
(1965) 11 MAD CK 0001
In the Madras High Court

K.R. Kothandaraman

APPELLANT

Vs

Commissioner of Income Tax

RESPONDENT

Date of Decision : 24-11-1965

Acts Referred:

Income Tax Act, 1922 — Section 7

Citation : (1966) 2 MLJ 473

Hon'ble Judges : K. Veeraswami, J

Bench : Division Bench

Judgement

K. Veeraswami, J.—The assessee is the managing director of a public limited company called "" Transformer and Switchgear Ltd."" He was

the promoter of the company and would appear to have established contacts with experts in a German concern in the particular type of business.

The company was incorporated on 28th November, 1956. Article 106 of the memorandum and articles of association provided for the

appointment of the assessee as the managing director of the company for a period of five years subject to the control and supervision of the Board

of Directors and upon the terms, provisions and conditions as to remuneration and management as specified in the agreement to be executed

between them. Pursuant to this article, they did enter into an agreement on 22nd May, 1957. The preamble referred to the services of the assessee

in promoting the company and his experience in the line of business and by Clause (1) he was appointed as the managing director of the company

for a period of five years from the date of its incorporation. Clauses (2) to (4) and Clause (9) defined his powers and duties as a managing director

which were to be exercised by him subject to the supervision, direction and control of the Board of Directors and also subject to the provisions of

the memorandum and articles of association. In consideration thereof and subject to the relative provisions in the Companies Act, 1956, and of the

services to be performed by the managing director, Clause (5) provided that:

the company shall pay to the managing director in respect of each year of account of the company... a monthly remuneration of Rs. 1,250 plus

commission at the rate of five per cent, on the net profits made by the company.

2. The commission was to become due and be paid to him yearly and he would be entitled to draw the same immediately after the annual accounts

of the company of each year were made up by him and profits certified by the auditors of the company and the accounts were laid before the

company in general meeting. But this is subject to the provision that the managing director would be entitled to draw the minimum remuneration in

monthly instalments not exceeding Rs. 1,250 per month. The assessee included the receipt of monthly remuneration in his Income Tax returns for

the assessment years prior to the assessment year 1960-61 under the head of "salary" and he had been assessed accordingly. The accounting year

for the company is the calendar year and for the assessee, the financial year. For the accounting year ended 31st December, 1959, the company

credited to the assessee a remuneration of Rs. 1,250 every month. But on 31st December, 1959, the company, however, debited the assessee

with a sum of Rs. 15,000 which represented the salary for the whole year. This was said to be pursuant to a resolution of the Board of Directors

dated 9th May, 1960 which was:

In view of the company not making any profit, the company decides to stop payment of remuneration of Rs. 15,000 per annum to the managing

director, Mr. K.R. Kothandaraman for the year 1959.

3. The assessee in respect of the assessment year 1960-61 claimed that he was not entitled to remuneration for the whole year of 1959 by virtue

of the resolution and that the credit entries made month after month did not entitle him to remuneration in the circumstances. This contention was

rejected and the sum of Rs. 11,250 credited to the assessee's account for nine "months from April to December, 1959 was brought to tax. The

assessee succeeded in his appeal in relation to this amount, the Appellate Assistant Commissioner being of the view that, by reason of the

company's resolution, the assessee was compelled not to demand the amount of

remuneration and that such compulsion was the result of business expediency. He was also of the view that there was no surrender of the remuneration because he was not entitled to any remuneration at all for the year ending 31st December, 1959. But the Tribunal, on appeal by the Revenue, reversed that decision. The Tribunal held that, having regard to the relationship of the assessee with the company under the agreement, he must be regarded as a salaried employee and the remuneration credited to him for the nine months was salary chargeable to tax u/s 7 of the Income Tax Act, 1922. It further held that as the resolution of the company was passed long after the accounting year of the assessee, it could not, in any event, abrogate the right of the assessee under the agreement, and literally read, the resolution had only the effect of stopping the payment of remuneration. At the instance of the assessee, the reference has been made to us u/s 66(1) of the Act, of the following question:

Whether, on the facts and in the circumstances of the case, the sum of Rs. 11,250 is assessable u/s 7 of the Income Tax Act ?

4. Having regard to the frame of the question, we are not called upon to answer whether the remuneration for the nine months would fall within

Section 10 or Section 12. The question is confined to whether the sum is assessable u/s 7. Two aspects of this question have been presented to us

on behalf of the assessee : (1) whether the sum represents salary, and (2) if it is salary, whether there was real income accrued to the assessee in

that sum. On the first aspect, the submission for the assessee is that the relationship of the assessee with the company is such that he could hardly

be treated as an employee. Under the terms of the agreement, he is invested with powers in the exercise of which he virtually carries on the

business of the company. The indicia, according to the argument, which determine the relationship between a master and servant are lacking. It is

recognised by learned Counsel for the assessee himself that the solution to this question lies in the terms of the agreement. We have already

referred to Article 106 of the memorandum and articles of association which itself made the appointment of the assessee as the managing (director

but left the terms of the appointment to be regulated by an agreement. The agreement no doubt invested the assessee with extensive powers of

management covering the entire conduct and exigencies of the business. But

provision was specifically made that he was to exercise his functions subject to the superintendence, direction and control of the Board of Directors and subject also to the provisions of the memorandum and articles of association. It is true as was held in *Lakshminarayan Ram Gopal and Son Ltd. Vs. The Government of Hyderabad*, that a master is one who not only directs what and when a thing is to be done but how it should be done. That is a principle often applied in distinguishing between an employee or a servant and an independent contractor, particularly in the field of industrial law. But we are not certain that this test is necessarily the only test in deciding whether the relationship of master and servant exists, for one has to take note of various changing factors in human and industrial relationships which regulate and change or alter the concept of the relationship of master and servant. Take, for instance, a driver of a private motor car. He is undoubtedly a servant of the employer but how often can it be said the employer tells the driver how to drive the motor car. It is even conceivable that the employer may not know driving himself or even less about the mechanism of a motor car. In such a case, however, one knows it as an obvious fact that the driver is a servant and is recognised as such by reference to other factors. But even applying the test of *Lakshminarayan Ram Gopal and Son Ltd. Vs. The Government of Hyderabad*, we are satisfied that the terms of the agreement and the functions assigned to the assessee and the reservation to the Board of Directors of the right of superintendence, direction and control show that the relationship between the company and the assessee is that of an employer and an employee. The Companies Act, 1956, under the provisions of which the company here was incorporated, defines the terms "director", "manager", "managing agent" and "managing director". Notwithstanding the nomenclature, it appears that, with reference to the terms of the agreement and the functions the assessee is called upon to exercise there under, he is virtually a manager but under the definition of a "manager" he has the management of the whole or substantially the whole of the affairs of the company. It may be seen that the term "manager" as defined in the Companies Act, 1956 includes also a director or any other person occupying the position of a manager by whatever name called, and whether under a contract of service or not. In this case, the agreement, in our

view, cannot be construed as anything other than a contract of service. It may be that a director of a company only by reason of that capacity will

not be a servant of the company : Commissioner of Income Tax, Bombay City v. Lady Navajbai R.J. Tata ILR (1947) Bom. 885 : 49 Bom. L.R.

66 but there is nothing to prevent him from being a servant of the company too under a special contract of service which he may enter into with the company.

5. Our attention is, however, invited by learned Counsel for the assessee to Inderchand Hari Ram Vs. Commissioner of Income Tax and C.P. and

Berar, and Commissioner of Income Tax, Madras Vs. K.R.M.T.T. Thiagaraja Chetty and Co., which, as we think, are of no assistance to him.

They are both cases of managing agency and relate to commission payable to it. In the first of these cases, the managing agency was a firm. Under

the memorandum and articles of association of the company of which it was the managing agent, it was entitled to a monthly allowance and a

certain commission on sales of the company's products and on its profits. The firm contended that the income received as the managing agent of

the company and as its sole selling agent should be assessed u/s 7 of the Indian Income Tax Act but the Revenue would not admit it and charged

the income u/s 10. The Allahabad High Court on a reference upheld the view of the Revenue and pointed out that the question, in which capacity

the sole agent was working, would depend upon the facts of each case. Commissioner of Income Tax, Madras Vs. K.R.M.T.T. Thiagaraja

Chetty and Co., was also a firm being the managing agent of a limited company, and under the managing agency agreement, it was entitled to a

certain monthly remuneration, a commission of 10 per cent. on the net profits of the company and a small percentage on sales and purchases.

During the year of assessment in that case, the assessee became entitled to a large amount by way of commission. By a resolution, the Board of

Directors decided to keep the entire commission in suspense without payment. This sum was debited as a revenue expenditure of the company and

was allowed as deduction in computing the profits of the company. The question was whether the managing agent was liable to pay tax on the

commission amount. According to the Revenue, since the assessee followed the mercantile method of accounting, the income having accrued, it

became assessable whether it was received or not. The Appellate Tribunal took a contrary view. But the High Court was of the view that there

was no material for the Tribunal's finding that the assessee was being assessed on cash basis in previous years. The decision of the High Court was

confirmed by the Supreme Court. It was suggested in the course of the arguments before the Supreme Court that the managing agency was not a

business. But the Supreme Court considered that this question was immaterial for the purpose of Income Tax because of Section 13 and so

refrained from deciding the point. Even so, it pointed out, in passing, that the point was directly decided in *Inderchand Hari Ram Vs.*

Commissioner of Income Tax and C.P. and Berar, to which we have made a reference. It may be seen, therefore, that *Commissioner of Income*

Tax, Madras v. K.R.M.T.T. Thiagaraja Chetti & Company (1953) S.C.J. 734 : (1953) 2 M.L.J. 823 : (1945) S.C.R. 258 did not decide the

question and does not help in deciding the question we are called upon to answer.

6. It may be that the concept of a servant may, in a sense, involve an element of agency but, on that account, a servant is not to be regarded as an

agent; and an agent is never a servant. We have already held that, having regard to the terms of the agreement and the functions which the assessee

exercised with reference to them, he should be regarded as a manager. In any case, -at best, he may be treated as a managing director under a

contract of service. Though a director simpliciter is not a servant of a company, when a managing director enters into an agreement of service,

there is no reach why he should not be held to hold two capacities, one of them as an employee of the company. In *Commissioner of Income Tax,*

Madras Vs. B. Nagi Reddy, this Court was of the view that the remuneration received by a managing director was salary. The question there was

whether the remuneration received by the managing director of a concern carrying on a business was income from business assessable u/s 10, or

income from salary assessable u/s 7, or income from other sources assessable u/s 12. This Court stated that the answer depended on the nature of

the activities and functions performed by the managing director. The agreement between the assessee and the company, which was engaged in the

production of films, provided that the assessee was appointed as managing director for ten years and was entitled to a monthly remuneration of Rs.

500. Subsequently, a resolution was passed by the company by which the assessee became entitled to 12 1/2 per cent, of the net profits of the

company in addition to the monthly remuneration. Following *Lakshminarayan Ram Gopal and Son Ltd. Vs. The Government of Hyderabad*, this

Court, as we said, expressed the view that the remuneration was not income assessable u/s 10. This Court observed that it was the nature and

scope of the activity, and not the extent of the operations, which was relevant in determining the question and added at page 191:

The remuneration of an agent is only the *quid pro quo* of the services rendered and however much such an agent may represent a business, he

cannot be said to be carrying on a business.

7. We are in respectful agreement with these observations. In this case it was the company that was carrying on the business and the assessee was

employed by the company in managing its affairs including the carrying on of its business. We are of opinion, therefore, that the monthly

remuneration credited to the assessee for the nine months in question represented his salary. We are not concerned in this Reference with the

nature of accrual to or receipt of the commission by the assessee and the capacity he held in relation to it. Though we do not exclude the possibility

of a combination of a servant and an agent in one and the same person, this question too we do not decide as it is unnecessary.

8. That takes us to the second aspect of the question. The argument for the assessee is that if Section 7 applies, no salary accrued to the assessee

during the relevant period. It is stated that, in view of the resolution of the Board of Directors, he became disentitled to payment of the salary and

so the assessee had no vested right in the credit entries and that unless he had such rights, the mere book entries cannot be taken to be an accrual

of salary to the assessee. We are afraid that the argument proceeds on a wrong conception of the effect of the entries in the books of the company

are of the resolution of the Board of Directors. As we said, under the agreement dated 22nd May, 1957 the company shall pay to him a monthly

remuneration of Rs. 1,250 and he will be entitled to draw that remuneration every month. These are the words used in the agreement:

...the company shall pay to the managing director... in monthly instalments not exceeding Rs. 1,250 per month.

9. This is not subject to any exception and the agreement does not provide for the Board of Directors, by a resolution, to stop or deny payment of this remuneration. It is no doubt true as held in Commissioner of Income Tax, Kerala and Coimbatore v. L.W. Russel (1964) 2 I.T.J. 124 : (1964) 2 S.C.J. 332. Bom. 35 : 62 Bom. L.R. 667 : AIR 1961 the word " allowed" in Section 7 of the Indian Income Tax Act, 1922 presupposes a vested right. But the agreement certainly conferred on the assessee a right at the end of the month to payment of the monthly salary. In fact, the folio relating to the assessee in the books of the company shows that practically at the end of every month a sum of Rs. 1,250 was credited to his account. The entry on 31st December, 1959 is : ""To M. D. Remuneration amount transferred... Rs. 15,000."" That would suggest not that the assessee had no vested right but the credit in his favour was transferred and not withdrawn which the company could not, as far as we can see, do under the terms of the agreement. It is contended, perhaps rightly, that the book entries are not necessarily conclusive and it cannot invariably be said that the income results from such entries of credit. But in the present context,, we have no doubt that the entries in the folio page relating to the assessee in the books of the company did result in accrual of salary from month to month for the period in question. Commissioner of Income Tax, Bombay City I Vs. Shoorji Vallabhdas and Co., is relied on by the assessee in support of a contention that it was-open to the company to withdraw the salary by a resolution passed subsequent to the assessment year. We do not think that the authority supports him, for, there the withdrawal was by a subsequent agreement between the assessee and the company and the agreement was during the assessment year itself. It is then contended that on the principle or doctrine of the "" real income"" laid down in H.M. Kashiparekh and Co., Ltd. Vs. Commissioner of Income Tax, Bombay North, Kutch and Saurashtra, it must be held that, in point of fact, there was no real accrual of salary, during the period in question, to the assessee. In that case, the assessee adopted the mercantile system of accounting. The assessee was the managing agent of a paper mill company and under the terms of the managing agency agreement, the assessee was under a duty to forego one-third of his commission where the profits of the company were not sufficient to pay a dividend of six per cent. For the accounting year ended 31st March, 1950, the assessee earned

a certain commission but, as a result of the resolutions passed by the company, the assessee gave up a considerable part of the commission in

December, 1950. The Tribunal held that what was foregone exceeded the proportionate profit provided for in the agreement; nevertheless it also

found that the excess was given up for reasons of commercial expediency. The Bombay High Court held:

It was the real income of the assessee-company for the accounting year that was liable to tax and the real income could not be arrived at without

taking into account the amount foregone by the assessee. In ascertaining the real income the fact that the assessee followed the mercantile system of

accounting did not have any bearing. The accrual of the commission, the making of the accounts, the legal obligation to give up part of the

commission, and the foregoing of the commission at the time of the making of the accounts were not disjointed facts; there was a dovetailing about

them which could not be ignored. The real income of the assessee was Rs. 27,644 and the amount of Rs. 97,000 foregone by the assessee could

not be included in the real income of the assessee for the accounting year.

10 It was further observed that the principle of real income was not to be so subordinated as to amount virtually to a negation of it when a

surrender or concession or rebate in respect of managing agency commission was made, agreed to or given on grounds of commercial expediency,

simply because it took place sometime after the close of an accounting year. Relying on this decision, learned Counsel for the assessee argues that

although the resolution of the Board of Directors was passed subsequent to the assessment year, it was passed on the ground of commercial

expediency and on the same ground the assessee was justified in foregoing the salary for a period of nine months. On that basis, it is said that there

was really no accrual of salary to the assessee for the period. We are unable to accept this contention. The Bombay High Court in that case was

concerned with what was admittedly a business income. That was a case of assessment u/s 10. Naturally, therefore, the question of business

expediency in relation to a loss or expenditure for the purpose of the business would be germane. We are unable to extend the doctrine of "real

income" in the context of commercial expediency to receipt or accrual of salary which is liable to tax u/s 7. On this view, it is unnecessary for us to

deal with the other question whether each accounting or assessment year being an independent unit, withdrawal of income by a resolution subsequent to the assessment year would have any effect on the computation of income in such assessment year. The point here is whether, where the salary had accrued to the assessee but the Board of Directors, by a resolution made subsequent to the assessment year, purported to stop payment of it, it can be said that, in the circumstances, there was no accrual of the salary to the assessee. In the first place, the resolution, worded as it is, does not purport to withdraw the salary already accrued to the assessee. All that it stated was "...the company decides to stop payment of remuneration of Rs. 15,000... to the managing director... for the year 1959." It only means withholding of payment of remuneration and not denial or withdrawal of the remuneration for the period. Even assuming that the resolution can be read as a withdrawal of the remuneration, even so we are of opinion that it would only amount to a kind of disposal by the assessee if he agreed to accept the resolution. On more or less similar circumstances, this Court took that view in *Kothari Mehta and Co. (PTE.) Ltd. Vs. Commissioner of Income Tax, Madras*, . There the managing agency commission under the terms of the agreement should be paid every year out of the profits of that year. There was also a provision that the commission should become payable to the managing agents on the company's auditors certifying the company's annual balance sheet. The audited accounts of the company for each year contained a statement to the effect that the managing agents had waived the commission due to them on; the profits. The accounts bore dates which were subsequent to the assessment years. The question arose whether if the managing agency commission had accrued to the assessee immediately upon the close of its accounting year, the waiver long subsequent to the close of the accounting year, was anything more than a disposal of the income, which had accrued to it and whether it would justify the claim that there was no accrual at all till the date of the waiver was made. The question was answered against the assessee. The learned Judges there observed at page 757:

As we have pointed out, there is no evidence of any agreement of any description which operated to alter the rate of commission or give up the

commission due to the assessee. No such agreement or transaction which could be regarded as an agreement was entered into during the accounting year. If after the accrual of the income, according to the terms of the managing agency agreement, the managing agents purported to give up any part of that income, that cannot be regarded as affecting the terms of the agreement whereunder such income had accrued to it. It follows that the view taken by the Department and the Tribunal that the income had accrued to the assessee in the instant case and that the waiver operated only as a disposal of that income is correct.

11. That precisely is the position in this case too. As we have already mentioned, the agreement, while providing for accrual of the salary or remuneration to the assessee every month provided nowhere for waiver of any part or whole of such remuneration; nor did the agreement reserve power for the Board of Directors to decide that the assessee should forego any part of his remuneration which had accrued to him. If the resolution, therefore, in this case is to be read as having the effect of denying the salary during the period of nine months to the assessee or if it is to be taken that the assessee had waived the accrued remuneration, such denial, withdrawal or waiver occurred subsequent to the assessment year, and it would, therefore, be totally ineffective in the computation of the income for the assessment year which would be liable to tax u/s 7. The entries made in the folio page relating to the assessee in the books of the company, having particular regard to the terms of the agreement, would appear to be irrevocable entries and it would not be open to the Board of Directors to cancel those entries in their effect by the resolution. On this view also, the remuneration for the period of nine months can be rightly brought to tax.

12. The question referred to us is answered against the assessee with costs. Counsel's fee Rs. 250.