
(1985) 11 CAL CK 0009

In the Calcutta High Court

Case No : Income-tax Reference No. 89 of 1980

Construction Machinery P. Ltd.

APPELLANT

Vs

Commissioner of Income Tax

RESPONDENT

Date of Decision : 19-11-1985

Acts Referred:

Income Tax Act, 1961 — Section 40

Citation : (1986) 51 CTR 390 : (1987) 164 ITR 394 : (1986) 26 TAXMAN 558

Hon'ble Judges : Mukul Gopal Mukherji, J; Dipak Kumar Sen, J

Bench : Division Bench

Advocate : Sukumar Roy, for the Appellant; A.C. Moitra, for the Respondent

Judgement

Dipak Kumar Sen, J.—Construction Machinery Private Ltd., the assessee, was incorporated under the Companies Act, 1956, on May 19, 1971, with three shareholders, namely, Atma Singh, Prem Chand Bhalla and Joginder Singh (the son of Atma Singh) who were allotted, respectively, 1010, 110 and 410 shares in the assessee-company. The assessee-company was incorporated with the principal object of taking over the business of Atma Singh carried on by him as a sole proprietor under the name and style of M/s. Construction Equipments and Parts Distributors.

2. On May 19, 1971, the date on which the assessee-company was incorporated, a separate agreement was entered into by and amongst the said Atma Singh, Prem Chand Bhalla and Joginder Singh, which provided that Atma Singh would be the first managing director of the assessee-company for life and that the entire management and control of the assessee would be retained in his hands. It was agreed further that the other two shareholders, namely, Prem Chand Bhalla and Joginder Singh, would also become the directors of the assessee-company.

3. On March 30, 1972, at a meeting of the directors of the assessee, a resolution was passed sanctioning payment of remuneration and house rent allowance to

the directors for the accounting period ending on March 31, 1972. It was resolved that Atma Singh be paid a remuneration of Rs. 3,000 per month with house rent allowance of Rs. 500 per month ; Prem Chand Bhalla be paid a remuneration of Rs. 2,000 per month with house rent allowance of Rs. 200 per month and Joginder was allowed a remuneration of only Rs. 500 per month.

4. The assessee closed its accounts for the first time on March 31, 1972, and was assessed to Income Tax for the assessment year 1972-73, the accounting year ending on March 31, 1972.

5. The Income Tax Officer found that the turnover of the assessee during the accounting period was Rs. 7,70,288, its gross profit was Rs. 1,77,512 and the total amount paid by way of remuneration to its directors was Rs. 68,600 leaving a small net profit of Rs. 2,826 to the assessee. He found further that the assessee carried on business with established companies like Tata Iron & Steel Co. Ltd., the Associated Cement Companies Ltd., etc., for which no special skill or experience was required. In computing the income of the assessee, the Income Tax Officer disallowed deduction of the remuneration paid to Joginder Singh wholly. Of the remuneration paid to Atma Singh and Prem Chand Bhalla, Rs. 1,500 and Rs. 1,000 per month, respectively, were allowed as deduction. The house rent allowances paid to Atma Singh and Prem Chand Bhalla were wholly disallowed.

6. Being aggrieved, the assessee preferred an appeal to the Appellate Assistant Commissioner of Income Tax. The Appellate Assistant Commissioner held that the remuneration paid was excessive considering the business needs, the turnover and the financial status of the assessee and upheld the decision of the Income Tax Officer.

7. The assessee preferred a further appeal to the Income Tax Appellate Tribunal. It was contended before the Tribunal that the remuneration paid to the directors of the assessee were reasonable inasmuch as Atma Singh, carrying on the same business as a sole proprietor, had an annual income of over Rs. 40,000. Prem Chand Bhalla, another director, was formerly in the service of another company on a salary of Rs. 1,500 per month with bonus of Rs. 750 per annum. After joining the assessee, Bhalla was put exclusively in charge of the business of the assessee at its Bombay branch and was wholly responsible for the development of the business at Bombay. It was contended for them that the turnover of the assessee's business, over Rs. 7 lakhs in the relevant assessment year, went up to Rs. 11 lakhs in the next year and to Rs. 12 lakhs in the third year. Joginder Singh, it was contended, was employed on salary and commission before he joined the assessee and that his income prior to the relevant assessment year was substantial.

8. The Tribunal held that neither Atma Singh nor Prem Chand Bhalla was compelled to join the assessee and that their income prior to their joining the assessee was not a relevant factor. The legitimate business needs of the

assessee did not warrant the remuneration which was paid to the said two directors. The Tribunal also found that the benefit accruing to the assessee from the service rendered by them did not also justify such remuneration.

9. The Tribunal, however, did not find any justification for disallowing the deduction of the entire remuneration paid to Joginder Singh which was found by the Tribunal to be reasonable. The Tribunal held that the remuneration paid to Joginder Singh should not have been disallowed only on the ground that he was the son of the managing director. There was no finding that he did not render any service to the assessee. Having regard to the legitimate business needs of the assessee, the Tribunal considered it reasonable to allow deduction at the rate of Rs. 250 per month on account of the remuneration paid to Joginder Singh and directed the Income Tax Officer to allow deduction of the said amount.

10. On an application of the assessee u/s 256(2) of the Income Tax Act, 1961, this court directed the Tribunal to refer the following questions as questions of law arising from the order of the Tribunal for the opinion of this court:

"1. Whether the Tribunal was right in law u/s 40(c) of the Income Tax Act, 1961, to sustain the remuneration of Shri Atma Singh at Rs. 1,500 per month and Rs. 1,000 to Shri P. C. Bhalla and Rs. 250 per month to Sri Joginder Singh and also upholding the disallowance of house rent allowance of Rs. 500 per month and Rs. 200 per month to Sri Atma Singh and Shri P. C. Bhalla, respectively ?

2. Whether the finding of the Tribunal and the conclusion drawn therefrom in upholding the disallowance of the directors' remuneration and house rent allowance were unreasonable and perverse ?"

11. At the hearing, the learned advocate for the assessee submitted that the Tribunal fell into an obvious and apparent error in disallowing the deduction of the entire remuneration paid to the directors. The authorities below proceeded throughout on the basis of their subjective opinion as to the reasonableness of the remuneration paid to the said directors. No reasons appear in the order of the Tribunal to show why any part of the remuneration paid to the directors should be disallowed.

12. The learned advocate for the Revenue contended to the contrary. The following decisions were cited at the Bar :

(a) Mund and Samont Co. (P) Ltd. Vs. Commissioner of Income Tax , Bihar, Orissa and Patna, . In this case, the articles of association of the assessee, a private limited company provided that remuneration payable to the managing director and the deputy managing director would be 30% of the annual net profits subject to a minimum of Rs. 5,000. In the assessment year in question, the Income Tax Officer while computing the taxable income of the assessee made an enquiry u/s 10(4A) of the Indian Income Tax Act, 1922, and disallowed deduction of a part of the remuneration paid to the managing director and the deputy managing director on the ground that the same was excessive and

unreasonable. The disallowance was confirmed by the Appellate Assistant Commissioner and the Tribunal. On a reference, the High Court held that the disallowance could not be held to be unjustified or illegal. In an appeal before the Supreme Court, it was held as follows (at pp. 271 and 272) :

"It is, however, for the taxpayer to establish by evidence that a particular allowance is justifiable. Apparently, no evidence was tendered by the assessee relating to the duties of the managing director and the deputy managing director, the services rendered by them, the manner in which the profits earned by the assessee were enhanced by reason of their special aptitude or qualifications, the legitimate business needs of the assessee and the benefit derived by or accruing to the assessee in consequence of the services rendered by the managing director and the deputy managing director. In the absence of any such evidence, the finding recorded by the Income Tax Officer and confirmed by the Appellate Assistant Commissioner and the Tribunal must be accepted."

(b) Commissioner of Income Tax, West Bengal Vs. Edward Keventer (Private) Ltd., . In this case, the Income Tax Officer held that the amounts paid to the four directors of the company and a personal assistant by way of remuneration and commission were unreasonable and excessive having regard to the legitimate business needs of the assessee and the benefit derived by or accruing to it therefrom but deduction of a part of the amounts paid was, however, allowed. The Appellate Assistant Commissioner confirmed the order of the Income Tax Officer. The Tribunal, however, found otherwise and held that no part of the remuneration or commission paid to the said persons could be held to be excessive. On a reference, the High Court accepted the view taken by the Tribunal. On a further appeal, the Supreme Court found that the turnover of the assessee was huge and there were more than one centre of business which were required to be supervised. It was also found that other expenditure by way of salaries to employees and other staff was only Rs 1,500 per month from which it was found that the persons concerned were attending to the business of the assessee. The Supreme Court upheld the decision of the High Court that the remuneration and commission paid to the directors and the particular employee were not excessive or unreasonable.

(c) Eastern Scales (P.) Ltd. Vs. Commissioner of Income Tax, . In this case, a dispute arose in respect of the deductibility of an increment in salary of the managing director of the assessee. On a reference, this court noted that the increments had been considered by the Tribunal in the light of the evidence adduced, namely, the legitimate business needs of the assessee and the benefit accruing to the assessee. The question referred was answered in favour of the Revenue.

(d) Calcutta Art Studio (Pvt.) Ltd. v. CIT [1919] 118 ITR 752 . In this case, the finding of the Tribunal that the salaries paid to the managing director and another director of the assessee were excessive and unjustified was challenged as perverse in a reference. It was found as a fact that sales had increased during

the regime of the said directors who ran the business of the company and that the services rendered by them were of technical nature required in the business of the assessee, viz., lithographic printing.

13. The court held that the legitimate business needs of an assessee must be considered not from the point view of a tax collector but that of a prudent businessman and that paucity of profits would not be the deciding factor in allowing or disallowing deduction of the remuneration paid. Profit in one year or loss in another, also should not by itself be the guiding factor.

14. In the instant case, disallowance of a part of the remuneration paid to Joginder Singh cannot be justified at all. The amount is not excessive and there is a finding that service had been rendered by this director. The turnover of the assessee and the gross profits justify the entire remuneration paid.

15. Prem Chand Bhalla appears to have rendered exclusive service for the setting up of the business of the assessee in Bombay, which has developed by reason of the services rendered by this director. The turnover of the business of the assessee as also of the profits of such business have increased in subsequent years. Evidence on this appeal was before the Tribunal. Evidence was also before the Tribunal that Prem Chand Bhalla had previously been employed at more or less the same salary in another concern though not as a director. This yardstick of the commercial worth of Prem Chand Bhalla has not been properly appreciated. On the evidence on record, we are unable to accept the conclusion of the Tribunal that remuneration paid to this director had been excessive.

16. So far as Atma Singh, the managing director, is concerned, only a part of his remuneration and the entire house rent allowance has been disallowed. Evidence is on record that he was the sole proprietor of the business in the earlier years and that such business was being carried on by the assessee with well-known and reputed companies. It is obvious that the earlier connections and contacts of Atma Singh with the other companies have been beneficial to the business carried on by the assessee. The Tribunal does not appear to have considered this aspect. The total amount paid to the managing director is Rs. 3,500 which by itself cannot be said to be excessive keeping in view the remuneration which was being paid to Prem Chand Bhalla who was put in charge of the business in Bombay.

17. For the reasons as above, we hold that the finding of the Tribunal that the remuneration paid to Prem Chand Bhalla and Joginder Singh were excessive and unjustified is perverse and its conclusion that deduction of a part thereof should be disallowed is erroneous in law and perverse.

18. To the extent as above, we answer question No. 1 in the negative and question No. 2 in the affirmative, both in favour of the assessee.

19. We remand the matter to the Tribunal to reconsider the case of Atma Singh. The Tribunal will take into account the evidence on record and, if necessary, take

further evidence and dispose of the matter in the light of the observations in this judgment.

20. There will be no order as to costs.

Mukul Gopal Mukherji, J.

21. I agree.