

SHAHZADA NAND & SONS

v.

THE COMMISSIONER OF INCOME TAX, PATIALA

April 12, 1977

[P. N. BHAGWATI, N. L. UNTWALIA AND S. MURTAZA FAZAL ALI, JJ.]

Allowable expenditure in computing the profits of the assessee from business—Whether the commission paid by the assessee to its employees an allowable expenditure u/s. 36(1)(ii) of Income Tax Act.

The appellants were the sole selling agents of the Oriental Carpet Manufacturers India Pvt. Ltd. in respect of yarn, cloth and blankets manufactured by them and for the sales effected by the appellants, as such sole selling agent's commission was paid to them by OCM. Since the appellants showed very satisfactory turnover from year to year, OCM started giving to them, in addition to the usual commission, over-riding commission @ 2½ per cent on the sales effected by the appellants. Since the turnover of the sales reached the figure of Rs. 54.28 lacs and over-riding commission increased to Rs. 1,13,449/- during the previous year corresponding to the assessment year 1963-64, the appellants paid out of the over-riding commission received by them a sum of Rs. 22,690/- (i.e. at the rate of 1½% of the sales) each to two of their employees viz., Saheb Dayal and Gurditta Mal since they were primarily responsible for the increased prosperity of the appellants. The commission so paid viz. Rs. 45,380/- was claimed by the appellants as a deductible expenditure in their assessment to income tax for the assessment year 1963-64. The Income Tax Officer disallowed the claim on the ground that there was no evidence to show that the increase in sales during the relevant accounting year was due to the efforts of Saheb Dayal and Gurditta Mal. The Appellate Assistant Commissioner rejected the appeal preferred to him and held that since no evidence had been produced by the assessee to prove that the activities of Saheb Dayal and Gurditta Mal in the relevant account year were of a nature different from those in the earlier years so that they put in any extra time or energy in the conduct of the business of the assessee so as to justify the payment of the commission, it could not be said that the commission was paid for services rendered by them. The Tribunal, in further appeal took the same view and held that since there was no proof to show that any extra services were rendered by Saheb Dayal and Gurditta Mal for which payment of commission in addition to salary and bonus could be justified, commission could not be said to have been paid for services rendered so as to attract the applicability of s. 36(1)(ii) of the Act. The High Court was also of the same view and answered the reference made to it, in favour of the Revenue.

Allowing the appeal by special leave, the Court,

HELD : (1) The sum of Rs. 45,380/- paid by the assessee to Saheb Dayal and Gurditta Mal by way of commission during the relevant accounting year was reasonable, having regard to all the circumstances of the case and it ought to have been allowed as a deductible expenditure u/s. 36(1)(ii) of the Income Tax Act. [537 B]

(2) Section 36, sub-section (1) clause (ii) does not postulate that there should be any extra services rendered by an employee before payment of commission to him can be justified as an allowable expenditure. What it requires, is only this, namely, that commission paid to an employee should be for some services rendered by him. It is not necessary that the commission should be paid under a contractual obligation. It may be purely voluntary.

(3) It is immaterial that the services rendered during the relevant accounting year were in no way greater or more onerous than the services rendered in the earlier years. There is no such requirement under the section and it is not justified by the language of s. 36, sub-section(1), clause (ii) and indeed if it were pushed to its logical extreme, even payment of bonus cannot be treated as permissible deduction under that provision. [534 G-H]

- A** (4) It is now well-settled that the mere fact that commission is paid *ex-gratia* would not necessarily mean that it is unreasonable. Commercial expediency does not mean that an employer should not make any payment to an employee unless the employee is entitled to it under a contract. What is the requirement of commercial expediency must be judged not in the light of the 19th Century *laissez faire* doctrine which regarded man as an economic being concerned only to protect and advance his self-interest but in the context of current socio-economic thinking which places the general interest of the community above the personal interest of the individual and believes that a business or undertaking is the product of the combined efforts of the employer and the employees and where there is sufficiently large profit, after providing for the salary or remuneration of the employer and the employees and other prior charges such as interest on capital depreciation, reserves etc., as part of it should in all fairness go to the employees. [536 E-G]
- B**

- C** (5) The question whether commercial expediency justified the payment of commission would have to be judged in the light of all the circumstances existing at the material time. In the instant case, the assessee felt, on grounds of commercial expediency that a part of the over-riding commission should be paid besides salary and bonus to its two employees who had worked so well and contributed to the prosperity of the assessee and did make the payment. [525 AB]

Laxmandas Sejram v. C.I.T. Gujarat 50 ITR 789 (Gujarat) approved.

- D** (6) The question whether the amount of the commission is a reasonable amount or not has to be determined with reference to the three factors laid down in s. 36(1)(ii). Though described loosely as conditions, they are not really conditions on the fulfilment of which alone the amount of commission paid to an employee can be regarded as reasonable. The reasonableness of the amount of commission has to be considered from the point of view of a normal, prudent businessman, and not on any subjecting standard of the assessing authority. [525 C-D]

Observation :

- E** It is high time that the administration of our tax law recognised the demand of social justice today viz., profit-sharing by the employees and encouraged it by adopting a progressive and liberal approach in the applicability of s. 36, sub-section (1), clause (ii). [536 H]

CIVIL APPELLATE JURISDICTION : Civil Appeal No. 1011 of 1972.

- F** Appeal by Special Leave from the Judgment and Order dated the 18th August, 1971 of the Punjab and Haryana High Court in Income Tax Reference No. 17 of 1971.

S. T. Desai, (Mrs.) *A. K. Verma* and *Shri Narain* for the Appellant.

T. A. Ramachandran and *R. N. Sachthey* for Respondent.

The Judgment of the Court was delivered by

- G** BHAGWATI, J.—The short question that arises for determination in this appeal is whether certain commission paid by the assessee to two of its employees is an allowable expenditure in computing the profits of the assessee from business. The assessee is a registered firm which at all material times consisted of five partners, namely, Chaman Lal, Madan Lal, Harbans Lal, Raj Mohan and Saheb Dayal representing a trust. Chaman Lal was the son of Saheb Dayal and Raj Mohan was the son of one Gurditta Mal. During the accounting year relevant to the assessment year 1963-64, Chaman Lal and Harbans Lal had their own independent factories and hence they were not attending
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to the business of the assessee and Raj Mohan too was not actively associated with the conduct of the business of the assessee as he was working with the Oriental Carpet Manufacturers India Pvt. Ltd. (hereinafter referred to as OCM). Thus, from amongst the partners, only Madan Lal was looking after the day-to-day management of the business of the assessee and he was assisted by Saheb Dayal and Gurditta Mal who were engaged as employees of the assessee. Saheb Dayal and Gurditta Mal were looking after the business of the assessee since a long time and they were each paid remuneration of Rs. 1000/- per month. The business of the assessee consisted of sole selling agency of OCM in respect of yarn, cloth and blankets manufactured by OCM and for the sales effected by the assessee as such sole selling agents, commission was paid to the assessee by OCM. The figures show that the business of the assessee prospered from year to year from 1959-60 onwards and there was a gradual increase in the turnover of the assessee which jumped from the figure of Rs. 39.99 lacs for the assessment year 1962-63 to the figures of Rs. 54.28 lacs for the assessment year 1963-64. Since the assessee showed very satisfactory turnover from year to year, OCM started giving to the assessee, in addition to the usual commission, over-riding commission at the rate of 2½% on the sales effected by the assessee and the over-riding commission thus received by the assessee during the previous years corresponding to the assessment year 1960-61 to 1963-64 was as follows :

<i>Assessment year</i>	<i>Amount Received</i>
1960-61	Rs. 35,964/-
1961-62	Rs. 61,818/-
1962-63	Rs. 83,922/-
1963-64	Rs. 1,13,449/-

Since the turnover of the sales reached the figure of Rs. 54.28 lacs and overriding commission increased to Rs. 1,13,449/- during the previous year corresponding to the assessment year 1963-64, the assessee decided to give to each of Saheb Dayal and Gurditta Mal, who were looking after the business and were primarily responsible for the increased prosperity of the assessee, commission at the rate of ½% of the sales out of 2½% overriding commission received from OCM and each of these two employees was accordingly paid by the assessee a sum of Rs. 22,690/- by way of commission. The aggregate amount of commission paid to Saheb Dayal and Gurditta Mal thus came to Rs. 45,380/- and this amount of commission was claimed by the assessee as a deductible expenditure in its assessment to income tax for the assessment year 1963-64. The Income Tax Officer, disallowed the claim of the assessee on the ground that there was no material produced by the assessee which would "prove the nature of services rendered by these two gentlemen in lieu of which the commission is claimed to have been paid" and there being no evidence to show that the increase in sales during the relevant accounting year was due to the efforts of Saheb Dayal and Gurditta Mal, the claim for deduction of the amount of commission as a business expenditure remained unproved. The assessee appealed against the disallowance of the amount of commission but the Appellate Assistant Commissioner in appeal affirmed the disallowance on the ground that no evidence had been

- A produced by the assessee to prove that the activities of Saheb Dayal and Gurditta Mal in the relevant account year were of a nature different from those in the earlier years or that they put in any extra time or energy in the conduct of the business of the assessee so as to justify the payment of the commission and hence it could not be said that the commission was paid for services rendered by them. The matter was carried in further appeal before the Tribunal, but the Tribunal also
- B took the same view and held that since there was no proof to show that any services were rendered by Saheb Dayal and Gurditta Mal for which payment of commission in addition to salary and bonus could be justified, commission could not be said to have been paid for services rendered so as to attract the applicability of section 36, sub-section (1), clause (ii). The Tribunal observed that it was not possible to say "that the increase in the turnover in the year under appeal
- C was due to the extra efforts put in by these two employees or that the employees had worked in the hope of receiving extra commission" and since bonus equivalent to three months' salary was paid to Saheb Dayal and Gurditta Mal in addition to their salary during the relevant accounting year, any extra services rendered by them, if any, "should be deemed to have been covered by the payment of this bonus". Since in the view taken by the Tribunal it was necessary that there should
- D be some extra services rendered by Saheb Dayal and Gurditta Mal for which payment of commission could be said to be justified and there was nothing to show that any such extra services were rendered by them, the Tribunal came to the conclusion that the payment of commission could not be said to be justified on grounds of commercial expediency and section 36, sub-section (1), clause (ii) had no application. The assessee being aggrieved by the order made by the Tribunal applied for a reference of the question of law arising out of the
- E order of the Tribunal and on the application of the assessee, the following question of law was referred for the opinion of the High Court :

- F "Whether on the facts and circumstances of the case, the sum of Rs. 45,380/- paid to L. Gurandittamal and L. Sahebdial, employees of the applicant firm is permissible deduction in computing the business income of the applicant?"

- G The High Court answered the question in favour of the Revenue. The view taken by the High Court was that in order to attract the applicability of section 36, sub-section (1), clause (ii), it was necessary that the payment of commission should be for services rendered and since there was no evidence led on behalf of the assessee to show that any extra services were rendered by Saheb Dayal and Gurditta Mal, which were responsible for increase in the sales and consequent enlargement of the overriding commission, there was no justification for payment of commission to them and the commission paid could not be said to be for services rendered. The High Court in this view
- H held that section 36, sub-section (1), clause (ii) was not applicable and no claim for deduction could be sustained under it. The correctness of this decision is impinged in the present appeal preferred by the assessee with special leave obtained from this Court.

Now, before we proceed to consider, the question which arises for determination before us, we must make it clear at the out set that in the present case the genuineness of the payment of commission made to Saheb Dayal and Gurditta Mal was at no time doubted by the Revenue authorities. It was not the case of the Revenue that this payment was not made or that it was sham or bogus. If that had been the finding, there would have been an end of the case of the assessee. No question would then have arisen for considering the applicability of section 36, sub-section (1), clause (ii). No payment having been made, no deduction would have been permissible. But here the commission was paid : it was a genuine payment and the only question was whether it was deductible as an allowable expenditure under section 36, sub-section (1), clause (ii). Section 36, sub-section (1) provides for making of various deductions in computing the income of an assessee under the head : "Profits and Gains of Business or Profession" and one such deduction is set out in clause (ii) which, as it stood at the material time during the assessment year 1963-64, read as follows :

"36(1)(ii) Any sum paid to an employee as bonus or commission for services rendered, where such sum would not have been payable to him as profit or dividend if it had not been paid as bonus or commission :

Provided that the amount of bonus or commission is reasonable with reference to —

- (a) the pay of the employee and the conditions of his service;
- (b) the profits of the business or profession for the previous year in question; and
- (c) the general practice in similar business or profession."

Saheb Dayal and Gurditta Mal were admittedly employees of the assessee. They were each paid a salary of Rs. 1000/- per month and for the previous year relevant to the assessment year 1963-64 bonus equivalent to three months' salary was also paid to each of them. The Income Tax Officer disallowed even this salary and bonus paid to Saheb Dayal and Gurditta Mal on the ground that there was nothing to show that any services were rendered by them and the payment of salary and bonus appeared to be *ex-gratia*. But this decision was reversed in appeal by the Appellate Assistant Commissioner who, following his earlier order dated 12th December, 1967 in the appeal against the assessment to tax for the assessment year 1962-63, allowed the payment of salary and bonus as a deductible expenditure. The Appellate Assistant Commissioner clearly recognised that Saheb Dayal and Gurditta Mal were employees of the assessee and were attending to the business of the assessee as such employees since a long time and Gurditta Mal was in fact "a seasoned and experienced businessman" and he looked after the assessee's transactions with OCM and on behalf of the assessee advised OCM in connection with designs etc. The Tribunal also found that Saheb Dayal and Gurditta Mal

A "were looking after the business of the assessee firm for a long time". Thus, there can be no doubt that services were rendered by Saheb Dayal and Gurditta Mal to the assessee and for these services, besides salary and bonus, commission was paid to them, because, according to the assessee, during the relevant accounting year, there was considerable enlargement in the turnover of the sales with consequent increase in the amount of overriding commission and the assessee felt, on grounds of commercial expediency, that a part of the overriding commission should be paid to the two employees who had worked so well and contributed to the prosperity of the assessee. The question is whether this commission qualifies for deduction as an allowable expenditure under section 36, sub-section (1), clause (ii).

B The only ground on which the High Court negated the applicability of section 36, sub-section (1), clause (ii) was that during the relevant accounting year Saheb Dayal and Gurditta Mal rendered the same services which they were rendering in earlier years and no extra services were rendered by them which could justify payment of commission in addition to salary and bonus. The High Court appeared to take the view that there must be correlation between the payment of commission and the services rendered and since commission was paid by the assessee for the first time during the relevant accounting year, there must be some extra services rendered by Saheb Dayal and Gurditta Mal in that year over and above the usual services rendered by them in the earlier years. Since, according to the High Court, there was no proof that any extra services were rendered by Saheb Dayal and Gurditta Mal, the High Court held that the payment of commission could not be said to be for services rendered within the meaning of section 36, sub-section (1), clause (ii). This view taken by the High Court is, in our opinion, plainly erroneous. Section 36, sub-section (1), clause (ii) does not postulate that there should be any extra services rendered by an employee before payment of commission to him can be justified as an allowable expenditure. What it requires is only this, namely, that commission paid to an employee should be for services rendered by him. For example, if an employee has not rendered any services at all during the relevant accounting year, no commission can be paid to him which would be an allowable expenditure. There must be some services rendered by an employee and where commission is paid for the services so rendered, section 36 sub-section (1), clause (ii) would apply and the commission to the extent to which it is found reasonable would be an allowable expenditure under that provision. It is not necessary that the commission should be paid under a contractual obligation. It may be purely voluntary. But it must be for services rendered and here services were in fact rendered by Saheb Dayal and Gurditta Mal during the relevant accounting year. It is true that the services rendered by these two employees during the relevant accounting year were in no way greater or more onerous than the services rendered by them in the earlier years, but that is immaterial. There is no such requirement and the argument based on it cannot be sustained. It is not justified by the language of section 36, sub-section (1), clause (ii) and indeed, if it were pushed to its logical extreme, it would be difficult to support even payment of bonus as a permissible deduction under that provision. Of course, the circumstance that no additional services are rendered

by an employee would undoubtedly be of some relevance in determining the reasonableness of the amount of commission but it would have to be considered along with other circumstances and the question whether commercial expediency justified the payment of commission would have to be judged in the light of all the circumstances existing at the material time. This was the view taken by the Gujarat High Court in *Laxmandas Sejram v. Commissioner of Income-Tax, Gujarat*,⁽¹⁾ and we wholly accept that view. It is, therefore, no answer to the applicability of section 36, sub-section (1), clause (ii) to say that no extra services were rendered by Saheb Dayal and Gurditta Mal during the relevant accounting year. The amount of commission having been paid for services admittedly rendered by them, the only question would be whether it was reasonable under section 36, sub-section (1), clause (ii).

Turning to the provisions of section 36, sub-section (1), clause (ii), we find that the proviso to that clause lays down three factors for the purpose of determining the reasonableness of the commission paid to an employee. The question whether the amount of the commission is a reasonable amount or not has to be determined with reference to these three factors. Sometimes these three factors are loosely described as conditions but they are not really conditions on the fulfilment of which alone the amount of commission paid to an employee can be regarded as reasonable. They are merely factors to be taken into account by the Revenue authorities in determining the reasonableness of the amount of commission. It may be that one of these factors yields a negative response. To take an example, there may be no general practice in similar business or profession to give commission to an employee, but, yet, having regard to the other circumstances, the amount of commission paid to the employee may be regarded as reasonable. What the proviso requires is merely that the reasonableness of the amount of commission shall be determined with reference to the three factors. But it is well settled that these factors are to be considered from the point of view of a normal, prudent businessman. The reasonableness of the payment with reference to these factors has to be judged not on any subjective standard of the assessing authority but from the point of view of commercial expediency. Let us see whether the amount of commission paid to Saheb Dayal and Gurditta Mal in the present case can be said to be reasonable from this stand point. It is clear from the order of the Tribunal that reliance was placed by the Tribunal mainly and substantially on the fact that the nature of the work done by Saheb Dayal and Gurditta Mal remained unchanged in the relevant accounting year and there was nothing to show that the increase in the turnover during the relevant accounting year was as a result of any extra efforts made by these two employees and hence it could not be said that there were any special circumstances which warranted the payment of commission to them. But, as already pointed out above, the commission paid to an employee cannot be branded as unreasonable merely because the employee has done in the relevant accounting year the same work which he was doing in the earlier years. Even where the nature of the work has remained the same, commercial expediency may require payment of commission to an employee. Here, Saheb Dayal and Gurditta

(1) 50 I.T.R. 763.

- A Mal were each receiving a salary of Rs. 1000/- per month and besides this salary, there were admittedly no other perquisites given to them. They were the persons attending to the business of the assessee and in fact Gurditta Mal was an experienced and seasoned businessman and it was he who was advising OCM in regard to designs etc. and he and Saheb Dayal were primarily responsible for the flourishing state of the business. The turnover of the sales of the assessee steadily rose from 1960-61 and in the relevant accounting year, it reached the exciting figure of Rs. 54.28 lacs. So also the overriding commission which started with the modest figure of Rs. 35,964/- in the accounting year relevant to the assessment year 1960-61 went on steadily increasing from year to year until it reached the figure of Rs. 1,13,449/- in the relevant accounting year. The assessee, therefore, felt that in view of the tremendous progress in the business which was largely the result of the services rendered by Saheb Dayal and Gurditta Mal, a part of the overriding commission should be paid to them, so that they may carry a sense of satisfaction that their efforts have been suitably rewarded and they may have an added incentive to work and may be spurred to greater efficiency in the future. It may be noted that the overriding commission of the assessee during the relevant accounting year was Rs. 1,13,449/- and the total profit was Rs. 3,08,034/- and if out of this total profit of Rs. 3,08,034/-, an aggregate sum of Rs. 45,380/- was paid to Saheb Dayal and Gurditta Mal as commission, it is difficult to see how such payment could be regarded as unreasonable. It is true that there was no obligation on the assessee to make payment of this commission to Saheb Dayal and Gurditta Mal, but it is now well settled that the mere fact that commission is paid *ex-gratia* would not necessarily mean that it is unreasonable.
- E Commercial expediency does not mean that an employer should not make any payment to an employee unless the employee is entitled to it under a contract. Even where there is no contract, an employer may pay commission to an employee if he thinks that it would be in the interest of his business to do so. It is obvious that no business can prosper unless the employees engaged in it are satisfied and contented and they feel a sense of involvement and identification and this can be best secured by giving them a stake in the business and allowing them to share in the profits. It would indeed be a wise step on the part of an employer to offer incentive to his employees by sharing a part of his profits with them. This would not only be good business but also good ethics. It would be in consonance with Gandhian concept as also modern socialistic thought which, with its deeply rooted faith in social and economic democracy, regards the employees as much as the employer as co-sharers in the business. If an employer earns profits to which the employees have necessarily contributed by putting in their labour, there is no reason why the employer should not share a part of these profits with the employees. That is the demand of social justice today and it is high time that the administration of our tax law recognised it and encouraged sharing of profits by employers with employees by adopting a progressive and liberal approach in the applicability of section 36, sub-section (1), clause (ii).
- H What is the requirement of commercial expediency must be judged not in the light of the 19th Century *laissez faire* doctrine which regarded man as an economic being concerned only to protect and

advance his self-interest but in the context of current socio-economic thinking which places the general interest of the community above the personal interest of the individual and believes that a business or undertaking is the product of the combined efforts of the employer and the employees and where there is sufficiently large profit, after providing for the salary or remuneration of the employer and the employees and other prior charges such as interest on capital, depreciation, reserves etc., a part of it should in all fairness go to the employees. We are, therefore, of the view that the sum of Rs. 45,380/- paid by the assessee to Saheb Dayal and Gurditta Mal by way of commission during the relevant accounting year was reasonable having regard to all the circumstances of the case and it ought to have been allowed as a deductible expenditure under section 36, sub-section (1), clause (ii).

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We accordingly allow the appeal, set aside the judgment of the High Court and answer the question referred by the Tribunal in the affirmative in favour of the assessee. The Commissioner will pay the costs of the appeal as also of the reference to the assessee.

S.R.

Appeal allowed.