

(1936) 03 CAL CK 0027
In the Calcutta High Court

LAKSHMI NARAYAN SEN and SONS, LTD., IN RE.

Date of Decision : 10-03-1936

Acts Referred:

Income Tax Act, 1961 — Section 10, 10(2)(ix)

Citation : (1936) 4 ITR 255

Hon'ble Judges : Derbyshire, C.J.;Costello, J

Bench : Full Bench

Judgement

COSTELLO, J. - The facts of this case are as follows : The assessee is a private limited Company in which three persons Jogendra Sen, Siddeswar Sen and Bankim Chandra Sen (the latter with his two brothers) each holds 100 shares of the nominal value of Rs. 1,000 per share. These three persons hold all the shares of the Company, the business of which consists of money lending, pawn-broking, the buying and selling of jewellery and is carried on at 62, Chowringhee Road, in this city. The assessment with which we are concerned is for the year 1933-34 and is on the income of the accounting year 1339 B. S. For that year the assessee made a return of income amounting to Rs. 16,222. The assessee was assessed by the income tax Officer on a total income of Rs. 37,182. The reason for this was that the income Tax Officer had found in the course of assessment that in the accounts of the Company a sum of Rs. 7,200 per annum, that is to say, Rs. 600 per month was debited as remuneration paid to each of the three persons whose names I have mentioned and the income tax Officer added back that sum to the taxable profits of the Company on the ground that these persons were the sole share-holders of the Company, that the Company maintained a regular establishment including a manager and that the drawings, therefore, represented a distribution of profits and would have been distributed as dividends, had they not been debited and paid out in the guise of remuneration to the same three persons in their capacity as directors of the Company for services which it is alleged they had rendered to the Company.

When the matter came before the Assistant Commissioner on appeal, he directed the income tax Officer to enquire what would be the market value of services identical with or similar to those alleged to have been performed by the directors

of the Company if such services had been rendered by a stranger and on receipt of the Income tax Officers report the Assistant Commissioner fixed the remuneration of the directors for the services rendered by them at a sum of Rs. 175 a month each, that is to say, Rs. 6,300 in all for the three in the course of the year and the Assistant Commissioner accordingly reduced the income of the Company by the amount. The assessee was dissatisfied with what the Assistant Commissioner had done and accordingly he formulated two questions which he said were questions of law arising out of the decision of the Assistant Commissioner.

The Commissioner of income tax did not altogether approve of the form in which the questions were stated and he accordingly redrafted these questions and formulated them as follows :-

(1) "Whether in applying Section 10 (2) (ix) of the Act, it is within the competence of the income tax Officer to go behind the actual payment made and examine if the payment or any portion thereof was or was not on a commercial footing ?"

and

(2) "Whether when an expenditure cannot be brought under any of the clauses of Section 10 (2), it can be allowed as a deduction at all in computing the taxable profits or gains of the business ?"

These two questions have been referred to us and it is these questions which we are required to answer.

The assessee put forward the contention that the three directors of the Company were authorised to draw an allowance each by virtue of the Articles of Association and he said that each of the Directors had the special qualifications and experience and training necessary for work of the nature required and further that they had a position of great responsibility and therefore the remuneration drawn by each of them was legitimately earned. The assessee put forward the argument that on a proper construction of Sec. 10 of the income tax Act, the income tax Officer could not disallow any payment which had actually been made by a Company to an employee and that in the present instance these directors were in the position of employees of the company. The assessee then said that though under the provisions of sec. 10 of the Income Tax Act tax must be paid by an assessee on the profits and gains of the business, the Act itself did not specify how these gains were to be computed and therefore they ought to be computed according to ordinary commercial method, and that after such gains had been computed in this manner sub-section (2) of Section 10 would come into operation with a view to testing whether the principles laid down in cls. (i) to (ix) of sub-section (2) had or had not been violated. The Commissioner of income tax put the matter thus :

"The assessee argues that the allowances paid to the shareholder-directors are

admissible deductions and though they may not fall under any specific sub-section of sub-section (2) of section 10, yet they are inherently admissible on a correct construction of Section 10, sub-section (1)."

With regard to the first question the Commissioner came to this finding :-

"The payments made in this case are not bona fide payments for services rendered and the payments in question are merely a device for enabling the company to escape super-tax when its profits reach a figure higher than the lowest figure on which companys super tax is chargeable."

The learned Commissioner was of opinion-and, in my view, rightly of opinion-that the matter was really a question of fact; but he said this :

"as I do not want to deny the assessee any right to which he may possibly be entitled, I think it best to submit the case to the Court."

I am clearly of opinion that this matter was really a question of fact and in this connection I would refer to the case of Rama Krishna Ramnath Firm of Tirora v. The Commissioner of income tax, Central Provinces and Berar. In that case it was held that the

"remuneration paid to a partner doing business in his individual capacity for services rendered to the firm would be a legitimate deduction from the assessable income of the firm; but sums paid to a partner as such, styled commission, pagdi (bonus) or present or by any other name would be simply the profits of the firm appropriated among the owners after they had been earned".

In the case which was then submitted by the income tax Commissioner, he said paragraph 20 of the case :

"The question is really a question of fact. No doubt the partner in question has a legal personality apart from that of the firm. He might conceivably do business in his individual capacity and in that capacity might render services to the firm in consideration of which the firm might pay him a remuneration which would be a legitimate deduction from the assessable income of the firm. But obviously, considering the opportunities for fraud that any such alleged arrangement would offer, very strict proof would be a legitimate deduction from the assessable income of the firm. But obviously, considering the opportunities for fraud that any such alleged arrangement would offer, very strict proof would reasonably be required of the existence of such an arrangement, and as a matter of fact, no attempt has been made to prove that such an arrangement exists in the present case".

The view taken by the learned Commissioner was adopted by the Court. At page 178 we find this :

"We cannot interfere with the decision of fact that the assessee has not proved that the arrangement to which the Commissioner refers really existed. The only answer which we can give to questions 5 and 6 is the statement of the law made

by the Commissioner of income tax."

In the present instance the learned Commissioner refers to the case of Messrs. B. K. Paul & Co. v. The Commissioner of income tax, Bengal. That was a case which came before Sir Charu Ghose (when he was the Acting Chief Justice of this Court), myself and Mr. Justice Ghose. The head-note of the report reads as follows :-

"Where in stating a case referring the question whether remuneration paid as salaries to the adult male members of a Hindu undivided family for services rendered to the family firm, were legally the income of the individual members or an appropriation of the profits of the firm, the Commissioner found, that the alleged salaries were not bona fide payments at all to bona fide employees of the business but merely a device to escape income tax the High Court returned the reference as not raising any question of law and hence incompetent."

The judgment that was given on that occasion was short and is as follows (at page 25) :-

"Having regard to the findings of fact arrived at by the Commissioner of income tax and which findings are summarized in paragraph 11 of the letter of reference by the Commissioner, we are not prepared to say that any question of law arises for our decision in this matter. In our opinion, the Reference, having regard to the said findings of fact, is clearly incompetent. The matter, therefore, will go back to the Commissioner with an expression of our views in manner indicated above".

The principle followed - if there is any principle underlying this case in 7 I T C 20 - is very much as that which should govern the present case.

The learned Commissioner seems to have sent the matter to us rather out of sympathy with the assessee and not because he himself was in any doubt as to the answer to the questions which had been formulated. I recall that in a case which came before this Bench in July last - In re Keshardeo Chamria - in the course of the judgment which I then gave, I expressed the opinion that where the learned "Commissioner holds that the case rests upon a question of fact, there is no obligation upon him to refer the matter to this Court at all". I think I explained that proposition by adding the words "no necessity whatever". In the present instance, in my opinion, there was no necessity for the learned Commissioner to have referred the present question to this Court, because it nearly always must be a question of fact whether or not the deduction which an assessee seeks to make can properly be described in the words of Section 10 (2) (ix) as an "expenditure (not being in the nature of capital expenditure) incurred solely for the purpose of earning such profits or gains". The Assistant Commissioner in the present case, after he had investigated the matter and made enquiries as to what would be the reasonable remuneration for the services of directors in circumstances similar to those in which the directors of the Company with which we are concerned were acting and he having come to

the conclusion that Rs. 175 per month would be a proper and reasonable remuneration for the services of the directors and having held that that sum might properly be deducted, that would really be a decision as a matter of fact with which this Court would not be prepared to interfere.

It was argued at the bar that the income tax authorities ought not to go behind the accounts - particularly when the accounts had been audited and certified by a competent accountant - for the purpose of ascertaining whether or not the sums which were said to have been paid were reasonable sums by way of remuneration for the services said to have been rendered. The case I have already cited, *Rama Krishna Ramnath Firm of Tirora v. The Commissioner of income tax, Central Provinces and Berar* indicates that it is quite competent for the income tax authorities to ascertain what the real situation is - whether the payments alleged to have been made were in fact made and if they were made whether they were bona fide payments made upon a proper basis or whether they really constituted a device for the purpose of evading the payment of income tax or super-tax. On this point I will refer also to the case of *The Electric and Dental Stores v. The Commissioner of income tax, Punjab and N. W. F. Provinces*. The head-note is as follows :-

"A decision by the Commissioner of income tax allowing partners salary as a business deduction in the assessment of the firms profits in a particular year does not operate as *res judicata* and cannot bind his successor in a subsequent year. Salary charged by working partners in a firm would be admissible as a deduction in the computation of the profits of the firm u/s 10 (2) (ix) of the income tax Act, if those partners were true employees and the payment of salary to them was bona fide and not a device to escape income tax".

As I have already indicated, the question whether payments are bona fide and not a device must always be question of fact. It follows, therefore, that we are of opinion that the view taken by the Assistant Commissioner and affirmed by the Commissioner of income tax as regards the admissibility of the deduction is the correct view.

It has been conceded in the course of the argument before us that if we agree with the Commissioner of Income tax as regards the answer to the first question, the second question scarcely arises. In any event it seems to me that the answer to that question is obvious and plain. Unless expenditure can be brought under the clauses of Section 10, sub-section (2), it cannot be allowed as a deduction in computing the profits from the business. In my view the matter is correctly stated by the learned Commissioner of income tax in the statement of the case. He says with regard to the second question :-

"The assessee contends that all expenses passed by an auditor must be allowed in order to compute the profits or loss of the business for income tax purposes. In my opinion, this contention is not sound, for while all expenses passed by an auditor are not expenses allowable under the income tax Act (e.g., payment of

income tax itself), all expenses allowable under the income tax Act are allowable by an auditor. It may be that in computing the profits or gains of a business within the meaning of Section 10 (1) of the income tax Act, many items shall not have to be deducted though these may not be expenditure at all. Loss occasioned by theft, embezzlement, bad debts, etc., may have to be taken into account for the purpose. The Legislature however is silent on these matters and these may be deductible on the ground that what the section provided for is the assessment of profits and gains of the business and in order to find out such profits and gains we must follow the ordinary commercial method. But so far as allowable items of expenditure are concerned, the Legislature having made express provisions for the purpose of Section 10 (2), I would submit that only those items that are noted there can be allowed."

That statement, in my opinion, is a correct statement of the position.

DERBYSHIRE, C. J., - I agree. The test to be applied is set out in sec. 10 (2) (ix) of the income tax Act -whether the sums of money allotted to directors are "expenditure" incurred solely for the purpose of earning profits or gains in a business. It has been said that the Articles of Association provide that those sums should be paid by way of remuneration to the directors. That is not conclusive that those sums are "expenditure" incurred solely for the purpose of earning profits or gains in the business. Such a provision in the Articles might be pre-designed to evade the incidence of the proper rate of income tax. It has been said also that the sums allotted have been passed by the auditors. That again is not conclusive. This is a taxation Act and what is allowable as a deduction is set out in the Act. The taxation authorities, in my view, are entitled to look at the resolutions and look at the provisions of the Articles of Association providing for the directorssalary, but they are not bound by them. They are entitled to consider the fact that the accountant passed the amounts allotted, but they are not bound by that fact. They are entitled to consider what payments are made for similar services in similar businesses. It is a question of fact in each case as to whether the sums allotted to directors are or are not incurred solely for the purpose of earning profits or gains in a business. In my view no real question of law arises in this matter. The question is whether the Commissioner of income tax has or has not properly appreciated and applied the law. In my view he has properly appreciated and has also properly applied the law in this case. The assessee must pay the costs of this Reference.

Reference answered accordingly.