

Ram Pershad

Vs

Commissioner of Income Tax, New Delhi.

Civil Appeal No. 1946 of 1969

(H. R. Khanna, K . S. Hedge, P. Jagmohan Reddy JJ)

24.08.1972

JUDGMENT

JAGANMOHAN REDDY, J. -

1. The assessee and his wife owned a large number of shares in a private limited company engaged in the business of running hotels. By virtue of Art. 109 of the Articles of Association of the said company, the assessee became the first Managing Director on terms and conditions agreed to and embodied in an agreement dated November 20, 1955 between himself and the company. Under the said agreement, the assessee was to receive Rs. 2,000/- per month, a fixed sum of Rs. 500/- p.m. as car allowance, 10 per cent of gross profits of the company and he and his wife were entitled to free board and lodging in the hotel. For the assessment year 1956-57 for which the accounting year is the year ending 30th September 1955, the assessee was assessed in respect of Rs. 53,913/- payable to him as 10% of the gross profits of the company which he gave up soon after the accounts were finalised but before they were passed by the general meeting of the shareholders. The above amount was given up by him because the company would not be making net profits if the stipulated commission was paid to him. The assessee claimed that the amount given up by him was not liable to be included in his total income because the amount had not accrued to him at all, at any rate, in the accounting year ended 31st March, 1956 and that even assuming that it had accrued in the account year ended 31st March, 1956, it is not taxable under sec. 7 or sec. 10 of the Indian Income-tax Act, 1922 (hereinafter called the 'Act') The Income-tax Officer, the Appellate Assistant Commissioner, the Tribunal and on a reference under sec. 66 (1) the High Court have all held that the 10% commission on gross profits amounting to Rs. 53,913/- was taxable as 'salary' under sec. 7 of the Act and that the income had accrued to the assessee during the previous year. Against the judgment of the High Court, this appeal is by special leave.

2. The question of law which were referred to the High Court under sec. 66 (1) of the Act are as follows :-

1. Whether the sum of Rs. 53,913/- was a revenue receipt of the assessee of the previous year ?
2. Whether the amount is chargeable under sec. 7 or sec. 10 of the Income-tax Act ?
3. If the amount is chargeable under sec. 10, is the assessee entitled to a deduction of Rs. 53,913/- under sec. 10(1) or sec. 10(2) ?

The High Court answered the first question in the affirmative and in favour of the Revenue, and on the second question it was of the view that the amount payable as commission was chargeable under sec. 7 as salary and not under sec. 10 of the Act. On this view, it did not think it necessary to answer

the third question. 3. When the matter came up earlier, this court on November 9, 1971 considered it necessary to call for a further statement of the case from the Tribunal on the third question on the basis of the materials before it and having regard to the decision of *Morvi Industries Ltd. vs. Commissioner of Income-tax*. The Tribunal in its supplementary statement of case has answered the question against the assessee and in favour of the Department in holding that the assessee is not entitled to deduction of the sum of Rs. 53,913/- either under sec. 10 (1) or 10 (2) of the Act.

4. It is not disputed that the commission payable to him would be a revenue receipt nor is it disputed that if it is chargeable under sec. 7 no other question would arise having regard to the finding based on the decision in *Morvi Industries*, case (supra) that the amount of Rs. 53,913/- had accrued to the assessee in the year of account. It is therefore necessary for us to consider whether the 10 per cent gross profits payable to the assessee under the terms of the agreement appointing him as the Managing Director is liable to be assessed as salary or under the head 'income from business'. It may be mentioned that 'salary' under sec. 7 of the Act includes also commission, wages, perquisites etc.

5. On behalf of the assessee, it was contended that in order to assess the income as salary it must be held that there was a relationship of master and servant between the company and the assessee. For such a relationship to exist, it must be shown that the employee must be subject to the supervision and control of the employer in respect of the work that the employee has to do. Where, however, there is no such supervision or control it will be a relationship of principal and agent or an independent contractor. Applying these tests, it is submitted that the appointment of the assessee as a Managing Director is not that of a servant but as an agent of the company and accordingly the commission payable to him is income from business and not salary. In support of this contention, reference has been made to *Halsbury's Laws of England*, *Bowstead on Agency* and treatises on *Company Law* by *Palmer, Gower, Penington and Burckley*.

6. There is no doubt that for ascertaining whether a person is a servant or an agent, a rough and ready test is, whether, under the terms of his employment, the employer exercises a supervisory control in respect of the work entrusted to him. A servant acts under the direct control and supervision of his master. An agent, on the other hand, in the exercise of his work is not subject to the direct control or supervision of the principal, though he is bound to exercise his authority in accordance with all lawful orders and instructions which may be given to him from time to time by his principal. But this test is not universal in its application and does not determine in every case, having regard to the nature of employment, that he is a servant. A doctor may be employed as a medical officer and though no control is exercised over him in respect of the manner he should do the work nor in respect of the day to day work, he is required to do he may nonetheless be a servant if his employment creates a relationship of master and servant. Similar is the case of a chauffeur who is employed to drive the car for his employer. If he is to take the employer or any other person at his request from place 'A' to place 'B' the employer does not supervise the manner in which he drives between those places. Such examples can be multiplied. A person who is engaged to manage a business may be a servant or an agent according to the nature of his service and the authority of his employment. Generally it may be possible to say that greater the amount of direct control over the person employed, the stronger the conclusion in favour of his being a servant. Similarly the greater the degree of the independence the greater the possibility of the services rendered being in the nature of principal and agent. It is not possible to lay down any precise rule of law to distinguish one kind of employment from the other. The nature of the particular business and the nature of the duties of the employee will require to be considered in each case in order to arrive at a conclusion as to whether the person employed is a servant or an agent. In each case the principle for ascertainment remains the same.

7. Though an agent as such is not a servant, a servant is generally for some purposes his master's implied agent, the extent of the agency depending upon the duties or position of the servant. It is again true that a director of a company is not a servant but an agent inasmuch as the company cannot act in its own person but has only to act through directors who qua the company have the relationship of an agent to its capacity. Managing Director may have a dual capacity. He may both be a Director as well as an employee. It is therefore evident that in the capacity of a managing director he may be regarded as having not only the capacity as persons of a director but also has been person of an employee, or an agent depending upon the nature of his work and the terms of his employment. Where he is so employed, the relationship between him as the Managing Director and the company may be similar to a person who is employed as a servant or an agent for the term 'employed' is, facile enough to cover any of these relationships. The nature of his employment may be determined by the articles of association of a company and or the agreement if any, under which a contractual relationship between the Director and the company has been brought about, whereunder the Director is constituted an employee of the company, if such be the case, his remuneration will be assessable as salary under sec. 7. In other words, whether or not a Managing Director is a servant of the company apart from his being a Director can only be determined by the articles of association and the terms of his employment. A similar view has been expressed by the Scottish Court of Session in *Anderson vs. James Sutherland (Petrhead) Ltd.* where Lord Normand at p. 216 said :

"..... the managing director has two functions and two capacities. Qua managing director he is a party to a contract with the company, and this contract is a contract of employment; more specifically I am of opinion that it is a contract of service and not a contract for service."

A number of cases have been referred before us but the conclusion in each of the decisions turned on the particular nature of employment and the facts disclosed therein. In each of these decisions the "context played a vital part in the conclusions arrived at." In *Commissioner of Income-tax vs. Manmohandas* this Court had occasion to consider the case of employment by a bank of a treasurer for its branches, sub-agencies and pay offices where he had to perform the duties, liabilities and responsibilities which by custom or contract usually devolved upon a treasurer as well as those specified in the agreement. The treasurer had to provide the staff for the cash section of the bank; he had power to suspend, transfer or dismiss any member of the staff and to appoint any other person in his place. He was responsible for all the acts of the staff so appointed which resulted in loss or damage to the bank and was responsible for the protection of the property of the bank and for the receipt of any bad money, or base money etc., was requested to transmit from one place to another, under guard provided by the bank, money, documents and properties of the bank. It was held that though the office of the treasurer was created by the agreement and that he held office under it, that was not decisive of the question whether the remuneration earned by him was as a servant of the bank. Receipt of remuneration for holding an office did not necessarily give rise to the relationship of master and servant between the holder of the office and the person who paid the remuneration. It was held that the treasurer was not a servant of the bank and the remuneration received by him was not salary Referring to the observations of Bhagwati, J. in *Dharangadhra Chemical Works Ltd. vs. State of Saurashtra*, Shah, J. observed (at p. 707) that the correct method of approach would be to consider whether having regard to the nature of the work, there was due control and supervision by the employer. In *Piyare Lal Adishwar Lal vs. Commr. of Income-tax, Kapur, J.* said (at p. 24) that :

"It is difficult to lay down any one test to distinguish the relationship of master and servant from that of an employer and independent contractor. In many cases the test

laid down is that in the case of master and servant, the master can order or require what is to be done and how it is to be done but in the case of an independent contractor an employer can only say what is to be done but not how it shall be done. But this test also does not apply to all cases, e.g. in the case of ship's master, a chauffeur or a reporter of a newspaper ..... In certain cases it has been laid down that the indicia of a contract of service are (a) the master's power of selection of the servant; (b) the payment of wages or other remunerations; (c) the master's right to control the method of doing the work; and (d) the master's right to suspension or dismissal."

8. Learned advocate for the appellant relies on the decision of Qamar Shaffi Tyabi vs. Commissioner of E. P. T., Hyderabad. That was a case which turned upon the nature of the contract entered into between the industrial trust fund and the assessee which in turn was governed by the agreements between the company and the trustees. Under the latter agreements, the trustees were given general conduct and management of the business and affairs of the mills and were entitled to appoint employees and delegate to other persons all or any of the powers etc. under the agreement subject to the approval of the Board of Directors. By separate agreements made at the same time the trustees were also appointed selling agents of the mills and by two supplemental agreements they were given power to delegate all or any other powers to other persons on such terms and conditions as they may think fit subject to the approval of the Board of Directors of the company. The trustees appointed the assessee under these terms as their delegate. In those circumstances, it was held that the appellant was neither a servant nor a mere sub-agent. He was an agent of the principal for such part of the business of the agency as was entrusted to him inasmuch as the trustees as agents had express authority to name another person to act for the principal in the business of the agency and they named the appellant with the approval of the Board of Directors.

9. A similar view was taken by this Court in Lakshminarain Ram Gopal vs. Government of Hyderabad. Bhagwati, J. speaking for the Court held that the assessee under the managing agency agreement, having regard to certain indicia discernable from that agreement was an agency. At p. 458 the functions of the assessee which were inconsistent with his being a servant were specified. They were :

1. The power to assign the agreement and the rights of the appellant thereunder;
2. The right to continue in employment as the agents of the company for a period of 30 years until the appellants of their own will resign;
3. The remuneration by way of commission of 21/2 per cent of the amount of sale proceeds of the produce of the company; and
4. The power of sub-delegation of cutions given to the agent under Art. 118.

All these circumstances went to establish that the appellants were the agents of, the company and not merely the servants remunerated by wages or salary.

10. In Commissioner of Income-tax, Bombay vs. Armstrong Smith Stone, C.J., and Kania, J. had held that under the terms of an agreement

the Managing Director was a servant of the company. There they had to consider a case whether the articles of association of the company provided that the assessee was to be the Chairman and

Managing Director of the company until he resigned office or died or ceased to hold at least one share in the capital of the company; that all the other Directors were to be under his control and were bound to conform to his directions in regard to the company's business; that his remuneration was to be voted by the company at its annual general meeting and that the sum received by him for managing the company's business which arose from out of the contractual relationship with the company provided by the articles for performing the services of managing the company's business. In these circumstances it was held that the remuneration was taxable under sec. 7 and not under sec. 12 of the Act. It appears that a large number of English cases were cited but these were not referred to. Stone, C.J., observed (at pp. 609-610) :-

"We have been referred to quite a large number of English cases the effect of which, I think, be summarised by saying that a director of a company as such is not a servant of the company and that the fees he receives are by way of gratuity, but that does not prevent director or a managing director from entering into a contractual relationship with the company, so that, quite apart from his office of director he becomes entitled to remuneration as an employee of the company. Further that relationship may be created either by service agreement or by the articles themselves. Now in this case there is no question of any service agreement outside the articles and, therefore, the relationship between the company and the assessee, Mr. Smith, depends upon the articles."

11. In Commissioner of Income Tax vs. Nagi Reddy the Madras High Court was considering the case of a Managing Director of a firm company who was also the Managing Director of another firm company on similar terms and remuneration, namely, that he was to get a monthly remuneration of Rs. 500/- and in addition a commission on net profits. The question there was, whether the remuneration received by him as Managing Director from these two companies was income from business assessable under sec. 10 of the Act. In that case a reference was made to the Bombay decision to Commissioner of Income Tax vs. Armstrong Smith (supra).

12. A detailed consideration of all the cases cited and the passages from text books referred to before us do not assist us in coming to the conclusion that the test for determining whether the person employed by a company is a servant or agent is solely dependent on the extent of supervision and control exercised on him. The real question in this case is one of construction of the articles of association and the relevant agreement which was entered into between the company and the assessee. If the company is itself carrying on the business and the assessee is employed to manage its affairs in terms of its articles and the agreement, he could be dismissed or his employment can be terminated by the company if his work is not satisfactory, it could hardly be said that he is not a servant of the company. Art. 109 of the articles of association before its amendment and relevant for the period which we are considering provided that he shall be the Managing Director of the company for 20 years on terms and conditions embodied in the agreement. Art. 136 states that subject to the aforesaid agreement, the general management of the business of the company shall be in the hands of the Managing Director of the company who shall have power and authority on behalf of the company to do the several things specified wherein which are usually necessary and desirable for the management of the affairs of the company. Art. 137 provides that the receipts signed by the Managing Director or on his behalf for any moneys or goods or property received in the usual course of business of the company shall be effectual discharge on behalf of and against the company for moneys, funds etc. It further provides that the Managing Director shall also have power to sign cheques on behalf of the company. Under Art. 138 he is authorised to sub-delegate all or any of the powers. Art. 138 enjoins that notwithstanding anything contained in those articles the

Managing Director is expressly allowed generally to work for and contract with the company and specifically to do the work of agent to and Manager of and also to do any other work for the company upon such terms and conditions and on such remuneration as may from time to time be agreed upon between him and the Directors of the Company. Art. 140 specifies powers in addition to the powers conferred on him as the Managing Director. Under Art. 141 the Managing Director shall have charge and custody of all the property, books of account, papers, documents and effects belonging to the said company wheresoever situate. Art. 142 provides that the Managing Director shall work for the executions of the decisions that may be arrived at by the Board from time to time and shall be empowered to do all that may be necessary in the execution of the decisions of the management of the company and shall do all things usual, necessary or desirable in the management of the affairs of the company or carrying out its objects. Cl. (k) of the agreement dated 29-11-1955 stipulates :-

"That the said Ram Pershad shall be at liberty to resign the said office upon giving three months notice to the company of his desire to do so. If the said Managing Director is found to be acting otherwise than in the interest of the company or is found to be not diligent to his duties as a Managing Director, the company, in General Meeting may terminate his services before the expiry of the said period of 20 years."

The other terms of the agreement enumerate the powers and duties given to him under the articles of association.

13. A perusal of the articles and terms and conditions of the agreement definitely indicates that the assessee was appointed to manage the business of the company in terms of the articles of association and within the powers prescribed therein. Reference may particularly be made to Arts. 139 and 142 to ascertain the nature of the control imposed by the company upon the Managing Director. Under the former the additional work which he can do as an agent or manager of the company can be done on terms and conditions and on such remuneration as can be agreed upon between him and the Directors of the Company and under the latter he had to execute the decisions that may be arrived at by the Board from time to time. The very fact that apart from his being a Managing Director he is given the liberty to work for the company as an agent is indicative of his employment as a Managing Director not being that of an agent. Several of the clauses of Art. 140 as pointed out by the High Court specifically empower the Board of Directors to exercise control over the Managing Director, such, for instance to accept the title of the property to be sold by the company, providing for the welfare of the employees, the power to appoint attorneys as the Directors think fit etc. As pointed out earlier under the terms of the agreement he can be removed within the period of 20 years for not discharging the work diligently or if he is found not to be acting in the interest of the company as Managing Director. These terms are inconsistent with the plea that he is an agent of the company and not a servant. The control which the company exercises over the assessee need not necessarily be one which tells him what to do from day to day. That would be a too narrow view of the test to determine the character of the employment. Nor does supervision imply that it should be a continuous exercise of the power to oversee or superintend the work to be done. The control and supervision is exercised and the exercisable in terms of the articles of association by the Board of Directors and the company in its general meeting. As a Managing Director he functions also as a member of the Board of Directors whose collective decisions he has to carry out in terms of the articles of association and he can do nothing which he is not permitted to do. Under S. 17(2) of the Indian Companies Act 1913 Regulation No. 71 of Table A which enjoins that the business of the company shall be managed by the Directors is deemed to be contained in the articles of association

of the company in identical terms or to the same effect. Since the Board of Directors are to manage the business of the Company they have every right to control and supervise the assessee's work whenever they deem it necessary. Every power which is given to the Managing Director therefore emanates from the articles of association which prescribes the limits of the exercise of that power. The powers of the assessee have to be exercised within the terms and limitations prescribed thereunder and subject to the control and supervision of the Directors which in our view is indicative of his being employed as a servant of the company.

14. We would therefore hold that the remuneration payable to him is salary. In this view, the other questions need not be considered, and the appeal is dismissed with costs.

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