Bharat Beedi Works (Private) Limited ... vs Commissioner Of Income-Tax on 7 May, 1993

Equivalent citations: 1993 AIR 1751, 1993 SCR (3) 606, AIR 1993 SUPREME COURT 1751, 1993 (3) SCC 252, 1993 AIR SCW 1947, 1993 TAX. L. R. 671, (1993) 69 TAXMAN 453, (1993) 3 SCR 606 (SC), 1993 KERLJ(TAX) 618, (1993) 3 JT 526 (SC), 1993 (3) JT 526, 1993 (3) SCR 606, (1993) 201 ITR 1063, (1993) 115 TAXATION 196, (1993) 112 CURTAXREP 247

Author: B.P. Jeevan Reddy

Bench: B.P. Jeevan Reddy, N Venkatachala

PETITIONER:
BHARAT BEEDI WORKS (PRIVATE) LIMITED AND ANR.ETC. ETC.

Vs.

RESPONDENT:
COMMISSIONER OF INCOME-TAX

DATE OF JUDGMENT07/05/1993

BENCH:
JEEVAN REDDY, B.P. (J)
BENCH:
JEEVAN REDDY, B.P. (J)
VENKATACHALA N. (J)

CITATION:
1993 AIR 1751 1993 SCR (3) 606
1993 SCC (3) 252 JT 1993 (3) 526
1993 SCALE (2)896

ACT:
Income-Tax Act 1961--S.40 (c)--Partners in firm also directors in a company--Whether royalty payments by company to firm falls within s. 40 (c)--Held, Payments are consideration for a valuable right parted by firm/ partners/directors of the assessee--Company a favour of assessee--Where agreement whereunder payments made not mere device or screen, it cannot be treated as payments made to directors qua directors--S.40(A) (2).

HEADNOTE:

A partnership firm consisting of three partners was engaged inter alia in the business of manufacturing and sale of beedies under the brand name "Mangalore Prakash Beedies". On May 20,1972 a private limited company called prakash beedies Ltd. the assessee-appellant was incorporated. One of its objects was to take over the business of the aforesaid firms which it did under an agreement dated 15 July 1972 whereby the firms sold its rights and assets to the company. For the use of the trade name, a royalty at 10p. for every 1000 beedies was to be paid by the company to the firm. This payment was made ever year by the assesse on account of royalty. The three partners of the firms were also directors of the company.

The relevant assessment years were 1974-75 and 1975-76. The facts in the other appeals are similar.

The assessee claimed deduction of the amount paid by it as royalty. The ITO allowed the deductions as claimed. The CIT in stio motu proceedings disallow the aforesaid deductions. On appeal, the tribunal restored the order of the ITO.

On reference, the High Court answered in fan,our of the revenue as the three directors of the assessee company were also partners in the firm. It held that in law, a firm is merely a collection or association of individuals for carrying on a business. Merely because the firm is an assessable entity, under the Income Tax Act, it does not follow that it is a juristic or legal entity. It must therefore be held that the payments to the firm were in reality made to the

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directors, thus attracting S. 40 (c).

Before this Court, it was contended for the assessee that payment to a firm is not ipso fact payment to the partners, directly or indirectly. In any event, the payments were made to the three persons not in their capacity of directors (qua directors). but in consideration of a valuable right parted by them in favour of the assessee-company. S. 40(c) was never intended to take in such payments. They relied on the budget speech of the Finance Minister and argued that the principle of interpretation noscitor a sociis must be applied to the words "remuneration, benefit or amenity".

The genuineness or validity of the agreement, the factum of payments as royalty, and that the brand name carries significant business value was not disputed. The question before this Court was whether the royalty payments fail within S. 40(c).

Allowing the appeal, this Court,

HELD : 1. Even assuming that the payments to firm were payments to partners, the said payments did not fall within S. 40(c). The payment,-. were made In consideration of a valuable right parted by the firm/partners/ directors of the assessee-company in favour of the assessee. So long as the agreement whereunder the said payments were made is not held

to be a mere device or a mere screen, the said payments cannot be treated as payments made to the directors (qua directors). (613-H, 614-A)
The payments were made by way of consideration for allowing the to use a valuable right belonging to them viz. the brand name. Such a payment may be liable to be scrutinised under sub-section. (2) of section 40 (A), but it certainly did not fall within the four corners of section 40(c). (614-A)
T.T. (Pvt.) Ltd. v. ITO Bangalore 121 ITR 551, approved.
CIT Patiale v. Avon Cycles (p) Ltd. 126 IT R 448 and India Jute Co. Ltd. v. CIT 178 ITR 649, referred to.
2. The power vested in the ITO is to determine whether any expenditure of allowance is excessive or unreasonable having regard to the legitimate business needs of the company and the benefit derived by the assessee or
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accruing therefrom. Any payment to a relative of a director or other persons mentioned in clause (c) will necessarily be examined applying the above test and if it is found that they are unwarranted, unreasonable or excessive, they will be disallowed. Such a situation does not arise herein. (615-C)
CIT, Bombay v. M/s. Indian Engineering and Commercial Corporation (p) Ltd. [1983] distinguished. JT 683.

JUDGMENT:

CIVIL APPELLATE JURISDICTION: Civil Appeal No. 1452 of 1987. From the Judgment and Order dated 10.7.1986 of the Kamataka High Court in I.T.R.C. No. 198 of 1987.

WITH C.A. Nos. 4462/89, 1822, 1902, 1465/87, 675, 658, 4461/89, 6093/90, 6204/ 90, 6092. and 6092 A of 1990. H. Salve, P.H. Parekh, Ms. Meenakshi Grover, R. Nariman, Ms. R. Gill and Ms. Simi Kr. for the Appellants. B.B. Ahuja, Ranbir Chandra and Ms. A. Subhasini for the Respondent.

The Judgment of the Court was delivered by B.P. JEEVAN REDDY J. These appeals are preferred against the judgment of the Karnataka High Court answering the question referred to it, at the instance of the revenue, in favour of the revenue and against the assessee. The question referred under section 256 of the Income Tax Act, 196 1, read as follows: "Whether on the facts and in the circumstances of the case, the Tribunal was right in holding that the sum of Rs. 1, 79, 742 could not be disallowed under section 40 (c) of the Income Tax Act, 1961." (The above question related to Assessment Year 1974-75. The question referred for A.Y. 1975-76 was identical except in the matter of amount). Since the facts in all the appeals are identical it would be sufficient to notice the facts in C.A. Nos. 6092 and 6092A/90 (Prakash Beedies (P) Lid. v. Commr. of Income Tax. Karnataka, Bangalore).

Prior to 15.7.1992, a partnership firm called K.M. Anand Prabhu & Sons, Mangalore, consisting of three partners K.M. Vishnudas Prabhu, K.M. Ramdas Prabhu and K.M. Shankar Prabhu was

engaged inter alia in the business of manufacturing and sale of beedies under the brand name 'Mangalore Prakash Beedies'. On May 20, 1972 a Private limited company called Prakash Beedies Limited (the assessee-appellant herein), was incorporated with its registered off-ice at Manoalore. One of its objects was to take over business of the aforesaid firm. Under an agreement dated July 15, 1972 between the firm and the company, the firm sold its rights and assets to the company on the terms and conditions set out therein. Clause 4(a) of the agreement, which alone is material for the purposes of these appeals reads:

> "(a) For the use of the trade name the Company shall pay royalty to the Vendor at the rate of 10ps. for every thousand beedies sold by the Company by using the trade name of the Vendor.

The royalty shall be worked out at the end of each quarter ending on March, June, September and December, on the sales made during each quarter. The royalty fixed hereby shall not be varied for a period of one year and may be reviewed and/or revised thereafter wards from time to time".

The assessee was making payments to the firm every year on account of royalty in terms of said clause. The three partners aforesaid of the firm were also the directors of the assessee- company.

For the assessment years 1974-75 and 1975-76, the assessee claimed deduction of the amount paid by it to the firm on account of royalty in terms of clause 4(a) of the agreement. The amounts paid during the accounting years relevant to the said assessment years were Rs. 3, 16, 526 and Rs. 3, 95, 742 respectively. The I.T.O. allowed the deductions as claimed. In exercise of the powers conferred on him by Section 263, the Commissioner of Income Tax initiated (suo moto) proceedings for revising the said assessments in so far as the aforesaid deductions were concerned. After hearing the assessee, he passed orders on September 16, 1976 whereunder he disallowed payments to the firm over and above the ceiling prescribed in Section 40(c). The assessee preferred appeals to the Tribunal against the orders of the I.T.O, The appeals were allowed and the orders of the I.T.O. restored. On reference, the High Court answered to question in the negative i.e., in favour of the revenue and against the assessee, on the following reasoning : the three directors of the assessee company were also the partners in the firm to which royalty payments were made. In law, a firm has no separate legal existence; it is not a juristic person or a distinct legal entity. It is merely a collection or association of the individuals for carrying on a business. Merely because the firm is an assessable entity under the Income Tax Act it does not follow that it is a juristic or legal entity. It must, therefore, be held that the payments made to the firm are in reality payments made to the directors. Such payments clearly attract and fall within the mischief of Section 40(c). The Commissioner was right in saying so and the opinion of the Tribunal to the contrary is unsustainable in law.

In these appeals, S/Shri Harish N.Salve and Rohinton Nariman assailed the correctness of the view taken by the High Court. They submitted firstly that the payments were made not to the directors of the assessee but to a firm which was a separate entity. A payment to a firm is not ipso facto a payment to the partners, directly or indirectly. In a firm there may be other partners besides the directors of the assessee-company. It may also happen that the firm has no income to distribute

because of the losses incurred by it which are set-off against the income so received. The High Court was in error in holding that payment to a firm is a payment to the partners. Assuming that a partnership firm is not a separate juristic entity distinct from its partners, even so the payments were made to the said three persons not in their capacity as directors (qua directors) but in consideration of a valuable right parted by them in favour of the assessee-company. Such payments do not and cannot fall within the mischief of Section4O(c). Section 40(c) was never intended to take in such payments. A company may take on lease the house of its directors for its legitimate business purposes and pay rent which is reasonable having regard to the market conditions, or it may pay even less than the market rate of rent. Whether the rent paid by the company to its director in such a case falls within Section 40(c), ask the counsel. Another illustration given by the counsel is where a director supplies raw material to the assessee-company for a price which is the appropriate market price. Would such payment also fall under section 40(c), they ask. The Budget speech of the Finance Minister in the Parliament, while introducing the said provision, is relied upon in support of their contention. It is also argued that the words "remuneration, benefit or amenity" occurring in Section 40(c) must be read having regard to the context in which they occur applying the principle NOSCITORA SPCOOS (recognition of associated words). If so read, the payments in question can never fall within the ambit of the said words.

Shri Ahuja, the learned counsel for the Revenue justified the reasoning and approach of the High Court having regard to the clear language employed in clause (c). The genuineness or validity of the agreement between the assessee-company and the firm is not disputed. The factum of payments made on account of royalty in terms of clause 4(a) of the said agreement is also not disputed. It is also not disputed that in the beedi trade, brand name carries significant business value. It is necessary to keep this factual context in mind while examining the question at issue. Section 40(c) read as follows during the relevant assessment years "40. Notwithstanding anything to the contrary in sections 30 to 39, the following amounts shall not be deducted in computing the income charge able under the head" profits and gains of business or profession",

(a).....

(b).....

(c) in the case of any company-

(i) any expenditure which results directly or indirectly in the provision of any remuneration of benefit or amenity to director or to a person who has a substantial interest in the company or to a relative of the director or of such person, as the case may be,

(ii) any expenditure or allowance in respect of any assets of the company used by any person referred to in sub-clause (i) either wholly or partly for his own purposes of benefit, if in the opinion of the Income-tax Officer any such expenditure or allowance as is mentioned in sub-clause (i) and (ii) is excessive or unreasonable having regard to the legitimate business needs of the company and the benefit derived by or accruing to it therefrom, so, however, that the deduction in respect of the aggregate of such expenditure and allowance in respect of any one person referred to in sub-clause

(i) shall, in no case, exceed-

(A) where such expenditure or allowance relates to a period exceeding eleven months comprised in the previous year, the amount of seventy-two thousand rupees;

(B) where such expenditure of allowance relates to a period not exceeding eleven months comprised in the previous year, an amount calculated at the rate of six thousand rupees for each month or part thereof comprised in that period:

> Provided that in case where such person is also and employee of the company for any period comprised in the previous year, expenditure of the nature referred to in clauses (i), (ii), (iii) and (iv) of the second proviso to clause (a) of sub-section (5) of section 40A shall not be taken into account for the purposes of sub-clause (A) or subclause (B), as the case may be;
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> (iii) * * * * Explanation.-The provisions of this clause shall apply notwithstanding that any amount not to be allowed under this clause is included in the total income of any person referred to in sub-clause (i);"
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> The Budget speech of the Finance Minister, in so far as it mentions the reasons for introduction of clause (c) of Section 40, reads as follows:
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> "I am firmly of the view that the fiscal instrument must be deployed to discourage payment of high salaries and remunerations which go ill with the norms of egalitarian society. I accordingly propose to impose a calling on the remuneration of company employees which would be deductible in the computation of taxable profits. The ceiling is being set at Rs. 5,000 per month. Together with the existing ceiling of Rs. 1,000 per month in the case of perquisites, the allowable overall ceiling on remuneration and perquisites, for purposes of taxation, will be at Rs. 6,000 per month....."

The object behind the provision undoubtedly was to discourage and disallow "payment of high salaries and remunerations which go ill with the norms of egalitarian society". The provision was, of course, not confined to the directors.' It took in relatives of directors, persons having substantial interest in the company and their relatives. The clause vested in the I.T.O. the power to determine whether any such expenditure or allowances as is mentioned in the said clause was excessive or unreasonable having regard to the legitimate business needs of the company and the benefit derived by or accruing to it therefrom. In addition to it, a ceiling was also prescribed beyond which such expenditure or allowance could not go in any event.

At this juncture, it would be appropriate to notice the provision contained in sub-section (2) of Sec 40A. Clause, A provides that where the assessee incurs any expenditure in respect of which payment has been made or is to be made to any person referred to in clause (b) of the sub-section, and the Income-tax Officer is of the opinion that such expenditure is excessive or unreasonable having

regard to the fair market value of the goods, services or facilities for which the payment is made or the legitimate needs of the business or profession of the assessee or the benefit derived by or accruing to him therefrom, so much of the expenditure as is so considered by him to be excessive or unreasonable shall not be allowed as a deduction. Clause (b) mentions the categories of persons to whom the provision in clause (a) applies. It includes directors of the company and their relatives among others. Clause b) also takes in any payment to any company, firm, association of persons or Hindu undivided family of which a director, partner or member, as the case may be, has substantial, interest in the business or profession of the assessee. In short, the net is cast very wide to ensure that excessive or unreasonable payments are not made to the persons in control of the affairs of the assessee in the name of paying for the goods, services and facilities rendered, supplied or extended by them, as the case may be.

That the payments made by the assessee-company to the firm on account of royalty in terms of clause (4) (a) of the agreement fall within the meaning of the expression 'expenditure' in sub-clause (i) of clause (c) is not disputed. The observations in CIT, Bombay. v. M/s. Indian Engineering and Commercial Corporation Private Uinited (Civil Appeal Nos. 1583 and 1584 (NT) of 1977 decided on 13.4.1993 by us-reported in (1993) 2 J.T. 683 do not say otherwise. That case arose under Section 40(A) (5). The payments in question were made to the directors by way of commission on sales. The question was whether the said payments fell within sub-clause (ii) of clause (a) of sub- section (5) of section 40(A). It was held that they did not. While holding so it was observed that it is difficult to say that payment of certain cash amount by way of commission on sales, directly to an employee, can be said to fall within the words 'where the assessee incurs any expenditure which results directly or indirectly'." The said observations were made in response to the Revenue's argument that the said payment constituted 'perquisites' within the meaning of sub-clause (ii) of clause (a) of Section 40(A) (5). The observations are clearly confined to the said sub- clause and have no relevance to any other provision in the Act. The observations cannot be read dissociated from their context. Coming back to the provisions of Section 4O(c) and the facts of the case before us the only question is whether the royalty payments to the firm fell within clause (c). We assume for the purpose of this argument that in this case, payments to firm were payments to partners. Even so, we think that the said payments did not fall within clause (C). The payments were made in consideration of a valuable right parted by the partners/ directors of the assessee company in favour of the assessee. SO long a,, the agreement whereunder the said payments were made is not held to be a mere device or a mere screen, the said payments cannot be treated as payments made to the directors as directors (qua directors). The payments were made by way of consideration for allowing the assessee to use a valuable right belonging to them viz., the brand name. Such a payment may be liable to be scrutinised under subsection (2) of Section 40(A), but it certainly did not fall within the four corners of Section 40(c).

In T. T Ltd. v. LTO., Bangalore 121 I.T.R. 55 1, a Bench of Karnataka High Court comprising D.M. Chandrashekhar, CJ. and E.S. Venkataramiah,J. has taken a view which accords with the one taken by us. Speaking for the Bench, E.S. Venkataramiah, J. (as he then was) observed:

> "A close reading of the above provision shows that s. 40(c) refers to an expenditure in- curred by making periodical payments to person mentioned in that clause apparently for any personal service that may be rendered by him. It cannot have any

reference to payments made by the assessee for all kinds of "services or facilities" referred to in s. 4OA(2) (a). It is argued that the proviso thereto suggests that any expenditure incurred for any kind of service which is referred to in the main part of s. 40A (2) (a) and the expenditure referred to in s. 40(c) belong to the same category. This contention is not correct. The expression "services" in s. 40A (2) (a) is an expression of wider import..... If the remuneration, benefit or amenity referred to in s. 40(c) is treated as the same as what is paid in return for "the goods, services or facilities" then irrespective of the fair market value of the goods, services and facilities provided by a person who may be a director or a person who has a substantial interest in the company or a relative of the director or of such person, as the case may be, only a maximum of Rs. 72,000 can be allowed to be deducted in computing the income of the company in any one year. We do not think that Parliament ever intended that such a result should follow. The goods, services and facilities referred to in s. 40A (2) (a) are those which have a market value and which are commercial in character. Many of the services and facilities referred to above are those which are nowadays provided by independent organisations.' The said decision has been followed by the Punjab and Haryana High Court in Commissioner of Income Tax, Patiala v. Avon Cycles (P) Ltd. 126 I.T.R. 448, The Calcutta High Court has also taken a similar view in India Jute Co. Ltd v.

Commr of Income-Tax 178 ITR 649.

Mr. Ahuja, learned counsel for the Revenue submitted that the argument of the assessee that only the payments made to directors as directors fall within clause (c) and not the other payments, becomes inapt when the payments are made to the relative,,, of the directors or to persons holding substantial interest in the assessee company or their relatives. The ceilinG prescribed in clause (c) cannot also be applied to such persons-says the counsel. The answer perhaps lies in the clause itself-in the power vested in the I.T.O. to determine whether any expenditure or allowance is excessive or unreasonable having regard to the legitimate business needs of the company and the benefit derived by the assessee or accruing therefrom. Any payment to a relative of a director or other persons mentioned in clause (c) will necessarily be examined applying the above test and if it is found that they are unwarranted, unreasonable or excessive, they will be disallowed. Since such a situation does not arise herein, we need not pursue the argument further. For the above reasons, we are of the opinion that the judgment under appeal cannot be sustained. It must he held that the payments in question did not fall within section 40(c). Accordingly, the appeals are allowed, the judgment of the High Court is set aside and the question referred to the High Court is answered in the affirmative, i.e., in favour of the assessee and against the revenue. No costs.

U.J. R. Appeal allowed.