

(1974) 08 CAL CK 0015
In the Calcutta High Court

Case No : Income-tax Reference No's. 71 and 72 of 1969

D.N. Sinha Pvt. Ltd.

APPELLANT

Vs

Commissioner of Income Tax

RESPONDENT

Date of Decision : 12-08-1974

Acts Referred:

Income Tax Act, 1922 — Section 10(2)

Citation : (1976) 102 ITR 491

Hon'ble Judges : Sabyasachi Mukharji, J;Janah, J

Bench : Division Bench

Advocate : A.K. Mitter and S. Ganguli, for the Appellant;B.L. Pal and P. Mazumdar, for the Respondent

Judgement

Sabyasachi Mukharji, J.—The assessee is a private limited company carrying on business of dealing in petroleum products and automobile spare parts. This reference arises out of the assessment years 1961-62 and 1962-63, the relevant previous years being Samvat years 2018 and 2019 which ended on October 20, 1960, and November 8, 1961, respectively. It appears that there were three directors of the company, namely, Sri D.N. Sinha, Sri P. N. Sinha and Smt. Karunamoyee Sinha at the material times. Sri P. N. Sinha is the son of Sri D.N. Sinha and Smt. Karunamoyee Sinha is his wife. Sri D.N. Sinha was the managing director. On February 8, 1961, the board of directors of the assessee-company increased the remuneration of Sri D.N. Sinha from Rs. 8,400 per annum to Rs. 12,000 per annum. A chart was produced giving the turnover and profits of the assessee for the relevant years which is to the following effect:

Assessment year Turnover Profit as per P & L A/C.

Rs. Rs.

1960-61 9,19,234 314

1961-62 9,41,963 460

1962-63 10,91,800 1,838

2. The net profits for 1961-62 and 1962-63 indicated above were after deducting the remuneration of Rs. 12,000 per annum given to Sri D.N. Sinha. In the course of the assessment for the assessment years 1961-62 and 1962-63, the question arose as to whether the remuneration to the managing director as claimed could be allowed. In the assessment order for 1961-62, the Income Tax Officer disallowed Rs. 2,000 out of Rs. 12,000 claimed as his remuneration for the following reasons:

" It is true that the assessee's business has shown an upward trend and it is quite likely that some portion of this increase is really due to additional services rendered by the managing director. But I do not fully agree with the assessee's contention that the entire increase in the turnover is due to the managing director's additional services to the company or that the increase in the remuneration is commensurate with the increase in turnover. As the business grows older the volume of transactions normally rises. Especially, in this line of business, where there is hardly no perfect competition of market, however, that progress of developing of economic transactions in this line of business will automatically go up though much labour was offered on the part of the management. The assessee has the same number of offices and pump stations as in the earlier year. There is no increase in branch offices, or pump stations as in the supervision and services on the part of the managing director. In view of the above I feel that director's remuneration to the extent of Rs. 10,000 will be quite reasonable. Keeping in view the business needs and nature of service rendered by the managing director, I, therefore, disallow Rs. 2,000 under this head."

3. For the same reasons he disallowed the managing director's remuneration to the extent of Rs. 2,000 in the assessment year 1962-63 also. The assessee appealed to the Appellate Assistant Commissioner. The Appellate Assistant Commissioner noticed that the company was controlled wholly by members of one family and the remuneration fixed by the resolution dated February 8, 1961, was passed by Sri P. N. Sinha, the son of Sri D.N. Sinhas and his mother. He felt that the increase in the remuneration to the extent of Rs. 1,000 per month could not be justified. Taking into consideration the fact that the volume of the business had increased to a certain extent, the Appellate Assistant Commissioner felt that it would be reasonable to allow remuneration @ Rs. 900, that is to say, Rs. 10,800 per annum. He thus disallowed a sum of Rs. 800 from the total income for each of the years under reference. Thereafter, the assessee preferred an appeal before the Tribunal. The Tribunal after discussing the aforesaid facts came to the conclusion that the proper test in a case of this kind was to see, having regard to the extent of the business as disclosed by the net profits of the assessee, whether the assessee would have employed an outsider giving him the same remuneration. The Tribunal felt that taking into account the result of the trading for these two years which according to the Tribunal were quite meagre,

the assessee would not have employed an outsider on a salary of Rs. 1,000 per month. In the premises, the Tribunal upheld the order of the Appellate Assistant Commissioner.

4. Thereafter, there was an application before the Tribunal for reference of certain questions of law to this court u/s 256(1) of the Income Tax Act, 1961. The Tribunal declined to refer any question. On an application made to this court u/s 256(2) of the Income Tax Act, 1961, the following two questions have been referred to this court :

"(1) Whether, on the facts and in the circumstances of the case, the increase in the managing director's remuneration, having regard to commercial expediency, and the future prospect of extension of the company's business, which resulted in an increase in the volume of transaction without a corresponding increase in the company's net profit, would be an admissible item of expenditure within the meaning of Section 10(2)(xv)?

(2) If the answer to question No. (1) is in the negative, whether, on the facts and circumstances of the case, the test applied by the Tribunal in determining the admissibility of increased remuneration paid to the managing director in the year under account would be erroneous in law after the judgment delivered by the Supreme Court formulating the rule of test in similar case for determining the admissibility of increased remuneration paid to the employee of a company in Commissioner of Income Tax v. Walchand and Company Private Ltd. (1967) 63 ITR 381 "

5. Having regard to the contentions urged in this case before the authorities and having heard the counsel for both the parties, it appears to us that the questions as directed by this court do not really formulate the controversy between the parties. We, therefore, reframe the questions into one single question in the manner following :

"Whether, on the facts and in the circumstances of this case, the disallowance made by the Tribunal in this case was justified u/s 10(2)(xv) of the Indian Income Tax Act, 1922 ? "

6. We have noted the facts briefly as mentioned hereinbefore. Another factor which has to be borne in mind in this case is that the revenue authorities and the Tribunal have not proceeded under the provisions of Section 10(4A) of the Indian Income Tax Act, 1922. If that was done, other considerations might have applied because in this case we are concerned with the remuneration of one of the directors of the company. It is not disputed that the director in question, Sri D.X. Sinha, performed certain functions for which he was paid certain remuneration. The assessee tried to justify the payment of increased remuneration to the said director by correlating the same with the increased profits of the company. The Tribunal felt that the increase in profits justified certain amount of increase in remuneration and the Tribunal did not think that the directors had nothing to do with the increase of the profit but felt that the increase was not so substantial as

to merit the increase claimed by the assessee. The test applied by the Tribunal in this case was whether the assessee would have paid an outsider this amount of remuneration for the work done by Sri D.N. Sinha. We are concerned in this reference whether the test applied by the Tribunal was correct or not. The Madras High Court had occasion to discuss this question in the case of *The Newton Studios Ltd., Madras Vs. The Commr. of Income Tax, Madras*, . There the Madras High Court observed that it was for the assessee to conduct his business and in his wisdom or other wise to fix the remuneration of his staff. The Income Tax Act did not clothe the taxing authority with any power or jurisdiction to determine the reasonableness or to refix the amount fixed by the assessee. In order that an expenditure might be one incurred wholly and exclusively for the purpose of earning the profits it was not necessary to show that the same was incurred out of " necessity ". If, however, the reality of the payment was Challenged or was in dispute, different considerations might arise or in case where there was an evidence pointing to some other considerations other than the purpose of business as accounting for payment of any remuneration made to an employee or a director. In such cases such portion of the amount claimed which was either not held to have been paid or paid for reasons other than the business expediency should be disallowed; and the reason for this was that either the portion disallowed was not paid or that the expenditure or a portion of it was not incurred solely and exclusively for the business of the assessee, and not on the ground that the taxing authority considered the remuneration was high or that with lesser remuneration the same services could have been obtained. Where, however, action is taken u/s 10(4A) of the Act, different considerations arise. Under the said provision the Income Tax Officer can disallow an expenditure or portion thereof in the case of companies, which results either directly or indirectly in the provision of any remuneration, benefit or amenity to a director or a person who has a substantial interest in the company within the meaning of Section 2(6C)(iii), if the Income Tax Officer is of opinion that such allowance was excessive or unreasonable having regard to the legitimate business needs of the company and the benefit accruing to it therefrom.

7. In the case of *F.E. Dinshaw Ltd. Vs. Commissioner of Income Tax, Bombay City*, the Bombay High Court again had to consider this question and it was held that an expenditure could be for the purpose of the business even though these might not be incurred with a view to make any profit.

8. In the case of *Swadeshi Cotton Mills Co. Ltd. Vs. Commissioner of Income Tax, Uttar Pradesh (No. 1)*, the Supreme Court observed that the question whether an amount claimed as expenditure was laid out or expended wholly and exclusively for the purpose of the assessee's business, profession or vocation had to be decided on the facts and in the light of the circumstances of each case but the Supreme Court observed that the final conclusion on the admissibility of such an allowance was one of law. The Supreme Court observed that merely because of the existence of an agreement between the assessee and his employee for payment of certain remuneration and the fact of the actual payment, the Income

Tax Officer was not bound to hold that the payment was made exclusively and wholly for the purpose of the assessee's business. Although there might be such an agreement in existence and the payment might have been made, it was still open to the income tax Officer to consider all the relevant factors in determining whether the remuneration paid to the employee or any portion thereof was properly deductible u/s 10(2)(xv) of the Indian Income Tax Act, 1922. In the peculiar facts and circumstances of that case the Supreme Court found that the directors whose remuneration was the subject-matter of the challenge, in that case, did not render any special service in the accounting year which had justified the payment of very much increased additional remuneration. It was, secondly, found that the work of the assessee-company had been substantially done by a firm of managing agents known as Jaipuria and Brothers Ltd. and very little work was done by the directors. It was also found that in the past the directors had been paid only the directors' fee at the rate of Rs. 100 per month and this was not considered by the directors to be inadequate for discharging their responsibility. The Supreme Court recorded that though in the accounting year the gross profits had been increased by about Rs. 30 lakhs, the increase was due to control of cloth having been lifted and not due to any effort on the part of the directors. It was also found that the assessee had stated that the payment of additional remuneration was made to the directors because there were three other companies to whom the assessee had also paid similar additional remuneration but no evidence to this effect was also forthcoming. In those special features of the case the Supreme Court found that there was evidence for the Income Tax authorities to come to the conclusion that the increased remuneration was not due exclusively and wholly for the purpose of the assessee's business but for other considerations. In that case, in our opinion, the increased remuneration was not disallowed because the revenue authorities found that the increased remuneration was unreasonable or that same services could have been had without the increased remuneration. It is true that certain facts might justify disallowance of the increased remuneration of the directors and other employees because such increase was due to extra-commercial considerations. If the increased remuneration and the expenditure was wholly disproportionate to the work done by the employees or the directors concerned or wholly disproportionate to the similar types of payments made in other similar concerns, these facts may provide good evidence in the absence of any good justification to come to the conclusion that the increased remuneration or expenditure was due to extra commercial considerations and not wholly and exclusively for the purpose of the business of the assessee. In such cases it is possible for the revenue authorities to disallow the expenditure or a portion thereof.

9. In the case of Commissioner of Income Tax v. Walchand & Co. Private Ltd., the Supreme Court observed in applying the test of commercial expediency for determining whether the expenditure was wholly and exclusively laid out for the purpose of business, reasonableness of the expenditure had to be judged from

the point of view of a businessman and not of the revenue. It was open to the Tribunal to come to the conclusion that the alleged payment was not really incurred by the assessee in the character of a trader or that it was not wholly and exclusively laid out for the purpose of the assessee's business and disallow it. But it was not the function of the Tribunal to determine the remuneration which in their view should be paid to an employee of the assessee. The employer in fixing the remuneration of his employee was entitled to consider the extent of his business, the nature of the duties to be performed and the special aptitude of the employee, future prospects of extension of business and a host of other related circumstances. It was erroneous to think that the increased remuneration could only be justified if there was corresponding increase in the profits of the employer. In the case of J.K. woolen Manufacturers Vs. Commissioner of Income Tax, U.P., the Supreme Court observed that in applying the test of commercial expediency for determining whether an expenditure was wholly and exclusively laid out for the purpose of the assessee's business, reasonableness of the expenditure had to be judged from the point of view of a businessman and not of the Income Tax department. It was of course, open to the Tribunal to come to the conclusion either that the alleged payment was not real or that it was not incurred by the assessee in the character of a trader or it was not laid out wholly and exclusively for the purpose of business of the assessee and to disallow it. It was not the function of the Tribunal to determine the remuneration which in their view should be paid to an employee of the assessee. In the case of Commissioner of Income Tax Vs. S. Krishna Rao, the Andhra Pradesh High Court observed that the test to find out whether a particular expenditure was wholly or partly justified or exclusively incurred for the purpose of business was not to see whether it was necessary nor would it be proper to see whether any other person similarly situated would have thought it reasonable to incur the expenditure to that extent. The true test, the Andhra Pradesh High Court felt, was to find out whether the businessman when he expended the money was acting reasonably in the interest of the business or influenced by any irrelevant and extraneous considerations. In the case of Bengal Enamel Works Ltd. Vs. Commissioner of Income Tax, West Bengal, the Supreme Court reiterated that where an amount paid to an employee pursuant to an agreement was excessive because of "extra-commercial considerations", the taxing authority had jurisdiction to disallow a part of the amount as expenditure not incurred wholly and exclusively for the purpose of business. Indisputably an employer in fixing the remuneration of his employee was entitled to take into consideration the extent of his business, the nature of the duties to be performed and the special aptitude of the employee, the future prospects of the business and other related circumstances and the taxing authority could not substitute its own view as to the reasonable remuneration which should have been agreed to be paid to the employee. But the taxing authority might disallow an expenditure claimed on the ground that the payment was not real and was not incurred by the assessee in the course of business or that it was not laid out wholly and exclusively for the purpose of the business of the assessee. Thereby, the Supreme Court felt, the authority did not

substitute its own view of how the assessee's business affairs should be managed but proceeded to disallow the expenditure because the conditions of its admissibility were absent.

10. Having regard to the facts of this case and bearing the above principles in mind, it appears that in this case there was no evidence that the assessee-company did not act in the interest of the company. The only test upon which the Tribunal proceeded to judge this question was whether the company would have employed an outsider with less remuneration than paid to the said D.N. Sinha. We may mention here incidentally, however, that there was of course no evidence that an outsider was available at a less salary. Therefore, when the Tribunal assumed that an outsider would have been available at a less salary, the Tribunal was speculating. Even assuming that an outsider would have been available that in our opinion is not the only test. Whether another employee would have been available at a less salary or whether the assessee-company could have managed to produce the same trading result by a cheaper expenditure or not is not the true test and unless in a particular case, either because the expenditure incurred was grossly disproportionate to the volume of the business or the nature of the business carried on by the assessee or that the payment made to an employee was wholly disproportionate to the salary or allowances paid to employees of similar types of concerns, leading or justifying the conclusion that the expenditure was not wholly and exclusively for the purpose of the business, about the reasonableness of the expenditure u/s 10(2) (xv) of the Income Tax Act, the revenue authorities, in our opinion, have no jurisdiction to substitute their own views of reasonableness to that of the assessee.

11. For the above reasons, we are of the opinion that the Tribunal was not justified in disallowing the portion of the allowance and we answer the question reframed in the negative and in favour of the assessee.

12. The assessee will get the costs of this reference.

Janah, J.

13. I agree.