BOMBAY HIGH COURT

Commissioner of Income-Tax

Vs

F.L. Smidth & Co. Ltd

(Chagla, C.J. S Desai, J.)

23.09.1958

JUDGMENT

Chagla, C.J.

1. The assessee is a private company and the assessment year is 1949-50 and the accounting year is the current year 1948. Now, the total assessable income of this company was Rs. 1,20,566, and at the general meeting held on the 23rd of December, 1949, no dividend was declared. Thereupon, the Income-tax Officer passed an order under section 23A and it is this order which was challenged by the assessee company and successfully challenged as far as the Tribunal was concerned. Now, in arriving at the assessable income of the assessee, the Income-tax Officer took into consideration a sum of Rs. 1,63,377, which were profits, according to the Department, earned by the assessee under section 42 (2) of the Income-tax Act and the contention of the assessee is that in deciding whether section 23A is applicable to this case and whether the Income-tax Officer has rightly exercised his power, this sum of Rs. 1,63,377 should be excluded in determining whether the profits of the company were such so as to attract the application of section 23A.

2. Now, let us first look at the scheme of section 23A. The first condition for the exercise of the power of the Income-tax Officer is the distribution of dividend by the company of less than the statutory percentage, which, at the relevant time, was 60 per cent. and in this case it is not disputed that looking to the total income of the assessee, which, as already pointed out, is Rs. 1,20,566, the company has not only not distributed the statutory percentage of dividend but has not distributed any dividend at all. It must be borne in mind that section 23A (1) deals with total income and the total income for the purpose of this section is not merely the actual income of the assessee but also any notional income which is assessable to tax and, therefore, although the income under section 42 (2) is notional income, it would form part of the total income of the assessee and it would be liable to tax. This notional income would also form part of the total income of the assessee for the purpose of determining whether there has been a distribution of the statutory percentage of dividend. That this income under section 42 (2) is notional income

cannot be disputed because turning to that section, it deals with notional income both under sub-section (1) and sub-section (2). In the case of sub-section (1) the income actually exists. The legal fiction introduced is with regard to the place where the income accrues and by reason of the legal fiction the income which may accrue elsewhere is made to accrue within the taxable territories and becomes a notional income of the assessee. In the case of sub-section (2) the fiction introduced is very different. The fiction introduced there is with regard to the income itself. In fact there is no income, but sub-section (2) introduces a legal fiction and makes a non-existent income, income of the assessee from the purpose of tax if the circumstances laid down in that sub-section are satisfied. We are here concerned with section 42 (2) and there can be no doubt that, although the assessee company was liable to pay tax on this income, this income is a notional income and not actual income. In other words, from a commercial point of view, it could never be said that the assessee earned this income or this income constituted the profits of the assessee from its business. The taxing authorities may look upon this income as profits of the assessee and may bring it to tax but from the point of view of businessmen, from a practical point of view, it would be ridiculous to suggest that an income which the assessee never earned was part of its actual profits.

3. Now, although the first condition for the exercise of the power of the Income-tax Officer is failure to distribute the statutory percentage of dividend, he cannot exercise that power unless the other condition laid down in the latter part of that sub-section is also satisfied and that second condition is that he must consider whether there are any losses incurred by the company in the earlier years and he must also consider the profits made by the company in the accounting year, and it is his duty having considered these two factors to decide whether the payment that the payment of a dividend would be unreasonable. If he decides that the payment of a dividend or a larger dividend would be unreasonable, then he cannot make an order. If he comes to the contrary conclusion, he can exercise his powers under section 23A. Now, the substance of the matter is this that for the purpose of the second part of section 23A, when the Income-tax Officer is considering the smallness of the profits, when the Income-tax Officer is considering the profits and is considering whether it would be reasonable or unreasonable to declare a larger dividend, the profits that he has to consider are not the total income referred to in section 23A (1), but actual profits from a commercial point of view. Whereas, the first part speaks of total income of an assessee, the second part of section 23A (1) refers to profits and, therefore the approach of the Income-tax Officer must be entirely different when he is considering the making of the order and considering whether the conditions are existent for the exercise of his power. Whereas, under the first part of section 23A he has to confine himself to the total income of an assessee, under the second part his approach must be from a commercial point of view. He must look at the actual income of the assessee and he must decide whatever the total income may be, whatever the assessable income may be, whether the actual profits are such as would be reasonable to suppose that the company could have declared a higher dividend ? If that be the correct approach, then the matter does not present any difficulty. The sum of Rs. 1,63,377, a already pointed out, is notional income of the assessee under section 42 (2). It is part of the total income. It is liable to

tax and admittedly the assessee company has not declared any dividend. Therefore, the first condition set out in the first part of section 23A (1) is satisfied. What about the second condition and that is where the trouble arises. Now, the view taken by the Department is that even under the second part of section 23A (1), the profits which the Income-tax Officer has to consider are profits which would include the sum of Rs. 1,63,377. One has only to state the proposition to realise how clearly insupportable and untenable it is. If the profits under section 42 (2) are notional, if they were never actual profits made by the assessee company, then how can it possibly be said that they constitute actual profits from a commercial point of view ? How can it also be said that the profits which did not in fact exist could ever have been distributed as dividends ?

4. Mr. Joshi has relied on sub-section (5) of section 23A which is now repealed. That sub-section far from helping Mr. Joshi, in our opinion, supports the contention of the assessee.

5. Now that sub-section provided that when a company is a shareholder deemed under sub-section (1) to have received a dividend, the amount of the dividend thus deemed to have been paid to it shall be deemed to be part of its total income for the purpose also of the application of that sub-section to distributions of profits by that company. Therefore, here again the Legislature is referring to the total income for the purpose of the first part of section 23A (1) and it provides that the notional dividend which a shareholder is supposed to have received shall form part of the total income of the company, if the company happens to be shareholder. But sub-section (5) does not make any reference to the question of the consideration of the profits which the Income-tax Officer has got to do for the purpose of the second part of section 23A (1). Therefore, unless we had some legislative provision which would have made it possible for the Income-tax Officer to include in the expression "profits" used in the second part of section 23A (1) the notional income earned by the assessee under section 42 (2), there is no warrant from the Income-tax Officer to consider this notional income when he is considering the profits of the assessee under the second part of section 23A (1) in order to decide whether the profits are so small that it would be unreasonable to make an order.

6. We took the same view of the law in two decisions which have been cited at the bar, namely, Sir Kasturchand Ltd. v. Commissioner of Income-tax and what we held was that in determining whether an order should be made under section 23A the Income-tax Officer has got consider not the assessable income of the company but the actual profits made by the company; and again in Bipinchandra Maganlal & Co. Ltd. v. Commissioner of Income-tax when the total income of the assessee was increased by a notional income, we held that, although the notional income was part of the assessable income, it did not constitute the actual profits of the assessee from a commercial point of view and that the Income-tax Officer was not justified in making an order on the basis that this notional income constituted the profits of the assessee.

7. Our attention has also been drawn by Mr. Joshi to the recent judgment of the Supreme Court in

Mazagaon Dock's case where the learned Judges of the Supreme Court have held that the income under section 42 (2) is a notional income.

8. The result is that the assessee succeeds on this reference and we must answer the question submitted to us in the negative.

9. Commissioner to pay the costs.

10. Question answered in the negative.