

N.M. Rayaloo Iyer and Sons, Mathurai Vs. Commr. of Income Tax Excess Profits Tax, Madras

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Court : Chennai

Decided On : Jan-11-1954

Reported in : AIR1955Mad56; [1954]26ITR265(Mad)

Judge : Satyanarayana Rao and ;Rajagopalan, JJ.

Acts : Excess Profits Tax Act, 1940 - Sections 21; Income-tax Act, 1922 - Sections 10 and 10(2); [Code of Civil Procedure \(CPC\), 1908](#); ;Excess Profits Tax Rules - Rule 12

Appeal No. : Case Referred Nos. 53 of 1952 and 44 of 1953

Appellant : N.M. Rayaloo Iyer and Sons, Mathurai

Respondent : Commr. of Income Tax Excess Profits Tax, Madras

Advocate for Def. : C.S. Rama Rao Sahib, Adv.

Advocate for Pet/Ap. : M. Subbaraya Ayyar, ;V. Sethuraman and ;S. Padmanabhan, Adv.

Judgement :

Satyanarayana Rao, J.

1. These two Referred Cases relate to the same assessee. R. C. No. 44 of 1953 relates to income-tax, and R. C. No. 53 of 1952 relates to Excess Profits Tax. Questions 2 and 3 are common in the two Referred Cases, and Question 1 In R. C. No. 44 of 1953 is :

'Whether in allowing a deduction under Section 10 (2)(xv). Income Tax Act, the Income-tax Officer is precluded from going into the question whether the amount was paid wholly and exclusively for the purpose of the assessee's business.'

Question 1 in the connected Reference is, Whether the Appellate Tribunal erred in law in holding that in accordance with the terms of the letter dated 17-4-1940 and 30-3-1943 and the conduct of parties, the Excess Profits Tax payable by the assessee should be deducted from the profits before the commission of 121/2 per cent, payable to N. M. R. V. Mahadevan Is calculated.'

Question 2 is,

'Whether there was any material before the Tribunal to hold that the commission payment to N. M. R. Mahadevan at 121/2 per cent, before deduction of excess profits tax or business profits tax was not wholly and exclusively laid out for the purpose of the assessee's business, and

3. Whether the commission payments to the branch managers and other employees is an expenditure laid out wholly and exclusively for the purpose of the business' Question 2 in Referred Case No. 53 of 1952 is, 'Whether there is any material on evidence sufficient in law for the appellate tribunal to hold that the

commission of 121/2 per cent, on profits paid to Mahadevan was unreasonable within the meaning of Rule 12, Schedule I, Excess Profits Tax Act.'

Question 3 relates to the payment of commission to branch managers.

2. In both the References, on ultimate analysis, the questions really are, whether the commission payable to Mahadevan under the agreement of 30th March 1943 is a permissible deduction under the Income Tax Act and under the Excess Profits Tax Act, and whether in arriving at the commission of 121/2 per cent, payable to Mahadevan the amount is to be calculated on the profits with or without deducting excess profits tax. The second question both under the Income-tax Act and the Excess Profits Tax Act is whether the commission paid to branch managers and Sub-managers is a justifiable deduction under the Income-tax Act and the Excess Profits Tax Act.

3. The facts relevant and as found in the statements of the case in the two References may be stated as follows. The assessee is Rayaloo Iyer and Sons, Madurai. We are concerned in these References with the assessment years 1943-1944 to 1948-1949, the accounting year being the corresponding Tamil year; and under the Excess Profits Tax Act, we are concerned with the chargeable accounting periods ending with 13-4-1943, 12-4-1944, 12-4-1945, and 31-3-1946, and under the business profits assessment, with chargeable accounting periods, 1-4-1946 to 12-4-1946, 13-4-1946 to 31-3-1947, 1-4-1947 to 13-4-1947, 14-1-1947 to 31-3-1948 and 1-4-1948 to 12-4-1948. The excess profits tax and the business profits tax were treated as consequential to the income-tax.

4. The assessee firm consists of three partners, who are divided brothers, and it came into existence after the partition in the family between the members on 13-4-1940. On 13-4-1946, Subbaraman, one of the brothers, ceased to be a partner, and the partnership continued with the two partners with effect from 14-4-1947 the share of Venkatakrishna Ayyar was taken over by Venkatakrishna Ayyar and Sons Ltd., which became a partner in the assessee firm. The partnership carried on business in dyes and chemicals in the name and style of Colours Trading Company, for which separate books of account were maintained. They were the agents for the Imperial Chemical Industries Ltd., Bombay, and were paid a commission in the first instance varying from 7 1/2 per cent, to 12 per cent, on different products.

On 1-7-4-1940 Mahadevan, the son of one of the brothers, who received special training for two years in the Imperial Chemical Laboratory at Bombay, was appointed as General Manager of Colours Trading Company. On the same date, there was an agreement of employment executed by one of the partners in favour of Mahadevan. The terms of his employment were that he should get Rs. 1,800/- per annum as remuneration, besides 5 per cent, of the net profits of the concern, calculated by deducting from the gross profits of the business the salaries and wages and other outgoings without making any deduction from capital. The agreement was to take effect from 13th April 1940, the commencement of the partnership.

After same time, on the representation of Mahadevan, that his remuneration was inadequate and was not commensurate with the responsibilities which he, undertook, his remuneration was increased with effect from 13-4-1943, as evidenced by the letter of the company dated 30th March 1943. Under this arrangement he was to get an increased salary of Rs. 250/- per mensem or Rs. 3,000/- per year 'for the present', and a commission at 121/2 per cent, on the net profits of the Colours Trading Company section from 13-4-1943. He was required by this agreement to devote all his attention to the development of the business, with a promise of further increment in course of time.

5. The Imperial Chemical Industries (India) Ltd. on 24th January 1944 increased the commission payable to Colours Trading Company, and allowed as special emergency allowance an extra commission of 5 per cent calculated on the total gross invoice price of all dyes, dye-stuffs and auxiliary products covered by their respective agreements and sold to them. This was to take effect from 1st January 1944. A condition was attached to the payment of this emergency allowance, that the distributors were expected to pass on at least 1 per cent, of this allowance to their respective Sub-distributors. In the next year the emergency allowance

was further increased by 10 per cent. In addition to the emergency allowance of 5 per cent already allowed to the distributors.

This is evidenced by the letter of the Imperial Chemical Industries Ltd., dated 23rd February 1945, and the arrangement was to take effect from 1st March 1945. In other words, the total commission payable to the Colours Trading Company including the emergency allowance of 15 per cent, came to about 25 per cent. Under the arrangement of 23rd February 1945 there was also a further requirement, that out of the 10 per cent, emergency allowance allowed under it the distributors should pass on a further 5 per cent., that is, not less than 6 per cent, made up of the 1 per cent, allowable under the arrangement of 1944 and the 5 per cent, required under the arrangement of 1945. The 1 per cent, under the arrangement of 1944 and the extra 5 per cent. under the arrangement of 1945 were the minimum which should be passed on by the distributors to the Sub-distributors, which implied that the distributors were at liberty to pay more according to their discretion.

6. At the time when the emergency allowance of 5 per cent, was allowed in 1944 the Colours Trading Company had 12 branches at Chirala, Madras, Salem, Pondicherry, Aruppukkottai, Rajapalayam, Tirunelveli, Bangalore, Adoni, Cannanore, Mangalore and Gudiyattain; and a further branch was opened at Tiruppur in the accounting year 1945-46. These branches were in charge of local managers appointed by the Company, who were in sole charge of the conduct of the business at the respective places subject, however, to the general control and superintendence by the partners of the assessee firm.

As they had no -sub-distributors and as practically the managers of each branch were in the analogous position of sub-distributors, from the emergency commission allowed under the arrangement of 1944 the assessee firm allowed to Its employees, the branch managers and assistant managers a commission of 4 per cent, over and above their basic salary, the dearness allowance, and the Deepavali bonus which it was already allowing. The firm entered into agreements with the employees between 10-2-1944 and 1-5-1944 providing for the payment of commission with effect from 13-1-1944, calculated with reference to the year's turnover of the branch, and at rates varying from 1 1/2 per cent, to 4 per cent.

There was however a requirement under the agreements, that the remuneration shall be payable for any year if the total amount of sales of dyes in the said branch exceeded one lakh of rupees; but if it was below, unless in special cases, the commission should not be allowed; but there was absolute discretion reserved to the employers to allow in such cases the commission at 4 per cent, even if the turnover of the business at each branch did not exceed the limit. The agreements entered into were practically and substantially in the same form, and a sample copy of the agreement was annexed to the statement of the case.

8. With the increase of emergency allowance in 1945 by the Imperial Chemical Industries Ltd., in the subsequent year the employers increased the commission payable to the branch managers and sub-managers to 7 1/2 per cent, and in some cases a little more, and revised agreements providing for the increased rate of commission were also entered into between the employees and the employers.

With effect, however, from 1-9-1946 the Imperial Chemical Industries reduced the percentage of commission to 10 per cent. For the first year under the arrangement of 1944, i.e., for the assessment year 1945-46 for the corresponding previous year ended 12-4-1944 the total of the commission payable to the employees other than Mahadevan came to Rs. 1,00,715/- as against the extra commission received by them from the imperial Chemical Industries which was Rs. 1,28,533/-. In the next year of assessment 1946-47, for the previous year ending with 12-4-1946, the claim increased to Rs. 2,44,688/- as against the extra commission which the assessee received from the Imperial Chemical Industries, which was Rs. 3,20,391/-. In the subsequent assessment year 1947-48, they received from the Imperial Chemical Industries Rs. 3,15,934/- and paid to the employees, Rs. 1,28,506/-, and in 1948-49 the ' assessment year they received Rs. 3,70,964/- and paid to the employees Rs. 1,75,079/-.

9. As regards Mahadevan, under the agreement of 17-4-1940, the Commission as per the agreement was paid and was claimed as a deduction in the assessment to income-tax and also in the excess profits tax

proceedings, i.e, the assessment year 1941-42 and the chargeable accounting period 12-4-1941. The Income-tax Officer and the Excess Profits Tax Officer disallowed the payment of salary and commission as not bona fide. But on appeal, the Appellate Assistant Commissioner by his order dated 28th July 1942 upheld the deduction holding that the agreement was genuine, and that the amount of salary and the rate of commission were reasonable and should be allowed. There was no further appeal by the department to the Tribunal, and in the subsequent assessment year 1942-43 and in the excess profits tax assessment for the corresponding chargeable accounting period ending 12-4-1942, the salary and commission were allowed by the Income-tax Officer and the Excess Profits Tax Officer.

10. During the assessment year 1943-44 and 1944-45 the increased commission payment to Mahadevan, calculated at 121/2 per cent, of the net profits of the Colours Trading Company, was disallowed by the Income-tax Officer, and the same was disallowed also by the Excess Profits Tax Officer in the chargeable accounting periods ended 12-4-1944, 12-4-1945 and 31-3-1946. The amounts claimed as deduction during these periods were Rs. 13,815/-, Rs. 28,768 and Rs. 14,205/- respectively.

When the matter finally reached the Appellate Tribunal on a reference under the Excess Profits Tax Act, the Tribunal held that, so far as Mahadevan was concerned, there was no justification for the entire disallowance of the commission by the Excess Profits Tax Officer, but that at the same time there was no justification for the claim of the assessee for an increase in commission from 5 per cent, to 121/2 per cent. They, however, directed that Mahadevan should be paid 5 per cent, of the net profits before the deduction of the excess profits tax or 121/2 per cent, after deduction of the excess profits tax, whichever was better. Following this order in the income-tax proceedings, the commission payable to Mahadevan was allowed to the extent indicated by the Tribunal as aforesaid.

11. The commission payable to the branch managers and assistant managers during the assessment years 1945-46, 1946-47, 1947-48 and 1948-49 was disallowed by the department, and the same was followed under the Excess Profits Tax Act for the chargeable accounting periods ending with 12th April 1945 and 31st March 1946. This decision was confirmed by the Appellate Assistant Commissioner and also by the Appellate Tribunal. So that, the main questions that arise for consideration in the case of Mahadevan are whether the disallowance of the commission, to the extent to which it was disallowed by the Appellate Tribunal, paid to Mahadevan is justified in law both under the Income-tax Act and under the Excess Profits Tax Act, and the mode in which the net profits on which 121/2 per cent. is to be calculated are to be arrived at.

The Tribunal following the decision of the Bombay High Court in -- 'Walchand & Co. Ltd. v. Hindustan Construction Co. Ltd.', AIR 1944 Bom 5 held 'that the excess profits tax should be deducted before the net profits were arrived at, and on that alone the 121/2 per cent, should be calculated. They did not, however, find that the 121/2 per cent, was unreasonable. The second set of questions relates to the commission paid to the branch managers and the assistant managers, and whether it is a permissible deduction under the Income-tax Act and the Excess Profits Tax Act.

12. The questions raised have to be decided on a proper interpretation of the three provisions, Section 16(2) (x) and Section 10(3) (xv) of the Income-tax, Act and Rule 13, Schedule 1, Excess Profits Tax Act. Their inter-connection has also to be determined with a view to find out to what extent the deduction of commission is permissible under law. Section 10(2)(x) is a specific provision, which relates to the bonus or commission paid to an employee for services rendered by him. It is as follows:

'Any sum paid to an employee as bonus or commission for service rendered, where such sum would not have been payable to him as profits or dividend if it had not been paid as bonus or commission:

Provided that the 'amount' of the bonus or commission is of a reasonable amount with reference to--

(a) the pay of the employee and the conditions of his service;

(b) the profits of the business, profession or vocation for the year in question; and

(c) the general practice in similar businesses, professions or vocations.'

Section 10(2) (xv), Income-tax Act, is as follows:

'any expenditure not being in the nature of capital expenditure or personal expenses of the assessee laid out, or expended wholly and exclusively for the purpose of such business, profession or vocation.'

Rule 12, Schedule I, Excess Profits Tax Act, 1940, is as follows:

'(1) In computing the profits of any chargeable period no deduction shall be allowed in respect of expenses in excess of the amount which the Excess Profits Tax Officer considers reasonable and necessary having regard to the requirements of the business and, in the case of directors' fees or other payments for services, to the actual services rendered by the person concerned:

Provided that no disallowance under this rule shall be made by the Excess Profits Tax Officer unless he has obtained the prior authority of the Commissioner of Excess Profits Tax.

(2) Any person who is dissatisfied with the decision of the Excess Profits Tax, Officer under this rule may appeal in the prescribed time and manner to the Appellate Tribunal.'

13. It must be remembered even at the outset that profits have to be calculated under the Excess Profits Tax Act on the principles on which the profits of a business are computed for purposes of income-tax under Section 10, Indian Income-tax Act, subject, however, to the provisions of Schedule I, Excess Profits Tax Act. Section 10, Income-tax Act, was expressly made applicable to computations under the Excess Profits Tax Act by Section 21 thereof. The profits of a business computed' for purposes of income-tax under Section 10 of that Act will be the primary basis for arriving at the profits of that business under the Excess Profits Tax Act; but that determination, as stated in Rule 1, Schedule I, Excess Profits Tax Act, is subject to the provisions of the First Schedule which contains Rule 12. We shall deal later with the question to what extent Rule 13, Schedule I, Excess Profits Tax Act, affects the determination of the profits with reference to Section 10, Income-tax Act.

14. As there is a specific provision in the Income-tax Act, circumscribing the limits under which a commission or bonus paid to an employee is to be allowed as a deduction, that specific provision, in our opinion, must prevail, and resort cannot in those circumstances be had to Section 10(2) (xv) of the Income-tax Act. This is also the view taken by the Bombay High Court in --'Subodhchandra Popatlal v. Commissioner of Income-tax', : AIR1954Bom234 (B). It is an accepted canon of construction of statutes that a specific provision always prevails and excludes a general provision. This aspect of the case, however, was not kept in mind by the Income-tax authorities and the Appellate Tribunal in considering the claims for deduction put forward by the assessee. The departmental authorities and the Appellate Tribunal dealt with the claims as falling within the purview of Section 10(2) (xv), Income-tax Act.

15. Under Section 10(2) (x), Income-tax Act, the bonus or commission is subject to the test of reasonableness, and the department has jurisdiction under that section to determine a reasonable amount as deduction. But in doing so, it has to take note of the three circumstances or considerations specified in the proviso to Section 10(2) (x). It is the cumulative effect of these considerations which should govern the determination of a reasonable amount under that clause. The only considerations therefore are the pay of the employee, the conditions of his service, the profits of the business for the year in question, and the general practice in similar business. The scope of Section 10(2) (xv) is entirely different from that of Section 10(2) (x), Income-tax Act. Neither the test prescribed by Section 10(2) (xv), that the amount is wholly and exclusively laid out or expended for the purpose of such business, nor the ancillary test of commercial expediency is strictly germane to the consideration of the reasonableness of the deduction claimed for amounts paid out as bonus or commission.

16. If under Section 10(2) (x), Income-tax Act, the commission or bonus paid to an employee is held to be a lawfully claimable deduction in whole or in part, what the effect of such a decision is on the application of Rule 12, Schedule I, Excess Profits Tax Act, is the further question for consideration. Rule 1 and Rule 12, Schedule I, Excess Profits Tax Act, are comprehensive in their scope; but we are not concerned in this case with the effect of these Rules on the deductions permitted by the Sub-sections of Section 10(2), Income-tax Act, other than 10(2)(x).

17. It is, however, necessary to examine the scope of the test prescribed by Section 10(2) (xv), Income-tax Act, because, in our opinion, there is not much difference in principle between the test laid down there and that laid down by Rule 12, Excess Profits Tax Act. Claims for deductions allowed under Section 10(2)(x), Income-tax Act, have to be considered over again, if they are to be allowed as deductions under the Excess Profits Tax Act by the application of Rule 12, Schedule I.

18. Under Section 10(2) (xv) the test is whether the expenditure was wholly and exclusively laid out for the purpose of such business. Under Rule 12 the Excess Profits Tax Officer is permitted to allow as a deduction such amount of expense which, in his opinion, is reasonable and necessary having regard to the requirements of the business. As we said before, the two tests do not differ very much in their scope. Both the tests include commercial expediency. Under each of these two provisions the test laid down by the Supreme Court in -- 'Eastern Investments Ltd. v. Commr. of Income-tax, West Bengal', : [1951]20ITR1(SC) (O in considering Section 12(2), Income-tax Act, in which the language employed is' similar, may well be applied.

The Supreme Court approved of the principles laid down in -- 'British Insulated and Helsby Cables Ltd. v. Atherton', (1926) AC 205. where Viscount Cave L.c. observed :

'It was made clear in the above cited cases of -- 'Usher's Wiltshire Brewery Ltd. v. Bruce', 1915 AC 433 and -- 'Smith v. Incorporated . Council of law reporting for England and Wales', 1914 3 KB 674 that a sum of money expended, not of necessity and with a view to a direct and immediate benefit to the trade, but voluntarily and on the grounds of 'commercial expediency, and in order indirectly to facilitate the carrying on of the business, may yet be expended wholly and exclusively for the purposes of the trade.'

After reviewing the facts of the case the learned Judges of the Supreme Court observed at page 280:

'On a full review of the facts it is clear that this transaction was voluntarily entered into in order indirectly to facilitate the carrying on of the business of the company and was made on the ground of commercial expediency.'

19. The same view was taken by the Bombay High Court in -- 'Tata Sons Ltd. v. Commissioner of Income-tax, Bombay', : [1950]18ITR460(Bom) (G), which was a case under Section 10(2) (xv), Income-tax Act. The question that arose for consideration was whether the voluntary payment by the managing agent of a certain sum of money as his share of the bonus, which the managed company paid to some of its officers, was a permissible deduction under Section 10(2) (xv), Income-tax Act. As the assessee, the managing agent, did not directly pay the bonus to the employees, the claim could not naturally be considered under Section 10(2) (x). The bonus was directly paid by the managed company to its employees, but the managing agent was required to contribute his share of the payment under the terms of the arrangement between the managed company and the managing agent. Chagla C. J. observed at page 384: 'Now, the decided cases show that one has not got to take an abstract or academic view of what is proper expenditure laid out or expended wholly and exclusively for the purposes of one's business. One has got to take into consideration questions of commercial expediency and the principles of ordinary commercial trading and the main consideration that has got to weigh with the Court is whether the expenditure was a part of the processes of profit-making. If the expenditure helps or assists the assessee in making or increasing the profits, then undoubtedly that expenditure would be expended wholly and exclusively for the purposes of business.'

The fact that it was a voluntary payment should not really matter, if the payment was made for reasons of

commercial expediency, and if it was shown that the payment was intended for making or increasing the profits of the assessee company. Had the managed company claimed the deduction, it would have been under Section 10(2)(x). It was the managing agent that claimed deduction, and the claim had to be investigated only under Section 10(2) (xv). Had the claim under Section 10 (2)(x) been considered reasonable, that by itself should have justified the test of commercial expediency and the test prescribed by Section 10(2) (xv) to allow the claim put forward by the managing agent.

20. In applying the test of commercial expediency to determine whether the expenditure is wholly and exclusively laid out for the purpose of the business, the reasonableness of the expenditure should be considered from the point of view of businessman and not from the point of view of outsiders including the Income-tax Officer. The Department might consider that such a large amount as in : [1950]18ITR460(Bom) (G)' was wholly unreasonable; viewing it purely from the point of view of a layman. The viewpoint of the businessman is all the more important under the present set-up, when the difficulties of running a business are more pronounced. The bonus that is paid to employees is no longer treated as a payment 'ex gratia', and the percentage of commission under the managing agency agreements is intended to give an inducement to the managing agent to exert to the best of his ability to increase the volume of business so as to bring into the business more profits.

The necessity to keep the employees in good humour and to keep them above want with a view to deter them, if possible, from becoming corrupt or even disloyal could be appreciated and realised only by a person who actually runs a huge growing concern, like the business of the Tatas in the case above referred to, and may not always be fully appreciated and sympathetically viewed by one unconnected with business. The 'requirements of the business' as laid down in Rule 12, Schedule 1, Excess Profits Tax Act, are, in our opinion, also to be judged against the same background, and the same principles have to be applied as under Section 10(2)(xv).

21. We have already pointed out that there is not much difference in principle between the requirements of Section 10(2) (xv) and those of Rule 12, Schedule 1, Excess Profits Tax Act. Both attract the justification of expenditure on grounds of commercial expediency, and to that extent, at any rate, there should be no difference at all. We find it rather difficult to envisage a position where an expenditure satisfies the test of Section 10(2) (xv), an expenditure incurred wholly and exclusively for the purpose of the business, not satisfying the test of Rule 12(1), an expenditure reasonable and necessary having regard to the requirements of the business. In our opinion, wholly and exclusively' in Section 10(2) (xv) would appear to be even more exacting in its requirements than the test of reasonableness and necessity prescribed by Rule 12.

22. We had to consider at some length the scope of Section 10(2)(xv), Income-tax Act, only to explain the scope of Rule 12. We now come back to the question, to what extent a deduction that satisfies the requirements of Section 10(2)(x), Income-tax Act, can be allowed or disallowed in the assessment of the excess profits by the application of Rule 12, Schedule I, Excess Profits Tax Act.

23. Mr. Ramarao Sahib, the learned advocate for the Commissioner, contended that, even if a claim for deduction satisfied the requirements of Section 10(2) (x), it would be open to the Excess Profits Tax Officer to disallow that amount on the ground that the expenditure was not reasonable and necessary having regard to the requirements, of the business, and that it would be open to the Excess Profits Tax Officer to consider what amount was reasonable in the circumstances of the case. To that statement no exception could be taken; but Mr. Ramarao Sahib contended further that under Rule 12 the Excess Profits Tax Officer could only cut down, if necessary, the deductions already allowed under Section 10(2) (x), Income-tax Act. We are unable to accept this contention, though it might receive some support from the observations of the learned Judges of the Bombay High Court in -- 'Jethabhai Hiraji & Co. v. Commissioner of Income-tax, Bombay : AIR1950Bom29 (H).

Mr. Ramarao Sahib pointed out that the proviso to Rule 12(1) requires the previous sanction of the Commissioner of Excess Profits Tax before any claim is disallowed under Rule 12, and the learned advocate

urged that it could apply only when a claim for deduction allowed under the Income-tax Act had CO be disallowed under the Excess Profits Tax Act. It is not clear to us that that is the only basis for prescribing the previous sanction of the Commissioner under Rule 12(1). Suppose the Income-tax Officer arrives at the conclusion that the bonus and commission are not wholly reasonable and disallows them either in toto or in part, would it not be stilt open to the assessee before the Excess Profits Tax authorities to claim this deduction on the ground that though in view of the considerations laid down by the proviso to Section 10(2) (x) it might not be a reasonable expenditure, still it might be an expenditure which was reasonable and necessary having regard to the requirements of the business within the meaning of Rule 12(2)

We have already pointed out that the test of commercial expediency is not germane to an enquiry into a claim under Section 10(2)(x); but It is a very relevant consideration In the application of Rule 12, Schedule I, Excess Profits Tax Act. If it is open to the Excess Profits Tax Officer under Rule 12 to disallow what was already allowed under Section 10(2) (x) it should be equally open to him to allow what was once disallowed, because the test, in Rule 12 is not identical with that prescribed by Section 10(2) (x), Income-tax Act. We are therefore unable to accept the contention of Mr. Ramarao Sahib, that the only Jurisdiction of the Excess Profits Tax Officer under Rule 12 is to disallow what was allowed under Section 10(2) (x). Income-tax Act. Even if a claim falls to satisfy the requirements of Section 10(2) (x), Income-tax Act, it is for the Excess Profits Tax Officer to decide whether it satisfies the requirements of Rule 12, Schedule I, Excess Profits Tax Act.

24. It is in the light of the discussion above that the questions raised in these two references have now to be considered. The case of Mahadevan, in our view, does not present much difficulty. The salary and the commission under the agreement of 1940 were upheld, and there was no dispute about it. The increased salary and the commission were agreed to in 1943, not on the ground that Mahadevan was called upon to discharge any extra duties or render additional service, but on the representation made by him that the remuneration previously granted to him under the arrangement of 1940 was inadequate and was not commensurate with the responsibilities which he undertook. The Company, after trying him for a period of about two years, thought fit to increase the' salary to Rs. 3,000/- per year, and increased the share of the profits from 5 per cent, to 12 1/2 per cent.

The Tribunal did not consider the salary to be unreasonable; nor did they consider the 12 1/2 per cent, allowed as unreasonable. But on the interpretation which they placed upon 'net profits' they arrived at the conclusion, that he should be paid either 5 per cent, of the net profits before deduction of excess profits tax or 12 1/2 per cent, after deduction of excess profits tax, whichever was better from his point of view. Though no express reference was made in the proceedings either before the Department or the Appellate Tribunal under Section 10(2) (x) of the Act, in view of the conclusion, that so much was reasonable, it is unnecessary to send the case back for reconsideration under Section 10(2) (x) of the Act. The question in the case of Mahadevan, therefore, is whether the interpretation placed upon 'net profits' by the Tribunal is correct.

25. The agreement of 1940 provided for a commission of 5 per cent, of the net profits of the concern, calculated by deducting from the gross profits of the business salaries and wages and other outgoings. The deductions contemplated were only from the gross profits and not from the net profits. Under the agreement of 1943, the 12 1/2 per cent, is to be paid on the net profits, and as this arrangement is merely a modification of the previous one, it can be taken that the expression 'net profits' in this is used in the same sense as under the arrangement of 1940.

The Tribunal was of opinion that in order to arrive at the net profits the excess profits tax must be excluded, and 12 1/2 per cent, must be calculated on the balance, while the contention of the assessee was that the excess profits tax should not be deducted in order to arrive at the net profits. We have to' decide which of the contentions is correct. The Tribunal followed the decision of the Bombay High Court in -- AIR 1944 Bom 5. That decision was based upon the majority view of the House of Lords in -- L. C. Ltd, v. G. B. Ollivant', 1945 13 ITR Sup 23 Viscount Simon, L. C. took a different view.

26. It cannot now be disputed that in arriving at net profits, they ought to be calculated inclusive and not exclusive of the amount payable for the year in respect of income-tax. This is settled by the House of Lords in - 'Ashton Gas Co. v. Attorney General, 1906 AC 10. As observed by Earl of Halsbury L. C. in that case, 'Now the profit upon which the income-tax is charged is what is left after you have paid all the necessary expenses to earn the profit. Profit is a plain English word; that is what is, charged with income-tax, But if you confound what is the necessary expenditure to earn that profit with the income-tax, which is part of the profit itself, one can understand how you get into the confusion which has induced the learned counsel at such very considerable length to point out that this is not a charge upon the profits at all. The answer is that it is. The income-tax is a charge upon the profits; the thing which is taxed is the profit that is made, and you must ascertain what is the profit that is made before you deduct the tax, you have no. right to deduct the income-tax before you ascertain what the profit is. I cannot understand how you can make the income-tax part of the expenditure. I share Buckley J.'s difficulty to understanding how so plain a matter has been discussed in all the Courts at such extravagant length.'

27. The majority view of the House of Lords was based upon the interpretation that 'net profits' mean 'divisible profits', i.e., profits out of which the taxes are deducted and thereafter distributed between the sharers, whether they are partners in a firm or shareholders in a company. But with great respect to the majority view, we think that the view of Viscount Simon L. C. is correct. The purpose and the incidents of a profit and loss account were fully explained by the Lord Chancellor at page 27. The main object or the purpose of a profit and loss account is to ascertain the balance of profit or loss of the enterprise during the year. Normally the first step in the account is to cast a trading account in which the receipts of the business are set off against the expenses directly incurred in earning those receipts. Then we arrive at the gross profit in the trading account, which will be carried to a profit and loss account as its opening item.

To the credit side are added interest or investment, rents or the like, and on the debit side the overhead expenses of the business are entered. The balance represents the net profits. The net profits thereafter are carried over to an appropriation account where against the net profits the various charges for which the profits are appropriated are debited; that is, for tax, for reserve, for dividends. The divisible profits are thus arrived at. Until the net profits are determined, the excess profits tax is not deducted or appropriated as an item of expenditure in the account.

It was observed by the Lord Chancellor at page 26, after referring to the decision relating to Income-tax in -- 1906 AC 10:

'Why is not the same thing true about excess profits tax? Varying a famous phrase of Lord Macnaghten in -- 'London County Council v. Attorney-General', 1901 AC 26, I venture to observe that excess profits tax, if I may be pardoned for saying so, is a tax on profits. It is a tax (very elaborately calculated, it is true) on profits, for it is a tax on excess profits -- it skims the cream off profits so far as they are in excess of the standard profit.'

28. From an examination of the provisions of the Excess Profits Tax Act, it will be seen that it is a tax on profits. That is, a share in the profits is taken by the State as a tax. The net profits must therefore be ascertained in accordance with the principles of commercial accountancy and the principles laid down under the Excess Profits Tax Act. It is from that that the tax is taken by the State. The distributable profits are arrived at only after the tax is appropriated from the net profits. For the reasons given by Viscount Simon in the decision referred to above, we think, with great respect to the majority opinion, that the principle to be followed is that expressed by Viscount Simon L. C. in that decision. It is unnecessary to examine at length the reasoning underlying the decision in -- AIR 1944 Bom 5. The same view was taken by a Full Bench of the Punjab High Court at Simla in- 'Commissioner of Income-tax, Delhi v. Delhi Flour Mills Co., Ltd.', after an elaborate examination of the decisions. We respectfully agree with the view taken by the Punjab High Court.

29. We are therefore of opinion, that the net profits should be calculated without deducting excess profits tax, and that in the case of Mahadevan, 124 per cent, of that should be allowed both under the Income-tax Act

and under the Excess Profits Tax Act.

30. There is then the question regarding the commission paid to the branch managers and assistant managers. Unfortunately, the question was considered only under Section 10(2) (xv), Income-tax Act, and under Rule 12, Excess Profits Tax Act, First Schedule. The Appellate Tribunal should have considered the question of the commission payable to them only under Section 10(2) (x). Income-tax Act. The reasonable amount has to be determined under that provision having regard to the test laid down in it. The commission was allowed only after the emergency allowance was granted to the assessee by the Imperial Chemical Industries. When it was increased in 1945, they also increased the commission to the employee. The agreement under which the emergency allowance was allowed by the Imperial Chemical Industries required that the distributors should pass on a minimum percentage of the commission to the Sub-distributors.

It is no doubt true that the branch managers and assistant managers were not Sub-distributors; but practically the business in those branches was carried on by them on behalf of the Colours Trading Company. The object of the Imperial Chemical Industries was that the allowance should not be retained in toto by the Colours Trading Company. Whether the percentage allowed, which was above the minimum permitted by the Imperial Chemical Industries is reasonable or not in the circumstances, and also having regard to the other remuneration allowed to the employees, is a matter for consideration by the Tribunal.

31. One aspect of the matter was not adverted to in the order of the Appellate Tribunal, though in the statement of the case it was referred to. The Ordinance against Hoarding and Profiteering was in force at that time, and black market trade was rampant. The prices soared up, and there was a temptation on the part of everybody to make a profit by trading in black market. In the statement of the case, the Tribunal adverted to the contention on behalf of the assessee, that the additional commission was intended to be passed on to Sub-dealers,

'that such additional commission was paid by the Imperial Chemical Industries (India) Limited, with the avowed object of keeping and retaining in the market their good reputation, that in accordance with the spirit of the letters of the Imperial Chemical Industries (India) Limited and in order that the other employees of the various branches may not resort to illegal or other shady dealings to the detriment of the assessee, it had agreed to pass on a portion of the additional commission so received to the branch managers and other employees who were virtually in the position of Sub-dealers and as such the commission payments were expenditure laid out wholly and exclusively for the purposes of the business.'

This background should also enter into the consideration in deciding the reasonableness of the commission allowed to the employees both under Section 10(2) (x). Income-tax Act and Rule 12, Excess Profits Tax Act. As there is no consideration of the question from this point of view, we are constrained to remit the case of branch managers and assistant managers to the Tribunal for further consideration and for a better statement of the case.

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