BOMBAY HIGH COURT

The Commission of Income Tax

Vs.

S.P. Jain

Income Tax Reference No. 76 of 1961

(Tambe and V.S. Deasai, JJ.)

08.02.1965

JUDGMENT

Y.S. Tambe, J.

1. In pursuance of the order made by the Supreme Court in Civil Appeals Nos. 457 and 458 of 1960, dated 4th May, 1961, the Income-tax Appellate Tribunal has stated this case, referring to us the following question of law :-

> "Whether on the facts and circumstances of the case, the sum of ₹ 7 lakhs is liable to tax under section 7 of the Indian Income-tax Act ?"

2. The assessee before us is an individual. We are here concerned with the assessment year 1950-51, the corresponding accounting period being the year ended on 31st March, 1950. The assessee was an employee of Dalami Cement and Paper Marketing Co. Ltd. (hereinafter referred to as the company). The assessee joined the service on 1st April, 1943, and the terms and conditions of his appointment have later been incorporated in a letter of 11th October, 1953 (annexure "A" to the statement of the case). We would be adverting to this letter later. Suffice it to state at this stage that the assessee was to look after the Bombay office organization of the company and was to get therefor a fixed amount of ₹ 4,000 per month. The company had also further agreed to pay to the assessee income-tax and super-tax due and payable on the said amount of remuneration per month, according to the rate prescribed in the yearly Finance Acts. The assessee was also further entitled to get from the company conveyance and entertainment allowances as agreed between them from time to time. The period of employment was for a definite period of 25 years commencing from 1st April, 1943, the company reserving its right to depute the assessee to look after the interest of any other of its concern. It was further provided in the letter that in the event of his services being terminated before the expiry of the period of 25 years, the assessee would

be entitled to compensation calculated as equivalent to ₹ 40,000 for each unexpired year of the duration of the assessee's employment. It is principally this clause relating to compensation that has to be considered in this case in recording our answer to the question referred to us.

3. The assessee worked as an employee of the company till the end of November 1949. As recorded in the letter of 14th February, 1950 (annexure "B" to the statement of the case) written by the company to the assessee, the assessee's employment ceased from 30th November 1949, on its unilateral termination by the company. The latter further provided :

> "As we have unilaterally terminated your employment and as a consequence of which you have claimed compensation for the termination of the office, the quantum of compensation has been considered and it was mutually agreed that a fixed sum of ₹ 7 lakhs will be paid to you as compensation for the cessation of your employment".

4. The letter further informed the assessee that a duplicate copy of the letter was sent to him and on his returning the duplicate copy duly signed he would be paid the said sum of ₹ 7 lakhs. In due course, the said amount of ₹ 7 lakhs was paid by the company to the assessee.

5. The Income-tax officer sought to bring this amount to tax under section 7(1) of the Act. On the other hand, the assessee claimed that the said amount of ₹ 7 lakhs was received by him as compensation for loss of his employment and was, therefore, not liable to tax. For certain reasons given by him in his order, the Income-tax Officer held that the said amount of ₹ 7 lakhs was paid by the company to the assessee for the past meritorious services of the assessee. This is what he has observed in paragraph 7 of his order :

> ~~"It cannot, therefore, be said that the amount of ₹~~ 7 lakhs is compensation for loss of employment. I am of the opinion that in view of the past meritorious services of the assessee the employer has suitably rewarded the assessee by a further payment of ₹ 7 lakhs. It is clear from the foregoing paragraph that ₹ 7 lakhs is remuneration paid by the employer for the past services rendered by the assessee and I therefore assess the same as such".

6. The assessee appealed against this order to the Appellate Assistant Commissioner. The Appellate Assistant Commissioner held that the said sum of ₹ 7 lakhs was received by the assessee as substitution of the source of income and not as substitution of the income, and, therefore, the said sum was received by the assessee solely as compensation for the loss of

employment. It therefore did not attract tax. In this view of the matter, the Appellate Assistant Commissioner allowed the appeal on this point and excluded the said sum of ₹ 7 lakhs from assessment.

7. The department appealed to the Tribunal against this order of the Appellate Assistant Commissioner. It appears from the separate orders written by the Accountant Member and the Judicial Member of the Tribunal that two contentions were raised before the Tribunal on behalf of the department. The first contention was that the letter written by the company to the assessee on 11th October, 1943, incorporating the basis of employment was not a genuine letter. This contention was overruled. The other contention raised was that the said amount was paid by the company to the assessee as payment for the past services rendered by the assessee. The Accountant Member of the Tribunal held that on the evidence on record the said amount of ₹ 7 lakhs paid to the assessee was not a payment made to him for the past services rendered by him. The nature of receipt in the hands of the assessee was capital, and, therefore, not assessable. The Judicial Member also held that the said amount of ₹ 7 lakhs was not paid to the assessee as remuneration for the past services rendered by him. He further held that the said sum did not attract tax. In this view of the matter, the appeal was dismissed.

8. The application of the department under section 66(1) was rejected by the Tribunal. Similarly, the application made to this court by the department under section 66(2) was rejected. On obtaining special leave from the Supreme Court, the Commissioner appealed to the Supreme Court, and the Supreme Court has given the aforesaid direction. In the opinion of this Lordships, the true nature of payment of the said sum of ₹ 7 lakhs received by the assessee fell to be determined on the legal effect of the terms of the agreement of employment, the letter terminating the employment, and the agreement under which ₹ 7 lakhs were paid by the company to the assessee.

9. The question to be considered is whether the said sum of ₹ 7 lakhs is liable to tax under section 7 of the Act. The geniuses of the aforesaid two letters of 11th October, 1943, and 14th February 1950, is not challenged before us. Similarly, it is not contended before us that the payment of the said sum of ₹ 7 lakhs was a remuneration for the past services rendered by the assessee to the company. On the other hand, it is the contention of the revenue before us that, on a true construction of these two documents, the payment of the said sum of ₹ 7 lakhs is "profits in lieu of salary paid by the company (a private employer) to the assessee" within the meaning of sub-section (1) of section 7 read together with Explanation 2 thereof as it stood at the material time. Section 7 relates to income that falls under the head "Salary". We are here concerned with the provisions of section 7 prior to its amendment by the Finance Act, 1955, which came into effect

from 1st April, 1955. The relevant part of the said sub-section (1) of section 7 and Explanation 2 read :

> "7. (1) The tax shall be payable by an assessee under the head "Salaries" in respect of.... profits in lieu of, or in addition, to any salary or wages, which are due to him from whether paid or not, or are paid by... any private employer...
> Explanation 2. - A payment due to or received by an assessee from an employer or former employer... is... a profit received in lieu of salary for the purpose of this sub-section, unless the payment is made solely as compensation for loss of employment..."

10. The Explanation gives an artificial definition of "profits received in lieu of salary" by including any payment due to or received by an assessee from an employer or former employer. However, payment which is made solely as compensation for loss of employment is excluded even in the extended definition of the expression from "profits in lieu of salary". There can be hardly be any doubt that the said amount of ₹ 7 lakhs is a payment received by the assessee from his employer. The real question, therefore, that has to be considered is whether the said payment has been made solely as compensation for loss of employment.

11. Mr. Joshi, learned counsel for the revenue, contends that on a true construction of the aforesaid two documents, the compensation paid is not solely as compensation for the loss of employment. On the other hand, the payment is a profit arising out of employment. He has referred us to the decisions reported in Dale *(H. M. Inspector of Taxes) v. De Soissons*[1], *Henry (H. M. Inspector of Taxes) v. Arthur Foster*[2], *Henry v. seph Foster*[3], *S.C. Hunter v. Dewhurst*[4], *V. D. Talwar v. Commissioner of Income-tax, Bihar*[5] *S.C.* and certain observations at page 273 in *Kettlewell Bullen and Co. Ltd. v. Commissioner of Income-tax*[6],

12. Mr. Palkhivala, learned counsel for the assessee, on the other hand, contends that on a true construction of the said two documents, the payment made is solely as compensation for the loss of employment, and, therefore, the said amount is not liable to tax. He placed reliance on *R.N. Agrawala v. Commissioner of Income-tax*[7], and *Barr, Crombie & Co. Ltd. v. Commissioner of Inland Revenue*[8],

13. The expression "compensation for loss of employment" has not been defined in the Act. In *Henry v. Foster*, Lord Justice Romer has defined the expression "compensation for loss of office" in the following words (page 634) :

> "Compensation for loss of office' is a well-known term, and, as I understand it, is means a payment to the holder of an office as compensation for being deprived of profits to which as between himself and his employer he would, but for an act of deprivation by his employer or some third party such as the legislature, have been entitled."

14. After referring to the said definition of the expression, "compensation for loss of office", Chief Justice Chagla in *W.A. Guff v. Commissioner of Income-tax*[9], at page 833 observed :

> "We are, therefore, of the opinion that the expression 'compensation for loss of employment' used in Explanation 2 to section 7 refers to any payment made, whether under a legal liability or voluntarily, to compensate or act as a solatium for the loss of employment suffered by the employee."

15. The aforesaid observations of Lord Justice Romer and Chief Justice Chagla have been cited with approval by their Lordships of the Supreme Court in *Commissioner of Income-tax v. E. D. Sheppard*[10], at pages 246 and 248.

16. Keeping these principles in mind, the facts of the case will have to be approached.

[1]1950 32 T.C. 118
[2](1932) 16. T.C. 605
[3](1963) 49 I.T.R, 261
[4](1932)16 T.C. 605
[5](1963)49 I.T.R. 122
[6](1964)53 I.T.R. 261, S.C
[7](1950)38 I.T.R. 67
[8](1947)15 I.t.R. (Suppl.)56
[9](1957)31 I.T.R. 826, s.c. 59 Bom. L.R. 436
[10](1962)48 I.T.R. 237, S.C. at pages 246 and 248

And this brings us to the two documents, on the construction of which the answer to the question turns. The letter of 11th October, 1943, is written by the company to the assessee, and consists of four paragraphs, the company confirms that the assessee will look after its (company's) Bombay office organisation, m and for which the assessee will be paid a fixed amount of ₹ 4,000 per month plus income-tax and super-tax due and payable on this amount of remuneration according to the rate prescribed in the yearly Finance Acts. It further provides that conveyance and entertainment allowances will be allowed to the assessee as may be agreed upon from time to time. The second paragraph provides that the term of employment will be for a definite period of 25 years commencing from 1st April, 1943. In the second paragraph, the company reserved its right to depute the assessee to look after the interest of any other concern and arrange for the assessee's remuneration being paid either by that other concern or by itself. The third paragraph reads :

> "You have requested that it should be made clear that should your services be terminated before the expiry of 25 years, then a definite compensation for loss of office the breach of agreement should be provided. In confirming that on the occurrence of any such contingency of our severing connections with each other or terminating the office of employment due to any reason whatsoever, it is hereby stipulated that you will be entitled to a compensation and the same shall be calculated as equivalent to ₹ 40,000 for each unexpired year of the duration of your employment."

17. In the last paragraph, a request has been made to the assessee to sign the duplicate of the letter and send it to the company for its office record.

18. The letter of 14th February, 1950, is written by the company to the assessee, and is signed by its secretary. It is in the following terms :

"Dear Sir,

We hereby now confirm that your employment with the company in Bombay office (in terms of the contract of employment with you from 1st April 1943, and confirmed in our letter dated 11th October, 1943) has ceased from 30th November, 1949.

As we have unliterally terminated your employment and as a consequence of which you have claimed compensation for the termination of the office the quantum of compensation has been considered and it was mutually agreed that a fixed sum of ₹ 7 lakhs will be paid to you as compensation for the cessation of your employment.

This letter is being sent to you in duplicate and we would thank you to please return the duplicate duly signed by you for our record. On receipt of the same we shall advise our Bombay office to give you a cheque for ₹ 7 lakhs."

19. The argument of Mr. Joshi is that the true construction of these two documents, it would be apparent that the assessee was well aware that his services were likely to be terminated by the employer. He envisaged the happening of such an event. He gave a right to his employer-company to terminate his services, stipulating that in that event he would receive payment at the rate of ₹ 40,000 per year for the entire unexpired term of the contract. This part of the bargain between the parties has been provided for in the third paragraph of the letter dated 11th October, 1943. The said paragraph provides that for whatever reason the services would be terminated, the employer was liable to make payment to him at a certain rate. The assessee may be even guilty of misconduct and yet he would be entitled period or whether his services were terminated before the expiry of the period. It was provided that he would be paid for the entire period. He was surrendering no rights. The happening of the event envisaged at the time of the formation of the contract took place at the end of November, 1949. On the happening of the event, the payment of ₹ 7 lakhs has been made in terms of the contract of employment provided in the third paragraph of the letter of 11th October, 1943. The termination of the employment of the assessee on 30th November 1949, did not put an end to the contract. A part of the contract subsisted, namely, paragraph 3 of the letter of 11th October, 1943. Payment being in accordance with the terms of the contract of employment is "profits in lieu of salary received by the assessee for the unexpired period". It is not compensation for loss of employment. Mr. Joshi laying emphasis on the bracketed portion in the first paragraph of the letter of 14th February, 1950, further argued that this letter shows that the payment has been made in accordance with the terms of the contract of employment. We find difficult to accept the construction which Mr, Joshi wants to put on the said two letters. It is true that the mere use of the expression, that the payment is "compensation for loss of office" or "loss of employment" by the parties concerned, is not determinative of the real nature of payment. The court has to ascertain, on the evidence tendered before it, as to what in substance is the real bargain between the parties. If the evidence discloses that the payment agreed to be made, though mentioned as "compensation for loss of office" or "loss of

employment", is in substance a payment for the services rendered in the past, or is a payment made in lump sum for services to be rendered in the further, or is a payment made in accordance with the obligation undertaken by the employer under the contract of employment, then, it would none the less be a profit arising from the employment, and not payment by way of compensation for loss of office or loss of employment. On the other hand, if on the evidence entered in the case, the court comes to a conclusion that payment agreed to be made was by way of a solatium for deprivation of employment of the employee, then it would be a compensation for loss of employment within the meaning of the second Explanation of section 7(1).

20. There is no evidence on record in this case other than the two documents throwing any light on what the bargain between the parties was. The genuineness of the letter of 11th October, 1943, was at one time challenged. The letter has been found both by the Appellate Assistant Commissioner as well as by the Tribunal to be a genuine one, and al already stated, it has not been contended before us that the said letter is not a genuine one. The said letter, therefore, is the only evidence as to the bargain between the parties. Reading the letter as a whole, we are unable to accept Mr. Joshi's argument that in the said letter a right has been given to the company to terminate the services of the assessee on making payment stipulated in paragraph 3 thereof. The term of employment has been stated to be "for a definite period of 25 years" commencing from 1st April, 1943. Under the agreement, the right which has been reserved to the company is only a right to depute the assessee to look after the interest of any other concern and arrange for the assessee's remuneration being paid either by that other concern or by the company itself. No other right has been reserved to the company. The contents of paragraph 3 further show that if his services were terminate prior to the expiration of 25 years, it would be a breach of the agreement. He requested that a provision be made for the measure of compensation if such an event in breach of the agreement occurs. The first part of paragraph 3 days that the assessee had requested that "it should be made clear that should his services be terminate before the expiry of 25 years, then, a definite compensation for loss of office and breach of agreement should be provided". The assessee, therefore, has characterised the termination of his services prior to expiration of the period of 25 years as breach of the agreement and loss of his office. The aforesaid claim of the assessee has been accepted in the latter part of the letter of the company. In the latter part, the company says that on the happening of any such contingency, the assessee would be entitled to claim compensation at the rate stated in the said letter. Now, the termination of the services prior to the expiry of 25 years has been characterised by the parties as breach of the agreement and loss of office, and in the letter part of the letter, a definite measure of compensation calculated as equivalent to ₹ 40,000 for each unexpired year of the duration has been agreed to. This being the evidence, and the only evidence in the case, in our opinion, the bargain between the parties was that payment of ₹ 7 lakhs was a compensation for loss of employment or office and was not a profit in lieu of salary within the meaning of the second Explanation to section 7(1). The clause "due to any reason whatsoever" has to be read in the context of what precedes it, and when so read, it becomes clear that the assessee has not stipulated that he should be paid even if he had

been dismissed for misconduct or negligence. What the assessee had demanded was that if his services were terminated prior to the expiry of the period in breach of the agreement, then he should be compensated. Terminating the service of the assessee for misconduct or negligence, etc., would not be termination of the contract in breach of the agreement. We are also unable to accept the argument of Mr. Joshi that, though the services of the assessee were terminated on 30th November, 1949, the contract of employment subsisted, or that paragraph 3 afforded a cause of action to the assessee and he could have enforced in the court of law rights acquired by him under paragraph 3 of the letter. In our opinion, what is provided in paragraph 3 is a measure of damages. Section 74 of the Contact Act makes it clear that, even though the parties agree for the quantum of damages in the event of breach of an agreement, the parties would not necessarily be entitled to get the entire amount as stipulated between the parties. On the other hand, what the person complaining of the breach of the contract would receive is a reasonable amount not exceeding the among stipulated for. After the termination of the contract on 30th November, 1949, the cause of action on which the assessee could have sued was the termination of his services in breach of the contract and not in enforcement of the alleged so-called agreement in paragraph 3 of the letter. The decisions on which Mr. Joshi has placed reliance are distinguishable on facts.

21. Facts in *Henry v. Foster* were : Arthur Foster and Joseph Foster and Col. Dewhurst were directors of a limited company. Article 109 of the company's articles provided that in the event of any director, who has held office for not less than five years, dying or resigning or ceasing to hold office for any cause other than misconduct, bankruptcy, lunacy or incompetence, the company should pay to him or his representative by way of compensation for loss of office a sum equal to the total remuneration received by him in the preceding five years. All the three directors had held office for not less than five years. Arthur Foster and Joseph resigned the office as directors and received from the company as "compensation" a payment calculated in accordance with article 109. It is not necessary to state the facts in Dewhurst's case, as no reliance is placed on Dewhurst's case. The Court of Appeal held that the said payment under article 109 constituted profit of office of the director and was properly assessable to income-tax under Schedule E for the last year of office. Lord Hanworth M. R., after examining article 104, which related to the remuneration paid to the contractor, and the provisions of article 109, at page 629 of the report, observed :

> "Now it is argued that those sums which became payable under the terms recorded in article 109 were compensation for the loss of office. Is that the substance of the matter ? When a man has died he is not compensated for the loss of his office; if he resigns voluntarily, why should he be paid compensation for the loss of his office ? It would seem as if those words were put in view of the possibility thereunder of escaping the charge to tax; but, as I have said, we have got to look at the substance of the matter, and the substance of this payment is this : It is contemplated as a part of the remuneration of the director payable to him, and estimated according to his service during a certain time, and

in addition to the amount paid to him under clause 104, there shall be estimated a sum which is to fall to be paid to him under clause 109. That seems to me to be by way of deferred remuneration and to enter to his benefit at a time when it may by very convenient to him to find himself entitled to a lump sum. In the case of his death, it cannot be said that it is by way of compensation for loss of his office that this sum falls to his executors. It surely must be this, and the only way to construe article 109 is this, that it is a sum which has been saved up by him so as to fall to his executors in the form of a deferred payment. So, in the case of his resigning it may be convenient to him to find that he has stored a sum which will then become payable to him."

22. It would be seen that on the construction of article 109, it has been found that the substance of the matter was that the payment was a deferred payment of remuneration for the services already rendered. Lord Justice Lawrence also took a similar view. At page 632 of the report, he observed :

"In my judgment, the determining factor in the present case is that the payment to the respondent, whatever the parties may have chosen to call it, was a payment which the company had contracted to make to him as part of his remuneration for his services as a director. It is true that payment of this part of his remuneration was deferred until his death or retirement or cesser of office, and that in the articles it is called 'compensation for loss of office.' It is however, a sum agreed to be paid in consideration of the respondent accepting and serving in the office of director, and consequently is a sum paid by way of remuneration of his services as director."

23. Similar also is the view of Lord Romer on the construction of article 109. At page 633 of the report, the observes :

"Now supposing that a director is employed upon the terms that he is to be paid in each year of his service a sum of Pounds 1,000, and in the last year of his service a sum of Pounds 5,000 in addition to the Pounds 1,000 no one I think could doubt in such a case that the Pounds 5,000 was a profit of his office, paid to him in respect of his office, that it was liable to income tax, and was to be treated for the purposes of tax as forming part of his salary for the last year of his office.

The case before us is precisely that case, with two exceptions : Firstly, that the sum is not fixed but has to be ascertained by reference to events which will not be determined until the last year of office - that can make no difference at all and, secondly, that article 109 expresses that the sum to be paid in the last year of office is to be compensation for loss of office. Now, do those words make any difference ? In my opinion they do not."

24. It would be seen that the view taken by all the learned judges on the construction of article 109 was that it was a deferred payment in respect of the services already rendered. Such,

however, is not the case here. The case put forward by the revenue that the payment of the said sum of ₹ 7 lakhs was remuneration in respect of his past services has been negatived by the income-tax authorities as well as the Tribunal, and has not been pressed before us.

25. Facts in Dale (H.M. Inspector of Taxes) v. De Soissons, in brief, were : Col. Soissons, respondent to the appeal, was employed as an assistant to the managing director of a company. His remuneration consisted of a fixed salary of Pounds 3,000 per annum, and a commission at a certain percentage calculated on profits. Col. Soissons had been employed in service in the year 1929, and since then the continued to be in service till 31st December, 1945. His service agreement was being renewed from time to time periodically. The last agreement was of date 5th July, 1945. Under this agreement, Col. Soisson's services were continued from 1st January, 1945, for a period of three years. Clauses 5 of the said agreement provided that :

> "If in the opinion of the board of directors of the company it is desirable for the better or more economical working of the company and conductive to the interests of the company so do the company shall be entitled to terminate Mr. De Soissons appointment hereunder as assistant to the managing director on 31st December, 1945, or 31st December, 1946, on giving to him three months previous notice writing, and on such termination of the said appointment becoming effective, Mr. De Soissons appointment hereunder shall be forthwith terminated there shall be paid to Mr. De Soissons by way of compensation for loss of office the amounts following :
> If the agreement is terminated Amount payable on the 31st day of December 1945 Pounds 10,000 1946 Pounds 6,000."

26. The company terminated the agreement on 31st December, 1945 and paid an amount of Pounds 10,000 to Col. Soissons. The question was whether the payment of the said amount was compensation for loss of office and, therefore, not liable to tax, or was in respect of the salaries fixed, wages, perquisites or profits arising from the employment and therefore liable to tax under Schedule E to the English Income Tax Act. Mr. Joshi laid great emphasis on the concluding observations of Sir Raymond Evershed in his judgment. They are :

> "I am satisfied to accept the last few words of Roxburgh J.'s judgment as giving expression entirely to my own conclusion, In the present case the Colonel surrendered to rights. He got exactly what he was entitled to get under his contract of employment. Accordingly the payment, in my judgment, falls within the taxable class'."

27. Laying emphasis on these observations he argues that this exactly is the case here. Payment as contemplated in the agreement contained in the letter of 11th October, 1943, has been made to the assessee for each unexpired year of the duration of his employment. He has surrendered nothing. He got everything that he had bargained for, and which he was entitled to get under the agreement. The amount, therefore, cannot be compensation for loss of employment. We have

already stated that what has been provided in paragraph 3 is the measure of damages in the event of cessation of employment and is not payment arising from or on account of employment. It is, therefore, not payment which could be said to be one which the assessee is entitled to get under his contract of employment. The observations of Sir Raymond on which reliance has been placed by Mr. Joshi have to be read and understood in the context of the finding of the learned judge after considering the evidence on record relating to the surrounding circumstances under which the contract had been made and the aforesaid term incorporated in the agreement. This is what the learned judge says at page 128 :

> "The case sets out the evidence, which indicates that the arrangement in fact come to and incorporation in the agreement to which I have alluded was a compromise, one side desiring a longer and securer term and the other, or at any rate some members of the board, that is, the employers, preferring an annual contract of services. I think that evidence is clearly consistent with and reflected by the terms of the agreement itself. As I have indicated, the effect of it was that Colonel De Soissons engaged himself, if called upon, to serve for three years at a remuneration which was specified, but right was given to the company to make his term a shorter one. In that event, as it seems to me, the remuneration for the services took the form in part of a remuneration plus a commission for the period he in fact served plus a further sum which he was contractually entitled to get under the terms of his agreement and as part of the bargain which he made."

28. It would be seen that for the proper understanding of the clause contained in the agreement, evidence of surrounding circumstances was led, and the evidence established that Colonel Soissons wanted a contract for long-term service while the directors desired that the contract for service should be for a shorter term for the duration of a year. In these circumstances, though the contract of service was made for a period of three years, a right was given to the employer to terminate the contract of service on making an additional payment of remuneration depending on the date on which the contract was terminated. In the instant case, there is no such evidence, nor does the letter of 11th October, 1943, say that any right was given to the company or was reserved to it to terminate the services of the assessee at the company's free will at a time before the expiry of the period of 25 years. On the other hand, the contract expressly provides that the term of employment will be for a definite period of 25 years, commencing from 1st April, 1943.

29. Facts in *V.D. Talwar v. Commissioner of Income-tax* were : Mr. Talwar was employed as the general manager of a company under the service agreement which provided, inter alia, that the period of service was 5 years, and that the company might terminate the services by giving 12 months notice, or paying any salary in lieu thereof, or in the case of any breach of the terms or conditions of service without any notice. Mr. Talwar had joined the service on 1st May, 1946. His services were terminated with effect from August 31, 1947, without notice, not for any default or misconduct on his part, but because the company did not want to continue the assessee in their employment. In lieu of the notice, the company paid 12 months salary and paid ₹ 18,096, which

was the amount arrive at after deducting from 12 months salary of ₹ 25,200 income-tax of ₹ 7,104. The question which fell for consideration was whether the said sum of ₹ 25,200 was taxable in the hands of the assessee. It was held that the service agreement provided that the assessee could serve either for five years at a monthly salary mentioned therein or, if the company so elected, for a shorter period upon the terms mentioned in the agreement. As the assessee's services were terminated in compliance with the terms of the agreement and salary in lieu of notice was paid to him, it could not be said that the assessee had surrendered any rights under the agreement or had been deprived of any such rights. He received exactly what he was entitled to under the contract and the amount revised by him was not compensation for loss of office, within the meaning of Explanation 2 to section 7 of the Act before its amendment in 1955. Again, it would be seen that the contract itself gave an option to the employer to terminate the services of the employee before the expiry of the term of the contract. In our opinion, such is not the case here.

30. Mr. Joshi then referred us to another decision in *Henley v. Murray (H. M. Inspector of taxes*[11]*),* which according to Mr. Joshi fell on the other side of the line, and in which the payment made was not taxed as profits arising from employment. Now, the facts in that case were : Mr. Henley was a director and the managing director of a private company. Under the service agreement, he was entitled as managing director to a fixed salary and commission and as a director he was entitled to fees. The service agreement, which was entered into on 17th January, 1938, was to continue until 31st March, 1944, and was thereafter terminable by three months notice in writing by either side. Mr. Henley was also entitled to director's fees as director of a subsidiary of the property company. By an agreement and at the request of the board of directors, Mr. Henley refined from the property company on 6th July, 1943. He was paid thereafter various amounts, but the dispute related only to the payment of Pounds 2,202 14s. 4d., which sum represented the remuneration he would have been entitled to for the period from 7th July, 1943, to 31st March 1944, if his appointment had continued to that date. The contention of Mr. Henley was that the said amount was paid to him as compensation for the surrender of his rights to further remuneration was upheld and it was held that the amount was not taxable. Mr. Joshi referred us to the following observations of Sir Raymond Evershed M. R. at page 362 of the report :

> "It is quite clear I think that bargains of this kind may take at any rate one of two forms. A man who has a contract in respect of which he is entitled to periodic remuneration may say, 'well, I will take now a lump sum instead of the periodic remuneration in the future, and though I will continue to serve under my contract, I shall not be expected to do quite as much work', or he may even say, I shall not be expected to do any work at all. If that were the form of the arrangement in this

[11](1950)31 T.C. 351

> case, I think it would be true to say that the lump sum which was paid was profits which

became payable under his contract, and that it was paid to him by virtue of his office or employment of profit within the meaning of the Schedule."

31. Referring to these observations, he contends that such is the arrangement here. In paragraph 3 of the letter of 11th October, 1943, the assessee, who had a contract in respect of which he was entitled to a periodic remuneration of ₹ 4,000 per month free of tax, has said that he will take a lump sum payment in respect of the periodic remuneration in the future and he shall not be expected to do any work after 30th November, 1949. This proposal of the assessee has been accepted by the company and the payment has been made. This is the payment made to him by virtue of the contract of employment. As we have already stated, such a construction could not be placed on paragraph 3 of the said letter. The passage on which reliance be placed is by way of a ratio deducted from certain cases, which were examples of the type of an arrangement. It is not necessary to refer to all of them, but it would be sufficient to refer to only one decision in *Hofman v. Wadman*[12], to bring out the true import of the observations. Here Hofman was appointed as works manager by a company in May 1940, for a period of five years at an agreed salary. The terms of the agreement were incorporated in a deed on 2nd May, 1940. By mutual consent the appointment was determined in December, 1940, and a certain payment was made. The arrangement under which the payment came to be made was incorporated in a letter, the material part of which was in the following terms :

> "I wish to refer to my conversation with your directors on the third instant and in reply to your letter of the same date... I now confirm that it is agreed : I. That the existing service agreements dated 2nd May, 1940,... and made between each of your directors and Parnall Components Limited,... shall be cancelled forthwith, subject to the continuance of the fixed remuneration provided for in clause 4 of each of the agreements..."

32. In pursuance of this agreement, the company continued to pay a monthly salary at the agreed amount till the end of January, 1941. On the construction of this letter it was held that though Hofman was relieved of his obligation to serve the company, the company was not relieved of its obligation to pay the salary to Mr. Joshi that the original service agreement itself in *Henely v. Murray* did not in terms provide for the quantum of payment to be made on the termination of the services of an employee, while in the other cases, i.e., of Arthur Foster; Joseph Foster, Col. Soissons and V. D. Talwar, the service agreements provided for the amount to be paid at the termination of the services. In the latter three cases payment has been held to be liable to tax. In the former case, i.e., of Henley's case, the amount is held not taxable. According to Mr. Joshi, the principle that follows is that where the initial agreement itself provides for making certain payments in the event of the termination of the services, the payment is under the contract of service and, therefore, taxable; but if such a provision is not made in the service agreement, the payment made under the subsequent agreement on termination of the services is not taxable, it being compensation for the loss of service. In our opinion, such a ratio does not follow from these decisions. The decisions in these cases have not turned on the presence or absence of a

term in the agreement, but, on the other hand, it would be seen from the discussion of these decisions that the decisions have turned on the construction of the true

[12](1946)27 T.C. 192

nature and substance of the arrangement between the parties relating to the payments made at the termination of the contract of employment.

33. In this connection, it would be useful to refer to the decision of this court in *R.N. Agrawala v. Commissioner of Income-tax.* Facts in that case were : Mr. Agrawala was appointed general manager of textile mill company for a period of five years on a certain specified monthly salary with certain perquisites and a commission on the profits. He joined service on 1st April, 1950. The contract further provided that if Mr. Agrawala failed to establish the mills on a sound basis within 12 months of joining the service, the company reserved a right to itself to terminate his services by giving six months notice on 1st April, 1951. The contract further provided that neither party could terminate the contract except on account of continued illness or permanent incapacity and in the event of any one of the parties terminating the contract except for these reasons, the party terminating the contract was liable to pay to the other the balance of the monthly remuneration for the unexpired period of the contract. Now, it may be observed that this contract in express terms provided for the payment of compensation in the event of the termination of the contract of employment in breach of the terms relating to the employment. Mr. Agrawala served a counter notice on the company demanding payment of ₹ 2 lakhs and odd for termination of his employment. As a result of the negotiations a certain sum was paid to Mr. Agrawala in full settlement of his claim for compensation under the agreement. The said arrangement reached had stated that Mr. Agrwala's services would be deemed to have been terminated on 2nd July, 1951. The question arose whether the said amount was compensation for loss of employment and therefore not taxable. This court held that the payment amounted to compensation for loss of employment and was not a payment under the terms of the agreement of employment. Mr. Joshi in the course of his replies argued that this case was distinguishable on facts inasmuch as the original service agreement in express terms provided that "either party cannot terminate the contract except on account of continued illness, etc." No doubt there is difference in the language used in the letter of 11th October, 1943, and the agreement in Agrawala's case. The language used here is : "The term of employment will be for a definite period of 25 years commencing from 1st April, 1943"; but the difference in language, in our opinion does not make any material difference. What is stipulated in both these agreements is that the term of the employment is for a definite period. The letter of 14th February, 1950, states that the employment of the assessee has ceased from 30th November, 1949. The second paragraph of this letter says that the services were terminated unilaterally by the company. The assessee has not consented to the termination of his services. The second paragraph further says that he claimed compensation for the termination of his office, and as a result of negotiations an amount of ₹ 7 lakhs was agreed to be paid by the company to the assessee. The order of the Income-tax Officer shows that though ₹ 7 lakhs are calculated according to the measure of

damages in paragraph 3, the salary would have come to about ₹ 7,36,000. In our opinion, the ratio that may be said to be deduced from these decisions is that if, on a true construction, the court comes to the conclusion that the substance of the agreement is that an option has been reserved for the employer to terminate the services of an employee at a point of time earlier than the stipulated period of the contract on making a certain stipulated payment, e.g., a salary in lieu of 12 months notice as in Talwar's case, then the payment made would be one under the contract of employment by an employer to the employee in exercise of the option given to him by the contract of employment itself, and would, therefore, be profits arising out of employment and would not be compensation for loss of employment within the meaning of Explanation 2 of section 7(1) of the Act. We have already stated that in our opinion there is no such option reserved in favor of the company under paragraph 3 of the letter of 11th October, 1943. On the other hand, what has been provided for is a measure of damages in the event of the termination of the service of the assessee by the company in breach of the service agreement.

34. For the reasons stated, in our opinion, the Tribunal was right holding that the said amount of ₹ 7 lakhs was not liable to tax under section 7 of the Indian Income-tax Act, 1922.

35. In the result, our answer to the question referred to us is in the negative. The Commissioner shall pay the costs of the assessee.

36. Question answered in the negative.
Answer accordingly.