

Hunsur Plywood Works Ltd.

Vs

Commissioner of Income-tax

(Suhas C. Sen, V. N. Khare JJ)

19.11.1997

JUDGMENT

SEN, J.

1. The appellant is a public limited company. The assessment years involved are 1972-73, 1973-74 and 1974-75. In regard to the above assessment years in the returns of Income filed by the appellant before the assessing authority a claim towards allowance of development rebate under section 33 of the Income-tax Act, 1961 (hereinafter referred to as 'the Act') was made. The assessing authority allowed the claim as made by the company. Subsequently the assessing authority noticed from the balance sheet of the appellant company that the company had made a transfer of sums from the development rebate reserve to share capitalisation account by issue of bonus shares. The assessing authority concluded that the issuance of bonus shares amounted to distribution of profits by capitalisation and thus the assessing authority was of the view that the provisions of section 155(5)(ii)(a) of the Act applied to the instant case as the development rebate reserve has been utilised for distribution by way of dividend or profits. Accordingly the assessing authority passed an order under section 154 of the Act withdrawing the development rebate claim allowed earlier.

2. The company went up on appeal. The appellate authority allowed its appeal. The claim of the appellant for development rebate was sustained.

3. The Appellate Tribunal on the Revenue's appeal concurred with the view taken by the first appellate authority and concluded that there was no distribution by way of dividend or profits in the issue of bonus shares.

4. Thereafter on the application by the Commissioner of Income-tax the following questions of law were referred to the High Court:

"(a) whether on the facts and in the circumstances of the case the ITAT is right in law in holding that issue of bonus shares from out of the development rebate reserve did not amount to distribution of profits within the meaning of section 34(3)(a)(i) and section 155(5)(ii)(a)?

(b) whether on the facts and in the circumstances of the case the ITAT is right in law in holding that the ITO is not justified in withdrawing the development rebate?"

5. The High Court after examining the provisions of Section 34(3)(a)(i) and Section 155(5)(ii)(a) of the Income Tax Act held that the issue of bonus shares resulted in distribution of profits and therefore the statutory requirement of Section 34(3)(a)(i) of the Act had been violated. The High Court answered both the questions in the negative and in favour of the Revenue. The assessee has

come up on appeal to this Court.

6. Section 33 of the Act deals with allowance of development rebate in respect of a new ship or new machinery or plant owned by the assessee if it was wholly used for the purpose of business carried on by him. The allowance is given subject to a number of conditions. We are concerned in this case with the condition laid down in Section 34 which is as under:

"34(3)(a). The deduction referred to in Section 33 shall not be allowed unless an amount equal to seventy five per cent of the development rebate to be actually allowed is debited to the profit and loss account of the relevant previous year and credited to a reserve account to be utilised by the assessee during a period of eight years next following for the purposes of the business of the undertaking other than-

(i) for distribution by way of dividends or profits."

7. Section 155(5)(ii)(a) which is also relevant in this case is as under:

"(5). Where an allowance by way of development rebate has been made wholly or partly to an assessee in respect of a ship machinery or plant installed after the 31st day of December 1957 in any assessment year under Section 33 of the Indian Income-tax Act, 1922 (XI of 1922) and subsequently -

(i) XX XX XX XX

(ii) at any time before the expiry of the eight years referred to in sub-section (3) of Section 34 the assessee utilised the amount credited to the reserve account under clause (a) of that sub-section -

(a) for distribution by way of dividends or profits."

8. The assessee created a development rebate fund to avail of the deduction under Section 33. Section 34(3)(a) does not prohibit the assessee from using any amount credited to the fund for the purpose of its business but he cannot utilise the amount for eight years for "distribution by way of dividends or profits". If the Income-tax officer finds that the assessee had utilised any amount out of the reserve fund for distribution by way of dividends or profits he can withdraw the allowance given under Section 33 by proceedings under Section 155.

9. In this case there is no allegation that the assessee has distributed any dividend out of the amounts standing to the credit of the fund. But the assessee issued bonus shares and for that purpose transferred the amount standing to the credit of the fund to the share capital account. The question is whether under these circumstances issuance of bonus shares will amount to distribution of profits.

10. The answer to the question is not easy. One view is that issue of bonus shares to the shareholders involves a dual operation by which an amount is released to the shareholders from a reserve fund but was retained by the company and applied in payment of the bonus shares which were issued as fully paid up. The shareholders are treated as having paid for the bonus shares and the supposed payments by the shareholders are taken to share capital account from reserve fund of the company. In effect, the shareholders have paid the face value of the bonus shares. It was to all intents and purposes equivalent to distribution of accumulated profits in cash by the company.

11. The second view is that when bonus shares are issued an amount equal to the face value of the shares cannot be regarded as having been received by the shareholders. The issuance of bonus shares was nothing but mere capitalisation of the profits of the company in respect of which certificates are issued to the shareholders entitling them to participate in the amount of the reserve but only as part of the capital.

12. The mechanism and effect of issue of bonus shares have been explained by the English Courts in a number of cases.

13. Lord Haldane in the case of *Inland Revenue Commissioners Vs. Blott* (1921) AC 171 held:

"My Lords for the reasons I have given I think it is a 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 word 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 shareholders 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 shareholder 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.

14. In that case Viscounts Haldane, finally and Cave held that an amount equal to the face value of the shares could not be regarded as received by the shareholders. A contrary view was taken by Lord Dunedin and Lord Sumner who held that the word "capitalisation" was somewhat hazy and the amount that was capitalised had to be treated as to have been paid to the shareholders.

15. In the case of *Commissioners of Inland Revenue Vs. Fisher's Executors* (1926) A.C. 395, Viscount Cave dealt with a case of a company which had large undistributed profits. It decided to capitalise a part of these profits and distribute it pro rate among the ordinary shareholders as a bonus in the form of five per cent debenture stock. The stock was duly issued conditions providing that the company might redeem the stock after a certain time and in certain event. The question that came up for decision was whether the bonus paid in the form of debenture stock was income in the hands of the shareholders and was therefore liable to super tax. Viscount Cave held:

"The whole transaction was "bare machinery" for capitalizing profits and involved no release of assets either as income or as capital."

16. In coming to this conclusion, Viscount Cave relied upon the following observation of Lord Finlay in *Blott's* case:

"The general scope and effect of these transactions is beyond dispute. There was an increase in the capital of the company by the retention of the amounts available for dividends. The use of the sums which had been available for dividend to increase capital would enable the company to carry on a larger and more profitable business which might be expected to yield larger dividends. The dividends however were to be in the future. so far as the present was concerned there was no dividend out of the accumulated profits; these were devoted to increasing the capital of the company. The company had power to do what it pleased with any profits which it might make. It might spend the accumulated profits in the improvement of the company's works

and buildings and machinery. These improvements might lead to a great accession of business and increase of profits by which every shareholder would benefit but of course it could not for a moment be contended that such a benefit would render him liable to super tax in respect of it. The benefit would not be in the nature of income and super tax can be levied only on income."

17. In our view, the principle stated by Lord Finlay really resolves the controversy raised in this case. The profits made by the Company may be distributed as dividends or retained by the company as its reserve which may be used for improvement of the company's works buildings and machinery. That will enable the company to make larger profits. There cannot be any dispute that the shareholders will benefit from the improvements brought about in the profit making apparatus of the company. Likewise, if the accumulated profits are capitalised and capital base of the company is enlarged this may enable the company to do its business more profitably. The shareholders will also benefit if the share capital is increased. They may benefit immediately by issue of bonus shares. But neither in the case of improvement in the profit making apparatus nor in the case of expansion of the share capital of the company can it be said that the shareholders have received any money from the company. They may have benefited in both the cases. But this benefit cannot be treated as distribution of the amount standing to the credit of any reserve fund of the company to its shareholders.

18. In fact the transfer of the amounts standing to the credit of Development Rebate Reserve to the share capital account does not involve any disbursement of money by the Company. Nothing comes out of the till of the company to the shareholder. The entire amount of money shown as development rebate reserve is retained by the company in another account. It cannot be said that by the issue of bonus shares the company had distributed its reserve fund to the shareholders even though it had retained the entire amount with it in the share capital account.

19. It must also be noted that while dealing with the question of valuation of bonus shares in the case of Commissioner of Income-tax Bihar Vs. Dalmia Investment Co. Ltd. 52 ITR 567, Hidayatullah, J. (as His Lordship then was) after referring to Blott's case (supra) preferred the view expressed by Viscounts Haldane, Finlay and cave to the dissenting view taken by Lord Dunedin and Lord Sumner. Dealing with effect of issue of bonus shares, Hidayatullah, J. held that "the floating capital used in the company which formerly consisted of subscribed capital and the reserves now becomes the subscribed capital of the Company". The certificates in the hands of the shareholders were property from which income will be derived in future.

20. Hidayatullah, J. in Dalmia's Case also quoted with approval a passage from a decision of the Supreme Court of United States Eisner Vs. Macomber (1920) 252 U.S. 189:

"A stock dividend really takes nothing from the property of the corporation and adds nothing to the interests of the shareholders. Its property is not diminished and their interests are not increased...The proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest the new shares and the original shares together representing the same proportional interests that the original shares represented before the issue of the new ones. In short, the corporation is no poorer and the stock-holder is no richer than they were before. If the plaintiff gained any small advantage by the change it certainly was not an advantage of \$417,450 the sum upon which he was taxed. What has happened is that the plaintiff's old certificates have been split up in effect and have diminished in value to the extent of the value of the new."

21. When a shareholder gets a bonus share the value of the original share held by him goes down. In effect, the shareholder gets two shares instead of the one share held by him and the market value as well as the intrinsic value of the two shares put together will be the same or nearly the same as the value of the original share before the bonus issue.

22. It appears from the various decisions cited hereinabove, that issuance of bonus share does not amount to distribution of accumulated profit of a company. The shareholder derives some benefit by the process of capitalising of the accumulated profits but at the same time the value of his original shareholding goes down. Viewed from any angle, it cannot be said that in this case, the assessee-Company had distributed any part of its Development Rebate Reserve Fund when it issued the bonus shares. The accumulated profit lying to the credit of the Development Rebate Reserve has been retained by the Company. The amount has been transferred to the share capital account. If that was not done the intrinsic value of the shares held by the shareholder would have been more. After the issue of the bonus shares the intrinsic value of the original shares have gone down rateably. The accumulated profits of the company have remained with the company in one account or another.

23. On behalf of the Revenue, our attention was drawn to the judgment in the case of *Leader Engineering Works Vs. Commissioner of Income Tax, Amritsar-II* 124 ITR 44. That was a case of partnership firm. The amount standing to the credit of development rebate reserve account was debited and the capital accounts of the partners in the partnership account were correspondingly credited. It was held that the identity of the development rebate reserve account had completely disappeared. The amount standing to the credit of that reserve was placed at the disposal of the partners who were free to withdraw the same for their own purposes. In that case it was held that the transfer of the amount standing to the credit of the development rebate reserve in the individual's account of the partners amounted to distribution of profits. We fail to see how this decision helps the Revenue in the facts of this case. The shareholders are not entitled to draw any money from the share capital account of the company. The money standing to the credit of the Development Rebate Reserve is retained by the Company in another account. A shareholder cannot claim that any part of the share capital of the company belongs to him or make use of it.

24. The question as to the substance of the transaction was also raised. The case, however has to be decided on the basis of the language of the statute. There has been no distribution from the development rebate fund. The result might have been different had the statute been differently worded but we shall have to take the statute as it is and not in any other sense. Moreover, as was pointed out by Lord Sumner in *Fisher's case* that 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.

25. In this case neither in form nor in substance has there been any distribution of profits by the company in making the bonus issue. If the substance and not the form of the transaction is looked to the issue of a bonus shares was in the language of Rowlatt, J. "a bare machinery" for capitalising profits and there was no distribution of profits to the shareholders.

26. We are unable to uphold the view expressed by the High Court that the issue of bonus shares in the facts of this case amounted to distribution of accumulated profits of the Company shown as Development Rebate Reserve Fund. The appeals are allowed. The judgment under appeal is set aside. There will be no order as to costs.