

(1992) 12 KAR CK 0006

In the Karnataka High Court

Case No : Income Tax R. Cs. No"s. 94 and 95 of 1990 & Income Tax R.Cs. No"s. 94 and 95 of 1990

Commissioner of Income Tax

APPELLANT

Vs

M.S.P. Rajes

RESPONDENT

Date of Decision : 04-12-1992

Acts Referred:

Companies Act, 1956 — Section 349
Income Tax Act, 1961 — Section 256 (1), 263

Citation : (1994) 81 CompCas 19 : (1993) 109 CTR 370 : (1993) 202 ITR 646 : (1993) 69 TAXMAN 461

Hon'ble Judges : R. Ramakrishna, J;K. Shivashankar Bhat, J

Bench : Division Bench

Judgement

K. Shivashankar Bhat, J.—The two questions referred u/s 256(1) of the Income Tax Act, 1961, read as follows :

"(1) Whether, on the facts and in the circumstances of the case, the Tribunal was right in holding that the remuneration received by the assessee from M. S. P. Exports P. Ltd. and M. S. P. Species P. Ltd., as managing director of these companies, was assessable under the head "Income from other sources" and not under the head "Income from salary" ?

(2) Whether the Tribunal was right in holding that the assessee was entitled to the deductions claimed in respect of the said income received as remuneration in his capacity as managing director of the said two companies ?"

2. The proceedings arise in respect of the assessment years 1980-81 and 1981-82. To appreciate the problem before us, it is necessary to state the following facts summarised in the statement of the case filed in earlier references Nos. 100 and 101 of 1989.

3. The assessee is an individual. He was the managing director of M. S. P. Exports Pvt. Ltd. In the assessment year 1981-82, he was also the managing

director of M. S. P. Spices Pvt. Ltd. Two resolutions dated May 12, 1976, and April 29, 1981, were passed by the board of directors of M. S. P. Exports Pvt. Ltd. as set out below :

"Resolution dated May 12, 1976 :

Resolved that Sri. M. S. P. Rajes and Sri P. Palaniswamy, directors of the company be and are hereby appointed as managing directors of the company for a term of five years from this day, and that Sri M. S. P. Rajes and S. Palaniswamy the managing directors of the company be and are hereby authorised to act for and on behalf of the company, in all matters, including the signing of any contracts with any authority or corporation. They shall be subject to the superintendence and control of the directors and shall represent the company in all matters except where the Act requires certain acts to be done by the board of directors at a meeting or by the company in general meeting.

Resolved that the said managing directors may exercise the powers and authorities conferred on them either jointly or severally. Each of the managing directors shall be paid a remuneration of five per cent. of the net profits of the company as defined u/s 349 of the Companies Act, 1956, subject to a minimum of Rs. 2,500 per month, the minimum remuneration being payable monthly.

Resolution dated April 29, 1981 :

Resolved that Sri M. S. P. Rajes and Sri S. Palaniswamy, managing directors of the company, whose term of appointments as managing directors of the company expires on May 11, 1981, be and are hereby re-appointed for a further term of five years from May 12, 1981, and they shall be paid a remuneration of five per cent. of the net profit of the company as defined u/s 349 of the Companies Act, 1956, each, subject to a maximum of Rs. 72,000 each per annum, as managerial remuneration."

4. In terms of the aforesaid resolutions, the assessee received remuneration. In the original assessments, the Income Tax Officer treated the amounts so received as income from other sources and against the same allowed expenditure like interest on funds borrowed for investment in the company, remuneration to assistant and travelling expenses. The Commissioner of Income Tax invoked his powers u/s 263 and held that the assessee should be treated as an employee of the companies as his work was subject to the general superintendence and control of the board of directors and as such the allowances claimed were not admissible.

5. The assessee approached the Appellate Tribunal. The Tribunal accepted the plea of the assessee by following its earlier decision in I.T.A. Nos. 770 and 771 of 1984 (which is the subject-matter of I.T.R.C. Nos. 100 and 101 of 1989). In the said earlier decision, the Tribunal had observed thus :

"It is not clear from the resolutions that the day to day activities of the directors are controlled by the board of directors of the company. The board of directors

act as a body. The board includes the assessee Sri Palaniswamy also. As argued by the assessee, the general power of superintendence exercised by the board of directors does not establish an employer-employee relationship between the companies and the assessee."

6. However, the Tribunal observed that, even on the assumption that the payments are by way of salary, the assessee will be entitled to claim deductions in respect of the expenses incurred by the assessee in earning the income. Similarly, interest paid on borrowings for investments in the companies also will have to be allowed against income from dividends and such allowance has to be given whether dividends are received or not in the light of the decision of the Supreme Court in CIT v. Rajendra Prasad Moody .

7. Mr. Raghavendra Rao, learned counsel for the petitioner, contended that, the decision of the Appellate Tribunal on the main question runs counter to the ratio of the decision of the Supreme Court rendered in Ram Pershad Vs. The Commissioner of Income Tax, New Delhi, In the said case, the assessee was the first managing director of the company appointed for a period of 20 years and the relationship was covered by certain terms and conditions embodied in a agreement. Under the articles of association of the company, the management of the business of the company was in the hands of the managing director.

8. Article 139 expressly enabled the managing director generally to work for and contract with the company and specifically to do work as an agent of the company. Article 140 empowered the board of directors to exercise control over the managing director in certain specific instances. Article 142 provided that the managing director shall work for the execution of the decisions arrived at by the board of directors of the company from time to time. One of the clauses of the agreement provided that the assessee was at liberty to resign his office upon giving three months" notice and that the company in general meeting could terminate his services before the expiry of the period of 20 years, if the assessee was found to be acting otherwise than in the interests of the company or was found to be not diligent in his duties. In addition to his monthly remuneration and a fixed monthly car allowance, the assessee was entitled to receive a commission of ten per cent. of the gross profits of the company.

9. The question was whether the assessee was an employee of the company in the said case. The Supreme Court held that he was an employee by pointing out that the employer, i.e., the company exercised supervisory control in respect of the work entrusted to the assessee. At page 126, the tests were enunciated thus :

"There is no doubt that for ascertaining whether a person is a servant or an agent, a rough and ready test is, whether, under the terms of his employment, the employer exercises a supervisory control in respect of the work entrusted to him. A servant acts under the direct control and supervision of his master. An agent, on the other hand, in the exercise of his work, is not subject to the direct

control or supervision of the principal, though he is bound to exercise his authority in accordance with all lawful orders and instructions which may be given to him from time to time, by his principal. But, this test is not universal in its application and does not determine in every case, having regard to the nature of employment, that he is a servant. A doctor may be employed as a medical officer and though no control is exercised over him in respect of the manner he should do the work nor in respect of the day to day work he is required to do, he may none the less be a servant if his employment creates a relationship of master and servant. Similar is the case of a chauffeur who is employed to drive the car for his employer. If he is to take the employer or any other person at his request from place "A" to place "B" the employer does not supervise the manner in which he drives between those places. Such examples can be multiplied. A person who is engaged to manage a business may be a servant or an agent according to the nature of his service and the authority of his employment. Generally it may be possible to say that the greater the amount of direct control over the person employed, the stronger the conclusion in favour of his being a servant. Similarly the greater the degree of independence the greater the possibility of the services rendered being in the nature of principal and agent. It is not possible to lay down any precise rule of law to distinguish one kind of employment from the other. The nature of the particular business and the nature of the duties of the employee will require to be considered in each case in order to arrive at a conclusion as to whether the person employed is a servant or an agent. In each case the principle for ascertainment remains the same.

Though an agent such is not a servant, a servant is generally for some purposes his master's implied agent, the extent of the agency depending upon the duties or position of the servant. It is again true that a director of a company is not a servant but an agent inasmuch as the company cannot act in its own person but has only to act through directors who qua the company have the relationship of an agent to its capacity. The managing director may have a dual capacity. He may both be a director as well as an employee. It is, therefore, evident that in the capacity of a managing director he may be regarded as having not only the capacity as persona of a director but also has the persona of an employee, or an agent depending upon the nature of his work and the terms of his employment. Where he is so employed, the relationship between him as the managing director and the company may be similar to a person who is employed as a servant or an agent, for the term "employee" is facile enough to cover any of these relationships. The nature of his employment may be determined by the articles of association of a company and/or the agreement, if any, under which a contractual relationship between the director and the company has been brought about, whereunder the director is constituted an employee of the company, if such be the case, his remuneration will be assessable as salary u/s 7. In other words, whether or not a managing director is a servant of the company apart from his being a director can only be determined by the articles of association and the terms of his employment."

10. Thereafter, the relevant principle was applied to the particular facts before the court, thus, as could be seen from page 132 :

"The very fact that apart from his being a managing director he is given the liberty to work for the company as an agent is indicative of his employment as a managing director not being that of an agent. Several of the clauses of article 140, as pointed out by the High Court, specifically empower the board of directors to exercise control over the managing director, such, for instance, to accept the title of the property to be sold by the company, providing for the welfare of the employees, the power to appoint attorneys as the directors think fit, etc. As pointed out earlier, under the terms of the agreement, he can be removed within the period of 20 years for not discharging the work diligently or if he is found not to be acting in the interest of the company as managing director. These terms are inconsistent with the plea that he is an agent of the company and not a servant. The control which the company exercises over the assessee need not necessarily be one which tells him what to do from day to day. That would be a too narrow view of the test to determine the character of the employment. Nor does supervision imply that it should be a continuous exercise of the power to oversee or superintend the work to be done. The control and supervision is exercised and is exercisable in terms of the articles of association by the board of directors and the company in its general meeting. As a managing director he functions also as a member of the board of directors whose collective decisions he has to carry out in terms of the articles of association and he can do nothing which he is not permitted to do. u/s 17(2) of the Indian Companies Act, 1913, regulation No. 71 of Table A which enjoins that the business of the company shall be managed by the directors is deemed to be contained in the articles of association of the company in identical terms or to the same effect. Since the board of directors are to manage the business of the company they have every right to control and supervise the assessee's work whenever they deem it necessary. Every power which is given to the managing director, therefore, emanates from the articles of association which prescribes the limits of the exercise of that power. The powers of the assessee have to be exercised within the terms and limitations prescribed thereunder and subject to the control and supervision of the directors which, in our view, is indicative of his being employed as a servant of the company."

11. It was pointed out that the resolution of the company appointing the joint managing directors was quite clear. It stated that they shall be subject to the superintendence and control of the directors. From this, it was contended that the joint managing directors in the instant case had to function subject to the superintendence and control of the board of directors and they were not free to discharge their functions in a manner they liked; the point of time at which the board may interfere with their functioning is not limited by the resolution. The board of directors is quite free to exercise its power of superintendence and control over the joint managing directors at any point of time the board deems fit. The fact that these managing directors control the shareholdings in the

company is clearly irrelevant because, in the matter of discharging their duties as joint managing directors, they are governed by the resolution under which they were appointed and the legal effect of the same will have to be inferred only from the articles of association and the resolution, in the absence of any other contract between the parties.

12. Learned counsel also cited a few more decisions which are :

- (1) K.R. Kothandaraman Vs. Commissioner of Income Tax, Madras,
- (2) Commissioner of Income Tax, Gujarat II Vs. Bachubhai Nagindas Shah,
- (3) Commissioner of Income Tax, Bombay City-II Vs. V.R. Chaphekar and Others,
- (4) Stya Paul Vs. Commissioner of Income Tax (Central), and
- (5) Commissioner of Income Tax Vs. Travancore Chemical Mfg. Co.,

13. In all these decisions, the courts have considered whether the appointed managing director was subject to any supervisory power and, in a few cases, the fact that managing director could be removed by a resolution of the company was taken as a guiding factor to hold that he is an employee.

14. Mr. Ramabhadran, learned counsel for the assessee, on the other hand, pointed out that there is no agreement governing the relationship between the joint managing directors and the company and, therefore, the relationship is governed by the articles of association and, obviously the resolution under which they were appointed may also be looked into. Learned counsel urged that the power of superintendence and control of the directors over the joint managing directors referred to in the resolution is only in respect of policy matters and not in respect of functioning of the joint managing directors. Learned counsel further highlighted the fact that, in the peculiar facts of this case, there will not be and there cannot be any effective control over these joint managing directors as they had 95 per cent. of the shareholding with them. Power of removal of these managing directors also is not specifically provided for. Learned counsel relied on a decision of the Assam and Nagaland High Court in DWIJENDRA CHANDRA CHOWDHURY Vs. COMMISSIONER OF Income Tax, ASSAM. SUBODH CHANDRA DUTTA v. COMMISSIONER OF Income Tax, ASSAM., Ten factors were summarised by the High Court in the said case to conclude that the joint managing directors were not employees of the company. It is unnecessary to refer to all of them. One of the factors was the executive powers and duties of the board of directors vested in the said joint managing directors and they could be removed only if declared insolvent or found guilty of misappropriation. In substance, the company's personality seems to have been the personality of these joint directors in the said case.

15. The tests applicable to find out whether there is a relationship of employer and employee in a given case were enumerated by the Supreme Court in Dharangadhara Chemical Works Ltd. Vs. State of Saurashtra, At page 268, the

Supreme Court held thus :

"The principle which emerges from these authorities is that the prima facie test for the determination of the relationship between master and servant is the existence of the right in the master to supervise and control the work done by the servant not only in the matter of directing what work the servant is to do but also the manner in which he shall do his work, or to borrow the words of Lord Uthwatt at page 23 in *Mersey Docks and Harbour Board v. Coggins and Griffith (Liverpool) Ltd.* [1947] 1 AC 1 (HL), at page 23 : "The proper test is whether or not the hirer had authority to control the manner of execution of the act in question".

16. The nature or extent of control which is requisite to establish the relationship of employer and employee must necessarily vary from business to business and is by its very nature incapable of precise definition. As has been noted above, recent pronouncements of the Court of Appeal in England have been expressed the view that it is not necessary for holding that a person is an employee, that the employer should be proved to have exercised control over his work, that the test of control was not one of universal application and that there were many contracts in which the master could not control the manner in which the work was done (vide observations of Somervell L.J. in *Cassidy v. Ministry of Health* [1951] 2 KB 343, and Denning L.J. in *Stevenson, Jordan and Harrison Ltd. v. MacDonald and Evans* TLR [1952] (CA) 101).

17. The correct method of approach, therefore, would be to consider whether, having regard to the nature of the work, there was due control and supervision by the employer or to use the words of Fletcher Moulton L.J. at page 549 in *Simmons v. Heath Laundry Co.* [1910] 1 KB 543, at pages 549, 550 :

"In my opinion, it is impossible to lay down any rule of law distinguishing the one from the other. It is a question of fact to be decided by all the circumstances of the case. The greater the amount of direct control exercised over the person rendering the services by the person contracting for them the stronger the grounds for holding it to be a contract of service, and similarly the greater the degree of independence of such control the greater the probability that the services rendered are of the nature of professional services and that the contract is not one of service".

18. Though Mr. Ramabhadran relied on this observation, we do not think that the observations in any way advance the contention of the assessee in the instant case, having regard to the wording of the resolution referred to already. We are of the view that the resolution appointing these joint managing directors in any way restricts or limits the scope of the power of superintendence and control vested in the board of directors. It is entirely irrelevant as to whether such a power has been exercised in the particular case. The very existence of such a power would render the relationship as that of employer and employee. In fact, the decision of the Supreme Court in *Ram Pershad Vs. The Commissioner of*

Income Tax, New Delhi, shows that the supervision does not imply that it should be a continuous exercise of power in overseeing or superintending the work to be done. The nature of the superintendence and control may vary depending upon the nature of the work to be performed.

19. In the instant case, it is also clear that a minimum sum of Rs. 2,500 per month is guaranteed to each of them irrespective of the result, which is an indication that these joint managing directors are being paid remuneration treating it as salary. In view of the above, we are of the view that the Appellate Tribunal has not taken a correct view and the answer to the first question has to be in the negative and in favour of the Revenue.

20. The answer to the second question necessarily will have to be consequential to the answer given to the first question because the remuneration received by the joint managing directors will have to be considered as salary and permitted deductions only could be deducted. Accordingly, the second question also is answered in the negative and in favour of the Revenue.