

## **PRIVY COUNCIL**

Commissioner of Income-tax, Bengal

Vs.

Mercantile Bank of India, Ltd.

Privy Council Appeal No. 34 of 1935

(Lords Thankerton, C.J. Russell Of Killowen, Maugham J. Sir Sidney Rowlatt and Sir Shadi Lal JJ.)

20.05.1936

### **JUDGMENT**

#### **LORD THANKERTON J.**

1. This is an appeal from a judgment of the High Court of Judicature at Fort William in Bengal, delivered on a reference of questions of law by the Commissioner of Income-tax, Bengal, under Section 66(1), Income-tax Act, 1922 (11 of 1922). These questions of law arose in course of an assessment for supertax and surcharge made by the Income-tax Officer upon the respondents, as trustees of the late Sir David Yule, for the year ending 31st March 1932, in respect of Rs. 5,71,30,000, being the nominal amount of certain bonus debentures issued to them in respect of their shareholding in certain companies in the year ending 31st March 1931. The respondents appealed to the Assistant Commissioner, Calcutta, and, while the appeal was pending the Commissioner, of his own motion, made the present reference to the High Court, asking the following questions of law, viz :

First Question. - The assessee being in his own name and through nominees the holder (a) of the whole of the share capital of companies as specified in the case, and (b) together with two trustees in their individual capacity, of the whole of the share capital of one company as specified : these companies being investment companies of the nature described in the case : and the said companies having issued to the assessee by way of bonus, debentures which have subsequently been paid off through the transaction specified in the case :.. . . (quaere) was there by these transactions any income, profits or gains which accrued or arose to or were received by the assessee within the meaning of Section 4 of the Act ?

Second Question. - If any such income did arise, when did it so arise ?

Third Question. - If any such income did arise, was its quantum an amount corresponding (a) to the full amount of the debentures or (b) to such part only as derived from the received and accumulated revenue profits of the companies, and excluding such part as derived from appreciated valuations of the companies investment- holdings ?

Fourth Question. - In the latter alternative, on what principles are the respective quanta to be accounted and ascertained ?

2. The parties were agreed in asking for the decision of the Board on the first question only. The facts are fully set forth in the statement of the case by the Commissioner, but they may be summarized as follows : The late Sir David Yule died on 3rd July 1928, leaving a very large estate, which mainly consisted of holdings of shares in 30 companies, with 20 of which the present appeal is concerned, being the companies which issued the debentures in question. The Commissioner has divided these 20 companies into two groups; in the first group all the capital was ordinary share capital, wholly held by the trustees in their own name or through nominees, the trustees being the beneficial owners of all the shares, and the debentures were issued wholly in the name of the trustees. In the second group, the trustees and their nominees did not hold all the ordinary share capital, the other shares being held by others of the 30 companies, and in one case, that of the Calcutta Discount Company, certain shares were held by two of the trustees individually. In the case of each company in the second group an issue of preferred ordinary shares was made to the trustees alone, and the debentures in question were thereafter issued to the trustees in respect of their holding of the preferred ordinary shares. For the purposes of the argument before their Lordships no distinction was drawn between the two groups of companies as regards the procedure under which the debentures came to be issued, and the procedure of the Calcutta Discount Company, Limited, was taken as sufficiently typical of the procedure of all the companies for that purpose. The following is an extract from a special resolution of that company passed on 3rd January 1930 and confirmed on 22nd January 1930 :

2. That the capital of the company be increased by the creation of 725 preferred ordinary shares of Rs. 100 each, and the same be issued to such persons as the secretaries may think fit:

(a) The preferred ordinary shares shall rank in priority to the ordinary shares both as to dividend and repayment of capital, and shall carry the right to a non-cumulative dividend of such amount as may be declared by the company in

general meeting but so that the ordinary shares shall not be entitled to any dividend in any year unless and until at least 5 per cent has been declared on the preferred ordinary shares for that year. The said preferred ordinary shares shall have no further right to participate in profits or surplus assets in a winding-up.

(b) The date from which such shares shall rank for dividend shall be 1st January 1930, or such later date as the secretaries shall think fit.

3. of these 725 preferred ordinary shares, 629 were allotted to the respondents, as trustees of the estate of the late Sir David Yule, and the residue (96) partly to one trustee and partly to another. At the same time the Calcutta Discount Co., Ltd., adopted a new article as Article 126 of its Articles of Association, from which the following is an extract:

126. The company in general meeting may at any time and from time to time pass a resolution that any sum not required for the payment or provision of any fixed preferential dividend and (a) for the time being standing to the credit of any reserve fund or reserve account of the company, including premiums received on the issue of any shares, debentures or debenture stock of the company, or (b) being undivided net profits in the hands of the company, be capitalised, and that such sum be set free for distribution, and be appropriated as capital to and amongst the preferred ordinary share-holders and ordinary shareholders respectively in the proportions in which they would have been entitled thereto if the same had been surplus distributable profits, and in such manner as the resolution may direct, and such resolution shall be effective, and the secretaries shall in accordance with such resolution apply such sum in paying up in full any unissued shares in the capital or any debentures or debenture stock of the company on behalf of the shareholders concerned, and appropriate such shares, debentures or debenture stock, and distribute the same credited as fully paid-up amongst such shareholders in the proportions aforesaid in satisfaction of their shares and interests in the said capitalised sum, or shall apply such sum or any part thereof on behalf of the share-holders aforesaid in paying up the whole or part of any uncalled balance which shall for the time being be unpaid in respect of any issued shares of any of the said classes held by such shareholders or otherwise deal with such sums as directed by such resolution.

The following is an extract from minutes dated 14th March 1931 :

Calcutta Discount Co., Ltd. Minutes of the Secretaries, dated 14th March 1931.

The secretaries having taken into consideration the financial position of the company and being satisfied that such position justified the distribution from the reserve fund of Rupees 1,45,00,000 in the form of a special capital bonus free of income-tax it was decided to recommend to the shareholders the payment of such a special capital bonus to be satisfied by the distribution among the members holding preferred ordinary shares in the company on 24th March 1931, of Rs. 1,45,00,000 of debentures carrying interest at 3 per cent. per annum from 1st January 1931, in proportion to the number of preferred ordinary shares respectively held by such members.

The notice convening the requisite meeting having been prepared it was decided to issue the same to the shareholders.

Andrew Yule and Co., Ltd.,

(Sd.) J. Sime,

Managing Director, Secretaries.

At an extraordinary meeting of the Calcutta Discount Co., held on 24th March 1931, the following resolutions were passed:

(1) That it is desirable to capitalise a sum of Rs. 1,45,00,000 being part of the amount standing to the credit of the reserve fund and accordingly that a special capital bonus of Rupees 1,45,00,000 free of income-tax be declared and such capital bonus be applied on behalf of the persons, who on 24th March 1931, were the holders of the 725 issued preferred ordinary shares of the company in payment in full for Rupees 1,45,00,000 of debentures of the company carrying interest at 3 per cent. per annum from 1st January 1931 (and to be charged upon the whole undertaking of the company).

(2) That to the above resolution the secretaries be and they are hereby authorised to create and issue such debentures as a special capital bonus free of income tax credited as fully paid and to distribute the same to the holders registered on 24th March 1931, of the 725 preferred ordinary shares in the company's capital in proportion to the number of such shares held by them respectively in full satisfaction of such capital bonus as aforesaid.

3A. The following is an extract from the minutes:

Calcutta Discount Co., Ltd.

Minutes of the Secretaries, dated 25th March 1931.

4. The resolution passed at the extraordinary general meeting of the company held on 24th March 1931, that it was desirable to capitalize Rs. 1,45,00,000 being part of the company's reserve fund having been considered and it was decided to create and issue

a series of debentures of a total nominal value of Rs. 1,45,00,000 consisting of 28 debentures of Rs. 5,00,000 each, one debenture of Rs. 4,00,000 and five debentures of Rs. 20,000 each, all carrying interest at the rate of 3 per cent. per annum, and to distribute the same to the holders registered on 24th March 1931, of the 725 issued preferred ordinary shares in proportion to the number of such shares held by them respectively in full satisfaction of capital bonus. One debenture for Rs. 5,00,000 was thereupon sealed and directed to be registered with the registrar of joint stock companies and that on obtaining the registrar's certificate the remaining debentures be sealed and issued.

5. As a result of the foregoing proceedings debentures of the Calcutta Discount Co. to the amount of Rs. 1,25,80,000 were issued to the respondents, the residue of the issue being allotted severally to the two trustees who each held a small quantity of the preferred ordinary shares. The debentures are dated 24th March 1931, and the amounts secured were repayable at latest on 31st December 1940, and were repayable at the option of the company at any time after three months' notice. The circumstances under which these debentures came to be issued are conveniently summarised in the judgment of the High Court as follows:

6. All the companies had very large accumulations of undistributed profits. The actual figures are immaterial. The trustees had to meet very heavy outgoings for duties both in the United Kingdom and in India in relation to the estate of the deceased, and it was to provide funds for such duties that a scheme was devised whereby accumulated profits would come into their hands and be available for the purpose of meeting such charges.

7. In fact the debentures were all redeemed by the companies at various dates prior to the end of February 1933, but the crucial date in the present question is the date of the issue of the debentures.

8. The High Court decided against the claim of the Crown, holding that the case was governed by the principles laid down by the House of Lords in *Inland Revenue Commissioners v. Blott*, and *Commissioners Inland Revenue v. Fisher's Executors*,. They rejected an argument of the Advocate-General directed against the validity of the proceedings of the companies, upon the ground that it was not open on the case as stated by the Commissioner, which proceeds on the footing that the transactions of the companies are unimpeachable. This argument was not pressed at the hearing before their Lordships. The question being whether, by the transactions in question, any

income, profits or gains accrued or arose to or were received by the assessee within the meaning of Section 4 Income tax Act, the Crown maintained (first) that the decisions in and *Commissioners Inland Revenue v. Fisher's Executors*, which were under the Imperial Income-tax Act, were not applicable, and that the decision of this Board in *Swan Brewery Co., Ltd. v. Rex*, applied in the present case; and (second) that, in any event, the facts in the present case rendered it distinguishable from the cases in and *Commissioners Inland Revenue v. Fisher's Executors*, in respect that the purpose of the transactions in the present case was not a genuine company purpose, but for the individual benefit of the controlling share-holders.

9. In the first place their Lordships are of opinion that, as regards the point here in issue, there is no ground for distinction between the Imperial Act and the Indian Act. In *Income-tax Commissioner v. Shaw Wallace and Co.*, Sir George Lowndes, in delivering the judgment of the Board, while expressing a general warning against treating questions under these Acts as in *pari materia*, said:

10. The object of the Indian Act is to tax "income," a term which it does not define. It is expanded, no doubt, into "income, profits and gains," but the expansion is more a matter of words than of substance."

11. This states compendiously the same view as is expressed in regard to the Imperial Act by Lord Macnaghten in *London County Council v. Attorney-General*, the company had passed resolutions by which its capital was increased by a new issue of shares, and a portion of the accumulated profits standing to the credit of the reserve fund corresponding to the amount payable on allotment of the shares was transferred to the credit of the share capital account, the new shares being then allotted as fully paid among the share-holders pro rata. It was held by the Board that these transactions were in effect a declaration of a dividend within the meaning of the Dividend Duties Act, 1902, of Western Australia, under Section 2 of which the word "dividend" was defined as including "every profit, advantage or gain intended to be paid or credited or distributed among the members of any company." In delivering the judgment of the Board Lord Sumner, referring to the argument of the appellant company, said:

12. The duty claimed is not, it is said, a duty on or in proportion to any advantage either to the company or the share-holder measured by the increased stability of the company's own position or the increased facility to the share-holder in marketing his shares: it is measured by and is levied upon the whole nominal value of the new shares allotted, which is not the same thing as the value of the advantage distributed.

Is this argument sound? Their Lordships agree with the Supreme Court of Western Australia in thinking that it is not. There can be no doubt that the new shares were distributed and were not the same things as the old ones. They certainly were supposed to be advantages to the members of the company, none the less that the making of the issue was probably an advantage to the company also. In so flourishing a business doubtless they really were advantages. The new shares were credited as fully paid, and, what is more, they were fully paid, for after the allotment the company held ?101,450 as capital produced by the issue of those shares and for that consideration, and no longer as an undivided part of its accumulated reserve fund. True, that in a sense it was all one transaction, but that is an ambiguous expression. In business, as in contemplation of law, there were two transactions, the creation and issue of new shares on the company's part, and on the allottees' part the satisfaction of the liability to pay for them by acquiescing in such a transfer from reserve to share capital as put an end to any participation in the sum of ?101,450 in right of the old shares, and created instead a right of general participation in the company's profits and assets in right of the new shares, without any further liability to make a cash contribution in respect of them. In the words of Parker, C.J. : 'Had the company distributed the ?101,450 among the share-holders and had the share-holders repaid such sums to the company as the price of the 81,160 new shares, the duty on the ?101,450 would clearly have been payable. Is not this virtually the effect of what was actually done ? I think it is.

13. It is unnecessary to resume in detail the facts in (1921) 2 AC 171 and (1926) AC 395. In (1921) 2 AC 171 the company applied accumulated profits in satisfaction of the amount due on the issue of bonus shares, while in (1926) AC 395 accumulated profits were similarly applied in respect of bonus debentures. In the latter case Lord Cave (at p. 400) states the principle of the decision in (1921) 2 AC 171 by quoting the opinion of Lord Haldane in that case, which was as follows :

14. My Lords, for the reasons I have given I think that it is, as matter of principle, within the power of an ordinary joint stock company with articles such as those in the case before us to determine conclusively against the whole world whether it will withhold profits it has accumulated from distribution to its shareholders as income, and as an alternative not distribute them at all, but apply them in paying up the capital sums which share-holders electing to take up unissued shares would otherwise have to contribute. If this is done, the money so applied is capital and never becomes profits in the hands of the share-holder at all. What the latter gets is no doubt a valuable thing.

But it is a thing in the nature of an extra share certificate in the company.

15. The case of bonus debentures was held to be indistinguishable from that of bonus shares. Nor does it seem possible to distinguish the facts of the present case from those in (1926) A C 395 , apart from the contention of the Crown that the real purpose of the transactions in the present case form a relevant ground of distinction. The case (1914) AC 231 was referred to in certain of the opinions in (1921) 2 AC 171. Lord Haldane (at p. 188) says:

16. There the transaction was in many respects analogous to that here. But the taxing statute was couched in very different language. . . . There were expressions in the judgment which may be construed as having gone rather further, and treated the payment made by the company as equivalent in substance to a payment by the company to the shareholders, and by them back to the company. It may have been so, and without a fuller knowledge of the facts in the case and of the local law than the report discloses, it is difficult to be quite sure about the point, but what is clear is that the wide character of the word "advantages" was a primary consideration in what was said by their Lordships who took part in advising his Majesty. I therefore do not feel embarrassed by the decision in that case.

17. Lord Finlay (at p. 199) thought that the reasoning in (1914) AC 231 was inconsistent with the decision of the House of Lords in *Bouch v. Sproule*, Lord Cave (at p. 202) said that the decision in (1914) AC 231 was no doubt fully supported by the definition clause in the Western Australia Act, but that, otherwise, he would hold it to be inconsistent with *Bouch v. Sproule*, Lord Dunedin, who dissented in (1921) 2 AC 171 stated (at p. 203) that (1914) AC 231 was a decision upon an Australian statute in the words of which if anything became an "advantage" it would fall within the tax. Lord Sumner, who also dissented in (1921) 2 AC 171 and also delivered the judgment of the Board in (1914) AC 231 was clearly of opinion (at p. 217) that what was said by the Judicial Committee in the latter case as to the effect in law and in business of a distribution of bonus shares, was part of the decision and could not be distinguished from (1921) 2 AC 171 .

18. Having carefully considered the judgment in (1914) AC 231 and the varying views taken of it in (1921) 2 AC 171 their Lordships are of opinion that the judgment must be regarded as having been primarily based on the distribution of the new shares being advantages within the meaning of the particular Act under consideration, while the further expression of opinion in the judgment rather regarded the transaction as

involving, in substance, a distribution of accumulated profits among the shareholders and a repayment by them to the Company, although the operation was in fact short circuited. For the purpose of the present question, their Lordships are clearly of opinion that the decisions under the Imperial Income Tax Act are more relevant to the similar question under the Income-tax Act than a decision under the different terminology of the Western Australian Act. Lastly their Lordships are clearly of opinion that the personal motive or purpose of the individual shareholders, even if they hold a controlling interest in the company, is irrelevant, if it is made out that the company has in fact capitalised the accumulated profits. It is sufficient to quote from the opinion of Lord Sumner in (1926) AC 395, in the decision of which he concurred, as follows (at p. 411):

In any case desires and intentions are things of which a company is incapable. These are the mental operations of its shareholders and officers. The only intention that the company has is such as is expressed in or necessarily follows from its proceedings. It is hardly a paradox to say that the form of a company's resolutions and instruments is their substance. At any rate, in the present case, there is no need to distinguish between form and substance in the transaction itself or to refer to desires or intentions, further than to examine what was done, for everything was carried out in plain terms and without concealment. What the requisite majorities of the shareholders desired and intended is pretty plain too, but that is another matter.

19. Their Lordships are therefore of opinion that the first question of law referred by the Commissioner of Income-tax should be answered in the negative, that the judgment of the High Court should be affirmed, and that the appeal should be dismissed with costs. They will humbly advise His Majesty accordingly.

Appeal dismissed.

Cases Referred.

(1921) 2 AC 171=90 LJ KB 1028=125 LT 497=65 SJ 642=37 TLR 762

(1926) AC 395=95 LJ KB 487=134 LT 681=10 Tax CC 302=42 TLR 340.

(1921) 2 AC 171

(1926) AC 395=95 LJ KB 487=134 LT 681=10 Tax CC 302=42 TLR 340.

(1914) AC 231 = 83 LJ PC 134=110 LT 211=30 TLR 199

(1921) 2 AC 171

(1926) AC 395=95 LJ KB 487=134 LT 681=10 Tax CC 302=42 TLR 340,  
1932 PC 138 =136 IC 742=59 IA 206=59 Cal 1343 (PC), at p. 212,

(1901) AC 26. In (1914) AC 231

(1888) 12 AC 385=56 LJ Ch 1037=36 WR 193=57 LT 345.

(1888) 12 AC 385=56 LJ Ch 1037=36 WR 193=57 LT 345.