

MADHYA PRADESH INDUSTRIES LTD.

v.

THE INCOME-TAX OFFICER, NAGPUR

April 16, 1970

[J. C. SHAH, K. S. HEGDE AND A. N. GROVER, JJ.]

Indian Income-tax Act (11 of 1922) s. 34(1)(a)—Circumstances for initiating proceedings under s. 34(1)(a)—If open to challenge in a Court of law.

The assessee paid commission to A, one of its selling agents, and claimed that amount as a revenue outgoing in the computation of its profits for that year. The Income-tax Officer made the order of assessment without expressly referring to the said deduction but proceeding on the basis that it was a permissible deduction. Later, the Income-tax Officer issued notices under s. 34(1)(a) of the Income-tax Act, 1922 stating that he had "reason to believe that" the income of the assessee had escaped assessment and was under-assessed. He sent a questionnaire to the assessee. Since the assessee did not reply to the questionnaire, the income-tax officer informed the assessee, that he presumed that no correspondence with A existed that no service was rendered by A and the payments made were without justification. The assessee filed petitions under Arts. 226 and 227 of the Constitution for restraining the Income-tax Officer from taking any action on the notices. The assessee's case was that it had placed all the material facts before the Income-tax officer that the Income-tax Officer had examined those facts before making the assessments, and that the Income-tax officer had added back the commission paid to another selling agent to the profits of the assessee, but took no objection to the commission paid to A. The High Court dismissed the petition. Allowing the assessee's appeal, this Court :

HELD : The proceedings taken under s. 34(1)(a) must be quashed. Two conditions must be satisfied in order to confer jurisdiction on the Income-tax Officer to issue the notice under s. 34 of the Act in respect of assessments beyond the period of four years, but within a period of eight years, from the end of the relevant year, viz. (i) the Income-tax Officer must have reason to believe that income, profits or gains chargeable to income-tax had been under-assessed, and (ii) he must have reason to believe that such "under-assessment" had occurred by reason of either (a) omission or failure on the part of the assessee to make a return of his income under s. 22 or (b) omission or failure on the part of the assessee to disclose fully and truly all the material facts necessary for his assessment for that year. Both these conditions are conditions precedent to be satisfied before the Income-tax Officer acquires jurisdiction to issue a notice under the section. If there are in fact some reasonable grounds for the Income-tax Officer to believe that there had been any non-disclosure as regards any fact, which could have a material bearing on the question of under-assessment, that would be sufficient to give jurisdiction to the Income-tax Officer to issue the notice under s. 34. Whether these grounds are adequate or not is not a matter for the Court to investigate. In other words, the sufficiency of the grounds which induced the Income-tax Officer to act is not a justiciable issue. It is of course open for the assessee to contend that the Income-tax Officer did not hold the belief that there had been such non-disclosure. In other words, the existence of

- A the belief can be challenged by the assessee but not the sufficiency of the reasons for the belief. The expression, "reason to believe" in s. 34 does not mean purely subjective satisfaction on the part of the Income-tax Officer. The belief must be held in good faith; it cannot be merely a pretence. It is open to the court to examine whether the reasons for the belief have a rational connection or a relevant bearing to the formation of the belief and are not extraneous or irrelevant to the purpose of the section. To this limited extent, the action of the Income-tax Officer in starting proceedings under s. 34 of the Act is open to challenge in a court of law. [273 E-H; 274 A-C]
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Calcutta Discount Company Ltd. v. Income-tax Officer Companies Dist. I and another; [1961] 2 S.C.R. 241; *S. Narayanappa and Ors. v. Commissioner of Income-tax Bangalore*, 63 I.T.R. 219; *Kantamani Venkata Narayana and Sons v. First Addl. Income-tax Officer, Rajahmundry*; 63 I.T.R. 638, followed.

C

- In the present case, the assessee in its writ-petitions had repudiated the assertion of the Income-tax Officer that he had reason to believe that due to the omission or failure on the part of the company to give material facts, some income had escaped assessment. Under those circumstances the officer who issued the notices under s. 34(1)(a) was expected to file an affidavit setting out the circumstances under which he formed the necessary belief. That officer had not filed any affidavit in these proceedings. The proceedings recorded by him before issuing the notices had not been produced nor his report to the Commissioner and even the Commissioner's sanction had not been produced. Hence it was not possible to hold that the Income-tax Officer had any reason to form the belief in question or the reasons before him were relevant for the purpose. [274 D-F]
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CIVIL APPELLATE JURISDICTION : Civil Appeals Nos. 2419 to 2421 and 2423 to 2425 of 1966.

E

Appeals by special leave from the judgment and order dated February 22, 1966 of the Bombay High Court, Nagpur Bench in Special Civil Applications Nos. 140 to 142 of 1962.

- F *A. K. Sen, G. L. Sanghi, Rameshwar Nath*, for the appellant (in all the appeals).

S. C. Manchanda, S. K. Aiyar and R. N. Sachthey, for the respondent (in all the appeals).

The Judgment of the Court was delivered by

- G **Hegde, J.** In these appeals by special leave, the only question of law that arises for decision is whether the respondent was competent to initiate proceedings under s. 34 of the Indian Income Tax Act, 1922 (which will hereinafter be referred to as the Act).

- H The respondent initiated proceedings under s. 34 of the Act against the appellant by issuing notices under that section on December 26, 1960 in respect of the assessment years 1953-54, 1954-55 and 1955-56. The appellant challenged the validity of

those proceedings by means of a writ petitions under Art. 226 and 227 of the Constitution in the High Court of Judicature at Bombay (Nagpur Bench). Those petitions were summarily dismissed. The appellant thereafter appealed to this Court after obtaining special leave from this Court. This Court allowed those appeals on April 8, 1965 holding that the High Court was not justified in summarily dismissing the writ petitions as the allegations made therein merited examination. Thereafter the High Court issued *rule nisi* in those petitions. The respondent opposed those petitions. After hearing the parties, the High Court again dismissed those writ petitions. Hence these appeals.

The facts of the case material for deciding these appeals have been set out in detail in this Court's order dated April 8, 1965. We shall briefly refer to them.

The above appeals relate to proceedings under s. 34 of the Act in respect of three assessment periods. It would be sufficient if we set out the facts relating to the assessment year 1953-54. There is no dispute that if the proceedings relating to that year are held to be invalid, similar would be the position regarding the proceedings relating to the other two assessment periods. On the other hand, if they are held to be valid, the same would be true in respect of the other assessment periods.

The appellant, Madhya Pradesh Industries Ltd. (hereinafter referred to as the company), is engaged in the business of mining manganese ore. On March 18, 1952, the company appointed M/s. J. K. Alloys Ltd. (hereinafter called 'Alloys') as its selling agents. In the account year relating to the assessment year 1953-54, the company paid as commission, Rs. 1,13,052/8/9 to the selling agents and claimed that amount as a revenue outgoing in the computation of its profits for that year. The Income-tax Officer made the order of assessment without expressly referring to the said deduction but proceeding on the basis that it is a permissible deduction. On December 26, 1960, the Income-tax Officer issued a notice to the company in exercise of his powers under s. 34 of the Act reciting therein that he having "reason to believe that" the income of the company assessable to income-tax for the assessment year 1953-54 had (a) escaped assessment and (b) under-assessed, he proposes to reassess the income that had escaped assessment or had been under-assessed. He called upon the company to deliver a return of the total income of the company assessable for the said assessment year 1953-54. In response to a letter sent by the company, the Income-tax Officer informed the company that the notice issued by him was under s. 34(1)(a). Thereafter there was some correspondence between the Income-tax Officer and the company. The Income-tax

- A Officer required the company to give him the information called for in the questionnaire issued by him. The company did not send any reply to the said questionnaire. On December 21, 1961, the Income-tax Officer informed the company that since the questions asked were not replied to, he presumed that no correspondence with Alloys existed and the payment of commission had been made without any justification, Alloys having rendered no service as selling agents.
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- C On April 2, 1962, the company moved the High Court of Judicature of Bombay (Nagpur Bench) praying for the issue of a writ of certiorari under Art. 226 of the Constitution or an appropriate direction or order under Art. 227 of the Constitution calling for the record of the case and for the issue of writs in the nature of Prohibition or Mandamus restraining the Income-tax Officer from taking any action or proceeding in enforcement or implementation of the notice dated December 26, 1960. The petition, as mentioned earlier, was rejected in *limini*.

- D In the writ petition, the plea taken by the company was that in issuing the notice under s. 34(1)(a) of the Act, the Income-tax Officer acted without jurisdiction and for a colourable purpose. Its case as set out in the writ petition is as follows :

- E In its return the company disclosed for the year ending March 31, 1953 Rs. 15,70,587/- as its total profits according to its books of account. In the statement under s. 38(3) of the Act filed with the return, the company disclosed that it had paid Rs. 1,13,052/8/9 as "commision sales" "on different dates" by cheques to Alloys and Rs. 6,091/4/- to J. S. Williams on October 4, 1952 by cheque as commission on sales. In the profit and loss account of the company filed with the return, the amount of Rs. 29,76,067/10/8 was disclosed as received by "sales less commission". On December 7, 1953, R. K. Gupta, a Director of the company made a statement before the Income-tax Officer stating that the commission was paid to Williams on the sales accounted for during the year ended March 31, 1953 and that the same should be allowed as deduction and that "similar was the case with the commission payable to J. K. Alloys Ltd., which had already been paid subsequently." On February 21, 1954, the Income-tax Officer called upon the company to produce amongst other documents, certificates showing whether any receipt included in the income, profits or gains had been credited or transferred to any assets, capital account, or any other liability account, a similar certificate regarding any credit for important expenses claimed under the head "profit and loss A/c", a list of buyers with full addresses along with quantity, number and net proceeds of export business as well as Indian sales, a statement setting out full details of various items of indirect expenses debited to profit
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and loss account and a statement of expenses grouped and sorted out under the heads, wages, salary and other emoluments. On June 21, 1954, the company filed the certificates and the statements demanded together with the statement showing that out of the sale proceeds, commission paid to Alloys and J. S. Williams was deducted. In the course of the assessment proceedings, R. S. Agarwal, a representative of the company appeared before the Income-tax Officer and agreed that the commission "debited as paid to Williams may be added back" and about Alloys he said that the commission "had already been paid". Thereafter on February 14, 1955, the assessment of the company was completed by the Income-tax Officer. The Income-tax Officer rejected the commission said to have been paid to Williams and added back that amount to the gross profits of the company. He took no objection to the commission paid to the Alloys.

The case pleaded by the company in the writ petition is that it had placed before the Income-tax Officer all the material facts; the Income-tax Officer before making the assessment had examined those facts and was satisfied with the explanation given by the company. The company denied that the Income-tax Officer had any reason to believe that by reason of the omission or failure on the part of the company to disclose fully and truly all material facts necessary for his assessment for the year in question income, profits or gains chargeable to income-tax have escaped assessment for that year or have been under-assessed. The company disputed that the Income-tax Officer had any reason before him to have the required belief. It also denied the fact that it had omitted or failed to disclose fully and truly all material facts necessary for the assessment in question or that any income, profits, or gains chargeable to income-tax have escaped assessment in that year.

Section 34(1) of the Act as at the relevant time read :

"If—

- (a) the Income-tax Officer has reason to believe that by reason of the omission or failure on the part of an assessee to make a return of his income under section 22 for any year or to disclose fully and truly all material facts necessary for his assessment for that year, income, profits or gains chargeable to income-tax have escaped assessment for that year, or have been under-assessed, or assessed at too low a rate, or have been made the subject of excessive relief under the Act, or excessive loss or depreciation allowance has been computed, or
- (b) notwithstanding that there has been no omission or failure as mentioned in clause (a) on the part

- A of the assessee, the Income-tax Officer has in consequence of information in his possession reason to believe that income, profits or gains chargeable to income-tax have been under-assessed or assessed at too low a rate, or have been made the subject of excessive relief under this Act, or that excessive loss or depreciation allowance has been computed.
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- C he may in cases falling under clause (a) at any time within eight years and in cases falling under clause (b) at any time within four years of the end of that year, serve on the assessee, or, if the assessee is a company, on the principal officer, thereof, a notice containing all or any of the requirements which may be included in a notice under sub-section (2) of section 22 and may proceed to assess or re-assess such income, profits or gains or recompute the loss or depreciation allowance; and the provisions of this Act shall, so far as may be, apply accordingly as if the notice were a notice issued under that sub-section :
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Provided that—

- E (i) the Income-tax Officer shall not issue a notice under this sub-section, unless he has recorded his reasons for doing so and the Commissioner is satisfied on such reasons recorded that it is a fit case for the issue of such notice;
- F (ii) the tax shall be chargeable at the rate at which it would have been charged had the income, profits or gains not escaped assessment or full assessment, as the case may be; and
- G (iii) where the assesment made or to be made is an assessment made or to be made on a person deemed to be the agent of a non- resident person under section 43, this sub-section shall have effect as if for the periods of eight years and four years a period of one year was substituted.

- H *Explanation.*—Production before the Income-tax Officer of account-books or other evidence from which material facts could with due diligence have been discovered by the Income-tax Officer will not necessarily amount to disclosure within the meaning of this section.”

In *Calcutta Discount Company Ltd. v. Income-Tax Officer Companies Dist. I and another*⁽¹⁾, this Court ruled that before an Income-tax Officer could issue a notice under s. 34(1)(a) of the Act, two conditions must co-exist, namely, that he must have reason to believe (1) that income, profits or gains had been under-assessed and (2) that such under-assessment was due to non-disclosure of material facts by the assessee. It was observed therein that where, however, the Income-tax Officer has prima facie reasonable grounds for believing that there has been a non-disclosure of a primary material fact, that by itself gives him the jurisdiction to issue a notice under s. 34 of the Act and the adequacy or otherwise of the grounds of such belief is not open to investigation by the court. It is for the assessee who wants to challenge such jurisdiction to establish that the Income-tax Officer had no material for such belief. Speaking for the majority Das Gupta J. observed therein :

"To confer jurisdiction under this section to issue notice in respect of assessments beyond the period of four years, but within a period of eight years, from the end of the relevant year two conditions have therefore to be satisfied. The first is that the income-tax Officer must have reason to believe that income, profits or gains chargeable to income-tax have been under-assessed. The second is that he must have also reason to believe that such "under-assessment" has occurred by reason of either (i) omission or failure on the part of an assessee to make a return of his income under s. 22, or (ii) omission or failure on the part of an assessee to disclose fully and truly all material facts necessary for his assessment for that year. Both these conditions are conditions precedent to be satisfied before the Income-tax Officer could have jurisdiction to issue a notice for the assessment or re-assessment beyond the period of four years but within the period of eight years, from the end of the year in question."

Proceeding further the learned judge observed :

"The position therefore is that if there were in fact some reasonable grounds for thinking that there had been any non-disclosure as regards any primary fact, which could have a material bearing on the question of 'under-assessment' that would be sufficient to give jurisdiction to the Income-tax Officer to issue the notices under s. 34. Whether these grounds were adequate or not for arriving at the conclusion that there was a non-disclosure of material facts would not be open for the

(1). [1961] 2 S.C.R. 241

- A court's investigation. In other words, all that is necessary to give this special jurisdiction is that the Income-tax Officer had when he assumed jurisdiction some *prima facie* grounds for thinking that there had been some non-disclosure of material facts".
- B Shah J. (one of us) in his dissenting judgment has observed that the expression "has reason to believe" in s. 34(1)(a) of the Indian Income Tax Act does not mean a purely subjective satisfaction of the Income-tax Officer but predicates the existence of reasons on which such belief has to be founded. That belief, therefore cannot be founded on mere suspicion and must be based on evidence and any question as to the adequacy of such evidence
- C is wholly immaterial at that stage. He further observed that where the existence of reasonable belief that there had been under assessment due to non-disclosure by the assessee, which is a condition precedent to exercise of the power under s. 34(1)(a) is asserted by the assessing authority and the record *prima facie* supports its existence, any enquiry as to whether the authority
- D could reasonably hold the belief that the under-assessment was due to non-disclosure by the assessee of material facts. necessary for the assessment must, be barred.

- In *S. Narayanappa and ors. v. Commissioner of Income Tax, Bangalore*⁽¹⁾, this Court held that two conditions must be satisfied in order to confer jurisdiction on the Income-tax Officer to issue the notice under s. 34 of the Act in respect of assessments beyond the period of four years, but within a period of eight years, from the end of the relevant year, viz. (i) the Income-tax Officer must have reason to believe that income, profits or gains chargeable to income-tax had been under-assessed and (ii) he must have reason to believe that such "under-assessment" had occurred by reason
- E of either (a) omission or failure on the part of the assessee to make a return of his income under s. 22 or (b) omission or failure on the part of the assessee to disclose fully and truly all the material facts necessary for his assessment for that year. Both these conditions are conditions precedent to be satisfied before the Income-tax Officer acquires jurisdiction to issue a notice under the section. If there are in fact some reasonable grounds for the
- G Income-tax Officer to believe that there had been any non-disclosure as regards any fact, which could have a material bearing on the question of under-assessment, that would be sufficient to give jurisdiction to the Income-tax Officer to issue the notice under s. 34. Whether these grounds are adequate or not is not a matter for the Court to investigate. In other words, the sufficiency of the grounds which induced the Income-tax Officer to
- H Act is not a justiciable issue. It is of course open for the assessee

to contend that the Income-tax Officer did not hold the belief that there had been such non-disclosure. In other words, the existence of the belief can be challenged by the assessee but not sufficiency of the reasons for the belief. Therein it was observed that the expression "reason to believe" in s. 34 does not mean purely subjective satisfaction on the part of the Income-tax Officer. The belief must be held in good faith: it cannot be merely a pretence. It is open to the court to examine whether the reasons for the belief have a rational connection or a relevant bearing to the formation of the belief and are not extraneous or irrelevant to the purpose of the section. To this limited extent, the action of the Income-tax Officer in starting proceedings under s. 34 of the Act is open to challenge in a court of law.

The same view was again expressed by this Court in *Kantamani Venkata Narayana and Sons v. First Additional Income-Tax Officer, Rajahmundry*⁽¹⁾.

In these cases, the company in its writ petitions had repudiated the assertion of the Income-tax Officer that he had reason to believe that due to the omission or failure on the part of the company to give material facts, some income had escaped assessment. Under those circumstances one would have expected the officer: who issued the notices under s. 34(1)(a) to file an affidavit setting out the circumstances under which he formed the necessary belief. We were told that one Mr. Pandey had issued the notices in question. That officer had not filed any affidavit in these proceedings. The proceedings recorded by him before issuing the notices have not been produced nor his report to the Commissioner or even the Commissioner's sanction has not been produced. Hence it is not possible to hold that the Income-tax Officer had any reason to form the belief in question or the reasons before him were relevant for the purpose. We have no basis before us to hold that the Income-tax Officer had jurisdiction to issue the impugned notices. Hence the proceedings taken by him have to be quashed.

For the reasons mentioned above, we allow these appeals, set aside the order of the High Court and quash the proceedings taken under s. 34(1)(a) of the Act. The respondent shall pay the costs of these appeals—hearing fee one set.

Y.P.

Appeal allowed.

(1) 63, I.T.R. 638.