Privy Council Appeal No. 18 *of* 1931.
Patna Appeal No. 49 *of* 1929.

Raja Raghunandan Prasad Singh and another - - - *Appellants*

v.

The Commissioner of Income Tax, Bihar and Orissa - - *Respondent*

FROM

THE HIGH COURT OF JUDICATURE AT PATNA.

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL, DELIVERED THE 24TH JANUARY, 1933.

Present at the Hearing:

LORD MACMILLAN.
SIR GEORGE LOWNDES.
SIR DINSHAH MULLA.

[*Delivered by* LORD MACMILLAN.]

This appeal brings before their Lordships eight questions relating to the taxable income of the appellants for the year 1926–27. The appellants carry on the business of moneylenders and are liable under Section 3 of the Indian Income Tax Act, 1922, to pay income tax for the year 1926–27 in respect of the profits or gains of their business in the previous year, 1925–26, as computed in accordance with the provisions of Section 10 of the Act.

Being dissatisfied with the assessment of the income tax officer and with the result of an appeal to the Assistant Commissioner, the appellants under Section 66 (2) required the Commissioner to refer to the High Court of Judicature at Patna a series of questions purporting to be questions of law arising out of the Assistant Commissioner's order. The Commissioner accordingly, as directed by the Act, drew up a statement of the case and referred it to the High Court with his own opinion on the eight questions which he formulated.

The transactions which have given rise to the questions at issue relate to the lending of money by the appellants or their predecessor (hereinafter called "the assessees") in connection

with a property known as the Srinagar estate. It appears that on the death of the proprietor of this estate in 1880 a one-third share thereof was in a partition suit awarded to his son Nityanand and the other two-thirds jointly to Kamlanand and Kalikanand, his sons by another wife. In 1894 Nityanand mortgaged his one-third share to the assessees for two lacs of rupees. Five years later he borrowed on further mortgage of his share a sum of three and a half lacs from the Benaili Rajas. On this latter mortgage the Benaili Rajas obtained in 1902 a decree against Nityanand for Rs. 4,57,159, principal and interest. His half-brothers in 1903 bought this mortgage decree for five lacs and in security of the purchase price mortgaged their two-thirds of the Srinagar estate to the Benaili Rajas. In the same year they purchased Nityanand's equity of redemption.

In July, 1904, there was due to the assessees under the mortgage of 1894 a sum of Rs. 4,33,135, being Rs. 2,00,000 of principal and Rs. 2,33,135 of interest, and to the Benaili Rajas under the mortgage of 1903 a sum of Rs. 5,25,815. The debtors, Kamlanand and Kalikanand, settled with the Benaili Rajas by paying them Rs. 815 from their own cash, and Rs. 3,00,000 borrowed from the assessees and by executing a fresh mortgage for the balance of Rs. 2,25,000 in favour of the Benaili Rajas. This left them indebted to the assessees to the extent of Rs. 4,33,135 + Rs. 3,00,000 = Rs. 7,33,135, for which sum they, along with Kamlanand's two minor sons, through him as their guardian, executed on 18th July, 1904, a mortgage on the Srinagar estate in favour of the assessees.

In 1912 there was due on the mortgage for Rs. 2,25,000 to the Benaili Rajas a sum of Rs. 3,34,000, and this was met by Kalikanand as *karta* of the joint family, borrowing three lacs on mortgage from the assessees on 7th November, 1912, and providing the balance of Rs. 34,000 in cash. The Benaili Rajas were thus finally paid off.

The assessees subsequently brought suits on the mortgage for Rs. 7,33,135 of 18th July, 1904, and the mortgage for Rs. 3,00,000 of 7th November, 1912, on which, taken together, a sum of Rs. 27,13,379 of principal and interest was due. Decrees were passed in favour of the assessees on 22nd December, 1917. The mortgaged property was put up for sale and was bought by the assessees at the price of Rs. 25,65,100 at Court sales on the 19th November, 1924, and the 31st January, 1925. The sales were confirmed on the 18th and 21st of December, 1925.

The general question arising may be said to be—How much, if any, of this sum of Rs. 25,65,100 is liable to income tax in the year 1926–27 as being profits or gains of the assessees' money-lending business for the year 1925–26? The assessees, it is important to bear in mind, keep their accounts on a cash basis.

Their Lordships propose to deal with the eight particular questions stated by the Commissioner in the order in which he

has numbered them, although this may not be the most logical sequence and it has not been followed in the judgment of the High Court.

The first question is thus formulated by the Commissioner :—

> " 1. When a bond is discharged and extinguished by a fresh bond and where the assessees have credited the principal and interest of this bond in their books of accounts, can notional interest on the first bond be said to arise in years subsequent to the execution of the second bond, and can it be charged to income tax subsequently ? "

Their Lordships deprecate the statement of questions of law in this abstract form divorced from the facts of the particular case. The real question is whether, when the assessees on 18th July, 1904, accepted a new mortgage for Rs. 7,33,135, representing to the extent of Rs. 2,33,135 the arrears of interest due under a previous mortgage of 14th June, 1894, and discharged the previous mortgage and all sums due thereunder, they thereby in effect received payment then and there of the arrears of interest due under the previous mortgage.

The assessees contended that the acceptance of the new mortgage in 1904 and the extinction of the previous mortgage operated payment of the arrears of interest due under the previous mortgage, which were included in the capital sum for which the new mortgage was granted ; and that the sum representing the arrears of interest should have been taxed, if at all, as a receipt of the year 1904 in which the new mortgage was granted. According to the Commissioner, the assessees were as a matter of fact assessed at the time in the amount of these arrears of interest, but the assessment was, on the appeal of the asseesees, discharged on the ground that the interest was not taxable until the mortgage was realised. As, under Section 34 of the Act, income which has escaped assessment in any year can be subsequently assessed only within one year from the end of that year, the assessees have now an obvious reason for reversing the contention which they appear to have successfully put forward on the previous occasion. The Commissioner further finds that the sum of Rs. 2,33,135 was " not shown separately as interest realised in the assessees' books of account of that year [*i.e.*, 1904] either in the interest account or in the personal account of the debtor "—a finding which seriously stultifies the question as framed by the Commissioner.

Their Lordships fully recognise that income may be received in kind as well as in cash and that the receipt of an equivalent of cash may be a receipt of income. In the case of *Californian Copper Syndicate* v. *Harris*, 1905, 6 F. 894 ; 5 T.C. 159, a company which dealt in mining properties sold certain property for fully-paid shares in another company and was held to be liable to income tax on the profit made on the transaction although no cash passed, but this was on the ground that the shares taken in exchange were realisable and were thus money's worth and the equivalent of cash. In the case of *The Royal Insurance Company, Ltd.*, v. *Stephen*, 1928, 44 T.L.R. 630 ; 14 T.C. 22, an insurance company, which

admitted that any profit which it made on the realisation of investments was liable to tax, effected an exchange of securities in pursuance of a railway amalgamation scheme. The new stocks received in place of the surrendered stocks had at the date of the exchange a definite market value which was less than the original cost to the company of the surrendered stocks. A claim was made by the company in computing its profits to deduct the difference as a loss sustained by it. For the Crown it was contended that there has been no realisation of investments, but merely an exchange of one set of investments for another. The company's claim was upheld by Rowlatt J. on the ground that it had in substance realised its former holdings and received for them money's worth of a definite amount. The loss was thus a realised loss susceptible of exact estimation in money. The transaction was on " a money basis." Reference may also be made to the recent case in the House of Lords of *Westminster Bank, Ltd.*, v. *Osler* (15th November, 1932), where the bank surrendered certain holdings of National War Bonds in exchange for other Government securities and the Crown claimed tax on the excess value of the substituted over the original securities. The question was whether these transactions were the equivalent of a realisation of the original holdings, and it was held that they were. " The exchange effected in the present case," said Lord Buckmaster, " was in fact the exact equivalent of what would have taken place had instructions been given to sell the original stock and invest the proceeds in the new security." The bank had thus in effect realised its profit, for it had received it in money's worth of a definitely ascertained amount. From these cases it is plain that the essence of the matter is that there must be an actually realised or realisable profit or loss.

Applying this principle to the assessees' transaction in 1904, their Lordships are of opinion that there was in the circumstances no realisation of the principal and interest of the original mortgage of 1894 and that when the assessees received the new mortgage for Rs. 7,33,135, which included the principal and interest of the original mortgage, they did not thereby receive payment or the equivalent of payment of the principal and interest of the original mortgage. No doubt the grantors of the new mortgage were not identical with the grantor of the original mortgage and the property mortgaged was greater in extent, but the substitution effected cannot in any real sense be described as the equivalent of a realisation of the original mortgage, principal and interest. What happened was that the assessees received a new and substituted security for an existing debt. To give security for a debt is not to pay a debt. If the assessees had received payment in kind of the amount outstanding on the original mortgage, in the shape, say, of realisable shares or bonds, the case would have been different, but they merely received further and better security for their debt. It is, in their Lordships' view, quite

immaterial that the assessees discharged the original mortgage and all liability under it, for that was merely an incident in the transaction whereby the new security was substituted for the old. Their Lordships accordingly hold that the assessees did not by virtue of the transaction of 1904 receive payment of the arrears of interest amounting to Rs. 2,33,135 then outstanding on the mortgage of 1894; that the assessees were not liable to be taxed on this sum as being income received when the new mortgage was granted; and that this sum of arrears of interest (though after 1904 secured by the new mortgage) continued to retain its character and remain due to the assessees down to the time of the judicial sales of November, 1924, and January, 1925. In so holding their Lordships find themselves in agreement in result with the Commissioner and the High Court.

The next question is unfortunately also stated in abstract form as follows:—

> "2. When a property is purchased in execution of a mortgage decree by the mortgagee subject to deposit of security sufficient to safeguard the interest of a party claiming a one-eighth share in the property to be unaffected by the decree, can the value of the whole property be taken into account for the purpose of computing profits, or, on the other hand, can the amount deposited in the Court as security in these circumstances be claimed as deductible expenditure in computing profits?"

The facts are that in 1923 Ghananand Singh, a minor son of Kalikanand, sued the assessees for a declaration that his one-eighth share of the Srinagar estate was not affected by the mortgage decrees obtained by the assessees on 22nd December, 1917. Pending a decision in this suit the assessees deposited in Court Rs. 3,20,633, being one-eighth of the purchase price of Rs. 25,65,100, at which they bought the property at the judicial sales. The Subordinate Judge pronounced a decree in favour of Ghananand Singh on 15th September, 1927. It is not stated whether an appeal was taken. The question is whether, on the assumption that any part of the purchase price of Rs. 25,65,100 at which the assessees bought the Srinagar estate is computable as income of the assessees in the year 1925–26, it is permissible to deduct from such part the amount of this deposit of Rs. 3,20,633.

The dates are important. It will be observed that the suit was brought in 1923, while the judicial sales at which the assessees purchased the property took place at the end of 1924 and beginning of 1925. The assessees were thus aware when they bid for the property that there was a possibility that they might in the event only obtain seven-eighths of it. They were nevertheless prepared to bid Rs. 25,65,100 for it. Had it not been for this risk they would presumably have given more for the property. In the next place, no decision was pronounced in the suit till 15th September, 1927, and until then the assessees could not say whether or not they would have to pay over the amount of the deposit to Ghananand Singh, and if an appeal was taken the

question would continue to remain in suspense. In these circumstances their Lordships are unable to see how in computing the profits or gains of the assessees' business for the year 1925–26 this deposit can legitimately be claimed as a deduction from the purchase price of the Srinagar estate or from such part of that purchase price as may be held to be an income receipt. It was not in its nature a deduction from the purchase price, for the purchase price was paid in the knowledge of the claim ; nor was it a sum actually expended in the year 1925–26, so as to be a debit in that year in the books of the assessees, which are kept on a cash basis, for it was then at most a contingent liability ; and in no respect does it answer the description of expenditure incurred in the year 1925–26 by the assessees solely for the purpose of earning the profits or gains of that year within the meaning of Section 10 (2) (ix). Their Lordships accordingly agree with the Commissioner and the High Court that the amount of the deposit is not a permissible deduction in the computation of the assessees' profits or gains for the year 1925–26.

The third question stated by the Commissioner is in the following terms :—

> "3. Can assessees claim as admissible deduction from their income of that year the amount of decree obtained against them by a subsequent mortgagee who has subsequently been held by the Courts to hold a prior mortgage over the property, and is the sum which eventually turns out to be a charge on the property purchased by the assessees in a mortgage decree (which sum had not been considered by the assessees to be such charge on account of an express covenant embodied in an original mortgage bond) an allowable deduction from taxable income in this case ? "

Here the facts are that the Benaili Rajas in 1923 sued the proprietors of the Srinagar estate and the assessees to recover the amount due on a mortgage of the estate dated the 29th April, 1910. On the 18th September, 1926, the Rajas obtained a decree in their favour for Rs. 1,50,818, which the Court held to be a valid and prior charge on the property purchased by the assessees.

It will be observed in this instance also that the assessees purchased the property at the judicial sales in 1924–25 in the full knowledge of the Rajas' claim and in bidding Rs. 25,65,100 presumably allowed for the possibility of this claim succeeding, as it ultimately did. Moreover, in the year 1925–26 the assessees made no expenditure of Rs. 1,50,818 and it was not till the 18th September, 1926, that this sum was declared to be a charge on the property purchased by the assessees. Their Lordships accordingly, for the reasons assigned in disposing of the preceding question, are of opinion that this sum of Rs. 1,50,818 is not a permissible deduction in the computation of the assessees' profits or gains for the year 1925–26, and in this result they agree with the Commissioner and the High Court.

On the fourth question no argument was offered by the assessees. Their Lordships are accordingly not called upon to deal with it, and the decision of the Commissioner and the High Court, which was adverse to the assessees, will stand.

The fifth question stated by the Commissioner is as follows :—

> " 5. Does the law contemplate taxation of notional receipts of income and profits arising from the purchase by the mortgagee of the mortgaged property ? Is not a purchase by the mortgagee of the mortgaged property sold in execution of a decree a capital transaction ? "

This is logically the first question for determination between the parties, for if no part of the price of Rs. 25,65,100, at which the assessees acquired the Srinagar estate, can be treated as an income receipt, the other questions would not appear to arise.

When a mortgage decree-holder, with the permission of the Court, bids for and purchases the mortgaged property at a judicial sale, Order 21, rule 72 (2), of the Civil Procedure Code provides that " the purchase money and the amount due on the decree . . . may be set off against one another and the Court executing the decree shall enter up satisfaction of the decree in whole or in part accordingly." The decree-holder thus in effect receives a transfer of the property at the value of the purchase price in satisfaction *pro tanto* of the liability of the mortgagors for principal and interest. So far as the purchase price exceeds the principal sum due under the mortgage the excess is applicable to any arrears of interest. The costs of the mortgage suits and the expenses of the sales may for the purposes of the argument be disregarded. To the extent, therefore, that the purchase price exceeds the principal sum due there is a realisation of interest—that is, a payment of interest. The interest is paid in the form of a credit in account and is re-invested in the purchase of the property.

In the present instance the principal sums due under the mortgages of 18th July, 1904, and 7th November, 1912, on the Srinagar estate when it was judicially sold amounted to Rs. 7,33,135 + Rs. 3,00,000 = Rs. 10,33,135. The price paid was Rs. 25,65,100, or Rs. 15,31,965 in excess of the principal sums due. This excess was plainly available to be set against the arrears of interest, costs and expenses. But the special question which arises is whether in the circumstances a further sum is attributable to interest, viz., the sum of Rs. 2,33,135, which on 18th July, 1904, was due as arrears of interest under the former mortgage of 14th June, 1894, and which was included in the principal sum of Rs. 7,33,135, for which the mortgage of 18th July, 1904, was granted.

Their Lordships, in disposing of the first question in the case, have decided that this sum of Rs. 2,33,135 of arrears of interest was not paid in 1904, and they are of opinion that when the assessees as the result of the judicial sales received payment in account of the sum of Rs. 7,33,135 due under the mortgage of 18th July, 1904, they then received payment for the first time of the arrears of interest included in that sum. To the extent of Rs. 2,33,135, therefore, the sum of Rs. 7,33,135 represented an income receipt and must, as already indicated, be brought into computation as such by the assessees for tax purposes.

On the general issue raised in this fifth question their Lordships accordingly find themselves in agreement with the answer given by the Commissioner and the High Court. The special point with which their Lordships have just dealt is a corollary to the answers to the first and fifth questions and the decision given upon it below will be affirmed.

The next question is thus stated by the Commissioner :—

> " 6. If the profits or gains arising to the assessees from the buying in of mortgaged property are taxable, what is the date on which the profits are deemed to have arisen ? Is it the date of decree, the date of sale, the date of confirmation of sale, or the date of delivery of possession ? "

The answer of the Commissioner and of the High Court was that the profits must be deemed to have arisen on the confirmation of the sales, *i.e.*, on the 18th and the 21st December, 1925, and their Lordships are of the same opinion. The decree is only a step towards realisation, and the date of the decree is therefore plainly not the date of realisation. Nor on the date of the sale does the purchaser obtain an indefeasible right, for under Order 21, rules 89, 90 and 91, the sale may be set aside on various grounds. It is only where no application is made under these rules or where such application is made and disallowed that the Court under Order 21, rule 92, makes an order confirming the sale, whereupon " the sale shall become absolute." It is then that the process of realisation is completed and any profit or income is realised by the decree-holder. This is so whether the property is purchased by the decree-holder himself or by a third party, for the right of set-off conferred on the purchasing decree-holder must also be dependent on the sale being rendered absolute by confirmation. No doubt Section 65 of the Code provides that " where immovable property is sold in execution of a decree and such sale has become absolute the property shall be deemed to have vested in the purchaser from the time when the property is sold and not from the time when the sale becomes absolute," but this provision does not come into operation unless and until the sale has become absolute. The actual date of realisation is not affected by this retrospective vesting of the property.

The seventh question formulated by the Commissioner is as follows :—

> " 7. Assuming that there are profits arising out of this transaction which are legally taxable, are the assessees entitled to deduct from these taxable profits expenses which are always entailed in taking delivery of possession and effecting mutation in the Collectorate Registers ? "

Their Lordships agree with the Commissioner and the High Court that the expenses incurred by the assessees in completing their title and entering into possession after the sales had become absolute are not deductible by the assessees from their taxable profits. The assessees in bidding for the property must have had in view that they would incur these expenses if they were the successful purchasers and doubtless estimated accordingly the price which they thought it worth their while to bid.

The eighth and last question is as follows :—

" 8. What is the correct method of computing the value of the property acquired by the assessees in this case ? "

It appears that the Civil Court Commissioners had valued the property before the sales at Rs. 17,13,701, and the assessees' contention was that it should be taken at this value instead of being taken at the value of Rs. 25,65,100, the price at which they acquired the property at the sales. Their Lordships, agreeing with the Commissioner and the High Court, are of opinion that the price which the assessees bid for the property at the public sale must be taken to be its market value, and there is no evidence to the contrary.

As their Lordships find themselves in the result in agreement with the answers given by the High Court to the several questions raised in this appeal, they will humbly advise His Majesty that the decree of the High Court of 7th August, 1928, be affirmed and the appeal dismissed. The respondent will have his costs of the appeal.

In the Privy Council.

RAJA RAGHUNANDAN PRASAD SINGH AND ANOTHER

v.

THE COMMISSIONER OF INCOME TAX, BIHAR AND ORISSA.

DELIVERED BY LORD MACMILLAN.

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