

Commissioner of Income-Tax, Madras

Vs

Amrutanjan Limited

Civil Appeals Nos. 521 to 523 of 1963

(K. Subha Rao, S. M. Sikri, J. C. Shah JJ)

28.04.1964

JUDGMENT

SHAH J. -

One Nageswara Rao Panthulu set up a business of manufacturing a "pain-balm" which was marked in the trade-name of "Amrutanjan". In September, 1936, the respondent company was floated as a public limited company under the Indian Companies Act, 1913, to acquire and carry on the business of manufacture and sale of "Amrutanjan". The authorised capital of the company was 7,000 ordinary shares and 3,000 preference shares of Rs. 100 each, and the issued and paid-up capital was 2,500 ordinary and 3,000 preference shares. The preference shareholders were under the articles of association entitled to a fixed dividend of 7 1/2 per cent. on the face value of the shares, with no right in the balance of the profits. The respondent company took over the business conducted by Nageswara Rao Panthulu for Rs. 5,50,000 paid in the form of 2,500 ordinary and 3,000 preference fully paid-up shares. This company was managed by a firm which, after the death of Nageswara Rao Panthulu, consisted of Ramayamma, widow of Nagesw

Under the articles of association of the company, both preference and ordinary shareholders were entitled to vote at the meeting of the company - each shareholder being entitled to exercise one vote for each share. In the course of assessment proceedings of the respondent company, the Income-tax Officer found that for the three years ending March 31, 1947, March 31, 1948, and March 31, 1949, the company had declared each year a total dividend of Rs. 38,750 at the rate of 7 1/2 per cent. on the preference shares and 6 1/2 per cent. of the amount available for distribution as computed under section 23A of the Income-tax Act, as it stood at the material time. The Income-tax Officer served a notice, after obtaining the approval of the Inspecting Assistant Commissioner of Income-tax, requiring the respondent company to show cause why an order under section 23A of the Income-tax Act, 1922, should not be passed against the company, and after considering the objections raised by the company ordered on March 31, 1953

Several contentions were raised before the revenue authorities and the Tribunal challenging the competence of the Income-tax Officer to pass an order under section 23A including the contention that the said provision was unconstitutional or ultra vires. These have been negated by the Tribunal and also by the High Court and it is unnecessary to refer to those contentions in these appeals as they do not survive for determination.

In a reference made under section 66(1) of the Indian Income-tax Act, the Tribunal referred three questions to the High Court of Judicature at Madras. The third question, which alone is material in these appeals, reads as follows :

"Whether the provisions of section 23A were correctly applied for the three relevant years ?"

The High Court held that the respondent company was one in which the public were substantially interested, and therefore, the Income-tax Officer had no jurisdiction to pass the order under section 23A of the Income-tax Act for any of the three years and on that footing answered the question in the negative. Against the order passed by the High Court, with certificate of fitness the Commissioner of Income-tax has appealed to this court.

Section 23A of the Indian Income-tax Act, 1922, before it was amended by the Finance Act, 1955, stood as follows :

"Where the Income-tax Officer is satisfied that in respect of any previous year the profits and gains distributed as dividends by any company up to the end of the sixth month after its accounts for that previous year are laid before the company in general meeting are less than sixty per cent. of the assessable income of the company of that previous year, as reduced by the amount of income-tax and super-tax payable by the company in respect thereof he shall, . . . . make with the previous approval of the Inspecting Assistant Commissioner an order in writing that the undistributed portion of the assessable income of the company of that previous year as computed for income-tax purposes and reduced by the amount of income-tax and super-tax payable by the company in respect thereof shall be deemed to have been distributed as dividends amongst the shareholder as at the date of the general meeting aforesaid, . . .

Provided further that this sub-section shall not apply to any company in which the public are substantially interested or to a subsidiary company of such a company if the whole of the share capital of such subsidiary company is held by the parent company or by the nominees thereof.

Explanation. - For the purpose of this sub-section, -

a company shall be deemed to be a company in which the public are substantially interested if shares of the company (not being shares entitled to a fixed rate of dividend, whether with or without a further right to participate in profits) carrying not less than twenty-five per cent. of the voting power have been allotted unconditionally to, or acquired unconditionally by, and are at the end of the previous year beneficially held by, the public (not including a company to which the provision of this sub-section apply). . . ."

The section was enacted with the object of preventing avoidance of super-tax by shareholders controlling the affairs of a company in which the public are not substantially interested, by the expedient of not distributing dividend out of the profits. Under the annual Finance Act for many years that rates of super-tax applicable to companies were much lower than the higher rates applicable to other assesseees. That gave an inducement to persons controlling companies to avoid the higher incidence of super-tax by transferring to limited companies their business. Thereby the source of earning was secured, the profits of the business could be accumulated till they were distributed in the form of capital, and in the meanwhile accumulation of undistributed profits received available to them for purposes of their other business. With a view to foil attempts made by persons holding controlling interests in companies to avoid payment of super-tax applicable to non-

corporate assessee by refusing to agree to distribution

It is now settled law that the distinction between the controlling group and the public is not along the line which distinguishes directors from the remaining members of the company. If a director does not belong to the controlling group, he will be regarded as a member of the public for the purpose of the third proviso and the Explanation to section 23A even though such director was directly entrusted with the management of the affairs of the company.

The Commissioner contends that the Explanation to sub-section (1) of section 23A is in reality a clause which defines what a company, in which the public are substantially interested, is. In terms, however, the Explanation raises a presumption and does not purport to define a company in which the public are substantially interested. On an analysis of the provisions of the third proviso to section 23A and its Explanation, the following position emerges :

- (1) Where there is no individual member or a group of members acting in concert holding fifty-one per cent. or more of the voting power, which controls the working of a company, it is from its very nature a company in which there is no controlling member or group, and, therefore, the public are substantially interested;
- (2) Where a shareholder holds or a group of shareholders acting in concert hold fifty-one per cent. or more of the voting power, the question is one of fact to be determined in each case, whether it is a company in which the public are substantially interested, having regard to the purpose for which the holding of the fifty-one per cent. or more is utilised;
- (3) Where not less than twenty-five per cent. of the voting power is allotted unconditionally to, or is acquired unconditionally by or is beneficially held by the public, it shall be presumed that the company is one in which the public are substantially interested. But in considering whether shares carrying not less than twenty-five per cent. of the voting right are held by the public, shares entitled to a fixed rate of dividend have to be excluded.

The reason of the rule which excludes from the computation of voting power holders of shares entitled to a fixed rate of dividend is that section 23A is directed primarily against the accumulation of undistributed dividends to avoid payment of non-corporate rates of super-tax. But shareholders who are entitled to a fixed rate of dividend are not directly interested in such accumulation, it matters little to them whether the dividend is immediately distributed to the ordinary shareholder or is accumulated, and therefore in assessing whether the twenty-five per cent. of the shares are vested in persons other than the controlling group, the shares yielding a fixed rate of dividend have to be ignored. But for the purpose of ascertaining the voting power, voting rights attached to all the shares must be taken into account.

No investigation has been made by the income-tax department whether there is any group of persons controlling the working of the company. It is true that Ramayamma was holding 87.40 per cent. of the ordinary shares issued by the company, and there is obviously no person who could hold twenty-five per cent. or more of the ordinary shares. In the present case, as already observed, the preference shareholders were entitled to vote at the meeting and the articles of association of the company made no distinction between the preference and the ordinary shareholders in the matter of exercise of voting rights. The total voting power was 5,500 - one vote for each share, ordinary and

preference alike - and twenty-five per cent. of that voting power is 1,375, but to invite the presumption under the Explanation this power must be exercisable only by the ordinary shareholders, and not by shareholders entitled to a fixed rate of dividend. The presumption under the Explanation could arise only, if twenty-five per cent. of

It was suggested that the expression "twenty-five per cent. of the voting power" would mean not twenty-five per cent. of the total voting power, but power exercisable in respect of shares other than shares entitled to a fixed rate of dividend. Prima facie, such an interpretation is not warranted if regard be had to the terms of the Explanation. But even that argument is of no value, for twenty-five per cent. of the voting power attached to the ordinary shares is not exercisable by the public. This, therefore, is a case in which shares not entitled to a fixed dividend carrying not less than twenty-five per cent. of the voting power are not shown to have been allotted unconditionally to, or acquired unconditionally by or beneficially held by the public. The Explanation, therefore, has no operation.

Whether in view of the third proviso the company may be regarded as one in which the public are substantially interested, is a question to which no attention was paid by the Tribunal. Whether in fact there exists such a controlling interest in the hands of one shareholder or a group of shareholder as would render the company one in which the public are not substantially interested is a question which therefore cannot be decided by this court.

The order of the High Court must therefore be confirmed, but on different grounds. The interpretation of the Explanation by the High Court, for reasons already set out, was incorrect; the Explanation had no application, because no presumption on the facts found could arise thereunder. The revenue authorities have not made any investigation on the question whether there existed any controlling interest in a group of persons, so as to bring the case within the third proviso.

The appeals must be dismissed with costs. One hearing fee.

Appeals dismissed.

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