

BOMBAY HIGH COURT

W.H. Brady & Company Ltd

Vs

Commissioner of Income-Tax

(R Kantawala, C.J. S Desai, J.)

30.06.1978

JUDGMENT

Kantawala, C.J.

1. The question in this reference relates to determination of capital gains realised by Messrs. W. H. Brady & Company Ltd., the assessee, on sale of 8,833 shares of New City of Bombay Manufacturing Company Ltd. (hereinafter referred to as "the company"). The assessee is a public limited company doing business as managing agents. Between 1922 and 1941, the assessee had bought 670 shares of the company and the cost thereof was Rs. 1,33,146. In May, 1942, the assessee acquired further 670 shares as bonus shares by virtue of its possessing 670 shares. Between April 16, 1942, and April 30, 1946, the assessee bought further 765 shares of the company for the aggregate price of Rs. 3,22,252. After this purchase, on April 30, 1946, the total holding of the assessee consisted of 2,105 shares of the company. On the strength of that holding, on that day, it received another lot of 2,105 shares as bonus shares. Subsequently between April, 1946, and February, 1960, the assessee acquired further, 4,623 shares for the aggregate of Rs. 8,55,122. The ruling rate of these shares on January 1, 1954, was Rs. 167.50 per share, while between April, 1946, and December, 1953, the rates at which the assessee had from time to time purchased the shares were higher than that rate.

2. In the year of account, i.e., the calendar year ending December 31, 1961, the assessee sold all the shares of the company at the rate of Rs. 275 per share, and the aggregate price realised by it came to Rs. 24,29,075. The assessee incurred expenditure of Rs. 51,843 in connection with the sale of these shares.

3. For the assessment year 1962-63, while assessing the assessee under the I. T. Act, a question arose as regards calculation of capital gains payable by it by reason of these shares. Before the taxing authorities the assessee claimed that the capital gains were only Rs. 5,99,899 calculated as under :

	Rs.	Rs.
Sale proceeds of 8,833 shares		24,29,075
Les : Actual cost of 6,058 shares	13,12,520	
Value of 2,775 bonus shares at Rs. 167.50, being the market value as on 1-1-54	4,64,813	
Expenditure incurred for sale	51,843	

		18,29,176

		5,99,899

4. In effect, the assessee segregated the bonus shares, treated their cost of acquisition as nil and sought to exercise the option of substituting the market value of the asset as on January 1, 1954, in respect of these shares in place of their cost of acquisition.

5. The ITO determined the capital gains at Rs. 7,50,958 as under :

	Rs.	Rs.
Sale proceeds of 8,833 shares		24,29,075
Les : Market price as on 1-1-1954		
Shares acquired before May, 1946	4,48,900	
Actual cost of the remaining shares	11,77,374	
Expenses in connection with sale	51,843	

		16,78,117

		7,50,958

6. The ITO considered the first lot of 670 shares purchased between 1922 and 1942 along with 2,010 bonus shares issued with reference to these original holdings. This lot of 2,680 shares included 670 shares originally purchased between 1922 and 1942, the first lot of 670 bonus shares issued in May, 1942, and the second lot of 1,340 bonus shares issued by reference to the original 670 shares and the first batch of the bonus shares. He spread the cost of original shares over the whole lot of 2,680 shares which included 670 original shares and 2,010 bonus shares. Since the average cost according to this formula was much less than the market price of the shares as prevailing on January 1, 1954, he gave the assessee the benefit of the option of the

market price as on January 1, 1954, in respect of this lot of 2,680 shares. In regard to the second lot of 765 shares bought between 1942 and 1946 and 765 bonus shares issued to the assessee in April, 1946, by reference to these shares, the average cost came to Rs. 210 per share. It was much higher than the market price of the shares as on January 1, 1954. The ITO, therefore, did not substitute the market price as on January 1, 1954, in place of the original cost in respect of the second lot. In respect of the third lot also, the position was the same as in the case of the second lot, except that in the third lot there were no bonus shares. No substitution was, therefore, necessary in the case of the third lot. On this basis, he calculated the capital gains at the sum of Rs. 7,50,958 as indicated above.

7. In an appeal preferred by the assessee, the AAC accepted the contention of the assessee that in respect of the bonus shares their cost would be nil and the assessee would be entitled to substitute the market price as on January 1, 1954. This conclusion was arrived at by him relying upon the decision of the Bombay High Court in the case of *Miss Dhun Dadabhoy Kapadia v. CIT*¹

8. In an appeal preferred by the revenue before the Tribunal, it was contended on its behalf that the decision of the Bombay High Court in the case of *Miss Dhun Dadabhoy Kapadia v. CIT*² on which reliance was placed by the AAC, was overruled by the Supreme Court, and the judgment of the Supreme Court was . It was urged before the Tribunal that the decision of the Supreme Court in the case of *CIT v. Dalmia Investment Co. Ltd.* was directly applicable to this case and according to that decision the cost of bonus shares had to be determined by spreading the cost of the original shares over the original and bonus shares and taking the average thereof. On behalf of the assessee, it was sought to be urged before the Tribunal that the said decision of the Supreme Court was applicable only in the case of dealers in shares, whereas the assessee was essentially an investor in shares. It was urged that each share was a commodity separate by itself and the cost of each share had to be determined separately without having regard to the cost of other shares. It was pointed out that under s. 55(2) of the I. T. Act, 1961, the expression "cost of acquisition" had been clearly defined and accordingly the cost had to be determined as provided in that definition without having any recourse to any judgment. The contentions urged on behalf of the assessee did not find favour with the Tribunal and the Tribunal held that the basis adopted by the ITO was in complete conformity with the principles for determination of cost of bonus shares laid down by the Supreme Court and the capital gains determined by him was the correct amount. In its order, the Tribunal pointed out that there is no difference in principle between determining the commercial profits of a dealer in shares on sale of shares and determination of capital gains realised by an investor on sale of shares. The Tribunal pointed out that the definition of the expression "cost of acquisition" in s. 55(2) did not make any difference whatsoever in the application of the principle laid down by the Supreme Court in *Dalmia Investment Co. Ltd.*'s case . The Tribunal applied the ratio laid down by Hidayatullah J., as he then was, in the case of

Dalmia Investment Co.'s case . The bonus shares cannot be said to have cost nothing to the shareholder because on the issue of the bonus shares, there is an instant loss to him in the value of the original holding. The earning capacity of the capital employed remains the same, even after the reserve is converted into bonus shares. By the issue of the bonus shares there is a corresponding fall in the dividends, actual or expected, and the market price moves accordingly. The method of calculation which places the value of bonus shares at nil cannot be correct.

9. The Tribunal pointed out that the decision of the Bombay High Court on which reliance was placed by the AAC, was reversed by the Supreme Court, and accordingly the Tribunal was persuaded to accept the contention urged on behalf of the revenue and to restore the capital gains to the amount determined by the ITO.

10. From this order of the Tribunal for the assessment year 1962-63, the following question has been referred to us for our determination :

"Whether, on the facts and in the circumstances of the case, the correct capital gains realised by the assessee on sale of shares of the New City of Bombay Manufacturing Company Ltd. was Rs. 5,99,899 as returned by the assessee, or Rs. 7,50,958 as determined by the Income-tax Office ?"

11. Mr. Dastoor, on behalf of the assessee, urged that each share of a limited company is a separate capital asset and for computation of capital gains the assessee has the option in respect of such of the shares as it may desire to retain the amount of actual cost of acquisition, while in respect of such of the shares as it may desire to sell to calculate on the basis of the price prevailing on January 1, 1954. The option to determine the cost of acquisition is with the assessee and in case where the cost of acquisition of shares is to be determined, where the shares are partly purchased and partly received by the assessee as free bonus shares, it is open to the assessee so far as the shares purchased by him are concerned, to consider the cost of acquisition as the price paid by him, and in regard to the other shares received by him as bonus shares, to consider the cost of shares as prevailing on January 1, 1954. Such option entirely lies with the assessee and it is neither open to the taxing authorities nor the Tribunal to interfere with that option exercised by the assessee. He submitted that such being the correct principle for determining the cost of acquisition, the manner in which the capital gains were calculated on behalf of the assessee at Rs. 5,99,899 was just and proper and the ITO and the Tribunal were in error in discarding that method of calculation and calculating them in a different manner. In short, his submission was that the contention urged on behalf of the assessee which was accepted by the AAC was right and proper and the capital gain received on account of the sale of the shares can only be computed at the figure of Rs. 5,99,899.

12. Under s. 48 of the I. T. Act, 1961, the income chargeable under the head "Capital gains" shall be computed by deducting from the full value of the consideration received or accruing as a result of the transfer of the capital asset the following amounts, namely -

- (i) expenditure incurred wholly and exclusively in connection with such transfer;
- (ii) the cost of acquisition of the capital asset and the cost of any improvement thereto.

13. Mr. Dastoor invited our attention to the definition of the expression "cost of acquisition" given in s. 55(2). We are concerned with sub-clause (1) of clause (2) of s. 55, and under that sub-section "cost of acquisition" in relation to a capital asset where the capital asset became the property of the assessee before the 1st day of January, 1954, means the cost of acquisition of the asset to the assessee or the fair market value of the asset as on the 1st day of January, 1954, at the option of the assessee. The argument of Mr. Dastoor is that having regard to this definition, since each share can be regarded as a separate capital asset, it is open to the assessee, if he so chooses, to value each share separately in such manner as he may desire, even though all the shares may pertain to the shares of the same limited company, irrespective of the fact that some of them might have been purchased by him as from time to time and the rest might have been received by him as free bonus shares by reason of his holding of the earlier shares.

14. For the purpose of computation of capital gains, how the bonus shares are to be valued has been considered by the Supreme Court in the case of CIT v. Dalmia Investment Co. Ltd. . It was held by the Supreme Court in this case that where bonus shares are issued in respect of ordinary shares held in a company by an assessee who is a dealer in shares, their real cost to the assessee cannot be taken to be nil or their face value. Hidayatullah and Shah JJ., who constituted the majority of the Bench, took the view that such bonus shares have to be valued by spreading the cost of the old shares over the old shares and the new issue (viz., the bonus shares) taken together if they rank pari passu and if they do not, the price may have to be adjusted either in proportion to the face value they bear (if there is no other circumstance to differentiate them) or on equitable considerations based on the market price before and after issue. Hidayatullah J. in his judgment pointed out that there are four possible methods for determining the cost of bonus shares. The first method is to take the cost as the equivalent of the face value of the bonus shares. The second method is that, as the shareholder pays nothing in cash for the shares, cost should be taken at nil. The third method is to take the cost of the original shares and to spread it over the original shares and bonus shares taken collectively. The fourth method is to find out the fall in the price of the original shares on the stock exchange and to attribute this to the bonus shares. The learned judge further pointed out that the method of computing the cost of bonus shares at their face value did not accord either with fact or business accountancy. He thereafter proceeded to consider whether the bonus shares are a gift and are acquired for nothing. At first sight, it looks as if they are so,

but the impact of the issue of bonus shares has to be seen to realise that there is an immediate detriment to the shareholder in respect of his original holding. By the issue of bonus shares pro rata which ranked pari passu with the existing shares, the market price was exactly halved, and divided between the old and the bonus shares. This will ordinarily be the case but not when the shares do not rank pari passu. When the shares rank pari passu, the result may be stated by saying that what the shareholder held as a whole rupee coin is held by him, after the issue of bonus shares, in two 50 np. coins. The total value remains the same, but the evidence of that value is not in one certificate but in two. He further proceeds to point out that the bonus shares cannot be said to have cost nothing to the shareholder because on the issue of the bonus shares, there is an instant loss to him in the value of his original holding. The earning capacity of the capital employed remains the same, even after the reserve is converted into bonus shares. By the issue of the bonus shares there is a corresponding fall in the dividends, actual or expected, and the market price moves accordingly. The method of calculation which places the value of bonus shares at nil cannot be correct. The learned judge then proceeds to consider the cost, where the new shares rank pari passu with the old shares or may be different. The method of cost accounting may have to be different in each case but in essence and principle there is no difference. One possible method is to ascertain the exact fall in the market price of the shares already held and attribute that fall to the price of the bonus shares. This market price must be the middle price and not as represented by any unusual fluctuation. The other method is to take the amount spent by the shareholder in acquiring his original shares and to spread it over the old and new shares treating the new as accretions to the old and to treat the cost, old price of the original shares, as the cost price of the old shares and bonus shares taken together. It is this last method that was suggested for acceptance on behalf of the revenue before the learned judge, and the learned judge pointed out that since the bonus shares rank pari passu with the old shares there is not difficulty in spreading the original cost over the old and the new shares and the contention of the department in this case was right. He further proceeds to point out that this simple method may present difficulties when the shares do not rank pari passu or are of a different kind. In such cases, it may be necessary to compare the resultant price of the two kinds of shares in the market to arrive at a proper cost valuation. In other words, if the shares do not rank pari passu assistance may have to be taken of other evidence to fix the cost price of the bonus shares. It may then be necessary to examine the result as reflected in the market to determine the equitable cost. In the case before him as the bonus shares ranked pari passu with the old shares, the original cost was spread over the old and the new shares and it was on that basis that the amount of capital gains was determined in that case. In our view, the ratio of the Supreme Court decision in Dalmia Investment Co. Ltd.'s case is directly applicable to the facts of the present case.

15. Reference was made by Mr. Dastoor to the decision of the Supreme Court in the case

Shekhawati General Traders Ltd. v. ITO . This was a case where the court was concerned with an issue of bonus shares after January 1, 1954. We are not concerned with a case of that type. Actually in this case the questions with which we are concerned did not arise for consideration and any attempt to pick up an isolated sentence shorn from the context is of no assistance to the court in view of the clear pronouncements of the Supreme Court in Dalmia Investment Co. Ltd.'s case , where the principles are fully crystallised.

16. The principle that was laid down in Dalmia Investment Company Ltd.'s case has been reiterated by the Supreme Court also in the case of *CIT v. Gold Mohore Investment Co. Ltd*³. It held that in the case of a dealer in shares who values his stock at cost, where bonus shares issued in respect of ordinary shares held by him rank pari passu with the original shares, the correct method of valuing the cost to the dealer of the bonus shares is to take the cost of the original shares, spread it over the original shares and the bonus shares collectively and find out the average of all the shares. An attempt was made in this case, on behalf of the counsel, to persuade the Supreme Court to depart from the principle laid down in Dalmia Investment Co. Ltd.'s case , but the Supreme Court pointed out that they reconsidered the matter again and were of the opinion that the method followed in Dalmia Investment Co. Ltd.'s case was the correct method.

17. It was sought to be urged by Mr. Dastoor that in Dalmia Investment Co. Ltd.'s case , the court was concerned with a dealer, whereas in the present case we are concerned with the investment in shares and a principle which may be applicable in the case of a dealer in shares ought not to be applied to the case of an investor. So far as this court is concerned, such a question is concluded by the decision of this court in the case of *D. M. Dahanukar v. CIT*⁴ to which I was a party. In this case, the view taken is that the correct method of valuing the cost to a person of bonus shares is to take the cost of the original shares, spread it over the original shares and the bonus shares collectively and find out the average price of all the shares. The method would be the same whether the assessee is a dealer in shares or an investor. Thus, it is not permissible, so far as this court is concerned. for Mr. Dastoor to contend that the case of an investor in shares is different from that of a dealer in shares.

18. It is quite apparent that if the principle laid down by the Supreme Court in Dalmia Investment Co. Ltd.'s case is borne in mind, then the method of calculation of capital gains canvassed on behalf of the assessee cannot be accepted. The method that has been adopted by the ITO, which has been approved by the Tribunal is on the average basis and having regard to the facts and circumstances of the case and the principle laid down by the Supreme Court in Dalmia Investment Co. Ltd.'s case , the amount of capital gains calculated by the ITO is correct. Thus, in our opinion, the Tribunal was right in affirming the view taken by the ITO that the capital gains realised by the assessee on sale of shares of the company, viz., the New City of Bombay

Manufacturing Company Ltd., was Rs. 7,50,958.

19. We answer the question referred to us accordingly. The assessee shall pay the costs of the revenue.

Cases Referred.

1[1963] 48 ITR 882

2[1963] 48 ITR 882

3[1969] 74 ITR 62

4[1973] 88 ITR 454 (Bom)