

(1962) 02 MAD CK 0034

In the Madras High Court

Case No : Tax Case No. 142 of 1959 (Reference No. 50 of 1959)

Harbour Engineering Private Ltd.

APPELLANT

Vs

Commissioner of Income Tax, Madras

RESPONDENT

Date of Decision : 22-02-1962

Acts Referred:

Finance Act, 1956 — Section 7

Income Tax Act, 1922 — Section 10(2), 10(4A), 66, 66(1)

Income Tax Act, 1961 — Section 10(2), 10(2)(i), 10(4A)

Citation : (1964) 52 ITR 249

Hon'ble Judges : Jagadisan, J

Bench : Single Bench

Judgement

Jagadisan, J.—This is a reference application u/s 66 of the Indian Income Tax Act. The assessee is a private limited company carrying on business at Madras as repairers of ships calling at the Madras Port. It commenced its business on and from January 1, 1955. The shareholders of the company and the number of shares held by them are as follow :

1. D.J. Hayden

50 shares.

2. M.V. Sastry

50 shares.

3. Mammu Meera Syed Mohammed

50 shares.

Total

150 shares.

All the three shareholders are directors of the company, and the first of them is also the managing director. The managing director is a qualified mechanical

engineer. M.V. Sastry is an electrical engineer with considerable experience. Syed Mohammed is a partner in Messrs. K.P.V. Sheik Mohammed Rowther & Co., well-known steamer agents at Madras. On and from April 1, 1955, the directors claimed to be paid remuneration at the rate of Rs. 500 per month for each director. The managing director claimed an additional salary of Rs. 1,250 per month from that date. This salary and remuneration were not drawn by the directors each month but were adjusted at the end of the calendar year 1955, which is the year of account of the assessee. For the assessment year 1956-57, relevant to the previous year ending December 31, 1955, the company claimed the total payment of salary and remuneration, Rs. 24,750, as permissible allowance in computing its profit. It returned an income of Rs. 2,316 after deducting the said sum of Rs. 24,750. The Income Tax Officer allowed the claim in respect of the payment of Rs. 11,250 as salary to the managing director but disallowed the rest of the claim on ground that it was excessive because 90 per cent of the profits of the company were absorbed in the shape of remuneration and salary. The assessee went up on appeal to the Appellate Assistant Commissioner who, however, took the view that the assessee's claim was well-founded. The appellate authority referred to the decision of *Newtone Studios Ltd. v. Commissioner of Income Tax* and observe :

He (the appellants representative) contends that the expenditure was incurred wholly and exclusively for the ? purpose of the business; that the Income Tax Officer has not pointed to consideration other than the purpose of the appellants business accounting for the payment made and that the reality of the payment has not been challenged. The managing director is a technician and manages the entire mechanical side. Shri Sastry with 35 years experience is in complete charge of electrical repairs, replacements, etc. The third director, Shri Syed, who is a partner of the firm of agents to Scindia and Eastern Shipping Corporation looks after canvassing orders, purchasing spare parts, etc. Evidence has been produced before me to show that on many days all the directors had to work all round the days. Considering all these factors, I feel that the entire remuneration should be allowed.

2. The department filed an appeal before the Income Tax Appellate Tribunal. The Tribunal agreed with the decision of the Income Tax Officer and set aside the order of the Appellate Assistant Commissioner. At the instance of the assessee the following question of law has been referred by the Tribunal u/s 66(1) of the Act:

Whether, on the facts and in the circumstances of the case, the disallowance of the remuneration of Rs. 13,500 paid to the three directors in the assessment year 1956-57 is right in law?

3. The subject-matter of dispute now before us is whether the payment of remuneration of Rs. 500 to each of the three directors of the company for nine months between April 1, 1955, and December 31, 1955, is a proper deductible allowance in computing the income and profits on the assessee company.

4. The resolution to pay remuneration to the directors was passed at a directors meeting held on May 7, 1955. The Tribunal has adverted to the fact that in the minutes book the figure 9 denoting the month in which the meeting was held is over-written by 5. Mr. Hayden appears to have conceded before the Tribunal that the minutes were not written by him contemporaneously with the holding of the meeting but were written later on with the aid of memoranda made by him. The annual general meeting of the company was held on May 21, 1956, and in that meeting the resolution of the board of directors to pay salary and remuneration to the directors was ratified. It is not necessary for us to go into the question whether there is a valid resolution binding the company to enable the directors to get the remuneration now claimed as deduction from the companys profits as we are of opinion that in any event the claim is not permissible in law.

5. On the question whether the directors rendered any substantial service to the company to justify payment of remuneration at the rate of Rs. 500 per month the Tribunal has discussed the matter in following wa :

No material was placed before us to show that the actual contribution of Messrs. Sastry and Mammu Meera Syed Mohammed justified the payments made to them. Admittedly the assessee company employed a number of workers who were actually employed for the purposes of effecting the repairs of the ships. Moreover, in the case of Mr. Mammu Meera Syed Mohammed, proof is utterly lacking for the work done by him, and, in our opinion, there is no justification for paying him a remuneration for merely canvassing work for the company which itself is not ? proved. He is admittedly an active partner in the leading firm of Messrs. K.P.V. Sheik Mohammed Rowther and it is futile to expect that he devoted his time and energy to the assessee company..... this is the first year of the companys business and out of a sum of Rs. 27,120 earned as profit during the year a substantial sum to the tune of Rs. 24,750 has been given away by way of remuneration to the directors. We are of opinion that the Income Tax Officer has acted reasonably in allowing remuneration of Rs. 11,250 to Mr. Hayden together with Rs. 3,453 by way of car and entertainment expenses to the same gentleman and in disallowing the remuneration claimed in respect of the other two directors.

6. We must observe that the finding of the Tribunal that the two directors, Sastry and Syed Mohammed, did not work for the company or devote their time and energy for running the companys affairs has not been shown to be erroneous on the materials on record. It is certainly significant to note that almost the entire income of the company has been taken hold of by the directors in the shape of remuneration and salary.

7. In computing the profits or gains of a business, profession or vocation, the assessee is entitled to claim certain allowances which are set out in section 10(2) of the Act. This provision is by no means exhaustive as the true profits or gains have to be ascertained and computed on the basis of recognised and accepted commercial principles. The allowances expressly provided for u/s 10(2) are in

respect of expenditure, such as rent for the business premises, repairs to such premises, interest on borrowed capital, etc., or they relate to capital assets such as depreciation, development rebate, balancing allowances and others. Section 10(4A) is a special provision which reads as follow :

10. (4A) Nothing in sub-section (2) shall, in the computation of the profits and gains of a company, be deemed to authorise the making of -

(a) any allowance in respect of any expenditure which results directly or indirectly in the provision of any remuneration or benefit or amenity to a director or a person who has a substantial interest in the company within the meaning of sub-clause (iii) of clause (6C) of section 2, or

(b) any allowance in respect of any assets of the company used by any person referred to in clause (a) either wholly or partly for his own purposes or benefit,

if in the opinion of the Income Tax Officer any such allowance is excessive or unreasonable having regard to the legitimate business needs of the company and the benefit derived by or accruing to it therefrom.

Explanation. - The provisions of this sub-section shall apply notwithstanding that any amount disallowed under this sub-section is included in the total income of any person referred to in clause (a)

8. This was introduced into the statute book u/s 7 of the Finance Act of 1956, with effect from April 1, 1956. This section is intended to prevent companies from claiming allowances which really benefit the directors, directly or indirectly, under the mask of allowances u/s 10(2). No allowance considered by the Income Tax Officer as excessive or unreasonable (having regard to the legitimate business needs of the company and the benefit derived by or accruing to the company there from) is ? permissible even though warranted by section 10(2) if it results directly or indirectly in the provision of any remuneration or benefit or amenity to a director or if it is in respect of any asset of the company used by the director wholly or partly for his own purposes or benefit.

9. Now, the words of the statute are plain and do not present any complexity. The section applies only to companies. The Income Tax Officer has to weigh the allowances against the legitimate needs of the company and the benefit derived by it from the allowances. The allowances made should not weigh down the business needs of the company and the benefit accruing to it. The allowances must be moderate and reasonable, in the opinion of the officer, who cannot of course disregard the conditions of the companys trade or business or the normal practice obtaining in such trade. A few illustrations will be helpful to understand the real scope of this section. A director owns a building which is let out to the company for its business for rent. Normally and in the usual course the building may not get more than Rs. 100 a month. The company pays a rent of Rs. 500 to the director, the owner of the building. The building is used solely for the purpose of the business of the company. But for section 10(4A) the payment of Rs. 500

per month as rent will be a properly deductible allowance u/s 10(2)(i). But by reason of section 10(4A) the Income Tax Officer can hold that the payment of Rs. 500 per month is excessive and unreasonable, that it is calculated to benefit the director indirectly and that the proper allowance would not only be Rs. 100, the rent which the company could have paid if the building had not been owned by the director. Regarding capital asset of the company like building, depreciation is permitted u/s 10(2) of the Act. But if the building is used by a director for his own personal purposes or benefit the allowance by way of depreciation will be hit by section 10(4A), clause (b).

10. It is not disputed that section 10(4A) is applicable to this case as it came into operation on April 1, 1956, and as the assessment year for consideration is 1956-57. The test of permissibility of the allowance is that provided for u/s 10(4A) and that is whether the allowance is not excessive or unreasonable having regard to the legitimate needs of the company and the benefit derived by it from the allowances. On the facts found we have no doubt that the correct test has been applied and that the decision of the Tribunal is right.

11. The question is answered in the affirmative and against the assessee who will pay the costs of the department. Counsels fee Rs. 250.

12. Question answered in the affirmative.