P. K. Badiani

Vs

The Commissioner of Income Tax, Bombay

Civil Appeal No. 1695 of 1971

(H.R. Khanna, N.L. Untwalia, Jaswant Singh JJ)

21.09.1976

JUDGMENT

UNTWALIA, J. -

1. This is an appeal by an assessee on grant of a certificate of fitness by the Bombay High Court under Section 66 A (2) of the Income-Tax Act, 1922 - hereinafter referred to as the 1922 Act. The assessee is an individual. We are concerned in this case with his assessment for the assessment year 1958-59 - corresponding accounting year being April 1, 1957 to March 31, 1958. The Income-tax Tribunal made a composite order disposing of the assessee's appeals in respect of two assessment years i. e. 1958-59 and 1959-60. The decision of the tribunal was partly in favour of the assessee and partly in favour of the revenue. In respect of the assessment year 1958-59, a reference under Section 66 (1) of the 1922 Act was made by the tribunal to the High Court. Four questions were referred - one at the instance of the Commissioner of Income-tax and three at the instance of the assessee. The High Court by its judgment under appeal which is reported in C. I. T. (Central), Bombay v. P. K. Badiani ((1970) 76 ITR 369 (Bom)), has answered almost all the questions against the assessee. Hence this appeal.

2. Mr. V. Rajgopal who had argued the case of the assessee before the High Court appeared before us in support of the appeal also. He could not and did not attach the decision of the High Court as respects the question 2, 3 and 4. But he strenuously urged before us for reversal of the High Court judgment in regard to question 1 which was referred at the instance of the Commissioner. If the assessee could succeed before us in getting an answer in his favour to the said question, then, substantially he would have succeeded in getting the whole of the relief.

3. The first and the only question which falls for our examination in this appeal was referred by the tribunal to the High Court in the following terms :

> (1) Whether the development rebate reverse created by the company by duly charging the amount to the profit and loss account and being allowable under the Act constituted 'accumulated profits' of the company within the meaning of Section 2 (6A) (c) of the Act ?

4. We proceed to state the necessary facts for determination of the above question only.

5. The assessee was a major shareholder (although at the relevant time being a major or minor shareholder did not make any difference in law) in the Sadhana Textile Mills Pvt. Ltd. which was indisputably a company in which the public were not substantially interested within the meaning of

Section 23 A of the 1922 Act. The assessee was also the Managing Director of the said private limited company. He had a mutual open and current account in the books of the company - the accounting year of which was the calendar year i. e. commencing from January and ending in December. The assessee in his accounting year 1957-58 had withdrawn considerable amounts of money from the company's account. The Income-tax Officer treated the withdrawals made by the assessee as advances or loans given by the company to him and taxed the amount as dividend under Section 2 (6A) (e) of the 1922 Act. The Appellate Assistant Commissioner modified the figure of the deemed dividend calculated by the Income-tax Officer and took the highest amount of advance made to the assessee by the company at a particular point of time in the year in question as the amount of dividend taxable in the hands of the assessee. The said amount was within the total figure of accumulated profits in the hands of the company at the relevant time i. e. December 31, 1956. It may just be stated here that according to the 1922 Act only the accumulated profits possessed by the company at the end of the corresponding previous year had to be taken into account unlike the corresponding provision engrafted in Section 2 (22) of the Income-tax Act, 1961 - hereinafter referred to as the 1961 Act, read with Explanation II thereto. It was found that the aggregate amount of development rebate allowed to the company under Section 10 (2) (vi-b) was Rs. 2,36,470. The said amount had been debited in the profit and loss account of the company for the accounting year 1956 leaving a balance of Rs. 6641 only in the profit and loss account. The Appellate Assistant Commissioner of Income-tax treated the entire sum of Rs. 2,43,111 as the amount of accumulated profits possessed by the company. Finding the highest amount of advance to the assessee at a particular point of time to be aggregating to Rs. 1,83,493. 70 he directed the addition of the said amount in the assessee's income under Section 2 (6A) (e) of the 1922 Act. The High Court has directed some modification in the calculation of the said amount while answering the other questions referred to it at the instance of the assessee and we need not go into their details.

6. The main question for our determination in this appeal is whether the aggregate of the development rebates allowed to the company under Section 10 (2) (vi-b) of the 1922 Act could be treated as accumulated profits in the hands of the company under Section 2 (6A) (e).

7. The Income-tax Acts have undergone numerous changes from time to time and various amendments have been made both in the 1922 Act as also in the 1961 Act. We shall do well to quote all the sub-clauses (a) to (e) of section 2 (6A) of the 1922 Act. They read as follows :

> 2. (6A) "Dividend" includes -
>
> (a) any distribution by a company of accumulated profits whether capitalised or not, if such distribution entails the release by the company to its shareholders of all or any part of the assets of the company;
>
> (b) any distribution by a company of debenture, debenture-stock or deposit certificates in any form, whether with or without interest, to the extent to which the company possesses accumulated profits, whether capitalised or not;
>
> (c) any distribution made to the shareholders of a company on its liquidation, to the extent to which the distribution is attributable to the accumulated profits of the company immediately before its liquidation, whether capitalised or not;
>
> (d) any distribution by a company on the reduction of its capital to the extent to which the company possesses accumulated profits which arose after the end of the

previous year ending next before the 1st day of April, 1933, whether such accumulated profits have been capitalised or not;

(e) any payment by a company, not being a company in which the public are substantially interested within the meaning of Section 23 A, of any sum (whether as representing a part of the assets of the company or otherwise) by way of advance or loan to a shareholder or any payment by any such company on behalf of for the individual benefit of a shareholder, to the extent to which the company in either case possesses accumulated profits;

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Explanation - The expression "accumulated profits", wherever it occurs in this clause, shall not include capital gains arising before the 1st day of April, 1946, or after the 31st day of March, 1948 and before the 1st day of April, 1956.

The expression "accumulated profits" occurring in clause (e) of sub-section (6A), or as a matter of fact in any of the other clauses, undoubtedly means profits in the commercial sense and not assessable or taxable profits liable to tax as income under the 1922 Act. It is a well-known concept of the taxation law that the term 'profits' in the various sections of the Income-tax Acts have not got the same meaning. In the context - sometimes it means the assessable profits and sometimes it means the commercial profits. In Palmer's Company Law, Twenty-First Edition at page 662 the distinction between profits, divisible profits and profits available for dividend has been pointed out. At the said page occurs an oftquoted classical passage from the judgment of Fletcher Moulton, L.J. in Re Spanish Prospecting Co. Ltd. ((1911) 1 Ch 92, 98 : 80 LJCh 210 : 27 TLR 76) which runs thus :

'Profits' implies a comparisons between the state of a business at two specific dates usually separated by an interval of a year. The fundamental meaning is the amount of gain made by the business during the year. This can only be ascertained by a comparison of the assets of the business at the two dates.

. . . If the total assets of the business at the two dates be compared, the increase which they show at the later date as compared with the earlier date (due allowance of course being made for any capital introduced into or taken out of the business in the meanwhile) represents in strictness the profits of the business during the period in question.

Bhagwati J. has quoted the above passage with approval in the case of E. D. Sassoon & Company Ltd. v. C. I. T., Bombay City (26 ITR 27, 46 : (1955) 1 SCR 313 : AIR 1954 SC 470). Almost to the same effect was the view expressed by Mahajan, J. as he then was, in the case of C. I. T., Bombay v. Ahmedabai Umarbhai & Co., Bombay (18 ITR 472 502 : 1950 SCR 335 : AIR 1950 SC 134). In C. I. T., Bombay City v. Bipinchandra Maganlal & Co. Ltd. (41 ITR 290 : (1961) 2 SCR 493 : AIR 1961 SC 1040) Shah, J. as he then was, delivering the judgment on behalf of the Court while interpreting the expression "smallness of profits" occurring in Section 23 A of the 1922 Act said at page 296.

A company normally distributes dividends out of its business profits and not out of its assessable income. There is no definable relation between the assessable income and the profits of a business

concern in a commercial sense. Computation of income for purpose of assessment of income-tax is based on a variety of artificial rules and takes into account several fictional receipts, deductions and allowances . . . . . Smallness of the profit in Section 23 A has to be adjusted in the light of commercial principles and not in the light of total receipts, actual or fictional.

The same view has been expressed by this Court in Gobald Motor Services (P) Ltd. v. C. I. T., Madras ((1966) 60 ITR 417 (SC). We think that the term "profits" occurring in Section 2 (6A) (e) of the 1922 Act means profits in the commercial sense - that is to say the profits made by the company in the real and true sense of the term. We may just give an example. Suppose the assessable profits of a company is Rs. 1,00,000 out of which the company had to pay a tax under the Income-tax - say to the extent of Rs. 30,000. Although payment of tax is not a sum deductible from the assessable profits of the company, in the commercial sense the company would be left with a sum of Rs. 70,000 only as profit. We may add that Mr. Rajgopal could not and did not seriously dispute this proposition of law.

8. The gravamen of the argument of the assessee has been that development rebate deductible from the assessable profit of the company is also a type of outgoing expenditure or out-of-pocket cost which is deductible while ascertaining the profits of the company in the commercial sense. Counsel submitted that it is in the nature of a depreciation allowance and is identical with initial depreciation; it should, therefore, be deducted from the commercial profits of the company as held by the Gujarat High Court in the case of C. I. T., Bombay North v. Viramgam Mills Co. Ltd. ((1961) 43 ITR 270 (Guj)) This argument found favour with the tribunal but was repelled by the High Court. The point is res integra and we have to examine the correctness of the view expressed by the High Court.

9. Depreciation allowance has been allowed to be deducted from the assessable profits of an assessee under Section 10 (2) (vi) of the 1922 Act corresponding to Section 32 of the 1961 Act. It would appear from the report of the Taxation Enquiry Commission 1953-54 Volume II as to what is the nature of the depreciation allowance; vide Chapter V, page 74. The normal depreciation provided in clause (vi) and the additional depreciation mentioned in clause (iv-a) of Section 10 (2) of the 1922 Act is permitted to be deducted from the 'written-down value'. By and large, the cost of replacement is allowed as deductions in lieu of depreciation in respect of certain assets. By the amendments made by the Income-tax Amendment Act, 1946, the Finance Act, 1955 and the Finance Act, 1956 certain initial depreciation was allowed in respect of buildings newly erected or the machinery and plant newly installed. Obviously, it was by way of an incentive for the new structures or the new installations. The amount of initial depreciation was not deductible in determining the 'written-down value' although under the proviso (c) it was to be taken into account in the aggregate of all allowances so as not to permit them to exceed the maximum limit provided therein. Development rebate was provided in clause (vi-b) with effect from April 1, 1955 by the Finance Act of 1955. There was an overlapping period of about two years in relation to the allowance of initial depreciation or the development rebate. But as provided for in clause (vi) an assessee could not have had both even in regard to that period. Although initial depreciation and development rebate were not identical as they differ in some material particulars, they were similar in nature as both were by say of incentive for installation of new machinery or plant. The initial depreciation or the development rebate was to be allowed, as the case may be, at a certain percentage of the actual cost of the machinery or the plant for the year of installation only. It was not a recurring allowance for the subsequent years like the allowance of the normal depreciation or the additional depreciation. The Taxation Enquiry Commission in its report aforesaid had recommended in Chapter VII, page 98 of Volume II for assisting the expansion and development of

productive enterprise by allowing them a proportion of new investment in fixed assets to be charged to current costs of production thereby permitting the taxable profits to be brought down to that extent. In the Finance Act of 1955 a provision was made to allow a development rebate of 25% of the cost of all new plant and machinery installed for business purposes instead of the then existing initial depreciation allowance of 20%. It would thus be seen that by way of an incentive for installation of new machinery and plants, initial depreciation allowance of 20% was replaced by a development rebate of 25%. But it was, like grant of export rebate by way of incentive to make more exports, in the nature of an incentive for setting up new machineries and plants. We do not find any warrant for accepting the contention of Mr. Rajgopal that the initial depreciation or the development rebate was allowed as an extra deductible allowance of business expenses in the year of installation of new machinery for meeting the ever increasing costs of its replacement in future years. In our opinion it was meant merely to reduce the tax liability of the assessee in order to give him an incentive to install new machineries or plants.

10. The Gujarat High Court in the case of Viramgam Mills Co. Ltd. was concerned with the question as to whether the normal depreciation reserve of the company could be taken to be the accumulations of past profits within the meaning of the proviso to Section 23 A of the 1922 Act as it stood at the relevant time. It held that it could not form part of the accumulated past profits as in the words of Wixon (vide Wixon's Accounts Hand Book) it was "the estimated expiration of asset value" or as observed by Paton in this Accountant's Hand Book, third edition it is an out-of-pocket cost as any other cost. Says the learned author in the above book at p. 746 thus :

> There is still widespread misapprehension as to the precise significance of the depreciation charge. It is often deemed a more or less imaginary and hypothetical element, and is sharply contrasted with the regular "out-of-pocket" operating costs. As a matter of fact there is nothing at all imaginary about depreciation as a cost of business operation and at bottom it is just as much an out-of-pocket cost as any other. The depreciation charge is merely the periodic operating aspect of fixed asset costs, and there is no doubt as to the reality of such costs. Far from being a non-out-of-pocket charge depreciation represents the extreme example of repayment.

Mr. S. T. Desai, learned Counsel for the revenue drew our attention to the decision of the Calcutta High Court in C. I. T., Calcutta v. Sri Bibhuti Bhushan Dutt ((1961) 48 ITR 233 (Cal)) and submitted that it has taken a view different from the one taken by the Gujarat High Court even in regard to the nature of normal depreciation allowance. The Calcutta case seems to be one of a property-holding company, the profits of which were assessable under Section 9 wherein the question of depreciation was not relevant. It is not necessary for us to examine in this case the exact nature of the normal depreciation allowance and whether it is deductible from the profits of a person while determining his commercial profits. The view expressed by the Gujarat High Court seems to be reasonably plausible and correct and for the purposes of this case we shall assume it to be so. Yet, we do not feel persuaded to accept the argument of the assessee and equate the initial depreciation or the development rebate with the normal depreciation. In our opinion such an allowance is in no sense a deductible item of cost or expenditure in the process of settlement of the commercial profits. Although it does not form part of the assessable profits, undoubtedly it does form part of the commercial profits.

11. In Tea Estates India Pvt. Ltd. v. C. I. T., West Bengal II ((1976) 4 SCC 446 : 1977 SCC (Tax) 9) one of us (Khann J.) delivering the judgment on behalf of the Court has interpreted the expression "accumulated profits" occurring in clause (c) of Section 2(6A) of the 1922 Act to include the

amount of development rebate in the commercial sense. It has been stated at page 794 :

> The acceptance of the contention would necessary postulate reading in Section 2(6A)(c) the words "accumulated profits as are liable to be taxed under the Act". The words "as liable to be taxed under the Act" are not there in the definition and it would not, in our opinion, be permissible to so construe in the clause as if those words were a part of that clause. There is also nothing in the language or context of what clause as would warrant such a construction. Accumulated profits would retain their character as such even though a part of them were not taxed as profits under the Act.

The purpose of Section 2(6A) of the 1922 Act corresponding to Section 2 (22) of the 1961 Act is to include within the terms "dividend" for the purpose of taxation certain distributions or payments of certain items of money or the like as deemed dividend for the purpose of taxation. Under clause (e) and advance or loan of money to a shareholder by a private company has been directed to be treated as dividend to the extent to which the company possessed accumulated profits. The advance or the loan, by a legal fiction, is to resemble the actual dividend. For the purpose of distribution of the dividend the amount of development rebate could form part of the profit of the company : fortiori, it would be so for the purposes of clause (e) also.

12. During the course of the arguments of this appeal, our attention was directed to a new facet of the question under consideration and that is this. In clauses (a) to (d) of Section 2(6A) of the 1922 Act so also in the corresponding clauses of Section 2(22) of the 1961 Act the expression "accumulated profits" is qualified by the expression "whether capitalised or not". But the latter phrase is conspicuously absent in clause (e). What is the purpose of this difference in the phraseology of the various clauses of sub-section (6A)? The reason is not far to seek and yet not helpful to the assessee in this case.

13. The profits of a company can be capitalised in accordance with the articles of association and the law. On the capitalisation of the profits they cease to be profits in the hands of the company. The nature of the assets is changed although it does not make any difference in the total assets of the company. But profits stands transmuted and transformed into capital. The most common example of capitalisation of profits is by issuance of bonus shares to the shareholders. Clauses (a) to (d) were intended by the legislature to cover the cases of accumulated profits even though they may be capitalised. But the legislature did not intend to rope in the capitalised profits in clause (e). We may add that though under clause (b) distribution by a company of debentures, debenture stock or deposit certificates in any form in lieu of capitalised profits is to be deemed dividend with the meaning of sub-section (6A), mere distribution of bonus shares after capitalising the accumulated profits, unless the distribution entails the release by the company to its shareholders of any part of the assets of the company, is not to be a deemed dividend. Even under the 1961 Act distribution of bonus shares to the equity shareholders after capitalising the profits in accordance with law is not to be a deemed dividend although distribution of such shares to preference shareholders is. It is thus clear that if money is paid to a shareholder of a private company by way of advance or loan after the accumulated profits have been capitalised in accordance with the law and the articles of association then such payment, although it may represent a part of the assets of the company or otherwise, cannot be corelated to the capitalised profits of the company. To the extent the profits have been capitalised the company cannot be said to possess any accumulated profits.

14. But the obvious difficulty in the way of the appellant is that the accumulated profits of the

company in the year in question were never capitalised. Mere transferring the sum of Rs. 2,36,470 by debiting it to the profits and loss account to the development reserve account did not amount to the capitalisation of profits. The nature of the assets in the hands of the company did not change. It remained profits in the hands of the company.

15. According to the Dictionary of English Law by Earl Jowitt, Volume 1, "capitalisation" means "the conversion of profits or income into capital, e. g. by resolution of a company". Buckley on the Companies Acts, thirteenth edition, has pointed out at page 907 :

> Profits carried to reserve do not cease to be profits unless and until they are effectually capitalised.

Says the learned author at page 912 after referring to Article 128 corresponding to Regulation 96 of Table "A" of the Indian Companies Act :

> A company may, if its constitution so allows, capitalize profits, instead of dividing them, by applying them in paying up unissued shares, or debentures or other securities, and issuing such shares or securities as fully paid to its members, thereby transferring the sum capitalized from profit and loss or reverse account to share or loan capital account.

To the same effect is the statement of the law to be found in Palmer's Company Law, twenty-first edition page 673. The "capitalisation of profits", says the learned author, means that profits which otherwise are available for distribution among the shareholders are not divided among them in cash, but that the shareholders are allotted further shares - or debentures - which are paid up wholly or in part out of those profits. The amount paid by the company out of its divisible profits on account of these newly issued shares is known as the bonus, and the share are referred to as bonus shares.

Lord Herschell in the case of Ann Bouch and William Bouch v. William, Bouch Sproule (12 AC 385) was considering as to what was the nature and substance of the transaction in question in the case. The learned and the noble Lord said at page 398 :

> I think we must look both at the substance and form of the transaction . . . . And it was obviously contemplated, and was, I think, certain that no money would, in fact, pass from the company to the shareholders, but that the entire sum would remain in their hands as paid-up capital.

And finally it was said at page 399 :

> I cannot, therefore, avoid the conclusion that the substance of the whole transaction was, and was intended to be, to convert the undivided profits into paid-up capital upon newly created shares.

16. The Madras High Court has pointed out in C. I. T., Madras v. K. Srinivasan ((1963) 50 ITR 788 (Mad)), to quote the placitum only :

> For the purposes of Section 2(6A)(e) of the Income-tax Act, 1922, "accumulated profits" include general reserves. Unless the profit is capitalised in some form or other mere transfer of the profits to any reserve account will not take away from profits the character of accumulated profits.

17. In Sheth Haridas Achratlal v. C. I. T., Bombay North, Kutch and Saurashtra, Baroda ((1955) 27 ITR 684 (Bom) - Chief Justice Chagla delivering the judgment on behalf of the Bench of the Bombay High Court said at page 690 :

> But when we compare the language used by the legislature in sub-clause (a), (b) and (d) and when we note the omission of the qualifying words in sub-section (c) then it is clear that the legislature advisedly did not intend to subject to tax those accumulated profits which had been capitalised.

It appears that the expression "capitalised or not" was added in clause (c) after this decision.

18. For the reasons stated above, we hod that the development rebate reserve created by the company by duly charging the amount of profit and loss account, although liable as a deduction under the 1922 Act, constituted accumulated profits of the company within the meaning of Section 2(6A)(e). We accordingly affirm the decision of the High Court and dismiss this appeal but in the circumstances make no orders as to costs.

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