SUPREME COURT OF INDIA

Khoday Distilleries Ltd.

Vs.

Commissioner of Income Tax

C.A.No.6654 of 2008

(S.H. Kapadia and B. Sudershan Reddy JJ.)

14.11.2008

JUDGMENT

S.H. KAPADIA, J.

1. Leave granted.

2. This civil appeal filed by the assessee seeks to challenge judgment and order passed by the Karnataka High Court dated 1.8.2007 in Gift Tax Appeal No. 2/02. In this civil appeal we are concerned with the assessment year 1987-88.

3. Two questions arise for determination in this civil appeal, which are as follows:

(i) Whether any "gift" arose in terms of Section 2(xii) of the Gift-tax Act, 1958 ("1958 Act") on the allotment of rights issue by the appellant company to its shareholders vide Board's Resolution dated 29.1.1986?

(ii) Whether there was any element of "gift" as defined under Section 2(xii) in the appellant issuing Bonus shares in the ratio of 1:23 in April/May, 1986? Answer to Question No. 1:

4. On 29.1.1986 the appellant company, on the other shareholders not exercising the option given to them to take up the right shares issued by the appellant, allotted them to the seven investment companies, who were the shareholders in the appellant's company. At this stage, it may be stated, that in all there were twenty-seven shareholders. Twenty shareholders did not subscribe to the rights issue and consequently the appellant-company allotted them to the remaining existing shareholders. The A.O. held that the said allotment by way of rights issue was without adequate consideration within the meaning of Section 4(1)(a) of the 1958 Act. He further held that the modus operandi was an attempt to evade taxes; that it was a colourable transaction and since the shares allotted were without adequate consideration, there was a deemed gift under Section 4(1) of the 1958 Act. Accordingly, the difference between the value of the shares on yield basis and the face value of Rs. 10/- at which the shares were allotted was sought to be brought to tax under the said section. Aggrieved by the decision of the A.O., the appellant carried the matter in appeal to CIT(A). It was held that the entire exercise undertaken by the appellant was to evade payment of wealth tax by the individual shareholders of the appellant-company. This finding was given by the CIT(A) on the ground that right shares were allotted because 20 existing shareholders out of 27 shareholders of the company did not subscribe for the rights. However, according to the CIT (A), gift tax proceedings had to be initiated by the Department not against the appellant company but it ought to have initiated gift tax proceedings against the existing shareholders who had renounced their rights. Having so held, the CIT(A) came to be conclusion that the entire exercise undertaken by the appellant was to avoid payment of wealth tax and, therefore, it was held that the company was liable to pay gift tax for transfer of the said shares to the seven investment companies. This decision of the CIT(A) stood reversed by the Tribunal which decided the appeal filed by the company against the Department. The Tribunal came to the conclusion that the allotment of rights by the appellant did not constitute "transfer" as it did not involve any existing property at the time of such allotment. According to the Tribunal, the seven investment companies made payment towards the face value of the shares and, consequently, it cannot be said that the contract was without consideration. It was further held that in this case there was no element of gift under Section 4(1)(a) as there was no transfer of property as defined under Section 2(xxiv) of the 1958 Act. Aggrieved by the decision of the Tribunal, the Department preferred Gift Tax Appeal No. 2/02, which, vide the impugned judgment, stood disposed of in favour of the Department, hence, this civil appeal.

5. Shri Soli J. Sorabjee, learned senior counsel appearing on behalf of the appellant, submitted that gift tax is not attracted on initial allotment of shares because there is no transfer of any existing movable property, namely, the shares. According to the learned counsel, till allotment is made, shares did not exist. It is only on allotment that shares come into existence. In this connection, learned counsel placed reliance on the judgment of this Court in the case of Sri Gopal Jalan &

Company v. Calcutta Stock Exchange Association Ltd. reported in 1964 (3) SCR 698. He also relied upon the judgment of this Court in the case of Sangramsinh P. Gaekwad and ors. V. Shantadevi P. Gaekwad (Dead) through LRs. and ors. reported in (2005) 11 SCC 314. Learned counsel further submitted that there is a vital difference between tax planning and tax evasion. According to the learned counsel, it is perfectly legitimate and permissible for an assessee to so arrange his affairs with a view to reduce its tax liability and such tax planning cannot be equated with tax evasion. In this connection, learned counsel submitted that the transaction in question was not sham or fictitious but real and it was given effect to. Moreover, it was contended that the stand taken by the Department, in this case, was conflicting inasmuch as according to the A.O. what was intended to be evaded was income-tax by the Directors of the appellant-company whereas, according to the CIT(A), the exercise undertaken by the appellant-company was to evade wealth tax. Learned counsel submitted in the alternative that even assuming whilst denying that there was an intention to evade income tax or wealth tax, the correct course open to the Department was to include the income or wealth in the income tax or wealth tax assessment of the concerned assessee. For the aforestated reasons, learned counsel submitted that the High Court should not have interfered with the decision of the Tribunal.

6. Shri Mohan Parasaran, learned Additional Solicitor General, appearing on behalf of the Department submitted that allotment of shares on rights basis under Section 81 of the Companies Act, 1956 would come under the concept of "deemed gift" under Section 4(1)(a) of the Gift-tax Act. According to the learned counsel, no sooner a declaration is made by the Board of Directors announcing issue of rights, a right accrues to the existing shareholders either to opt for rights or to renounce it in favour of existing shareholders. In this connection, learned counsel submitted that no sooner the Board of Directors decide to issue rights, the existing shareholders who are offered rights get a tangible right to opt for allotment or they could renounce it in favour of existing shareholders and as and when said option is exercised, the right gets crystallized and, therefore, in such cases where renouncement takes place on exercise of the option in favour of the existing shareholder(s) there would be a transfer of an existing interest, which transfer would attract Section 4(1)(a) of the Gift-tax Act. In this connection, learned counsel placed heavy reliance on the judgment of the Madras High Court in the case of S.R. Chockalingam Chettiar v.Commissioner of Gift-Tax reported in (1968) 70 ITR 397.

7. At the outset, we may state that none of the above arguments have been considered by the High Court in its impugned judgment. In the case of Sri Gopal Jalan & Company (supra) a question arose as to the meaning of the word "allotment". It was held that in Company Law the word "allotment" means appropriation out of previously unappropriated capital of a company, of a certain number of shares, to a person and till such allotment, the shares do not exist as such. It is only on allotment that the shares come into existence and in every case the words "allotment of shares" have been used to indicate the creation of shares by appropriation out of the unappropriated share capital to a particular person.

8. In our view, the judgment of this Court in Sri Gopal Jalan & Company (supra) squarely applies to the present case. There is a vital difference between "creation" and "transfer" of shares. As stated

hereinabove, the words "allotment of shares" have been used to indicate the creation of shares by appropriation out of the unappropriated share capital to a particular person. A share is a chose in action. A chose in action implies existence of some person entitled to the rights in action incontradistinction from rights in possession. There is a difference between issue of a share to a subscriber and the purchase of a share from an existing shareholder. The first case is that of creation whereas the second case is that of transfer of chose in action. In this case, when twenty shareholders did not subscribe to the rights issue, the appellant allotted them to the seven investment companies, such allotment was not transfer. In the circumstances, Section 4 (1)(a) was not applicable as held by the Tribunal.

9. Since heavy reliance is placed by the learned Additional Solicitor General on the judgment of the Madras High Court in the case of S.R. Chockalingam Chettiar (supra), we may state that the said judgment has no application to the facts of the present case. In that case, the facts were as follows. Appellant was a shareholder of S.R.C.M. Ltd.. Appellant was an assessee. Appellant was entitled to apply for 800 equity shares in a fresh issue of capital by the company with a option to renounce the same as provided for in Section 81 of the Companies Act, 1956. On 15.6.1957, appellant renounced these shares in favour of S, who applied for those shares on the strength of the renunciation. The Gift-tax Officer held that the renouncement involved the gift of a valuable right and, evaluating the value of the gift as the difference between the market value of the shares on the date of renunciation (15.6.1957) and the value at which they were issued to the existing shareholders, levied gift tax on the total amount. On Reference to the High Court, it was held that the right to obtain a specified number of right shares under Section 81 of the Companies Act in the fresh issue of capital is a tangible right and is not an interest in future property but it is existing property as defined in the Gift-tax Act and, therefore, Tribunal was right in directing the Gift-tax Officer to levy gift tax on the market quotations of the rights. This judgment has no application to the facts of the present case. In the case of S.R. Chockalingam Chettiar (supra), the assessee was an individual shareholder, who was held to be a donor. In that case, the company allotting the shares was not treated as an assessee under the Gift-tax Act. The liability under the Gift-tax Act to pay the gift tax is on the donor. In the present case, one fails to understand how the appellant- company could be treated as donor. S.R. Chockalingam Chettiar was a shareholder of S.R.C.M. Ltd. and he was sought to be assessed under the Gift-tax and not S.R.C.M. Ltd.. Therefore, judgment in S.R. Chockalingam Chettiar has no application.

10. There is a difference between "renunciation" and "allotment". In this case, the Department has confused the two concepts. The judgment of the Madras High Court in the case of S.R. Chockalingam Chettiar (supra) dealt with the case of renunciation in which case under certain circumstances the renouncer could be treated as a donor liable to be taxed under Section 4(1)(a) of the Gift-tax Act, 1958. That is not the situation here. In the present case, the Department has sought to tax the appellant- company as a donor under the 1958 Act for making allotment of right shares. The Department has not taxed the renouncer shareholders despite the decision of CIT(A). Allotment is not a transfer. Moreover, there is no element of existing right in the case of allotment as required under Section 2 (xii) of the 1958 Act. In the case of renunciation for inadequate consideration in a given case Section 4(1)(a) could stand attracted. However, in such a case, the Department has to proceed against the renouncer (shareholder). For the above reasons, the judgment of the Madras High Court in S.R. Chockalingam Chettiar case has no application.

11. One more aspect needs to be mentioned. As stated above, in this case, even according to CIT(A), the right shares were allotted to the seven investment companies because the other existing shareholders did not subscribe for the shares. According to CIT(A), the gift tax proceedings ought to have been initiated against the existing shareholders, who had renounced their rights. We are surprised that despite the orders passed by CIT(A), the Department did not initiate proceedings under the Gift-tax Act against the shareholders who had renounced their rights, particularly when the CIT(A) has specifically said so in her order. For the aforestated reasons, we hold that the word "allotment" indicates creation of shares by appropriation out of the unappropriated share capital to a particular person and that such creation did not amount to transfer. That, in any event, liability to pay gift tax would be on the donor (shareholder) who exercises the option to renounce and not on the appellant-company. Accordingly, question no. 1 is answered in favour of the appellant and against the Department. Answer to Question No. 2:

12. The second issue to be decided is whether there is element of "gift" in the appellant issuing bonus shares in the ratio of 1:23 in April/May, 1986. In addition to the levy of gift tax on the allotment of right shares, the A.O. levied gift tax on the bonus shares issued later by the appellant.

13. When a company is prosperous and accumulates a large surplus, it converts this surplus into capital and divides the capital amongst the members in proportion to their rights. This is done by issuing fully paid shares representing the increased capital. The shareholders to whom the shares are allotted have to pay nothing. The purpose is to capitalize profits which may be available for division. Bonus shares go by the modern name of "capitalization shares". If the Articles of a company empowers the company, it can capitalize profits or reserves and issue fully paid shares of nominal value, equal to the amount capitalized, to its shareholders. The idea behind the issue of bonus shares is to bring the nominal share capital into line with the excess of assets over liabilities. A company would like to have more working capital but it need not go into the market for obtaining fresh capital by issuing fresh shares. The necessary money is available with it and this money is converted into shares which really means that the undistributed profits have been ploughed back into the business and converted into share capital. Therefore, fully paid bonus shares are merely a distribution of capitalized undivided profit. It would be a misnomer to call the recipients of bonus shares as donees of shares from the company.

14. Our aforesaid view, namely, that bonus shares go by the modern name of "capitalization shares" finds support in the judgment of this Court in the case of Hunsur Plywood Works Ltd. v. Commissioner of Income- tax reported in (1998) 229 ITR 112. The relevant portion of which reads as under:

"...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.

The mechanism and effect of issuance of bonus shares have been explained by the English courts in a number of cases.Lord Haldane in the case of IRC v. Blott (1921) 2 AC 171 (HL) held (page 184):

"My Lords, for the reasons I have given I think 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 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."

In that case, Viscounts Haldane, Finlay 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.

In the case of Commissioners of Inland Revenue v. Fisher's Executors (1926) AC 395 (HL), Viscount Cave dealt with the case of a company which had large undistributed profits. It decided to capitalise a part of these profits and distribute it pro rata 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 events. 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 (page 404):

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

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."

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.

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.

It must also be noted that while dealing with the question of valuation of bonus shares in the case of CIT v. Dalmia Investment Co. Ltd. (1964) 52 ITR 567 (SC), Hidayatullah, J. (as His Lordship then was), after referring to Blott's case, preferred the view expressed by Viscounts Haldane, Finlay and Cave to the dissenting view taken by Lord Dunedin and Lord Sumner. Dealing with the 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.

Hidayatullah J., in Dalmia case, also quoted with approval a passage from a decision of the Supreme Court of the United States, Eisner v. 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 interest that the original shares represented before the issue of the new ones. ... In short, the corporation is no poorer and the stockholder 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."

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.

It appears from the various decisions cited hereinabove, that issuance of bonus shares 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."

15. One of the points raised on behalf of the Department was that the entire exercise undertaken by the appellant constituted tax evasion. According to the Department, by a paltry investment of Rs. 10 lacs (approximately) the seven investment companies became owners of 24,00,168 shares of M/s Khodey Distilleries Ltd. worth Rs. 2,40,01,680. According to the Department, the market value of the said shares and the yield from the said shares were totally disproportionate to the investments made by the seven investment companies. Therefore, according to the Department, the modus operandi adopted by the appellant was an exercise

in tax evasion.

16. As stated above, we do not know the reason why the Department had not proceeded under the Income-tax Act, 1961 if, according to the Department, the case was of tax evasion. According to the CIT(A), the appellant had undertaken an exercise to avoid wealth tax whereas according to the A.O. the exercise undertaken by the appellant was to evade Gift Tax and in the same breadth the A.O. states that the entire exercise was to evade tax by allotting shares to the Directors which attracted the deeming provisions of Section 2(22) of the 1961 Act (see page 35 of the Paper Book). There is utter confusion on this aspect. Therefore, in our view, on the question of evasion of tax, the contention of the Department is conflicting. In fact, as stated above, the Department has messed up the

entire case. The Department has not kept in mind the difference between "allotment" and "renunciation". The Department has not invoked the provisions of the Gift-tax Act against the renouncer shareholder despite the observation of the CIT(A) in that regard.

17. None of the above aspects has been dealt with by the High Court in its impugned judgment.

18. For the aforestated reasons, the impugned judgment of the High Court is set aside and the civil appeal filed by the assessee stands allowed with no order as to costs.