

# PATNA HIGH COURT

Dalmia Investment Co. Ltd

Vs

Commissioner of Income-Tax

(Ramaswami, C. J)

28.11.1960

## JUDGMENT

### **Ramaswami, C. J**

1. In this case the assessee is a public limited company holding investment of shares and also dealing in shares. On January 1, 1948, that is, the first day of the accounting period, the assessee was holding 1,10,747 shares of the Rohtas Industries Limited at a book value of Rs. 15,57,902. The details of the shares are as follows :Book value Rs.Old issues 17259 shares brought forward from 1945 3,10,951 Bonus shares 31909 shares received in 1945 3,19,090 New issues 59079 shares brought forward from 1945 8,88,561 New purchases 2500 shares brought forward from 1947 39,300 Total shares 1,10,747 valued at ...

15,57,902 It appears that in 1944 the assessee was holding 31,909 ordinary shares of the old issues of the Rohtas Industries Limited. In that year the Rohtas Industries Limited allotted one bonus share for each ordinary share held by the shareholders. The assessee accordingly received 31,909 bonus shares. These shares were of the face value of Rs. 3,19,090 at the rate of Rs. 10 per share. The assessee, therefore, debited the share account by Rs. 3,19,090 with a corresponding entry in the capital reserve account for the same amount. The entire lot of 1,10,747 shares was sold by the assessee on January 29, 1948, to Messrs. Dalmia Cement & Paper Marketing Limited for a consideration of Rs. 15,50,458. The sale price was deducted from the book value of Rs. 15,57,902 and the assessee claimed a loss of Rs. 7,444 on the sale of the shares. The claim was rejected by the Income-tax Officer on the ground that the cost of the bonus shares should be computed at an "average basis" in view of the principle laid down by the Bombay High Court in Emerald and Co. Ltd. v. Commissioner of Income-tax. The Income-tax Officer computed the net profit of the assessee to be Rs. 2,39,317 which was liable to be taxed under section 12B of the Income-tax Act. The assessee took the matter in appeal to the Appellate Assistant Commissioner, who held that section 12B of the Income-tax Act was not applicable to the case, but the assessee

had received the bonus shares free of cost, and the cost of Rs. 3,19,090 for the bonus shares shown in the account books of the assessee was a fictitious entry. The Appellate Assistant Commissioner accordingly held that the assessee was liable to be taxed on the amount of profit to the extent of Rs. 3,11,646. When the matter came up in appeal before the Income-tax Appellate Tribunal, it was contended on behalf of the assessee that the Appellate Assistant Commissioner was wrong in holding that the cost of 31,090 bonus shares was nil. In the alternative the contention of the assessee was that at any rate the bonus shares should have been valued on average basis according to the decision of the Bombay High Court in *Emerald and Co. Ltd. v. Commissioner of Income-tax*. The Appellate Tribunal rejected both the contentions of the assessee and held that the bonus shares were issued free of cost to the assessee and thUnder section 66 (1) of the Indian Income-tax Act the Income-tax Appellate Tribunal has submitted the following question of law for the opinion of the High Court :

"Whether on the facts and circumstances of the case the profit computed at Rs. 3,11,646 on the sale of shares in Rohtas Industries Ltd. was in accordance with law ?"

After having heard learned counsel for both the parties I am of the opinion that the question should be reframed in the following manner in order to bring out the real point in controversy between the parties :

"Whether on the facts and circumstances of the case the income-tax authorities are right in holding that the sum of Rs. 3,11,646 or any other sum, is legally taxable in the assessee's hands on the sale of shares of the Rohtas Industries Limited ?"

On behalf of the assessee S. N. Dutta put forward the argument that the income-tax authorities were erroneous in holding that the bonus shares were issued free to the assessee and hence the cost price of the bonus shares from the point of view of the assessee was nil. It was submitted by learned counsel that the cost price of the bonus shares should be fixed at the face value of Rs. 10 per share and, accordingly, there was no profit made by the assessee in the accounting year on account of the sale of the entire lot of 1,10,747 shares. It was contended that the computation of profits by the income-tax authorities is wrong and the assessee is not liable to pay any tax on the sale of the shares as no profit was realised out of the transaction. The question presented, therefore, for determination in this case is what is the valuation of the bonus shares-whether the valuation should be at the face value as contended for on behalf of the assessee, or whether it should be at nil as contended for on behalf of the income-tax authorities ? In this connection it is important to remember that a company may "capitalise" profits by issuing fully paid shares to the shareholders. But this can only be done if the articles of the company contain provision authorising such procedure. The principle is that a company cannot issue "bonus shares" for

which the shares holders subscribe nothing. But the company can, if its articles so provide, declare a dividend or bonus out of its undistributed profits and at the same time issue corresponding number of new shares, and it can payment in full of the shares issued to them. Technically the transaction is carried out in the following manner : the bonus is provided out of the credit balance of the profit and loss account or out of reserves, both being items appearing on the liabilities side of the balance sheet, so that the balance sheet then forward shows the profit and loss account or reserves at a reduced figure and the issued capital at a correspondingly of Table A of the English Companies Act, 1948. There are exactly similar provisions in the (Indian) Companies Act, 1956 (1 of 1956), namely, regulations 96 and 97 of Table A. Regulation 96 reads as follows :

"96. (1) The company in general meeting may, upon the recommendation of the board, resolve -

(a) that it is desirable to capitalise any part of the amount for the time being standing to the credit of any of the companys reserve accounts, or to the credit of the profit and loss account, or otherwise available for distribution; and

(b) that such sum be accordingly set free distribution in the manner specified in clause (2) amongst the members who would have been entitled thereto, if distributed by way is dividend and in the same proportions.

(2) The sum aforesaid shall not be paid in cash but shall be applied subject to the provision contained in clause (3), either in or towards -

(i) paying up any amounts for the time being unpaid on any shares held by such members respectively;

(ii) paying up in full, unissued shares or debentures of the company to be allotted and distributed, credited as fully paid up, to and amongst such members in the proportions aforesaid; or

(iii) partly in the way specified in sub-clause (i) and partly in that specified in sub-clause (ii).

(3) A share premium account and a capital redemption reserve fund may, for the purposes of this regulation, only be applied in the paying up of unissued shares to be issued to members of the company of fully paid bonus shares.

(4) The board shall give effect to the resolution passed by the company in pursuance of this regulation."

Regulation 97 is to the following effect :

97. (1) Whenever such a resolution as aforesaid shall have been passed, the board shall -

(a) make all appropriations and applications of the undivided profits resolved to be capitalised thereby, and all allotments and issues of fully paid shares or debentures, if any; and

(b) generally do all acts and things required to give effect thereto.

(2) The board shall have full power -

(a) to make such provision, by the issue of fractional certificates or by payment in cash or otherwise as it thinks fit, for the case of shares or debentures becoming distributable in fractions; and also

(b) to authorise any person to enter, on behalf of all the members entitled thereto, into an agreement with the company providing for the allotment of them respectively, credited as fully paid up, of any further shares or debentures to which they may be entitled upon such further shares or debentures to which they may be entitled upon such capitalisation, or (as the case may require) for the payment up by the company on their behalf, by the application thereto of their respective proportions of the profits resolved to be capitalised, of the amounts or any part of the amounts remaining unpaid on their existing shares.

(3) Any agreement made under such authority shall be effective and binding on all such members."

It is manifest, in view of these statutory provisions, that the bonus shares are not issued free to the shareholders, but the consideration for the issue of the bonus shares is the dividend or bonus which is provided and declared by the company out of its undistributed profits. It is true that no cash is paid by the shareholders for the allotment of the bonus shares, but the consideration given by a shareholder for the bonus share is something in the nature of a set-off for the dividend which is due to be paid to the shareholder out of the undistributed profits of the company. My concluded opinion, therefore, is that the real cost of the bonus shares to the assessee in this case is the value of the shares as shown in the books of account of the Rohtas Industries Limited. This view is borne out by the decision of the Judicial Committee in *Swan Brewery Co. Ltd. v. King*. It appears that the Dividend Duties Act, 1902 (of Western Australia), provided by section 6 that a company carrying on business in Western Australia and not elsewhere which declared any dividend shall pay a duty equal to one shilling for every twenty shillings of the amount or value of such dividend. Section 2 of the above Act provided that "dividend" shall include "every dividend, profit, advantage or gain intended to be paid or credited to or distributed among any members or directors of any company except the salary or other ordinary remuneration of

directors." The appellant in that case passed resolutions : (1) that the capital of the company should be increased by Pounds 101,450 divided into 81,160 new shares of Pounds 1 5s. each; (2) that the sum of Pounds 101,450, being a portion of accumulated profits standing to the credit of the reserve fund, should be transferred to the credit of the share capital account; (3) that the new shares should be allotted as fully paid up among the shareholders pro rata. It was held by the Judicial Committee that the transactions were tantamount to a declaration of a dividend amounting to Pounds 101,450 within the Dividend Duties Act, 1902, and that the appellant company was liable to pay duty upon the amount under that Act. At page 235 of the report Lord Summer has stated the legal position as follows :

"The new shares were credited as fully paid, and, what is more, they were fully paid, for after the allotment the company held Pounds 101,450 as capital produced by the issue of those shares and for that consideration, and no longer as an undivided part of its accumulated reserve fund. True, that in a sense it was all one transaction, but that is an ambiguous expression. In business, as in contemplation of law, there were two transactions, the creation and issue of new shares on the companys part, and on the allottees part the satisfaction of the liability to pay for them by acquiescing in such a transfer from reserve to share capital as put an end to any participation in the sum of Pounds 101,450 in right of the old shares, and created instead a right of general participation in the companys profits and assets in right of the new shares, without any further liability to make a cash contribution in respect of them. In the words of Parker, C. J., Had the company distributed the Pounds 101,450 among the shareholders and had the shareholders repaid such sums to the company as the price of the 81,160 new shares, the duty on the Pounds 101,450 would clearly have been payable. Is not this virtually the effect of what was actually done ? I think it is."

The same view has been expressed by Lord Greene, M. R., in *Osborne v. Steel Barrel Co. Ltd.* as follows :

"It was strenuously argued on behalf of the Crown that if a company acquired stock in consideration of the issue of fully paid shares to the vendor, that stock must, for the purpose of ascertaining the companys profits, be treated as having been acquired for nothing, with the result that when it comes to be sold, the Revenue is entitled treat the whole of the purchase price obtained on the sale as profit. This is a remarkable contention and it would require conclusive authority before we could accept it. The cases relied on in its support were *Commissioners of Inland revenue v. Blott* and *Lowry v. Consolidated African Selection Trust Ltd.* neither of which, in our view, has any bearing on the point. The argument really rests on a misconception as to what happens when a company issues

shares credited as fully paid for a consideration other than cash. The primary liability of an allottee of shares is to pay for them in cash; but when shares are allotted credited as fully paid, this primary liability is satisfied by a consideration other than cash passing from the allottee. A company, therefore, when in pursuance of such a transaction it agrees to credit the shares as fully paid, is giving up what it would otherwise have had, namely, the right to call on the allottee for payment of the par value in cash. A company cannot issue Pounds 1,000 nominal worth of shares for stock of the market value of Pounds 500, since shares cannot be issued at a discount. Accordingly, when fully paid shares are properly issued for a consideration other than cash, the consideration moving from the company must be at the least equal in value to the par value of the shares and must be based on an honest estimate by the directors of the value of the assets acquired."

In Blotts case and Greenwoods case, when before the Court of Appeal, Scrutton, L. J., pointed out that this operation of giving shares and the acceptance of the shares by shareholders can only be done through the machinery appropriate to a company and with due regard to the relations between the shareholders and the company. At page 673 of the report Scrutton, L. J., stated :

"It is to be noted that the company cannot issue fully paid-up shares by simply capitalizing the reserve fund and applying it to the payment of the shares. For the reserve fund is the companys, and fully paid-up shares must be paid for by someone other than the company. As a matter of machinery therefore a bonus or dividend payable to the shareholders must be declared and then appropriated to the payment up of the bonus shares, so that the shareholder pays for his shares by his bonus or dividend."

The point has also been very clearly put by Lord Sumner in his dissenting speech in the House of Lords in the same case, at page 142 :

"The scheme and the principle of the statute law on this subject are clear. It takes two to make a paid-up share. A share issued, whether it is part of the companys original issue of capital or is one issued on the occasion of surplus profit arising, is a share to be paid for: paid for by the allottee in meal or in malt; in money, unless by contract between himself and the company he is enabled to satisfy his obligation to pay by some other consideration moving from himself to the company. Under the contract in question what consideration so moves from the shareholders ? None that I can see, except the discharge of the companys debt for a dividend, which has become due to him by being declared. When debt for dividend is set off against debt for calls and the account is squared, the equivalent of payment of a dividend takes place."

On behalf of the Income-tax Department Mr. R. J. Bahadur referred to the decision of the majority of the Law Lords in that case. But the ratio of the majority decision has really no bearing on the question for determination in the present case. It appears that the question for determination in the present case. It appears that the respondents in that case were shareholders in a limited company, which, under the authority of its articles of association, had declared a bonus out of its undivided profits and, in satisfaction of such declared a bonus out of its undivided profits and, in satisfaction of such bonus, had allotted to its shareholders as fully paid up certain ordinary shares forming part of the companys authorised but unissued capital. It was decided by the majority of the House of Lords (Viscounts Haldane, Finlay and Cave) that the shares credited to the respondents in respect of the bonus, being distributed by the company as capital, were to income in the hands of the respondents for the purposes of super-tax assessment, but should be treated as capital payment. Lord Summer and Lord Dunedin made dissenting speeches. Reference was also made by Mr. R. J. Bahadur to the decision of the Supreme Court of the United States in Mark Eisner v. Myrtle H. Macomber. But the question for decision in that case also was whether the receipt of bonus shares by the shareholders should be treated as taxable income or whether it was capital payment received by the assessee. The majority of the Supreme Court held that it was a capital payment and the bonus shares should not be treated as income liable to be taxed; but there are two dissenting judgments in that case by Holmes, J., and Brandeis, J. It is manifest that the question to be determined in the present case is different. The learned standing counsel also referred to the decision of the Bombay High Court in Emerald and Co. Ltd. v. Commissioner of Income-tax where the method of "averaging" was adopted. But when the case was taken up to the Supreme Court, the question of the proper method for valuing the bonus shares was left open and no decision was given on this point and the case was disposed of on another line of reasoning. I am, however, of the opinion for reasons already stated that the bonus shares should be valued at the face value of the shares and with the greatest respect I differ from the view expressed by the Bombay High Court in Emerald and Co. Ltd. v. Commissioner of Income-tax on this point. For the reasons expressed, I hold that, in the facts and circumstances of this case, there is no legally taxable profit made by the assessee on the sale of shares of the Rohtas Industries Limited and the income-tax authorities were wrong in holding that the profit should be computed at Rs. 3,11,646 or any other amount. I would accordingly answer the question of law referred by the Income-tax Appellate Tribunal in favour of the assessee and against the income-tax Department. The assessee is entitled to the costs of this reference. Hearing fee Rs. 250.

**Kanhaiya Singh, J. - I Agree.**

Reference answered accordingly.

