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## J. K. WOOLLEN MANUFACTURERS

v.

### COMMISSIONER OF INCOME-TAX, U.P.

August 2, 1968

B [J. C. SHAH, V. RAMASWAMI AND A. N. GROVER, JJ.]

*Income-tax Act (11 of 1922), s. 10(2)(xv)—Commission to employee higher when profits exceed a lakh—Whether deductible from employer's assessable income.*

C The assessee—a Mill, appointed V, as its General Manager, on a salary of Rs. 1000/- p.m., and car allowance of Rs. 250/- p.m., plus commission of 12½% on the net profits of the firm and in case the profits exceeded Rs. 1 lakh, the commission payable was 25%. In the first year of the appointment the mill suffered loss, next year commission was paid at 12½% of the profits, and the next year commission paid was 25% as the profits exceeded the figure stipulated. After the death of V, one of the Directors was appointed to manage its affairs and given a total remuneration of Rs. 24,000/- per annum and the post of General Manager was abolished. The assessee claimed deduction from its assessable income the amount paid to V at the rate of 25% of the profits. The Income-tax Officer disallowed the claim and determined Rs. 5,000/- as reasonable amount payable. Against the amount disallowed, the assessee appealed to the Appellate Assistant Commissioner, who allowed payment of commission at 12½% as in its view that rate was reasonable considering the practice in similar business concerns. The assessee appealed to the Appellate Tribunal and the appeal was dismissed. The Tribunal took the view that the General Manager carried responsibility equal to that of the Director, so the commission paid to V, in excess of Rs. 24,000/- per annum, i.e., the amount paid as total remuneration to the Director, was not really paid wholly for the purpose of carrying on business. On reference, the High Court answered the question against the assessee. The assessee in appeal to this Court contended that the higher rate of commission on profits was inserted to create the interest of V, who had special aptitude and experience in the line and the mill was running at a loss and it was only after sometime of V's taking over that the mill made large profits, so the amount paid to V, was an amount laid out or expended wholly or exclusively for the purpose of the business of the assessee, and it was wrongly disallowed.

F HELD: In the circumstances established by the assessee, the entire amount paid to V, was an amount laid out or expended wholly and exclusively for the purpose of the assessee.

G In applying the test of commercial expediency for determining whether an expenditure was wholly and exclusively laid out for the purpose of the business, reasonableness of the expenditure has to be adjudged from the point of view of the businessman and not of the Income-tax Department. It is, of course, open to the Appellate Tribunal to come to a conclusion either that the alleged payment is not real or that it is not incurred by the assessee in the character of a trader or it is not laid out wholly and exclusively for the purpose of the business of the assessee and to disallow it. But it is not the function of the Tribunal to determine the remuneration which in their view should be paid to an employee of the assessee. An employer in fixing the remuneration of his employees is entitled to consider the extent of his business, the nature of the duties to be performed and the special aptitude of the employee, future prospects of extension by

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the business and a host of other related circumstances. The question as to whether an amount claimed as expenditure was laid out or expended wholly or exclusively for the purpose of business, profession or vocation as required under s. 10(2) (xv) of the Income-tax Act has to be decided on the facts and in the light of the circumstances of each particular case. But the final conclusion on the admissibility of an allowance is one of law. [529 D; 529H-530 C]

*C.I.T. Bombay v. Walchand & Co. Private Ltd.* 65 I.T.R. 381, applied to.

*Swadeshi Cotton Mills Co. Ltd. v. C.I.T., U.P.* 63 I.T.R. 57, referred to.

**CIVIL APPELLATE JURISDICTION :** Civil Appeal No. 591 of 1967.

Appeal by special leave from the judgment and order, dated May 22, 1962 of the Allahabad High Court in Income-tax Reference No. 424 of 1958.

*M. C. Chagla* and *B. P. Maheshwari*, for the appellant.

*B. Sen*, *B. D. Sharma* and *R. N. Sachthey*, for the respondent.

The Judgment of the Court was delivered by

**Ramaswami, J.** The appellant (hereinafter called the 'assessee') carried on the business of manufacture and sale of blankets and other woollen cloth. For the assessment year 1948-49 the assessee claimed a deduction of Rs. 75,465 as commission paid to the General Manager Shri J. P. Vaish. According to the terms of appointment Shri J. P. Vaish was to draw a fixed salary of Rs. 1,000 p.m., commission of 12½% on the net profits of the firm payable after the accounts had been ascertained fully by the auditors and a car allowance of Rs. 250 p.m. It was one of the terms of the appointment that in case the profits exceeded Rs. 1 lakh, the commission payable to Shri J. P. Vaish was 25%. Shri J. P. Vaish was also given free medical facility for himself and the members of his family. In terms of the letter of appointment Shri Vaish got no commission in the first year as the mill suffered a loss. In the next year the profit being less than Rs. 1 lakh, Shri Vaish received a sum of Rs. 4,063 as commission. For the assessment year 1948-49, the assessee paid a sum of Rs. 75,465 as commission to Shri J. P. Vaish calculated at the rate of 25% on the profits. The assessee claimed deduction of the said amount from the assessable income. By his assessment order, dated June 30, 1949, the Income Tax Officer disallowed the claim on the ground that it was excessive and quite unreasonable looking to the salary paid to Shri Vaish. He also found that no general practice of giving commission at the rate of 25% existed in the assessee's line of business. Taking into account the circumstances of the case, the Income Tax Officer determined a sum of Rs. 5,000 as a reasonable amount payable as commission. Against the disallowance of Rs. 70,465 paid as commission to the General

- A** Manager, the assessee preferred an appeal to the Appellate Assistant Commissioner of Income Tax who by his order, dated October 31, 1949 found that Rs. 5,000 was not sufficient and it was reasonable to allow the payment of commission at the rate of 12½%. He accordingly increased the commission payable from Rs. 5,000 to Rs. 37,732 in that year. The assessee took the
- B** matter in appeal to the Income Tax Appellate Tribunal which by its order, dated July 10, 1950 dismissed the appeal. As directed by the High Court, the Appellate Tribunal submitted a statement of case under s. 66(2) of the Income Tax Act, 1922 on the following question of law :—

- C** “Whether in the circumstances of the case, the sum of Rs. 37,733 paid to the General Manager Shri J. P. Vaish, which has been disallowed by the Income-tax Appellate Tribunal was an amount laid out or expended wholly or exclusively for the purpose of the business of the assessee ?”

- D** By its judgment, dated May 22, 1962, the High Court answered the question against the assessee. Against the judgment of the High Court the present appeal is brought by special leave.

Section 10(2)(x) and 10(2)(xv) of the Income Tax Act, 1922 at the relevant time read as follows :

- E** “10(2)(x) : any sum paid to an employee as bonus or commission for services 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—

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- (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 business profession or vocations;
- G**

- 10(2)(xv) : Any expenditure (not being in the nature of capital expenditure or personal expenses of the assessee) laid out or expended wholly or exclusively for the purpose of such business, profession or vocation.”
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It was contended on behalf of the assessee that in the circumstances of this case the amount of Rs. 37,733 paid to Shri J. P.

Vaish was an amount laid out or expended wholly or exclusively for the purpose of the business of the assessee and was wrongly disallowed by the Income Tax Appellate Tribunal. It was pointed out that Shri J. P. Vaish was in no way related to the proprietors of the firm and the commission on profits clause was inserted to create the interest of Shri J. P. Vaish in the running of the mill which was "old and unbalanced" and had never worked continuously or satisfactorily before it was taken over by the assessee. During the first 14 months the mills made no profit and Shri J. P. Vaish was paid nothing beyond his salary and car allowance. In the next 12 months he succeeded in securing an order for Lohis from Government and so the mill made some profit and the amount of the Manager's commission was proportionately very small in terms of the agreement. The large profit in 1946-47 was made due to new design of civilian rugs Shri Vaish introduced for the first time in the mill after studying public tastes and the qualities and designs prevailing in the market. It was also said that Shri Vaish had a special aptitude to show in his work so far as the marketability of the goods was concerned. After the death of Shri Vaish in July 1947, the firm was converted into a company and the post of the General Manager was abolished and one of the Directors who managed the affairs of the company was given Rs. 18,000 per annum as remuneration and Rs. 6,000 per annum as allowance for the accounting year 1947-48. The Appellate Tribunal took the view that the post of General Manager carried the responsibility equal to that of the Director who was given the charge of the conduct of business after the death of Shri Vaish, the General Manager. This post carried a remuneration of Rs. 18,000 plus Rs. 6,000, *i.e.*, a total remuneration of Rs. 24,000 per annum and therefore the commission paid to Shri Vaish in excess of this amount was not really paid wholly for the purpose of carrying on business. But it was pointed out on behalf of the assessee that Shri J. P. Vaish had taken over the mill at a time when it was old and dilapidated and in the first 14 months the mill made no profit and Shri Vaish was paid nothing beyond the salary and car allowance. In the succeeding year he was able to secure an order from the Government on account of which the mill made some profit. Shri Vaish introduced for the first time a new design of civilian rugs in the year 1946-47 during which a large profit was made. It was therefore contended on behalf of the assessee that the position of Shri Vaish who worked in the mill at the initial stage and of the Managing-Director was not comparable and the Appellate Tribunal was wrong in taking this circumstance into consideration. Counsel for the assessee also pointed out that Shri Vaish was educated in a Public School at Dehra Dun and thereafter studied at the Benaras College and at the Engineering College of the Benaras Hindu University for Electrical and Mechanical Engi-

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A neering and then joined the Commerce College at Delhi. After that he had training in the Aluminium Corporation of India Ltd., Lakshmi Rattan Cotton Mills Ltd. and the Road Products Ltd., Rampur. In view of the circumstances of the case it was urged on behalf of the assessee that the entire amount of Rs. 75,465 paid to Shri Vaish was an amount laid out wholly and exclusively for the purpose of the business of the assessee within the meaning of s. 10(2)(xv) of the Income Tax Act, 1922.

B We should make it clear that in this case we are not called upon to decide whether the Income Tax Officer could exercise the power he exercised under s. 10(2)(x) of the Income Tax Act. The question referred by the Tribunal and answered by the High Court only deals with the claim of deduction of the amount paid to Shri J. P. Vaish under s. 10(2)(xv) and not under s. 10(2)(x) of the Act.

C The question as to whether an amount claimed as expenditure was laid out or expended wholly or exclusively for the purpose of business, profession or vocation as required under s. 10(2)(xv) of the Income Tax Act has to be decided on the facts and in the light of the circumstances of each particular case. But, as observed by this Court in *Swadeshi Cotton Mills Co. Ltd. v. C.I.T., U.P.*<sup>(1)</sup>, the final conclusion on the admissibility of an allowance is one of law. In the present case, both the Appellate Assistant Commissioner and the Appellate Tribunal rejected the view of the Income Tax Officer that the rate of commission paid to Shri Vaish was not fixed on account of business considerations but there was some collateral reason. But considering the practice in similar business concerns, the Appellate Assistant Commissioner expressed the view that the rate of 12½% commission was reasonable and the allowance was therefore restricted to half of the amount claimed by the assessee. The view of the Appellate Assistant Commissioner has been affirmed by the Income Tax Appellate Tribunal. The case of the assessee, however, is that a higher rate of commission of 25% was fixed for Shri J. P. Vaish because the mill was old and dilapidated and it never made profit of even a lakh of rupees in the past and that the rate of 25% was fixed in order to create special interest of the General Manager for accomplishment of the task entrusted to him. In our opinion, neither the High Court nor the Appellate Tribunal has applied the proper legal test in this case. As pointed out by this Court in *C.I.T., Bombay v. Walchand & Co. Private Ltd.*,<sup>(2)</sup> in applying the test of commercial expediency for determining whether an expenditure was wholly and exclusively laid out for the purpose of the business, reasonableness of the expenditure has to be adjudged from the point of view of the businessman and not

(1) 63 I.T.R. 57.

(2) 65 I.T.R. 381.

of the Income Tax Department. It is, of course, open to the Appellate Tribunal to come to a conclusion either that the alleged payment is not real or that it is not incurred by the assessee in the character of a trader or it is not laid out wholly and exclusively for the purpose of the business of the assessee and to disallow it. But it is not the function of the Tribunal to determine the remuneration which in their view should be paid to an employee of the assessee. It was also pointed out in that case that an employer in fixing the remuneration of his employees is entitled to consider the extent of his business, the nature of the duties to be performed and the special aptitude of the employee, future prospects of extension by the business and a host of other related circumstances. In our opinion, the principle of this decision applies to the present case and it must accordingly be held that in the circumstances established by the assessee the entire amount of Rs. 75,465 paid to the General Manager Shri J. P. Vaish was an amount laid out or expended wholly and exclusively for the purpose of the business of the assessee.

For the reasons expressed we hold that the question of law referred to the High Court must be answered in the manner indicated and this appeal is accordingly allowed with costs.

Y. P.

*Appeal allowed.*