Ramchandra Dhonde Datar vs Commissioner Of Income-Tax, M.P., ... on 15 March, 1961

Equivalent citations: [1961]43ITR22(BOM)

JUDGMENT

V.S. Desai, J.

1. This is an income-tax reference under section 66(1) of the Income-tax Act and raises a question under section 7(1), read with Explanation 2, of the Act as it stood before its amendment by the Finance Act of 1955.

2. The assessee had been a manager of the All India Reporter Ltd., for a long time. On March 23, 1943, an agreement was entered into between him and the All India Reporter Ltd., specifying the terms of service of the assessee. The preamble of this agreement stated that as the assessee had put in very valuable services in the company since its inception in promoting, building up its business and bringing it in repute which it was enjoying and was still continuing to serve the company, the agreement was being entered into in appreciation thereof. Clause (1) of the agreement provided that the employees would be paid a salary of 3 1/2% of the gross sales received by the company in the year or a sum of Rs. 12,000 whichever was greater from April 1, 1943. Under clause (2) the appointment of the employee was to be for ten years from April 1, 1943, to be renewed automatically for such like period at the option of the employee. Clause (3), which is the most material clause for our consideration, ran as follows :

> "It is further agreed that the employee shall at the time of the termination of the service before or after the period of appointment for any cause whatsoever be paid a sum equal to 3 years' salary calculated at the rate at which he was drawing the salary at the date of termination of the service, as compensation for cessation of his services. In case of termination of the service by death of the employee such sum as aforesaid shall be paid to his heir or heirs as the case may be."

3. The next relevant clause in this agreement was clause (7), under which it was provided "Either party should give six calendar months' notice in case of termination of the service before the period stipulated in the agreement."

4. After the assessee had served under this agreement for some years, disputes arose between him and the company and on April 22, 1948, a notice was served by the company on the assessee dismissing him from service peremptorily on charges of misconduct, neglect of duty, disobedience and bad faith. In this notice the company also made a claim of Rs. 51,657 from the assessee. This notice was replied to by the assessee on May 28, 1948. Subsequently, on April 19, 1951, the assessee

filed Civil Suit No. 21/B/1952 against the company seeking to recover a sum of Rs. 1,30,000 from the company on various grounds. This suit was decided and decreed in favour of the assessee in respect of a part of the claim which he had set up. In the decree which was so made in favour of the assessee on July 17, 1953, he was awarded a sum of Rs. 36,000 as compensation for three years as per clause (3) of the agreement of service. A sum of Rs. 6,000 was also awarded to the assessee as for salary for six months in lieu of notice as per clause (7) of the agreement of service, an amount of Rs. 625 by way of interest at 6% up to the date of the institution of the suit and a further sum of Rs. 8,614 by way of interest from the date of suit till the date of suit till the date of realisation. The decree also awarded Rs. 3,921 by way of costs. Out of the amounts, which were awarded by the decree, the Income-tax Officer brought to tax a total amount of Rs. 51,239 consisting of the items of Rs. 36,000 paid under clause (3) of the agreement and Rs. 6,000 paid under clause (7) of the agreement, and the amount of interest awarded by the decree, namely, Rs. 625 for interest up to the date of institution of the suit and Rs. 8,614 for interest from the date of the suit onwards. The assessment year during which this amount was brought to tax was 1954-55, the corresponding accounting year for the period being the year ending March 31, 1954.

5. The assessment was upheld by the Appellate Assistant Commissioner. The assessee appealed to the Tribunal against the order of the income-tax authorities. Before the Tribunal the assessee contended that the amounts which had been brought to tax by the income-tax authorities were not liable to tax in view of the provisions of section 7(1) and Explanation 2, of the Income-tax Act of 1922 as they stood at the material time. According to the assessee the said payments were made as compensation for loss of employment and he relied in support of his contention on the case of P. D. Khosla. The contention of the Department, on the other hand, was that the amounts, which were brought to tax, were not by way of compensation but were amounts, which were decreed in favour of the assessee in terms of the agreement of service. The Department contended that clauses identical in terms with clauses (3) and (7) of the agreement in the present case were contained in the agreement of service of the assessee's brother also had that the said clauses had been construed and interpreted by the Nagpur High Court in the case of the assessee's brother and it was held that the amounts, which were payable under the said clauses were not solely as compensation for loss of employment within the meaning of the latter part of Explanation 2 of section 7 of the Income-tax Act.

6. The Tribunal upheld the contentions, which were raised by the Department. It took the view that the amounts of Rs. 36,000 and Rs. 6,000 were decreed by the court in the assessee's suit under paragraphs (3) and (7) of the agreement and there was no claim decreed in favour of the assessee on the basis of compensation for wrongful dismissal. It further took the view that the amounts, which were claimed and decreed under clauses (3) and (7) of the agreement, were not solely as compensation for loss of employment. In the view of the Tribunal, the case of P. D. Khosla was distinguishable from the case of the assessee and the ratio if that case did not apply to the assessee's case. As to the interest awarded by the decree the argument advanced before the Tribunal was which was awarded towards interest by the decree was also not taxable. The Tribunal held that the contention was utterly untenable because interest was taxable unless specifically exempted under the specific provisions of the Act. The Tribunal accordingly dismissed the assessee's appeal. On an application made by the assessee under section 66(1) of the Income-tax Act, the Tribunal drew up a

statement of the case and referred the following two questions of law as arising out of its order :

> "(i) Whether on the facts and circumstances of the case, the sum of Rs. 42,000 could be held as a payment solely as compensation for loss of employment and not by way of remuneration for past services and as such not profits within the meaning of Explanation 2 to section 7(1) ?
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> (ii) Whether the amount of Rs. 9,239 towards interest on the aforesaid sum of Rs. 42,000 was taxable under the Indian Income-tax Act ?"

7. Now, the material portion of section 7 and Explanation 2, of the Income-tax Act of 1922 as they stood at the relevant time are as follows :

> "The tax shall be payable by an assessee under the head 'Salaries' in respect of any salary... or profits in lieu of, or in addition to, any salary... which are due to him, from, whether paid or not, or are paid by or no behalf of,... a company... or any private employer;...
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> Explanation 2. - A payment due to or received by an assessee from an employer or former employer or from a provident or other fund, is to the extent to which it does not consist of contributions by the assessee or interest on such contributions a profit received in lieu of salary for the purposes of this sub-section, unless the payment is made solely as compensation for loss of employment and not by way of remuneration for past services."

8. The question that has to be considered is whether the amounts of Rs. 36,000 and Rs. 6,000 awarded under the decree are by way of salary of profits in lieu of or in addition to any salary within the meaning of section 7(1) or whether they are payments to which the employee was entitled solely as compensation for loss of his employment. Now, in the suit, which the assessee had filed against the company, these amounts had been claimed as per the terms of the agreement. The basis of the claim in so far as these amounts were concerned was not damages for wrongful dismissal but specific performance of the terms of the agreement. The claim in the suit was also awarded on the same basis. It is, however, contended that the terms of the agreement under which this claim was awarded themselves provided for compensation for loss of employment. The argument, therefore, was that the payments which had been obtained as per terms of the agreement were liquidated damages or agreed compensation for loss of employment. In our opinion the soundness of this argument must depend upon the proper construction of the agreement and in particular clauses (3) and (7) thereof.

9. Now, in proceeding to construe the agreement of service in the present case it must be remembered that before the date on which this agreement was entered into, the employee had served the company for a number of years and had rendered valuable and useful service to the company. The preamble of the agreement itself stated as follows :

> "Whereas Mr. R. D. Datar has put in very valuable services in the company since its inception in promoting, building up its business and bringing it into repute which it enjoys and is still continuing to serve the company, it is in appreciation therefor hereby agreed that :"

10. It would, therefore, be clear that the terms on which the agreement was being entered into were influenced by the appreciation by the company of the meritorious services of the employee in the past and in agreeing to the said terms its intention was not only to remunerate the employee for services in future but also to reward him for past services. The first term of the agreement provided that the salary which would be paid to the employee from April 1, 1943, will be equal to 3 1/2 per cent. of the gross sales received by the company in the year or a sum of Rs. 12,000 whichever was greater. The second term provided that the appointment under the terms of the agreement would run for a period of ten years from April 1, 1943, in the first instance and the employee would have the option to have it automatically renewed for such like period in future. Now, along with these two terms, which provide for payment of salary and the duration of the employment, must be read clause (7) of the agreement, which provides that either party to the agreement would have to give six calendar months' notice in case of termination of service before the date stipulated in the agreement. In view of clauses (2) and (7) of the agreement, it would be clear that what was intended and agreed to between the parties was that although the employee's appointment on the terms fixed in the agreement was ordinarily intended to run for a period of ten years with an option to the employee to renew the said employment to renew the said employment on the same terms for a further period of ten years, both the employer and the employee were free to bring about a termination of the service on giving six months' notice. This was not, therefore, a case where under the agreement the employer contracted to have the employee's services unalterably for a certain fixed period. In view, of clause (7) of the agreement, if the employee's service was terminated by giving a six months' notice, the employee would have no cause to complain of breach of term (2) of the agreement. We then come to clause (3) of the agreement, which we have already set out earlier in the judgment. What is provided under this clause is that at the termination of the service of the employee at whatever time, whether before or after the date of the appointment, and for whatever cause, the employee would be paid a sum equal to three years' salary calculated at the rate at which he was drawing his salary at the date of the termination of the service. This payment, it is provided in this clause, would be regarded as compensation for cessation of his services and even in case of termination of service by death of the employee, the said sum would be paid over to his heirs. There can be no doubt, in our opinion, that the payment contemplated under this clause was a terminal payment in appreciation of his past services to the company. As we have already pointed out, the agreement itself was in appreciation of the services of the employee and this term of the agreement is all the more so. The agreement was entered into on March 23, 1943, and the appointment on the terms contained in this agreement was to commence from April 1, 1943. This clause provided that even if the services of the employee were terminated before the appointment on the terms and conditions of the said agreement became effective, the employee would still be entitled to the benefit of this clause and would get the payment as stated therein. It could not, therefore, be said, as contended by the assessee, that this clause was providing for liquidated damages arising out of breach of the terms and conditions of the agreement. It will also be further seen that the sum payable under this clause is made payable in case of every termination irrespective of the clause of

the termination of service. Even if the termination had been brought about by willful default on the part of the employee or as a result of a wrongful act on his part or by his misconduct, he was still entitled to the payment. As a matter of fact, that was the stand, which the assessee himself had taken in the suit, which he had filed against the company. A payment, which is contemplated to be made to an employee at the termination of his services even if such termination is due to his fault, negligence or misconduct, cannot be said to be compensation for loss of employment. There is further the provision that even in case of the death of the employee, the amount would be paid over to his heirs. There is hardly any question of compensation for loss of service in case of death of the employee.

11. Mr. Thakkar, however, has argued that the payment under this clause would have different characteristics in different circumstances and in the circumstances which arose in the present case entitling the employee to claim this payment, the payment would have the characteristics of compensation for loss of employment. It may be, he says, that where the termination of the service is due to the fault of the employee or by reason of his death or where the termination has been effected by giving six months' notice as provided in clause (7) of the agreement or by the employee voluntarily agreeing to resign or leave the service, the payment under clause (3) may have the characteristics of a terminal payment made for past service but where the services of the employee are terminated without justification and wrongfully by the employer, thus giving rise to the claim for damages on the part of the employee, the payment contemplated under this clause could rightly be regarded as damages or compensation for wrongful deprivation or loss of service.

12. Now, we do not agree with this contention of Mr. Thakkar. Where the term of the agreement has provided, as in the present case, that the parties to the agreement will be at liberty to terminate the service by a six months' notice on either side, a clause like clause (3) providing for payment of three years' salary as a payment of compensation for cessation of service cannot be regarded as fixing the liquidated damages in case of wrongful dismissal. As we have already pointed out although under clause (2) of the agreement the appointment is provided for a period of ten years, it did not provide for certainty of employment for the said term by reason of clause (7) which permitted the termination of the service by a six months' notice. There is, therefore, no good reason for providing three years' remuneration as liquidated damages for loss of employment for the unexpired period of service. It must also be remembered that the amount which is payable under this clause is the same in all cases of termination and does not vary according to the circumstances in which the termination is brought about, that is, whether it is brought about by a fault of the employer or the fault of the employee; or without any fault on the part of either of them. In our opinion, therefore, the intention of the parties in providing this clause was not to provide for compensation for loss of employment but to provide for a terminal payment in all cases of termination of service and the provision was motivated by the appreciation of the employee's services in the past. At any rate, it seems impossible for us to take the view that the payment allowed under this clause could be said to be solely for compensation for loss of employment. In order that the payment may be saved under the relevant part of Explanation 2 to section 7 of the Act, the payment has to be solely as compensation for loss of employment. Even assuming, therefore, that the argument of Mr. Thakkar that in providing for clause (3) in the agreement the element of compensation for loss of service was not altogether left out of consideration by the parties, is correct, we do not think that the payment under that clause was ever meant to be solely as compensation for loss of service.

13. In our opinion the view taken by the Tribunal as regards this item or Rs. 36,000, which was awarded to the assessee under clause (3) of the agreement, is correct.

14. It is then urged by Mr. Thakkar that at any rate so far as the payment of Rs. 6,000, which was awarded to the assessee by the decree under clause (7) of the agreement, was concerned, the said amount is awarded solely as compensation for loss of service. His contention is that where an agreement of service provides for notice of a certain period to be given to the employee for termination of his services and the services are terminated without giving such notice, the employee is entitled to the salary for the period of notice as damages for his dismissal contrary to the terms of his service. The damages so awarded to him are for loss of service for the notice period, which the employee was entitled to render and the employer bound to receive. In support of his submission that the salary payable for the notice period to the employee is in the nature of solatium for termination of his services, Mr. Thakkar has relied on the case of Guff v. Commissioner of Income-tax.

15. We find it difficult to understand how the salary, which is payable to an employee for the notice period can be regarded as compensation for loss of service. If the notice is given for the required period and the employee serves during the said period and receives payment, it is impossible to argue that the salary which he has received for the work put in by him is not his salary for the period. If, on the other hand, the notice is given and the salary for the period for which the notice is required to be given is also given to the employee but no service is taken from him during that period of notice, we cannot see how the payment made to the employee, which the employer was bound to make, can be regarded as compensation paid to the employee. Even though the notice is given terminating the service at the end of the notice period, the relationship of master and servant continues until the end of the period and the circumstance whether the master takes the service or does not take service from the employee does not make any difference to his liability to pay for the employment of the servant. Now, where the term of service provides for a notice to be given but the service is terminated in breach of that term and the servant is entitled to claim salary for the notice period, his claim in our opinion is based on the terms of service and proceeds on the basis that although the service is purported to be terminated with immediate effect in view of the condition requiring a notice to be given for termination of service, the liability of the master to pay his servant up to the end of the notice period still continues and is enforceable under the agreement of service. What is paid to the servant, therefore, even in such a case in our opinion is a payment to which he was entitled under the terms of his service and not as compensation or damages or even solatium for loss of service or for wrongful termination of service. The case on which Mr. Thakkar has relied in this connection does not help him. The facts of that case were entirely different. There a six months' notice was given to the employee on March 23, 1948. The employee served during the whole period of the notice and even a little beyond and ultimately his services were terminated on November I3, 1948. At the date of the termination, however, he was given by the company a sum of Rs. 12,000, which was equivalent to six months' salary. The question that arose in that case was, whether this amount, which was paid to the employee, could be regarded as salary paid to him so as to be liable to tax. It was held that in view of the fact that a notice terminating his services was given on March 23, 1948, the amount of Rs. 12,000 which was paid to him could not be regarded as salary in view of the notice but was, on the facts and circumstances of that case, only as voluntary payment made as

compensation or solatium for terminating the employment, which termination had been brought about by the accidental closure of the department in which the employee was serving.

16. In our opinion, therefore, the amount of Rs. 6,000 which was awarded by the decree to the assessee under clause (7) of the agreement was also not compensation paid for loss of employment.

17. We then come to the amount of interest, which was awarded to the assessee under the decree. The total of interest awarded by the decree was Rs. 9,239, which consisted of two items; Rs. 625 towards interest at the rate of 6% per annum from the date of termination of service to the date of the suit and Rs. 8,614 after the date of the suit at the court rate of 4% per annum on the decretal claim until realisation. Before the Tribunal the contention raised was that since the principal amount, namely, the amount of Rs. 42,000, was not taxable, the amount of interest thereon was also exempt from the payment of tax. That argument will not be available to the assessee since the principal amount is held to be taxable. A fresh contention, however, was raised by Mr. Thakkar though it was not raised before the Tribunal, that the interest having been awarded by way of damages is not an income received and, therefore, is not taxable. Now, in connection with this argument it must be first pointed out that the amount of Rs. 8,614 which has been awarded after the date of suit on the decretal amount, is not by way of damages but under the power of the court to grant interest at the court rate. The argument of Mr. Thakkar will not, therefor, apply to this item of Rs. 8,614. It is well settled that where a sum is received by way of interest under a contract or award or a decree it is clearly income. Since this amount of Rs. 8,614 has been awarded as interest by the court under its decree at the court rate of interest, it is clearly income liable to tax. The amount of Rs. 625 which was granted as interest up to the date of suit was claimed by way of damages and was granted as such. But as has been observed in Westminster Bank Ltd. v. Riches, the real question for the purpose of deciding whether the Income-tax Act applies is whether the added sum is capital or income, not whether the sum is damages or interest. The amount of interest of Rs. 625 which the decree awarded constituted the interest on the amounts which were payable to the assessee on the termination of his services and which the company ought to have paid to him on the said date. The amount, therefore, though granted by way of damages, was still an item of taxable income in the hands of the assessee. Even with regard to the amount of Rs. 625, therefore, the same was properly brought to tax by the income-tax authorities. In our opinion, therefore, none of the contentions raised by Mr. Thakkar is sustainable and the assessee's appeal has been rightly dismissed by the Tribunal.

18. On the questions, which have been referred to us by the Tribunal in the present case, our answers accordingly will be as follows :

19. As to the first question our answer is that the sum of Rs. 42,000 could not be held as a payment solely as compensation for loss of employment within the meaning of Explanation 2 to section 7(1) of the Act.

20. Our answer to the second question is in the affirmative.

21. The assessee will pay the costs to the Department.

22. Reference answered accordingly.