

Secret commission paid to employees of competitors restricted to 1% of total sales

Summary – The High Court of Gujarat in a recent case of Patel Brothers, (the Assessee) held that where assessee claimed deduction of secret commission paid to employees of different companies who had given business to assessee, since assessee had not kept any accounts as to where and to whom such commission was paid, Tribunal was justified in allowing assessee's claim to extent of one per cent of total sales

Facts

- The assessee was a partnership firm engaged in the business of electrical contractor. For the relevant assessment year, the assessee had filed the return of income claiming deduction of payments made by way of secret commission.
- The case of the assessee was that secret commission was paid to the employees of different companies, who had given the business to the assessee.
- The Assessing Officer opined that the assessee failed to establish that there was a practice for payment of such commission in the particular line of business; the assessee failed to adduce satisfactory evidence to show that the payments were actually made; and, lastly, that the assessee failed to establish that such payments were wholly and exclusively for the purpose of business. He, thus, disallowed the entire claim of the assessee.
- The Commissioner (Appeals) formed an opinion that the expenditure claimed by the assessee was excessive as compared to the preceding years and also compared to the turnover. He also noted that the GP rate had come down from 13.26 per cent in the earlier year to 10.26 per cent in the current year. He, therefore, while allowing the expenditure, limited the same to 1 per cent of the total sales.
- The Tribunal referred to the *Explanation* to Section 37(1) added by Finance (No. 2) Act, 1998 with retrospective effect from 1-4-1962 to hold that expenditure was barred by such provision.
- However, since the Commissioner (Appeals) had already allowed assessee's claim partially, the Tribunal upheld the order of Commissioner (Appeals).
- On appeal:

Held

- Sub section (1) of section 37 provides that, any expenditure not being expenditure of the nature described in sections 30 to 36 and not being in the nature of capital expenditure or personal expenses of the assessee laid down or expended wholly and exclusively for the purpose of business or profession shall be allowed in computing the income chargeable under the head 'Profits and gains of business or profession'. Thus any expenditure barring those excluded under sub section (1) of

section 37 laid out or expanded exclusively for the purpose of business or profession would be allowable expenditure.

- In this context, no limitation is imposed in the said provision on any secret commission paid by the assessee, if it is otherwise demonstrated that the same was expended wholly or exclusively for the purpose of business or profession.
- Even though the courts have recognized the allowability of a deduction in the nature of secret commission, yet considerable onus has been placed on the assessee to establish such fact.
- Secret Commission would ordinarily be in a nature of payment in which the assessee would be reluctant to reveal the identity of the recipients. Such expenditure when allowed as a deduction would reduce the income of the assessee without the revenue being able to verify whether the recipients had offered such income to tax. Even otherwise such commission by very nature of things would be a small portion of an assessee's turnover. This flows the requirements of keeping such deductions down to a small proportion and casting a heavy burden on the assessee to establish that expenditure in question was made and that it was wholly and exclusively for the purpose of business.
- Coming back to facts of the case, the Assessing Officer questioned the very foundation of such expenditure. He was of the opinion that there was no nexus established by the assessee between the expenditure and the purpose of business. It was, in this background, after referring to the comparative data of the current year and the earlier years in relation to the assessee's turnover, expenditure under the head of secret commission and the gross profit ratio that the Assessing Officer disallowed the entire claim.
- Had this been final finding approved by the Commissioner (Appeals) and the Tribunal, perhaps, the assessee would have been correct in contending that total disallowance was not justified, particularly, when year after year in the earlier assessment years, the assessee had claimed such deduction and the same, in principle, was also accepted by the revenue. However, the Commissioner (Appeals) has not disallowed the entire claim but limited it to 1 per cent of the turnover of the assessee noticing that the claim of secret commission, had shot up to 7.03 per cent of the turnover for the year under consideration whereas the gross profit rate had gone down from 13.26 per cent to 10.26 per cent. More importantly, it was noticed that as against the net profit of Rs. 6.14 lacs, the assessee claimed to have paid secret commission of Rs. 19.85 lacs. The revenue authorities also noted that the assessee had not kept any accounts or receipts of where and to whom such commission was paid.
- When these are the parameters which the Commissioner (Appeals) considered, for restricting the claim, there is no reason to interfere in exercise of Court's jurisdiction to consider substantial question of law.
- For the purpose of *prima facie* consideration, the reference to the explanation of sub-section (1) of section 37 may not be warranted. However, insofar as final outcome is concerned, eventually, what the Tribunal did was to confirm the decision of Commissioner (Appeals) as it stood. Therefore,

without being seen as having approved the reasonings of the Tribunal in rejecting the assessee's appeal, insofar as the final conclusion of confirming the order of the Commissioner (Appeals) is concerned, there is no scope for interference.

- In the result, the assessee's appeal is dismissed.