs. 1,72,60,595 which included a sum of Rs. 13,07,440 being the equivalent of the amount of the guaranteed interest paid in sterling by the Secretary of State on the share of the capital of the company. For the purposes of the present reference the contract of the company with the Secretary of State may be taken to be on all fours with the contract of the Bengal-Nagpur Railway Company, Limited, with the Secretary of State. The Bengal-Nagpur Railway Company, Limited, claimed that it was only taxable in respect of the amount which it received in India at the end of the year as its share of the surplus profits. A Full Bench of the Calcutta High Court held that the company was only liable in respect of its share of the surplus profits received in return for its services in the management of the railway, and not in respect of the moneys received in London. It was considered that the payment of the guaranteed interest in London was independent of the earnings of the railway and that the repayment of the amount of the guaranteed interest constituted the payment of a debt due from the company to the Secretary of State.

In *Madras and Southern Mahratta Railway Co., Ltd.* v. *The Commissioners of Inland Revenue*(2) the question was whether the company was liable to corporation profits tax in respect of the amount which it received from the Secretary of State as guaranteed interest. Admittedly there is no difference in principle between assessment in England to the corporation profits tax and assessment to Indian income-tax. It was held by ROWLATT J.

(1) (1922) I.L.R. 49 Cal. 815 (S.B.). (2) (1926) 12 T.C. 1111.

that the guaranteed interest paid by the Secretary of State formed part of the company's profits and that the recoupment to the Secretary of State out of the surplus profits represented a distribution of profits within the prohibition of deduction from the profits in section 53 (2) of the Finance Act, 1920. ROWLATT J. put the question this way:

"Are the profits of the company for the purpose of corporation profits tax the amount of their share before the Secretary of State is recouped, or are they only the balance which is left to them after the Secretary of State is recouped? That is what the question is, or to put it in another way, are they to be taxed on that balance, or are they to be taxed on that balance plus the amount of the guaranteed interest, which is only putting the same thing in another way?"

In deciding the case against the company the learned Judge said:

"If you put it in commercial or financial language or look at it from the commercial or financial point of view, the position simply is that these share-holders have been paid out of the proceeds of the working of the railway, and the revenues of India have not paid them a penny. The money they have got is simply because the railway has been so successful, and for no other reason they have got it. If it had not been successful they would have got some of it from the Secretary of State for India, but that position has not arisen; or, if you use language framed more exactly with respect to tax law, this, in my judgment, is the position, that the railway company have earned all these profits, all their one-fifth share, or whatever it is, of the profits of the railway company and it does not matter in the least that they have had to apply those profits, being profits from the working of the railway in making good to the Secretary of State a guarantee which he had honoured provisionally in favour of the share-holders . . . The Secretary of State is recouped out of what is called the company's share of the surplus receipts and as I have pointed out, the extent of his recoupment depends upon the amount of the profits. I think that this is a distribution of profits within the prohibition in section 53, sub-section 2 (*b*) of the Finance Act, 1920. I

COMMISSIONER OF INCOME-TAX, MADRAS v. M. & S. M. RY. CO., LTD.

LEACH C.J.

think it is a distribution of profits. It is a distribution of profits in recoupment of a guarantor who guaranteed those profits—guaranteed them if you like to the share-holders, but what he guaranteed are the profits. He has guaranteed that the people who put up the capital shall have a return on the capital, and if the profits unaided give that return, the person who gives the guarantee gets them to make good his guarantee. It seems to me the very simplest case of the application of profits, after they have become profits, by way of distribution of them to make good to somebody who has taken the risk of those profits not reaching that amount."

Both the company and the Income-tax authorities accept the decision of ROWLATT J. in *Madras and Southern Mahratta Railway Co., Ltd.* v. *The Commissioners of Inland Revenue*(1), as correctly stating the law and consequently are agreed that *Bengal-Nagpur Railway Company, Ltd.* v. *The Secretary of State for India*(2) ought not to be followed. While accepting the judgment of ROWLATT J. in *Madras and Southern Mahratta Railway Co., Ltd.* v. *The Commissioners of Inland Revenue*(1), Mr. Grant has contended on behalf of the company that the payment of interest on the £5,000,000 in London cannot be regarded as profits accruing or arising in British India within the meaning of section 4 of the Indian Income-Tax Act, 1922. In fact this is the only point taken on behalf of the company. As the correctness of the decision in *Madras and Southern Mahratta Railway Co., Ltd.* v. *The Commissioners of Inland Revenue*(1) is not challenged, I fail to see any basis for the argument that the receipt of the interest in London must be taken to be income earned there. The decision of ROWLATT J. emphatically negatives the contention. The basis of his judgment is that all the profits of the undertaking are earned in India and

(1) (1926) 12 T.C. 1111. (2) (1922) I.L.R. 49 Cal. 815 (S.B.).

the payment by the Secretary of State in London is merely a provisional payment which he recovers out of the profits in India.

There are cases arising under the Indian Income-Tax Act which also militate against Mr. Grant's contention. In *Commissioner of Income-tax, Bombay Presidency* v. *Sarupchand Hukamchand*(1) the Bombay High Court had to consider whether section 4 (1) of the Indian Income-Tax Act, 1922, applied in these circumstances. A company registered in Indore, a Native State, entered into an agreement with a firm in Bombay under which the firm was to open and maintain at the company's expense shops in Bombay and elsewhere for the sale of the company's goods, to keep the books of account in Indore in respect of all sale-proceeds and disbursements of the company, to charge a commission of 1¼ per cent on the gross sale proceeds of all cloth and yarn produced by the company, and to pay itself out of the moneys of the company all sums due to it by way of commission or otherwise. The sale-proceeds of the Bombay shop were all sent to Indore and the commission was paid there. It was contended that in these circumstances no income accrued or arose in British India, but the contention was rejected and the decision was approved of by the Privy Council in *Commissioner of Income-tax, Bombay* v. *Chunilal B. Mehta*(2). In *In the matter of the Bishop of Lucknow*(3) the Allahabad High Court held that a sum of money paid annually in London to the Bishop of Lucknow by the trustees of a certain fund as a gratuitous and unconditional personal allowance of the holder of the Lucknow See was income accruing or arising in British India and was assessable as salary

(1) (1930) I.L.R. 55 Bom. 231. (2) I.L.R. [1938] Bom. 752 (P.C.).
(3) (1931) I.L.R. 54 All. 223.

COMMISSIONER OF INCOME-TAX, MADRAS v. M. & S. M. RY. CO., LTD.

LEACH C.J.

under section 7 (1) of the Act. In *In the matter of V. G. Every*(1) the Calcutta High Court held that commission earned by an assessee in British India for services rendered there as an employee of a company which was received by him in the United Kingdom while on leave, was income which had accrued or arisen in British India within the meaning of section 4 (1).

It is not necessary to carry the discussion any further. There is ample authority in the cases which I have quoted to support the contention of the Income-tax authorities that all the profits of the company accrue or arise in British India and therefore I would answer the question referred to us in the affirmative. I would add that the Court is not called upon to consider whether the payment in London would constitute profits arising in British India in the event of the working of the undertaking not realizing sufficient to reimburse the Secretary of State at the end of the year, as this situation has not arisen.

As the reference has been made by consent in order that there should be a pronouncement by the Court on the question, there will be no order as to costs.

KING J.—I agree.

KRISHNASWAMI AYYANGAR J.—I also agree.

Solicitors for Respondents—*King & Partridge.*

N.S.

(1) LL.R. [1937] 2 Cal. 327.