

GANGA SARAN AND SONS PVT. LTD.
CALCUTTA

v.

B INCOME TAX OFFICER & ORS.

April 23, 1981

[P.N. BHAGWATI, AND E.S. VENKATARAMIAH, JJ.]

C *Income Tax Act 1961, S. 147—Income Tax—Escaped assessment—Duty of assessee to disclose fully and truly all material facts necessary for his assessment for that year—Meaning of.*

D *Director in sole charge of management of business of assessee—Paid remuneration for services—Utilisation of the remuneration by director—Assessee whether under obligation to disclose to the Income Tax Officer in the course of its assessment.*

E The assessee was incorporated as a Private Limited Company in March, 1947 with G as its Managing Director and it took over the business of the trading company carried on by 'D' in Delhi. D was the brother-in-law of G and was placed in charge of the management of the business of the Delhi Branch of the assessee and he was paid a salary of Rs. 1000 per month, commission at the rate of 1 per cent on the sales of the Delhi Branch and bonus equivalent to three months salary.

F The assessments of the assessee for the years 1949-50 to 1959-60 were finalised on the basis of the decisions of the Income-Tax Tribunal and the amounts paid to the Managing Director and the other Directors including D by way of salary, commission and bonus were allowed in full as permissible deductions and so was the interest paid on the credit balances in their respective accounts.

G On the 28th March, 1968, the Income Tax Officer issued a notice under Section 148 of the Income Tax Act, 1961 seeking to reopen the assessment of the assessee for the assessment year 1959-60 on the ground that the income of the assessee had escaped assessment at the time of the original assessment. The Income Tax Officer, however, did not state the reasons which had led to the belief that the income of the assessee had escaped assessment by reason of omission or failure to disclose material facts nor did he give any reasons though requested by the assessee.

H The assessee's writ petition challenging the validity of the notice was allowed by a Single Judge and the notice issued by the Income Tax Officer was quashed. It was held that there was no omission or failure on the part of the

assessee to disclose material facts relating to his assessment and that there was no reason to believe that any part of the income of the assessee had escaped assessment at the time of the original assessment by reason of wrong allowance of the remuneration paid to D as a permissible deduction.

The Division Bench allowed the appeal, holding that the Income Tax Officer had reason to believe that the remuneration paid to D had been wrongly allowed as a permissible deduction by reason of omission or failure on the part of the assessee to disclose the material facts and the notice issued by the Income Tax Officer was justified.

Allowing the appeal to this Court,

HELD : 1. (i) Neither of the two conditions necessary for attracting the applicability of Section 147(a), was satisfied. The notice issued by the Income Tax Officer is therefore without jurisdiction. [574 G]

(ii) It is not possible to sustain the conclusion that the assessee omitted or failed to disclose fully and truly any material facts relating to his assessment.

[574 F]

2. (i) Before the Income Tax Officer can assume jurisdiction to issue notice under Section 147(a), two distinct conditions must be satisfied. First, he must have reason to believe that the income of the assessee has escaped assessment and secondly, he must have reason to believe that such escapement is by reason of the omission or failure on the part of the assessee to disclose fully and truly all material facts necessary for his assessment. If either of these conditions is not fulfilled, the notice issued by the Income Tax Officer would be without jurisdiction. [571 F]

(ii) The important words under Section 147(a) are "has reason to believe" and these words are stronger than the words "is satisfied.". The belief entertained by the Income Tax Officer must not be arbitrary or irrational. It must be reasonable or in other words it must be based on reasons which are relevant and material. The Court, cannot investigate into the adequacy or sufficiency of the reasons which have weighed with the Income Tax Officer, in coming to the belief, but the Court can examine whether the reasons are relevant and have a bearing on the matters in regard to which he is required to entertain the belief before he can issue notice under Section 147(a). If there is no rational and intelligible nexus between the reasons and the belief, so that, on such reasons, no one properly instructed on facts and law could reasonably entertain the belief, the conclusion would be inescapable that the Income Tax Officer could not have reason to believe that any part of the income of the assessee had escaped assessment and such escapement was by reason of the omission or failure on the part of the assessee to disclose fully and truly all material facts and the notice issued by him would be liable to be struck down as invalid. [571 G-572 C]

3. Even a close relative who is in management and charge of a business on a full time basis is entitled to be paid remuneration and, in fact, it would be wholly unreasonable to expect him to work free of charge. [573 C]

A In the instant case D was the brother-in-law of G the Managing Director of the assessee but this circumstance cannot lead to an inference that the payment of remuneration to D who was solely managing and looking after the business of the Delhi Bench of the assessee was sham and bogus. There is nothing unusual in D giving a loan to his brother-in-law, the Managing Director or making gifts to the son, wife and daughter-in-law of the Managing Director who were his close relatives. Any inference that the payment of remuneration to D was sham and bogus cannot be drawn merely from the manner in which he expended the amount of remuneration received by him, particularly when the persons to whom he gave a loan and made gifts were his close relatives.

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[573 E-574 B]

4. The statements of account of D with the assessee for the relevant accounting year as also the previous years were with the Income Tax Officer at the time of the original assessment and these statements of account clearly showed that out of the amount of remuneration credited to his account, he had made gifts to the sons of G on 31st July, 1957 and given a loan to G on the 25th August, 1958 and the Income Tax Officer was fully aware that G was the Managing Director of the assessee. The assessee could not therefore be said to be under an obligation to disclose to the Income Tax Officer in the course of its assessment as to how the director who was in sole charge of the management of the business of the assessee, and who was being paid remuneration for the services rendered by him to the assessee, had utilised the amount of remuneration received by him. [574 C-F]

CIVIL APPELLATE JURISDICTION : Civil Appeal No. 1146 of 1973.

E From the judgment and order dated the 1st, June 1972 of the Calcutta High Court in Appeal No. 150 of 1971 arising out of Matter No. 262 of 1968.

Debi Pal, A.K. Verma and K.J. John for the Appellant.

F *V.S. Desai, Champat Rai and Miss A. Subhashini* for the Respondents.

The Judgment of the Court was delivered by

G **BHAGWATI**, J. This appeal by certificate is directed against an order passed by a Division Bench of the High Court of Calcutta allowing an appeal against a decision of a Single Judge which quashed and set aside a notice dated 28th March 1968 issued by the Income Tax Officer under section 148 of the Indian Income Tax Act, 1961 seeking to reopen the assessment of the assessee for the assessment year 1959-60. The facts giving rise to the appeal are a little important and they may be briefly stated as follows.

Prior to March 1947, one Deo Datt Sharma carried on business in Delhi in the name of Sharma Trading Company. The business was quite a prosperous one and the record shows that Deo Datt Sharma was making an average profit of about Rs. 36,000 per year. In March 1947, the assessee was incorporated as a private limited company with Ganga Saran Sharma as its managing director and it took over the business of Sharma Trading Company as a going concern in consideration of allotment of 1703 shares in the share capital of the assessee to Deo Datt Sharma. The share capital of the assessee consisted of 8500 shares out of which 1703 shares were allotted to Deo Datt Sharma, 15 shares were held by Ganga Saran Sharma and 3500 shares, by a company called Narendra Trading Company controlled by Ganga Saran Sharma and his wife. It may be pointed out at this stage that Deo Datt Sharma was the brother-in-law of Ganga Saran Sharma. When business of Deo Datt Sharma was taken over by the assessee, Deo Datt Sharma was appointed Director of the assessee along with two other persons. Deo Datt Sharma was placed in charge of management of the business of Delhi Branch of the assessee and he was paid a salary of Rs. 1000 per month, commission at the rate of 1 per cent on the sales of the Delhi Branch and bonus equivalent to three months' salary. Ganga Saran Sharma and the other two directors were also paid salary, commission and bonus but it is not necessary to set out the quantum of the emoluments paid to them, because in this appeal we are concerned only with the emoluments paid to Deo Datt Sharma and not with the emoluments paid to other directors.

The Income Tax Officer while assessing the assessee to tax for the assessment year 1949-50 disallowed the claim of the assessee for deduction in respect of payments made to the managing director and other directors on account of commission and bonus. On appeal by the assessee the Appellate Assistant Commissioner disagreed with the view taken by the Income Tax Officer and allowed the entire amount paid to the managing director and other directors by way of commission and bonus. So far as Deo Datt Sharma is concerned, the Appellate Assistant Commissioner observed that having regard to the fact that this very business was carried on by Deo Datt Sharma prior to its taking over by the assessee and it was a prosperous business earning on an average about Rs. 36,000 per year and after taking over of the business by the assessee, Deo Datt Sharma continued to be in sole management of the

A business of the Delhi Branch, the aggregate amount paid to him could not at all be regarded as excessive and was allowable as a permissible deduction. Thus the entire amount paid by the assessee to the managing director and other directors was allowed by the Appellate Assistant Commissioner as a deduction in computing the taxable income of the assessee. The assessee had thereafter no difficulty in claiming deduction of the amount paid to the managing director and other directors on account of salary, commission and bonus, but again in the assessment year 1956-57, the Income Tax Officer disallowed a substantial portion of the remuneration paid to the managing director and the assessment made by the Income Tax Officer was confirmed in appeal by the Appellate Assistant Commissioner and in further appeal by the Income Tax Tribunal. This led to the making of a reference and the High Court answered the question referred to it in favour of the assessee and held that the disallowance of a portion of the remuneration paid to the managing director was not justified. While making the assessment for the assessment year 1957-58, the Income Tax Officer once again disallowed a part of the remuneration paid to the managing director as also the amounts of interest paid to the directors on the balances lying to the credit of their respective accounts with the assessee on account of undrawn remuneration. The Appellate Assistant Commissioner in appeal held that the interest paid to the directors on the balances lying to the credit of their respective accounts was an allowable expenditure but he sustained the disallowance of a portion of the remuneration paid to the managing director. The assessee thereupon preferred a further appeal to the Tribunal and after considering all the facts and circumstances of the case, the Tribunal came to the conclusion that the remuneration paid to the managing director as also to the other directors was not at all excessive and no portion of it could justifiably be disallowed. The result was that not only was the remuneration paid to the managing director and the other directors allowed in full as a permissible deduction but also the amount of interest paid on the credit balances in their respective accounts was allowed to be deducted as a permissible expenditure. Obviously, and this could not be disputed on behalf of the Revenue, the accounts of the managing director and other directors including Deo Datt Sharma showing the amount of remuneration credited and the withdrawals debited in each year were produced before the Income Tax Officer and he was aware that only a very small amount was withdrawn by Deo Datt Sharma out of the remuneration credited in his account. The

record also shows that on a querry made by the Income Tax Officer the assessee furnished inter alia the assessment file number of Deo Datt Sharma who was being assessed in Delhi. The assessment for the assessment year 1958-59 also followed the same course upto the stage of appeal before the Income Tax Tribunal and ultimately the amount of interest paid to the directors on the credit balances in their respective accounts was allowed as a permissible deduction to the assessee. The assessment of the assessee for the subsequent year 1959-60 was thereafter completed on the basis of the decision of the Income Tax Tribunal for the two earlier assessment years and the amounts paid to the managing director and other directors including Deo Datt Sharama by way of salary, comission and bonus were allowed in full as permissible deductions and so was the interest paid on the credit balances in their respective accounts.

On 28th March, 1968 the Income Tax Officer issued a notice under section 148 of the Income Tax Act, 1961 seeking to reopen the assessment of the assessee for the assessment year 1959-60 on the ground that the income of the assessee had escaped assessment at the time of the original assessment. Since a period of four years had already elapsed from the close of the assessment year 1959-60 and no notice could be issued under section 147 (b), it was obvious that the notice issued by the Income Tax Officer was based on section 147 (a), and it could be justified only if it could be shown that the Income Tax Officer had reason to believe that, by reason of omission or failure on the part of assessee to disclose any material facts, the income of the assessee had escaped assessment. The Income Tax Officer however did not indicate in the notice as to what were the reasons which had led him to believe that the income of the assessee had escaped assessment by reason of omission or failure to disclose material facts nor did he give any reasons though requested by the assessee to do so. The assessee thereupon preferred a writ petition in the High Court of Calcutta challenging the validity of the notice on the ground that there was no omission or failure on the part of the assessee to disclose any material facts at the time of the original assessment and that in any event, there was no reason to believe that any part of the income of the assessee had escaped assessment by reason of such omission or failure. The writ petition was admitted and rule was issued by a single Judge of the Calcutta High Court. The Income Tax Officer, possibly on service of the rule, addressed a letter dated 19th June 1968 to the assessee stating that

A the notice was issued by him because he had reason to believe that the payment of remuneration to Deo Datt Sharma was bogus and false. The Income Tax Officer also stated in the affidavit filed by him in reply to the writ petition that after the assessment of the assessee was completed for the assessment years upto 1963-64, the Income Tax Officer came to learn that Deo Datt Sharma was the brother-in-law of Ganga Saran Sharma, managing director and that Deo Datt Sharma had disposed of the income received by him by way of remuneration from the assessee, in the following manner :

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1. On 31st July 1957 he made a gift to Shri Narendra Sharma son of Shri Ganga Saran Sharma, Managing Director of the Company.	Rs. 12,550.00
2. On 25th August 1958 he made a loan to Ganga Saran Sharma.	Rs. 2,25,000.00
D	Total 2,37,550.00

and thereafter, out of the amount lying to his credit in the account with the assessee, he had made the following gifts :

E	On 5th December 1960 gift to Brahma Devi wife of Ganga Saran Sharma	Rs. 1,01,101.00
F	On 21st December 1960 gift to Indu Sharma daughter-in-law of Ganga Saran Sharma	Rs. 15,101.00
	On 26th December 1961 gift to Hemlata Sharma daughter-in-law of Ganga Saran Sharma.	Rs. 50,101.00

G The Income Tax Officer stated that out of the total amount of remuneration of Rs. 3,51,000 received by Deo Datt Sharma during the period upto 31st March 1962, he had paid tax in the sum of about Rs. 65,000/- and spent a total sum of Rs. 2,37,550 on account of gifts and loan as aforesaid and the withdrawals made by him for his own purposes thus did not amount to more than Rs. 4000 per year. These facts, according to the Income Tax Officer, showed

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that the remuneration paid to Deo Datt Sharma was not genuine and was sham and bogus and the amount of such remuneration alleged to have been paid to Deo Datt Sharma was wrongly allowed as a permissible deduction and hence the assessment of the assessee was liable to be reopened by issue of a notice under section 147 (a).

The learned single Judge of the Calcutta High Court who heard the writ petition took the view that there was no omission or failure on the part of the assessee to disclose any material facts relating to his assessment and that in any event, there was no reason to believe that any part of the income of the assessee had escaped assessment at the time of the original assessment by reason of wrong allowance of the remuneration paid to Deo Datt Sharma as a permissible deduction. The writ petition was accordingly allowed by him and the notice issued by the Income Tax Officer was quashed and set aside. The Income Tax Officer thereupon preferred an appeal before a Division Bench of the Calcutta High Court and the learned Judges constituting the Division Bench allowed the appeal, holding that the Income Tax Officer had reason to believe that the amount of remuneration paid to Deo Datt Sharma had been wrongly allowed as a permissible deduction by reason of omission or failure on the part of the assessee to disclose the material facts set out above and the notice issued by the Income Tax Officer was justified. The assessee thereupon preferred the present appeal in this Court after obtaining a certificate of fitness from the High Court of Calcutta.

It is well settled as a result of several decisions of this Court that two distinct conditions must be satisfied before the Income Tax Officer can assume jurisdiction to issue notice under section 147 (a). First, he must have reason to believe that the income of the assessee has escaped assessment and secondly, he must have reason to believe that such escapement is by reason of the omission or failure on the part of the assessee to disclose fully and truly all material facts necessary for his assessment. If either of these conditions is not fulfilled, the notice issued by the Income Tax Officer would be without jurisdiction. The important words under section 147 (a) are "has reason to believe" and these words are stronger than the words "is satisfied". The belief entertained by the Income Tax Officer must not be arbitrary or irrational. It must be reasonable or in other words it must be based on reasons which are relevant and material. The Court, of course, cannot investigate into the adequacy or sufficiency of the reasons which

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A have weighed with the Income Tax Officer in coming to the belief, but the Court can certainly examine whether the reasons are relevant and have a bearing on the matters in regard to which he is required to entertain the belief before he can issue notice under section 147 (a). If there is no rational and intelligible nexus between the reasons and the belief, so that, on such reasons, no one properly instructed on facts and law could reasonably entertain the belief, the conclusion would be inescapable that the Income Tax Officer could not have reason to believe that any part of the income of the assessee had escaped assessment and such escapement was by reason of the omission or failure on the part of the assessee to disclose fully and truly all material facts and the notice issued by him would be liable to be struck down as invalid.

B Now here on the facts as admitted or found it is clear that Deo Datt Sharma was carrying on the same business prior to the incorporation of the assessee as a private limited company and this business was yielding him an average profit of about Rs. 36000 per year. When the assessee, on incorporation, took over the business as a going concern from Deo Datt Sharma it appointed Deo Datt Sharma as a director and placed him in sole charge of the management of the Delhi Branch of the business. In fact, it could not be disputed on behalf of the Revenue that Deo Datt Sharma was looking after the business of the Delhi Branch of the assessee in the same manner in which he was doing when he was sole proprietor of the business and for this work done by him, Deo Datt Sharma was paid salary at the rate of Rs. 1000 per month, commission at the rate of one per cent on the sales of the Delhi Branch and bonus equivalent of three months' salary. The amount of remuneration paid to Deo Datt Sharma was thus not without consideration; in fact, it was paid for valuable services rendered by Deo Datt Sharma in solely managing the business of the Delhi Branch of the assessee. Now once it is conceded that Deo Datt Sharma was in sole charge and management of the business of the Delhi Branch of the assessee and was rendering full time service to the assessee in that capacity, it is difficult to see how any one could reasonably come to the belief that the payment of remuneration made to him was sham and bogus. Surely, the Income Tax Officer could not expect Deo Datt Sharma to devote his full time and energy to the business of the Delhi Branch of the assessee without any remuneration whatsoever. The actual remuneration paid to Deo Datt Sharma was in fact found to be genuine and reasonable by the Appellate Assistant Commissioner

while disposing of the appeal of the assessee for the assessment year 1949-50 as also by the Income Tax Tribunal while disposing of the appeal for the assessment year 1957-58. It is true that Deo Datt Sharma was the brother-in-law of Ganga Saran Sharma, the managing director of the assessee, but this circumstance cannot by any stretch of imagination lead to an inference that the payment of remuneration to Deo Datt Sharma who was solely managing and looking after the business of the Delhi Branch of the assessee was sham and bogus. Even a close relative who is in management and charge of a business on a full time basis is entitled to be paid remuneration and, in fact, it would be wholly unreasonable to expect him to work free of charge.

The Revenue, however, relied strongly on the fact that out of the total amount of remuneration of Rs. 3,51,000 received by Deo Datt Sharma and credited to his account with the assessee, he had not withdrawn more than Rs. 4,000 per year for himself and an aggregate sum of Rs. 2,37,550 was expended by him in giving a loan to Ganga Saran Sharma and making gifts to the son, wife and daughters-in-law of Ganga Saran Sharma on diverse dates between 31st July, 1957 and 26th December 1961. We fail to see how this fact can lend itself to the inference that the payment of remuneration to Deo Datt Sharma was bogus and not genuine. It is an admitted fact that Deo Datt Sharma was the brother-in-law of Ganga Saran Sharma and there is nothing unusual in Deo Datt Sharma giving a loan to Ganga Saran Sharma or making gift to the son, wife and daughters-in-law of Ganga Saran Sharma who were his close relatives. It is indeed difficult to appreciate how any inference can reasonably be drawn that the payment of remuneration to Deo Datt Sharma was sham and bogus merely from the manner in which he expended the amount of remuneration received by him, particularly when the persons to whom he gave a loan and made gifts were his close relatives. It is possible that Deo Datt Sharma had other financial resources apart from the remuneration derived by him from the assessee and he therefore decided to give a loan and make gifts to his close relatives out of the remuneration received by him for valuable services rendered to the assessee. In fact, if he had no other financial resources, it is extremely difficult - one might say, almost impossible - to believe that he worked for the assessee and managed and looked after the business of the Delhi Branch on a full time basis without any remuneration or in any event on a

A paltry remuneration of Rs. 4,000 per year when the managing director and other directors who were working like him were getting much more from the assessee and as the proprietor of the business prior to its taking over by the assessee, he was earning an average profit of about Rs. 36,000/- per year. We are clearly of the view that on these facts the Income Tax Officer could have no reason to believe that the payment of remuneration to Deo Datt Sharma was sham and bogus and that the amount of remuneration paid to him was wrongly allowed as a permissible deduction.

C We may point out that, in fact, the statement of account of Deo Datt Sharma with the assessee for the relevant accounting year as also the previous years were with the Income Tax Officer at the time of the original assessment and these statements of account clearly showed that out of the amount of remuneration credited to his account, he had made a gift of Rs. 12,550 to the son of Ganga Saran Sharma on 31st July 1957 and given a loan of Rs. 2,25,000 to **D** Ganga Saran Sharma on 25th August, 1958 and the Income Tax Officer was fully aware that Ganga Saran Sharma was the managing director of the assessee. It is possible and we may assume it in favour of the Revenue, that the subsequent gifts made by Deo Datt Sharma to the wife and daughters-in-law of Ganga Saran Sharma were not disclosed to the Income Tax Officer at the time of the original assessment, but these gifts being subsequent to the relevant accounting year, the assessee was not bound to disclose the same to the Income Tax Officer. Moreover, it is difficult to appreciate how the assessee could be said to be under an obligation to disclose to the Income Tax Officer in the course of its assessment as to how a director who was in sole charge of the management of the business of the assessee and who was being paid remuneration for the services rendered by him to assessee, had utilised the amount of remuneration received by him. We do not think it possible to sustain the conclusion that the assessee omitted or failed to disclose fully and truly any material facts relating to his assessment.

G We must in the circumstances hold that neither of the two conditions necessary for attracting the applicability of section 147(a) was satisfied in the present case and the notice issued by the Income Tax Officer must be held to be without jurisdiction.

H We accordingly allow the appeal, set aside the judgment of the Division Bench and restore that of the learned single Judge quashing

and setting aside the notice dated 28th March 1968 issued by the A
Income Tax Officer against the assessee. The Revenue will pay the
costs of the assessee throughout.

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Appeal allowed