

PETITIONER:
COMMISSIONER OF INCOME TAX, DELHI (CENTRAL-I)

Vs.

RESPONDENT:
M/S. CONTINENTAL CONTRACTION LTD.

DATE OF JUDGMENT: 03/02/1998

BENCH:
SUJATA V. MANOHAR, S.S.M. QUADRI

ACT:

HEADNOTE:

JUDGMENT:

J U D G M E N T

Mrs. Sujata V. Manohar, J.

The appeals pertain to assessment year 1983-84. The following question of law was referred to the High Court for determination at the instance of the Revenue :

"Whether on the facts and in the circumstances of the case, the Tribunal was correct in holding that having regard to the provisions of Sections 40 (c) and 40A (5) (b) of the Income-tax Act, the remuneration paid to the Directors in respect of their employment outside India had to be excluded from the limit of Rs. 72,000/- laid down in the first proviso to Section 40A (5) (a) as well as Section 40(c) of the Income-tax Act, 1961?"

Facts:

The respondent-assessee is a civil construction company which has executed a large number of projects outside India. Its overseas projects include irrigation and hydle projects in Libya, a fibre board factory at Abu-Sukhir in Iraq and the Karkh Water Supply Project, Banghdad which had a total value of 534 million dollars.

For the assessment year 1983-84, the assessee had paid a sum of Rs. 14,0074,570/- to its Directors as remuneration and commission. The Income-tax officer disallowed a sum of Rs. 13,94,98,570/- being excess amount over the limit of Rs. 72,000/- per Director prescribed under Section 40(C) and Section 40A(5) (a) of the Income-tax Act, 1961. The respondent did not dispute the disallowance of Rs. 7,61,05,230/- payable to the tow India based Directors subject tot he allowance of Rs. 72,00/- each as laid down in Section 40(c) and 40A (5)(a). The dispute related to the remuneration paid to the Directors who were stationed outside India in connection with the work of the respondent-assessee. According to the assessee the amount paid to its employee-Directors in respect of their employment outside

India was not to be taken into account while calculating the ceiling under Section 40A(5) or Section 40(c).

The assessee filed an appeal before the Commissioner of Income-tax who modified the order of the Income-tax Officer and held that any remuneration paid to employee - Directors in respect of any period of their employment outside India should not be taken into account while calculating the expenditure subject to the ceiling limit of Rs. 72,000/- under Section 40(c) and 40A(5)(a). The department preferred an appeal before the Tribunal from the order of the Commissioner of Income-tax. The Tribunal dismissed the appeal.

On the application of the department the Tribunal referred the question set out above as a question of law to the High Court. The High Court by its impugned judgment and order dated 24.5.1990 answered the question in the affirmative and against the Revenue. The present appeals are filed on a certificate granted by the High Court of fitness to appeal.

The relevant provisions of Section 40(c) are as follows:

"Section 40: Notwithstanding.....
the following amounts shall not be deducted in computing the income chargeable 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 or benefit or amenity to a director.....

(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 or benefit,

if in the opinion of the Income-tax Officer any such expenditure or allowance as is mentioned in sub-clauses (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-clauses (i) shall, in no case, exceed-

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

(B) where such expenditure or 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 a case where such person is also an 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 sub-clause (B), as the case may be;"

Section 40(c), therefore, deals with the remuneration, benefit or amenity to a Director of a company (and other persons described there in) and any expenditure or allowance in respect of any asset of the company used, inter alia, by a Director. The ceiling of allowable expenditure which can be deducted is fixed at Rs 72,000/- when such expenditure or allowance relates to a period exceeding eleven months. If the period is less than eleven months then the ceiling expenditure is to be excluded at the rate of Rs. 6,000/- per months. Under the proviso set out above, certain expenditure is of the kind referred to in clauses (i), (ii), (iii) and (iv) of the second proviso to Section 40A (5) (a). Section 40A(5) relates to expenditure relating to payment of any salary or providing any perquisite to an employee or a former employee of the assessee. There is a ceiling on deductible expenditure of this nature which is provided under Section 40A(5). The relevant provisions of Section 40A (5) are as follows:

"40A(5)(a) : Where the assessee-

- (i) incurs any expenditure which results directly or indirectly in the payment of any salary to an employee or a former employee, or
- (ii) incurs any expenditure which results directly or indirectly in the provision of any perquisite (whether convertible into money or not) to an employee or incurs directly or indirectly any expenditure or is entitled to any allowance in respect of any assets of the assessee used by an employee either wholly or partly for his own purposes or benefit,

than, subject to the provisions of clause (b), so much of such expenditure or allowance as is in excess of the limit specified in respect thereof in clause (c) shall not be allowed as a deduction:

Provided that where the assessee is a company, so much of the aggregate of-

- (a) the expenditure and allowance referred to in sub-clauses (i)

and (ii) of this clause; and
(b) the expenditure and allowance referred to in sub-clauses (i) and (ii) of clauses (c) of section 40, in respect of an employee or a former employee, being a director or a person who has a substantial interest in the company or a relative of the director or of such person, as is excess of the sum of seventy-two thousand rupees, shall in no case be allowed as a deduction:

Provided further that in computing the expenditure referred to in computing the expenditure referred to in sub-clause (i) or the expenditure (ii) of this clause or the aggregate referred to in sub-clause (ii) of this clause or the aggregate referred to in the foregoing proviso, the following shall not be taken into account, namely :-

- (i) the value to any travel concession or assistance referred to in clauses (5) of section 10;
- (ii) passage moneys or the value of any free or concessional passage referred to in sub-clause (i) of clause (8) of section 10;
- (iii) any payment referred to in clauses (iv) or clause (v) of sub-section (1) of section 36;
- (iv) any expenditure referred to in clause (ix) or sub-section (1) of section 36.

(b) Nothing in clause (a) shall apply to any expenditure or allowance in relation to-

- (i) any employee in respect of any period of his employment outside India;
- (ii) any employee being an individual referred to in sub-clause (vii) or sub-clause (vii-a) of clause (6) of section 10 in respect of any period during which he is entitled to the exemption under sub-clause (vii) or, as the case may be, sub-clause (vii-a) aforesaid;
- (iii) any employee whose income chargeable under the head "Salaries" is seven thousand and five hundred rupees or less."

[underlining ours]

The permissible limit of deduction for expenditure falling under sub-clauses (i) and (ii) of Section 40A (5) (a) is laid down in clause (c). In respect of salaries to an

employee or former employee, the permissible deduction is up to an amount at a rate of Rs. 5,000/- per month during the period of an employee's employment in India during the previous year. In respect of expenditure on perquisites under clause (a) (ii), the permissible deduction is up to 1/5th of the amount of the salary payable to the employee or an amount calculated at the rate of Rs. 1,000/- for each month or part thereof comprising the period of employment in India of the employee during the previous year, whichever is less. Thus ceiling for expenditure deductible under clauses a(i) is Rs. 60,000/- and clause a(ii) is Rs. 12,000/-. However, in the case of an employee or former employee who is also a Director of the company, the proviso to Section 40A(5) (a) provides that the ceiling for deduction is an overall ceiling of Rs. 72,000/- in respect of a sum allowance referred to in Section 40A(5)(a)(i) and (ii) which cover expenditure on an employee, plus expenditure and allowances referred to Section 40(c)(1) and (ii) which relate, inter alia, to a Director.

In the case of an employee, however, section 40A(5)(b) provides that while calculating the expenditure or allowance in relation to an employee under Section 50A(5)(a), certain expenditure will not be taken into account. This includes, inter alia, any expenditure or allowance in relation to an employee in respect of any period of his employment outside India. The question we have to consider is whether such expenditure when incurred in connection with an employee who is also a Director, will be similarly excluded while calculating the aggregate of expenditures under Section 40A(5)(a)(i) and (ii) plus expenditure and allowances under Section 40(c) (i) and (ii) incurred in connection with that employee-Director. According to the department, so long as the employee is also a Director, expenditure of the kind referred to in Section 40A(5)(b) cannot be excluded from expenditure while calculating the ceiling limit under Section 40(c) or Section 40A(5)(a). The department has submitted that such an exclusion is permissible only in the case of an employee who is not a Director at the relevant time when the expenditure was incurred.

The question of interpreting the provisions of Sections 40(c) and 40A(5) in connection with persons who are both employees and Directors of the company has come up for consideration in a number of cases before the High Court and before this Court. In the impugned judgment before us (which is reported in 185 ITR 178), the Delhi High Court has looked at the legislative history of these two provisions with a view to examining their effect. Section 40(c) as it originally stood and the amendments made in Section 40(c) have been set out in the High Court's judgment. Originally, Section 40(c) itself contained sub-clause (iii) dealing with expenditure which results directly or indirectly in the provision of any remuneration or benefit or amenity to an employee. The ceiling prescribed was Rs. 5,000/- per month for any period of employment after 29th day of February, 1963. The expenditure on perquisites with a ceiling of 1/5th of the amount of the salary payable to the employee was subsequently also added. The expenditure on employees is now removed from Section 40(c) and incorporated in Section 40A(5).

The two Sections 40(c) and 40A(5) are, however, not mutually exclusive. In section 40(c), the proviso, for example, refers to a case where the Director (or a person who had a substantial interest in the company or a relative of the Director or of such person) is also an employee of the company for any period prescribed in the previous year.

In that situation, expenditure of the nature referred to in clauses (i), (ii), (iii) and (iv) of the second proviso to clause (a) of Section 40A(5) shall not be taken into account for the purpose of calculating the ceiling under Section 40(c). These excluded items are items such as the value of any travel concession, passage money, payment referred to in Section 36(1)(iv) and (v) and expenditure referred to in Section 36(1)(ix). These items in Section 36 deal with contribution towards provident fund, approved gratuity fund and promotion of family planning. Similarly Section 40A(5) does not deal only with employees. It also deals with employee-Directors in the first proviso to sub-section (5)(a). In the case of employee-Directors both these sections are applicable.

There have been a number of cases in the various High Courts as well as that is Court which have dealt with the question: which ceiling applies when a person holds the positions both of a Director and an employee. Section 40(c) prescribes an overall ceiling of Rs. 72,000/- on expenditure covered in Section 40(c). Under Section 40A (5), there is a ceiling of Rs. 60,000/- on expenditure in respect of salary and Rs. 12,000/- in respect of perquisites totalling Rs. 72,000/-. This Court considered this question in the case of Commissioner of Income-tax v. Indian Engineering and Commercial Corporation Pvt. Ltd. [1993 (201) ITR 723]. This Court has held (page 728) that in the case of Directors who are also employees both these sections will be attracted and the higher of the two ceilings has to be applied. The same view had earlier been taken by the Andhra Pradesh High Court in the case Commissioner of Income-tax v. D.B.R. Mills [172 ITR 366], and by the Bombay High Court in the case of Commissioner of Income-tax v. Hico Products Pvt. Ltd. [201 ITR 567] where the Bombay High Court emphasised the first proviso to Section 40A(5) (a) where an express provision is made that if an employee is also a Director or a person specified in Section 40(c) the aggregate of expenditure and allowances specified in Section 40(c), sub-clauses (i) and (ii) as well as expenditure and allowances specified in Section 40A(5)(a)(i) and (ii) shall not exceed Rs. 72,000/-. In other words, the total emoluments and perquisites of Directors who are also employees will be allowed up to the limit of Rs. 72,000/- as a deductible expenditure. In such cases, therefore, though the Directors are also employees, the separate callings prescribed of Rs. 60,000/- and Rs. 12,000/- under Section 40A(5)(c) will not apply. The contrary view taken by the Kerala High Court in Travancore Rayons Ltd. v. Commissioner of Income-tax [162 ITR 732] is, therefore, no longer good law.

We need not, in this connection, refer to the earlier judgments of the Gujarat High Court which have been discussed at length in the impugned judgment. After the decision of this Court in the case of Commissioner of Income-tax v. Indian Engineering and Commercial Corporation (supra), the Gujarat High Court has now, in the case of Commissioner of Income-tax V. Synpol Products Pvt. Ltd. [217 ITR 154] held that in the case of Directors who are also employees, both the provisions will be attracted. The higher of the two ceilings will have to be applied.

We have now to consider in this light whether the provisions of Section 40A(5) (b) will apply for the purpose of calculating the expenditure so covered when the expenditure is incurred in connection with a Director who is also an employee. Under Section 40A(5)(b)(i) nothing in clause (a) which deals with expenditure on salaries and

perquisites of an employee shall apply, inter alia, to any expenditure in relation to an employee in respect of any period of his employment outside India. Therefore, for example, in calculating the expenditure on the salary of an employee, the salary paid in respect of his employment outside the expenditure which is subject to a ceiling limit. Under Section 40A(5)(b)(ii) and (iii), similarly certain other expenditures in connection with an employee are also excluded from the ceiling limit. The question is whether such expenditure will be excluded from the ceiling limit of a Director-employee. If for the purpose of ceiling on expenditure, both Sections 40(c) and 40A(5) are to be applied to employee-Directors, there is no reason why for the purpose of deciding what is to be excluded from the expenditure subject to such ceiling, both the sections cannot be taken into account. Both sections constitute a composite scheme. In the case of employee-Directors, both will operate. After all, the purpose of prescribing a ceiling on expenditure in connection with Directors and employees under Section 40(c) and Section 40A(5), is to discourage a company or an organisation from paying excessive salaries, remuneration, perquisites etc. to its employees and/or Directors. If it does so, the organisation will not be able to claim the entire expenditure as deduction, but only expenditure up to the ceiling limit. However, from this ceiling limit, certain kinds of expenditure on employees have been excluded- presumable because this kind of an expenditure was considered as reasonable and permissible. One such category of expenditure is expenditure on an employee in respect of his period of employment outside India. Presumably the organisation may have to pay to an employee posted outside India amounts which may be much higher than what he may be entitled to in India in view of the exigencies of the situation, his requirements at the place of posting and the fact that the amount may have to be paid in a foreign country. This expenditure is, therefore, not subject to a ceiling. The same considerations would apply to a Director-employee also who is posted outside the country in the course of his work. A Director-employee does not cease to be an employee nor his requirements less than those of an employee. Therefore, in his case also what the Act itself has viewed as reasonable allowable expenditure, should be allowed. We do not see any reason to hold that Section 40A(5)(b) will not apply to employee-Directors when this Court, in the case of employee-Directors has held, both Sections 40(c) and 40A(5) as applicable. For determining the ceiling, the higher ceiling has to be taken into account. Similarly, for determining permissible expenditure which is outside the ceiling limit also, both the sections will have to be applied. Therefore, expenditure under Section 40A(5)(b) which is excluded from the expenditure on which a ceiling is placed under Section 40A(5)(a), will have to be excluded in the case of an employee-Director also. Under the proviso to Section 40A(5)(a), in the case of an employee-Director for the purposes of ceiling, expenditure which has to be taken into account is both under Section 40A(5)(a) as well as under Section 40(c). For calculating the expenditure and allowances under Section 40A(5)(a), one has to exclude the expenditure and allowances referred to in Section 40A(5)(b). Therefore, in the case of Director-employee also while calculating the expenditure and allowances spent on a Director-employee under Section 40A(5)(a) and Section 40(c), expenditure of the kind referred to in Section 40A(5)(b) had to be necessarily excluded.

A similar view has been taken by the Madras High Court in the case of Commissioner of Income-tax V. Lucas TVS Ltd. [226 ITR 281]. The Madras High Court was concerned with foreign technicians working under a contract in India and falling under Section 10(6)(vii-a). Under Section 40A(5)(b)(ii) expenditure incurred in relation to such an employee is to be excluded from the expenditure for which a ceiling is prescribed under Section 40A(5)(a). The Madras High Court held that in the case of a Director-cum-employee also, if he is covered by Section 10(6)(vii-a), such expenditure would be excluded from the ceiling limit prescribed under Section 40(c) as well as Section 40A(5)(a). The Madras High Court has rightly observed (page 291) that there is nothing to suggest that the remuneration which is excluded from the scope of consideration for the purpose of Section 40(c) of the Act. Both Sections 40(c) and 40A(5) have to be read together in determining the ceiling prescribed under Section 40A(5) of the Act which includes ceiling prescribed for Director-employees. Also if certain items go out of reckoning in Section 40A(5) of the Act, then on the principle of harmonious construction, the same will have to go out of reckoning in calculating a common ceiling prescribed for Director-employees both under Section 40(c) and 40A(5)(a) proviso.

The Delhi High Court was, therefore, right in coming to the conclusion that any expenditure covered by Section 40A(5)(b)(i) in respect of an employee-Director shall not be taken into account for the purposes of calculating the aggregate of expenditure under the proviso to Section 40A(5)(a) for the application of the ceiling limit prescribed there.

The question, therefore, is answered in the affirmative and in favour of the assessee. The appeals are dismissed with costs.