

BRITISH INDIA CORPORATION

v.

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

October 3, 1972

[K. S. HEGDE, P. JAGANMOHAN REDDY AND I. D. DUA, JJ.]

Excess Profits Tax Act, 1940, Schedule I, r.12 (1)—Determination by officer whether expenditure is reasonable and necessary—Tests for.

Rule 12 (1) of Schedule 1 to the Excess Profits Tax Act, 1940, is designed to prevent the dissipation of excess profits by inflating expenditure which has no relation to the requirements of the business. The test is whether the expenditure is unreasonable and unnecessary 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. All relevant facts, especially commercial expediency or commercial practice, must be taken into consideration by the Excess Profits Tax Officer in considering whether the expenditure is reasonable and necessary; that is, he could not apply the rule to increases that can be justified on ordinary commercial principles, because, an increase in profits may in certain cases be due to increase in the activity of the management or increase in the establishment justifying a corresponding increase in the expenditure. But when huge profits are earned, not due to any activity of managers but due to national emergencies such as war situations, the government is entitled to a certain share of the excess profits computed under the Act. Any commission paid on the excess profits for which the managers or employees made no sort of contribution would *ex facie* be unreasonable and unnecessary and the Excess Profits Tax Officer would be justified in disallowing the proportion, which, according to him, was unreasonable and unnecessary having regard to the requirements of the business. [530A-D; 531G-H; 532A]

In the present case, the assessee is a public limited company having several branches and subsidiary companies. It has a Board of Directors which looks after its business. The managers who look after the branches of the company are also members of the Board. The assessee was remunerating its directors by way of commission based on a certain fixed percentage of its net audited profits. The phrase 'net audited profits' was clarified to mean the amount after depreciation had been allowed for, but prior to any allocation or appropriation of profits including provision for taxation. The Excess Profits Tax Act came into force on April 5, 1940, and on 27th July, 1940, the phrase 'including provision for tax' in the clarification, was further clarified that it was intended to cover all forms of taxation including excess profits tax and other like impositions. Therefore, no deduction of excess profits tax was to be made *prior to* the calculation of managerial commissions. For the chargeable accounting years 1945 and 1946 the Excess Profits Tax Officer found that the assessee had made large profits and held that if the commission was to be paid on the net audited profits the whole excess profits would be taken into account for the payment of commission; that a portion of the commission attributable to excess profits, in the peculiar circumstances of war conditions, was not reasonable and necessary within the meaning of r. 12 (1), and that any payment, in excess of the agreed proportion of the net profits *after* deduction of excess profits tax, was not justified. He, therefore, disallowed a percentage of the said excess profits which would be payable to the State on account of excess profits tax liability. [526A-H; 527A-C]

A On the question whether the disallowance for each of the years was rightly made, the Tribunal and the High Court held against the assessee.

Dismissing the appeal to this Court,

HELD: The Excess Profits Tax Officer and the Tribunal have given valid reasons for not allowing the entire commission claimed on the basis of the audited accounts without deducting the excess profits tax. [531G]

B *Ahmedabad Manufacturing & Calico Printing Co. v. Commr. of E.P.T.*, 38 I.T.R. 675 followed.

British India Corporation Ltd. v. Commr. of E.P.T., 33 I.T.R. 826 and *Shyamlal Pragnarain v. C.I.T.*, 27 I.T.R. 404 referred to

C CIVIL APPELLATE JURISDICTION : Civil Appeal Nos. 1987 to 1988 of 1969.

Appeals by certificate from the judgment and order dated October 22, 1965 of the Allahabad High Court in Income-tax Reference No. 154 of 1957.

D *S. T. Desai, Alok Kumar Verma and B. P. Singh* for the appellant.

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

The Judgment of the Court was delivered by

E JAGANMOHAN REDDY, J. These appeals are by certificate against the Judgment of the Allahabad High Court in a reference under s. 21 of the Excess Profits Tax Act, 1940 (hereinafter called the 'Act') read with s. 66(2) of the Indian Income-tax Act, 1922. The questions referred were in respect of the two chargeable accounting periods being January 1, 1945 to December 31, 1945 and January 1, 1946 to March 31, 1946 and are given below :—

F 1. Whether on the facts and circumstances of this case the amount of Rs. 5,39,057/- was rightly disallowed under rule 12(1) of the Schedule to the Excess Profits Tax Act?

G 2. Whether on the facts and circumstances of this case the amount of Rs. 1,28,743/- was rightly disallowed under rule 12(1) of Schedule I to the Excess Profits Tax Act?

Both these questions were answered in the affirmative.

H The facts and circumstances of the case on which these answers were given are :—The assessee is a public limited company (hereinafter called the 'Corporation') having several branches and subsidiary companies. It has a Board of Directors which looks after its business. The branches of the Company are looked after by managers who are members of the Board of Directors. It

appears that for a long time and even before the Act came into force the corporation has been remunerating its directors including the Managing Director and branch managers by way of commission based on a certain fixed percentage of its net audited profits. This commission was in addition to the directors' fees and/or stipulated monthly salary. In the case of a branch manager the amount of commission to be paid was calculated on the profits of the branch of which he was in charge. In the case of others the profits made by the Corporation as a whole were taken into consideration. The commission to be paid was either fixed at the time of appointment or by resolution passed subsequently. In so far as the two chargeable accounting periods are concerned, the position in regard to the payment of the commission has been set out in the statement of the case but this is not relevant for the purpose of these appeals except to note, as we have earlier mentioned, that the commission was to be calculated with reference to the net audited profits which phrase was clarified by a resolution of the Corporation dated February 24, 1940. That resolution is as follows :—

“Commission.

In order to regularise previous Resolutions on the subject of Managerial Commission, the Board resolved that commission on profits would be payable to the Managing Director and the Branch Managers entitled thereto, on net audited profits, only after depreciation had been allowed for but prior to any allocation or appropriation of such profits including provision for taxation.”

Though it is not mentioned in the statement of the case we can take judicial notice of it that the Excess Profits Tax Bill was introduced in the Central Legislative Assembly on January 27, 1940 and after it was passed, received the assent of the Governor-General on April 5, 1940. On July 27, 1940 the phrase ‘including provision for taxation’ was further clarified by the following resolution :—

“The Board, therefore, resolved that the words ‘including provision for taxation’ were intended to and did specifically cover all forms of taxation including the Excess Profits Tax and other like impositions and, therefore, no deduction of excess profits tax and other like impositions from the audited profits should be made prior to the calculation of Managerial commissions. The Board also resolved that this ruling, which could only be regarded as fair and reasonable should have effect retrospectively to the commission paid in respect of the year 1939.”

- A In respect of the chargeable accounting period ending December 31, 1945 the Excess Profits Tax Officer had observed in his order dated December 15, 1947 as follows :—
- B “For reasons stated in the order dated 30-3-1945 and Rule 12 Schedule I for the chargeable accounting period up to 31-12-1943, I hold that, having regard to the requirements of the business and the actual services rendered by the persons concerned, the commission allowed to the management and directors is both unreasonable and unnecessary. Any payment in excess of the agreed proportion of the net profits after deduction of Excess Profits Tax is not justified.”
- C The Excess Profits Tax Officer accordingly held that Rs. 11,47,143 for the first chargeable accounting period and Rs. 11,06,693 for the second chargeable accounting period could not be allowed and was further of the view that a portion of it was not reasonable and necessary having regard to the requirements of the business and the actual services rendered by the persons concerned. It was
- D pointed out that the commission of the nature under consideration was being paid by the Corporation even before the Act came into force and that such commission was being allowed in its entirety for purposes of computing profits under s. 10 of the Income-tax Act, 1922 in the two corresponding assessments made under s. 10 of the Income-tax Act. Though this was so under the Income-tax
- E Act the Excess Profits Tax Officer on the facts of the case and having regard to rule 12 of the Schedule to the Act took the view that since the commission in the respective chargeable accounting periods were paid out of the profits which could not be retained by the Corporation, a portion of the commission attributable to the Excess Profits Tax Act earned in the peculiar circumstances of a national calamity was not “reasonable and necessary” within
- F the meaning of the said rule. It was found that for the first chargeable accounting period the Excess profits payable were approximately Rs. 64,36,000/- but if the commission was to be paid on the net audited profits of Rs. 1.37 crores, the whole excess profits which could not be retained by the Corporation for its own use would be taken into account for the payment of the commission as such be determined the portion to be disallowed was at
- G 8.4% of the said excess profits which will be payable to the State on account of the Exces Profits Tax liability. On this basis the amount worked out was Rs. 5,39,057. Applying the same method for the following accounting chargeable period ended March 31, 1946 he determined the amount as Rs. 1,28,743/-. These two
- H amounts were disallowed in the assessments for the respective chargeable accounting periods. In arriving at these amounts, the Excess Profits Tax Officer ignored the terms of appointment and the resolutions and drew support from the orders passed by the

Tribunal in respect of the two prior assessments for the accounting periods ended December 31, 1943 and December 31, 1946, against which orders of the Tribunal a reference had earlier been made to the Allahabad High Court. This reference was then pending before it when the subsequent assessments were being dealt with. In the appeals against assessments made for the accounting periods in the instant case, it was admitted on behalf of the Corporation before the Tribunal that there was no new material other than what was on record in the Excess Profits Tax assessment files and the Tribunal files relating to the chargeable accounting periods for the years 1943 and 1944. These files were produced before the Tribunal in the appeals for the assessments in question. The Tribunal however dismissed those appeals following its earlier decision relating to the chargeable accounting periods for 1943 and 1944. Against that order the High Court on a reference under the Act considered a similar question, viz. whether the amounts claimed by the Corporation in respect of each of the assessment year was rightly disallowed under rule 12(1) of the First Schedule to the Act.

In the earlier reference for the assessment in respect of the assessment years 1943 and 1944, a Bench of the Allahabad High Court in *British India Corporation Ltd. v. Commr. of E.P.T.*⁽¹⁾ consisting of Bhargava, J. (as he was) and Mehrotra, J. were of the view that the findings of the Excess Profits Tax Officer that the payments were both not necessary and not reasonable amounted to holding that the previous practice and agreements gave no indication that the commission had to be paid without deducting the excess profits tax from the net profits and that the payments made were beyond the terms of the agreement. According to that court this was not the basis on which the question of reasonableness and necessity of the payments had to be decided. But what the officer and the Tribunal ought to have decided is the question whether or not these payments were necessary and justified, having regard to the ordinary commercial practice and commercial expediency and taking into account the services rendered by the persons to whom the payments were made. Bhargava, J. who delivered the judgement of the Bench in arriving at the conclusion that the disallowance of the amounts was act justified followed a Full Bench judgement of that Court in *Shyamlal Pragnarain v. C.I.T.*⁽²⁾. In that Full Bench it was observed that what the Excess Profits Tax Officer had to bear in mind is that the amount could be disallowed in whole or in part if it was found that it was not reasonable and it was not necessary having regard to the requirements of the business and the actual services rendered by the managers. The question as to the terms of the contract, it said "may have been a

(1) 33 I.T.R. 826.

(2) 27 I.T.R. 404.

A matter of importance as between the employer and the employee but not for the purposes of the determination of the question of reasonableness or necessity either under the Income-tax Act or the Excess Profits Tax Act" which had to be judged in the light of the requirements of business and to the exigencies of the business keeping in view ordinary commercial practice and commercial expediency.

B When the Tribunal decided the appeal which is the subject matter of this reference, the decision of the High Court, as we said earlier, had not been rendered and consequently it did not have the benefit of that decision the High Court in the judgment under appeal however observed :—

C "The Full Bench did not discuss whether for disallowing a deduction both unreasonableness and want of necessity are required or either is enough and presumed presumably from the fact that both reasonableness and necessity are required for allowing it that both are required. As the question was not expressly raised before and decided by Bhargava and Mehrotra, JJ. in one case and the Full Bench in the other case, the assumption on which they proceeded would not bind us."

D In our view, these observations are not justified because in both those cases the aspects referred to were certainly kept in view in determining the questions before them. It appears that the Revenue did not appeal against the decision of Bhargava and Mehrotra, JJ. in the case above referred. The Excess Profits Tax Officer had made the assessments basing them on the reasons given in the earlier orders relating to the chargeable accounting years 1943 and 1944 which were referred to in the statement of the case. We also find that the High Court in its earlier judgment was not justified in thinking that the Excess Profits Tax Officer had not applied the requirements of rule 12 of the Schedule to the Act.

F Rule 12(1) of Schedule I which is relevant is as follows :—

G "(1) In computing the profits of any chargeable accounting 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;

H 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."

This rule is designed to prevent the dissipation of the excess profits by inflating expenditure which has no relation to the requirements of the business. The test is, whether the expenditure is unreasonable and unnecessary 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. There is of course no reference in this rule to commercial expediency or commercial practice in considering whether an expenditure is unreasonable and unnecessary having regard to the requirements of the business. But that is another way of saying that all relevant factors must be taken into consideration by the Excess Profits Tax Officer in considering whether that expenditure is reasonable and necessary. What it means is that the Excess Profits Tax Officer could not apply the rule to increase that can be justified on ordinary commercial principles because an increase in profits may in certain cases be due to increase in the activity of the management or increase in the establishment justifying a corresponding increase in the expenditure. The Full Bench decision in *Shyamal's* case came up for consideration by this Court in *Ahmedabad Manufacturing & Calico Printing Co. v. Commr. of E.P.T.*⁽¹⁾. That was also a case where the question was whether in determining the profits on which the percentage had to be determined for payment of bonus to five of its employees and the contribution to be made to the provident funds of 53 employees, deduction of depreciation, income-tax and super-tax in respect of first category and deduction of income-tax or excess profits tax in respect of the second category could be made before arriving at the profits. The Excess Profits Tax Officer came to the conclusion that the payments were unnecessarily large and unreasonable having regard to the requirements of the business and without taking up each individual case he held, applying rule 12 that it was not necessary for the assessee company for the purpose of its business to calculate the bonus or the contribution on that basis of net profits before the deduction of excess profits tax. He accordingly disallowed the excess of the payment calculated without deduction of that tax. In upholding the disallowance this Court held that there was material on which the Excess Profits Tax Officer could arrive at a finding and on which the Tribunal could confirm that finding. In that case also the Excess Profits Tax Officer, in the assessment order relating to the chargeable accounting year ending December 31, 1943 gave sufficient reasons for disallowing the amounts which reasons were incorporated by reference in the assessment orders pertaining to the disallowance of the claim in the chargeable accounting years in question. In the earlier order the reasons given were as follows :—

“The rates of commission were fixed long prior to the commencement of the present war and no deduction

(1) 38 I.T.R. 675.

A was admittedly made for the Excess Profits Tax liability in computing the net profit of the corporation for the purpose of calculating commission payable to directors and management. As a result of war conditions the profits of the Corporation have gone up tremendously from about Rs. 10 lakhs in the pre-war period to about

B Rs. 2 crores during the relevant chargeable accounting period and the commission to management on the basis of net profits has risen in the same proportion. Since the Excess Profits Tax, which is intended to prevent the owner of a business from making a large fortune out of what is a national danger, is not deducted out of net profits in calculating commission, 'an employee stands to benefit from the national emergency to a greater extent than an employer'; (*Walchand & Co. Ltd. v. The Hindustan Construction Co. Ltd.* (12 I.T.R. 104). It therefore, appears both unnecessary and unreasonable to pay more than the agreed proportion of the profits after deduction of Excess Profits Tax. In the circumstances,

D I hold that the increased expenditure under commission although of a nature which under the provisions of s. 10 of the Income-tax Act, is in itself an allowable deduction, is unreasonable and unnecessary having regard to the requirements of the business and the actual services rendered by the persons concerned."

E After giving these reasons he went on to say :

"Having held that the aforesaid payments of commission are unjustifiable and exceptional the question arises as to what the reasonable amount, having regard to the requirements of the business and the actual services rendered by the persons should be. As mentioned

F above, any payment in excess of the agreed proportion of the net profits after deduction of Excess Profits Tax is unreasonable and unnecessary."

The Excess Profits Tax Officer accordingly computed what was the reasonable amount of commission which should be allowed. We can find very little justification in the criticism that no reasons

G have been given by the Excess Profits Tax Officer or the Tribunal for not allowing the entire commission claimed on the basis of the audited accounts without deducting the taxes paid including the excess profits tax. It is obvious that when huge profits are earned not due to any activity of the managers but due to war situation, the Government is entitled to a certain share of the excess profits computed under the Act. Any commission paid

H on the excess profits for which the managers or employees made no sort of contribution would *ex facie* be unreasonable and unnecessary and the Excess Profits Tax Officer was perfectly justified

in disallowing certain proportion which according to him was unreasonable and unnecessary having regard to the requirements of the business. In this view, the answers rendered by the High Court cannot be disturbed and these appeals are accordingly dismissed with costs. **A**

V.P.S.

Appeals dismissed.