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THE COMMISSIONER OF INCOME-TAX, MADRAS

v.

CHARI AND CHARI LTD.

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April 9, 1965

[K. SUBBA RAO, J. C. SHAH AND S. M. SIKRI, JJ.]

Income Tax Act, 1922, s. 10(2)(xv)—*Deduction claimed by assessee of commission paid to director for special duties—Rate of commission bona fide determined by assessee—Whether open to revenue to review such rate.*

C

Managing Agency—Compensation for termination of—Circumstances in which such compensation is revenue.

The respondent, a private limited company, carried on business in tobacco and other commodities and also acted as managing agents for the N company and for two other companies. It had three directors, all of whom were paid a fixed remuneration for attending to the business of the company. On June, 21, 1951, the respondent company was appointed an agent of the Central Government for buying, checking, leaf drying, and retaining and reselling tobacco under, and in accordance with, directions issued from time to time. On June 22, 1951, the respondent passed a resolution placing one of the directors, A, in "special charge" of all the work under the contract with the Central Government and agreed to pay him 30 per cent of the net profits from the contract. Under this arrangement, for the year ended 31st March 1952, commission at 30 per cent was calculated and paid to A and was claimed in the assessment year 1952-53 as a permissible deduction under s. 10(2)(xv) of the Income-tax Act, 1922. The Income-tax Officer allowed only 10 per cent of the net profit for the services rendered by A and disallowed the balance amount claimed by the respondent.

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The managing agency agreement of the respondent with the N Company was terminated in September 1951, when the State Government acquired the undertaking of that company, and the respondent was paid Rs. 17,346 as compensation for premature termination of its agency. This amount was taken into account by the Income-tax Officer in computing the respondent's income for the year ended March 31, 1952.

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Appeals against the order of the Income-tax Officer to the Appellate Assistant Commissioner and to the Tribunal challenging the disallowance of part of the commission and inclusion of the compensation for termination of the managing agency were unsuccessful. On a reference on both these points, the High Court decided them in the respondent's favour.

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HELD: (i) The contract with the Government was, for the respondent, an important contract requiring special attention by a person well acquainted with the practical details of the business. If for such special services the management as prudent business men for advancing the interest of respondent *bona fide* regarded 30 per cent of the net profits as reasonable remuneration, the revenue authorities were not justified in reviewing that opinion and reducing the rate of remuneration. [697B, C]

A Where, on a consideration of the relevant materials the Appellate Tribunal is of the opinion that a particular remuneration is not *bona fide,* or is unreasonable, the High Court, in exercising its advisory jurisdiction, has no power to interfere with that opinion; but in the present case, material circumstances relating to the nature of the contract and the special services to be performed were not at all taken into account by the revenue authorities. [697C-E]

B (ii) Ordinarily, compensation for loss of office or agency is regarded as a capital receipt; but this rule is subject to an exception that payment received even for termination of an agency agreement, where the agency is one of many which the assessee holds, and the termination of the agency does not impair the profit-making structure of the assessee, but is within the frame-work of the business, it being a necessary incident of the business that existing agencies may be C terminated and fresh agencies may be taken, is revenue and not capital. However, in the absence of evidence as to what effect the determination of the managing agency of the N company had upon the business of the respondent, the mere circumstance that the respondent had managing agencies of two other companies without more would not bring the present case within the exception [698H; 699 A-C]

D *Kelsal Parsons & Co.* v. *Commissioners of Inland Revenue,* 21T.C. and *Kettlewell Bullen & Co.* v. *C.I.T. Calcutta,* [1964] 8 S.C.R. 93 explained and distinguished.

CIVIL APPELLATE JURISDICTION: Civil Appeal No. 215 of 1964.

E

Appeal from the judgment and order dated August 24, 1961 of the Madras High Court in Case referred No. 102 of 1957.

Niren De, Additional Solicitor-General, R. Ganapathy Iyer and *R. N. Sachthey,* for the appellant.

F *R. Thiagarajan,* for the respondent.

The Judgment of the Court was delivered by

Shah, J. The respondent is a private limited Company. It carried on business in hides and skins, minerals, tobacco and other commodities, and also acted as managing agents for the Nellor G Power and Light Company Ltd. and for two other Companies. T. M. Ayyadurai, T. M. Rangachari and P. C. Chakrabarti were directors of the Company. Each director was paid a fixed remuneration of Rs. 4,800/- per annum for attending to the business of the Company. On June 21, 1951 the respondent was appointed by the Central Government as its agent for buying, checking, weighing, H leaf drying, storing, transporting, retaining and reselling tobacco under and in accordance with the directions issued from time to time. The Central Government agreed to pay to the respondent price of the tobacco purchased, charge at the rate of one anna per lb. for tobacco not redried, and at the rate of two annas per lb. for tobacco redried, and commission on all purchases. On June 22, 1951 the respondent passed a resolution placing T.M. Ayyadurai in "special charge" for arranging purchases of tobacco on credit,

inspecting tobacco at Guntur and at Madras Port, and for supervising shipment of tobacco, and agreed to pay him 30 per cent of the net profit as remuneration. Under the contract with the Government of India Rs. 1,38,454/- became due to the respondent as commission in the account year ending March 31, 1952. After providing Rs. 41,473/- for expenses, 30 per cent of the balance being Rs. 29,094/- was paid to T. M. Ayyadurai as commission and was claimed in the assessment year 1952-53 as a permissible deduction under s. 10(2)(xv) of the Indian Income-tax Act, 1922. The Income-tax Officer allowed only 10 per cent of the net profit for the services rendered by T. M. Ayyadurai in the contract for tobacco purchase and sale, and disallowed Rs. 19,796/- out of the amount claimed by the respondent.

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The managing agency agreement of the respondent with the Nellore Power and Light Company Ltd., was terminated with effect from September 28, 1951 when the Government of the State of Madras in exercise of the powers conferred upon it by the Electrical Undertakings Acquisition Act, 1949 compulsorily acquired the undertaking of that Company, and the respondent was paid Rs. 17,346/- as compensation for premature termination of its agency. This amount was taken into account by the Income-tax Officer in computing the income of the respondent in the assessment year ending March 31, 1952.

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Appeals against the order passed by the Income-tax Officer to the Appellate Assistant Commissioner and to the Tribunal challenging the disallowance of part of the commission and inclusion of compensation for termination of the managing agency agreement were unsuccessful.

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The Tribunal thereafter being directed by the High Court of Judicature, Madras under s. 66(2) of the Indian Income-tax Act, drew up a statement of the case and referred the following two questions to the High Court:—

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"(1) Whether on the facts and in the circumstances of the case the disallowance of a sum of Rs. 19,796/- out of the remuneration paid to Mr. T. M. Ayyadurai is justifiable; and

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(2) Whether a sum of Rs. 17,346/- which represented compensation received by the assessee for the loss of the managing agency of the Nellore Power and Light Company Ltd. is income liable to tax?"

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The High Court answered both the questions in the negative.

Allowance in respect of the amount covered by the first question was sought by the respondent under s. 10(2)(xv) of the Income-tax Act, 1922, which provided:

"any expenditure not being an allowance of the nature described in any of the clauses (i) to (xiv) inclusive, and

A 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."

The question whether an amount claimed as expenditure was laid B out or expended wholly and exclusively for the purpose of such business, profession or vocation has to be decided on the facts and in the light of circumstances of each case. But as observed by this Court in *Eastern Investments Ltd.* v. *Commissioner of Income-tax, West Bengal*(1) the final conclusion on the admissibility of an allowance claimed is one of law. The High Court had therefore C power to call upon the Tribunal to submit a statement of the case under s. 66(2) of the Indian Income-tax Act. In considering whether the expenditure to remunerate a person for services rendered is allowable under s. 10(2)(xv) the Income-tax Officer must have regard to all the circumstances, such as, nature and special character of the service, practice if any in the trade for payment of a D percentage of profit to an employee in similar circumstances, qualifications of the employee for rendering the service, amount if any paid by the assessee to another person for rendering similar service, normalcy of the allowance having regard to the practice in the trade, existence of any other extraordinary and abnormal circumstances in the arrangement or special reasons or circumE stances which may suggest that the transaction was abnormal, and the like.

The normal business of the respondent was in hides and skins, minerals and tobacco. It does not appear, however, that the turnover of the Company was large. The contract to purchase tobacco on behalf of the Government of India was apparently out F of the way of the normal business of the respondent and demanded the setting up of a special organisation. Under the terms of the contract the respondent was to be the agent of the Central Government for buying, checking, weighing, leaf drying, storing, transporting, retaining and reselling tobacco under and in accordance with the directions given to it from time to time by the Govern- G ment. The respondent agreed to buy tobacco within the ceiling price fixed as and when directed by the Government, and was responsible for buying proper grades of tobacco, for correctly checking the weights, for taking delivery from the sellers, for redrying it whenever so directed, for securing proper packing for transport by rail road or sea so as to conform to standards of packing usually H employed in the export of tobacco or standards to the satisfaction of the purchaser, and for getting the tobacco inspected by the Tobacco Grading Inspectorate of the Indian Central Tobacco Committee according to the AGMARK standards. The respondent had to place a godown at the disposal of the Government within their premises at Guntur. The respondent had to use its best

(1) 20 I.T.R. 1.

endeavour to buy as cheaply as possible within the ceilings prescribed and to sell it for such maximum price as may be obtainable, not being below the price prescribed by the Government, to re-sell tobacco which the Government may direct it to sell by instructions in writing, in such manner and at such price as may be specified by the Government, and to finance the entire transaction of purchasing tobacco in the first instance out of its own funds. The respondent was to take all necessary steps to safeguard the stocks and to maintain fire-fighting services. Goods purchased by the respondent if not of the grade or quality were liable to be rejected by order of the Tobacco Grading Inspector. Performance of the contract evidently required expert knowledge of the practical side of the business of purchasing tobacco, getting it redried if it was raw, and of packing, storing, transporting and shipping it.

The respondent had entered into a profitable contract, but any negligence in purchasing, storing, packing, transporting and shipping the goods might have resulted in serious losses to the respondent. The Income-tax Officer accepted that the expenditure for payment of remuneration for attending to the contract was laid out for the purpose of the business of the respondent, but reduced the stipulated rate to 10 per cent on two grounds: that T. M. Ayyadurai was the brother of T. M. Rangachari, and that he was, as a director of the Company, bound to attend to all the activities of the Company including the contract.

There is no evidence that the agreement was motivated by considerations other than strictly business considerations. There is also no evidence that as a director T. M. Ayyadurai was bound to attend to all the activities of the Company including the special contract with the Central Government. The duties which the director was bound to perform for earning the remuneration of Rs. 400/- per month are not on the record, but even in the opinion of the taxing authorities the duties of T. M. Ayyadurai as director did not cover attendance to the contract with the Government. T. M. Ayyadurai and T. M. Rangachari are brothers, but that by itself is not sufficient to justify an inference that unreasonable or excessive remuneration was agreed to be paid. The person who was called upon to attend to a contract of this magnitude was required to have expert knowledge of the business, apply his time exclusively thereto, travel from time to time, maintain supervision and control at the stage of purchase, redrying, packing, transport and loading for shipment. Presumably T. M. Ayyadurai was such a person, and that is why he was selected for earning for the respondent a large amount of commission by duly performing the contract.

The Appellate Assistant Commissioner merely paraphrased the decision of the Income-tax Officer and regarded 10 per cent of the net profits as reasonable. The Appellate Tribunal observed that the Appellate Assistant Commissioner had given "clear and

convincing reasons in support of the disallowance" to which they had nothing more to add. An analysis of the reasons given by the Income-tax Officer discloses no grounds to support the view that remuneration at a rate exceeding 10 per cent of the net profit was excessive or unreasonable. We are of the view that the contract with the Government was for the respondent an important contract requiring constant and vigilant application and supervision by a person well-acquainted with the practical details of the business. If the management of the respondent as prudent businessmen for advancing the interest of the respondent *bona fide* regarded 30 per cent of the net profits as reasonable remuneration, the revenue authorities were not justified in reviewing their opinion and reducing the rate of remuneration. It is true that if on a consideration of the relevant materials, the Appellate Tribunal is of the opinion that a particular remuneration stipulated to be paid is not *bona fide*, or is unreasonable, the High Court in exercising its advisory jurisdiction has no power to interfere with that opinion. But the material circumstances relating to the nature of the contract, the services to be performed and the nature of the duties by the employee were not at all taken into account by the Tribunal and the income-tax authorities. We therefore agree with the High Court that the first question should be answered in the negative.

The contract under which the respondent Company was appointed managing agent for the Nellore Power and Light Company Ltd., was to ensure till 1960, but it had to be prematurely terminated because the Government of Madras exercising its powers under the Madras Electrical Undertakings Acquisition Act, 1949 had compulsorily acquired the electricity undertaking. With the acquisition of that undertaking the right of the respondent as managing agent ceased. Under s. 15 of the Electrical Undertakings Acquisition Act, the Government was bound to pay compensation which would include compensation for termination of the managing agency agreement. The respondent received Rs. 17,346/- as compensation for termination of the agency, computed in the manner laid down in s. 15 of that Act. *Prima facie*, such a receipt being in lieu of extinction of an asset of the assessee, is a capital receipt. It was urged, however, on behalf of the revenue that the respondent was carrying on business of taking up managing agencies and that by the extinction of one of the managing agencies, the business structure of the respondent was not impaired. In a recent judgment delivered by this Court in *Kettlewell Bullen and Company Ltd., v. Commissioner of Income-tax, Calcutta*(1), it was pointed out that:

> "It may be broadly stated that what is received for loss of capital is a capital receipt: what is received as profit in a trading transaction is taxable income. But the

(1) [1964] 8 S.C.R. 93.

difficulty arises in ascertainting whether what is received in a given case is compensation for loss of a source of income, or profit in a trading transaction." A

The Court further observed:

"It cannot be said as a general rule, that what is determinative of the nature of the receipt is extinction or compulsory cessation of an agency or office. Nor can it be said that compensation received for extinction of an agency may always be equated with price received on sale of goodwill of a business. The test applicable to contracts for termination of agencies is: what has the assessee parted with in lieu of money or money's worth received by him which is sought to be taxed? If compensation is paid for cancellation of a contract of agency, which does not affect the trading structure of the business of the recipient, or involve loss of an enduring asset, leaving the taxpayer free to carry on his trade released from the contract which is cancelled, the receipt will be a trading receipt: where the cancellation of a contract of agency impairs the trading structure, or involves loss of an enduring asset, the amount paid for compensating the loss is capital." B C D

Turning to the facts of the present case, it must in the first instance be observed that it is for the revenue to establish that a particular receipt is income liable to tax, and beyond stating that the respondent was the managing agent of the Nellore Power and Light Company Ltd. and of two other Companies, there is no other evidence about the nature of the business of the two other Companies of which the respondent was the managing agent, about their relative importance *qua* the managing agency of the Nellore Power and Light Company Ltd., and whether by reason of the extinction of the managing agency of the Nellore Power and Light Company Ltd., any enduring asset was lost to the respondent, or its trading organisation was adversely affected. The Income-tax Officer observed that the "Company's business of Managing Agency as such had not come to an end", the Company still continues as "managing agents of other companies". Even after surrender of one of the agencies, the Company carries on business as before, its structure not being affected" and therefore "the receipt is to be considered as revenue, in accordance with the decision in *Kelsal Parsons and Company* v. *C.I.R.* 21 T.C. No. 608.", and with that view the Appellate Assistant Commissioner and the Tribunal agreed. But in the absence of evidence as to what effect the determination of the managing agency of the Nellore Power and Light Company Ltd., had upon the business of the respondent, the mere circumstance that the respondent had managing agencies of two other companies without more will not bring the case within *Kelsal Parsons and Company* v *Commissioners of Inland Reve-* E F G H

A *nue*(1). In *Kettlewell Bullen and Company's* case(2) this Court pointed out that ordinarily compensation for loss of office or agency is regarded as a capital receipt, but the rule is subject to an exception that payment received even for termination of an agency agreement, where the agency is one of many which the assessee holds, and the termination of the agency does not impair
B the profit-making structure of the assessee, but is within the framework of the business, it being a necessary incident of the business that existing agencies may be terminated, and fresh agencies may be taken, is revenue and not capital. *Kelsal Parsons and Company's* case(1) falls within the exception to the ordinary rule, and circumstances which brought the case of the respondent within
C the exception must be clearly established. The High Court was of the opinion that compensation received for taking over the Nellore Power and Light Company Ltd., was a capital receipt not liable to be taxed, and on the materials placed before us, we are unable to disagree with the High Court on this question.

D The appeal therefore fails and is dismissed with costs.

Appeal dismissed.

(1) 21 T.C. 608.

(2) [1964] 8 S.C.R. 7.