

Commissioner of Income Tax, Delhi (Central-I)

Vs

Continental Construction Ltd.

Civil Appeals Nos. 3311-13 of 1993

(Sujata V. Manohar, S. M. Quadri JJ)

03.02.1998

JUDGMENT

SMT. SUJATA V. MANOHAR, J. –

1. 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 40-A(5)(b) of the Income Tax Act, the remuneration paid to the Directors in respect of their employment outside India has to be excluded from the limit of Rs. 72,000 laid down in the first proviso to Section 40-A(5)(a) as well as Section 40(c) of the Income Tax Act, 1961 ?"

Facts :

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

3. For the Assessment Year 1983-84, the assessee had paid a sum of Rs. 14,00,74,570 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 40-A(5)(a) of the Income Tax Act, 1961. The respondent did not dispute the disallowance of Rs. 7,61,05,230 payable to the two India-based Directors subject to the allowance of Rs. 72,000 each as laid down in Sections 40(c) and 40-A(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 40-A(5) or Section 40(c).

4. 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 the 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 Sections 40(c) and 40-A(5)(a). The department preferred an appeal before the Tribunal from the order of the Commissioner of Income

Tax. The Tribunal dismissed the appeal.

5. 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.

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

"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-clause (i) shall, in no case, exceed -

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

(B) where such expenditure 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 40-A shall not be taken into account for the purposes of sub-clause (A) or sub-clause (B), as the case may be;"

7. Section 40(c), therefore, deals with the remuneration, benefit or amenity to a Director of a company (and other persons described therein) 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 amount is to be calculated at the rate of Rs. 6000 per month. Under the proviso set out above, certain expenditure is to be excluded while calculating the ceiling limit under Section 40(c). The excluded expenditure is of the

kind referred to in clauses (i), (ii), (iii) and (iv) of the second proviso to Section 40-A(5)(a). Section 40-A(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 40-A(5). The relevant provisions of Section 40-A(5) are as follows :

"40-A. (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,

then, 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 clause (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 in 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 sub-clause (i) or the expenditure or allowance 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 of any travel concession or assistance referred to in clause (5) of Section 10;

(ii) passage moneys or the value of any free or concessional passage referred to in sub-clause (i) of clause (6) of Section 10;

(iii) any payment referred to in clause (iv) or clause (v) of sub-section (1) of Section 36;

(iv) any expenditure referred to in clause (ix) of 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."

8. The permissible limit of deduction for expenditure falling under sub-clauses (i) and (ii) of Section 40-A(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. 5000 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. 1000 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 clause (a)(i) is Rs. 60,000 and clause (a)(ii) is Rs. 12,000. However, in the case of an employee or a former employee who is also a Director of the company, the proviso to Section 40-A(5)(a) provides that the ceiling for deduction is an overall ceiling of Rs. 72,000 in respect of a sum total of expenditure, i.e., the expenditure and allowances referred to in Section 40-A(5)(a)(i) and (ii) which cover expenditure on an employee, plus expenditure and allowances referred to in Section 40(c)(i) and (ii) which relate, inter alia, to a Director.

9. In the case of an employee, however, Section 40-A(5)(b) provides that while calculating the expenditure or allowance in relation to an employee under Section 40-A(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 40-A(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 40-A(5)(b) cannot be excluded from expenditure while calculating the ceiling limit under Section 40(c) or Section 40-A(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.

10. The question of interpreting the provisions of Sections 40(c) and 40-A(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 *Continental Construction Ltd. v. CIT* ((1990) 185 ITR 178 (Del)), 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. 5000 per month for any period of

employment after 28th 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 40-A(5).

11. The two Sections 40(c) and 40-A(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 40-A(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 40-A(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.

12. There have been a number of cases in the various High Courts as well as this 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 40-A(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 CIT v. Indian Engineering and Commercial, Corpn. (P) Ltd. ((1993) 3 SCC 246 : (1993) 201 ITR 723). This Court has held (SCC p. 251 : ITR p. 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 of CIT v. D. B. R. Mills ((1988) 172 ITR 366 (AP)) and by the Bombay High Court in the case of CIT v. Hico Products (P) Ltd. (No. 1) ((1993) 201 ITR 567 (Bom)) where the Bombay High Court emphasised the first proviso to Section 40-A(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 40-A(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 ceilings prescribed of Rs. 60,000 and Rs. 12,000 under Section 40-A(5)(c) will not apply. The contrary view taken by the Kerala High Court in Travancore Rayons Ltd. v. CIT ((1986) 162 ITR 732 (Ker)) is, therefore, no longer good law.

13. 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 CIT v. Indian Engineering and Commercial Corpn. ((1993) 3 SCC 246 : (1993) 201 ITR 723) the Gujarat High Court has now, in the case of CIT v. Synpol Products (P) Ltd. ((1996) 217 ITR 154 (Guj)) 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.

14. We have now to consider in this light whether the provisions of Section 40-A(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 40-A(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 India will not be taken into account for the purposes of calculating the ceiling. This expenditure is outside the expenditure which is subject to a ceiling limit. Under Section 40-A(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 40-A(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 40-A(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 (presumably 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 are 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 40-A(5)(b) will not apply to employee-Directors when this Court, in the case of employee-Directors has held, both Sections 40(c) and 40-A(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 40-A(5)(b) which is excluded from the expenditure on which a ceiling is placed under Section 40-A(5)(a), will have to be excluded in the case of an employee-Director also. Under the proviso to Section 40-A(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 40-A(5)(a) as well as under Section 40(c). For calculating the expenditure and allowances under Section 40-A(5)(a), one has to exclude the expenditure and allowances referred to in Section 40-A(5)(b). Therefore, in the case of a Director-employee also while calculating the expenditure and allowances spent on a Director-employee under Section 40-A(5)(a) and Section 40(c), expenditure of the kind referred to in Section 40-A(5)(b) has to be necessarily excluded.

15. A similar view has been taken by the Madras High Court in the case of CIT v. Lucas TVS Ltd. ((1997) 226 ITR 281 (Mad)). 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 40-A(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 40-A(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 40-A(5)(a). The Madras High Court has rightly observed (p. 291) that there is nothing to

suggest that the remuneration which is excluded from the scope of consideration in Section 40-A(5)(a) of the Act by virtue of Section 40-A(5)(b) of the Act, should be taken into consideration for the purpose of Section 40(c) of the Act. Both Sections 40(c) and 40-A(5) have to be read together in determining the ceiling prescribed under Section 40-A(5) of the Act which includes ceiling prescribed for Director-employees. Also if certain items go out of reckoning in Section 40-A(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 Sections 40(c) and 40-A(5)(a) proviso.

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

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