CHAPTER 4

ASPECTS OF CHARGABILITY OF INCOME CHANGING HANDS

a. INTRODUCTION

One of the most baffling areas in the field of tax jurisprudence has been the concepts of 'distribution' and 'taxability' of dividends. It is often said that the prevailing practice of taxing dividends, once in the hands of the company and again in the hands of the shareholder amounts to 'double taxation'. Professor Douglas Kahn states on U.S. Practice, where the same practice prevails, as under:

"Under a partnership and to a lesser extent, a trust or estate, a corporation does not serve as a tax conduit for passing its income to its beneficiaries. A corporation must pay taxes on its income less its allowable deductions, and a corporate distribution of earnings to a shareholder qua shareholder does not provide any deduction for the corporation; even though it will usually constitute income to the shareholder. This phenomenon is sometimes characterized as a 'double tax' or a 'dual tax'.

Both in India and in the U.K. the courts have held that the tax paid by a company is paid by it as a separate entity, and not as an agent of its shareholders. If, nevertheless, the income tax laws of these countries contain a provision giving credit to the shareholder for the income tax paid by the company, it is done purely on practical consideration, rather than on a legally deductible principle. The House of Lords held in Blott's case as under:

"Plainly, a company paying income tax on its profits does not pay as agent for its shareholders. It pays as a tax-payer, and if no dividend is declared, the shareholders have no direct concern in the payment. If a dividend is declared, the company is entitled to deduct from such dividend a proportionate amount of the tax previously paid by the company; and in that case the payment by the company operates in relief of the shareholder. But no agency, properly so called, is involved".

2. Inland Revenue v. Blott, 8 TC 101, 136 (HL)
This principle has been accepted by Courts in India. The Bombay High Court held in Guzdar v. CIT as under:

"Not only are a company and a shareholder separate and independent entities under the general laws; but even under the Indian Income Tax Act a company is a separate entity for the purpose of assessment from a shareholder. A company pays income tax on its income or its profits. It does not pay income tax on behalf of the shareholders."

b. TAXATION OF DIVIDENDS

1) HISTORICAL RETROSPECT

It is pertinent to mention here only that immediately after Blott's case, the position was changed in England, and prior to 1965, companies while paying a dividend to its shareholder could deduct and retain income tax from that dividend. Income Tax was, therefore, paid only once on income which was distributed to shareholders by way of dividend, and thus the system of company taxation 'did not make a rigid distinction' between the company, and its shareholders. On this view, the company's income is no more than the aggregate income of the individual members.

Thereafter, the U.K. Finance Act, 1965 introduced a new tax, corporation tax, which is charged on all the profits of a U.K. resident company, whether they be income, profits or capital gains, wherever they arise. This new tax brought out a firm distinction between the company and its shareholders, for whilst the company itself pays only corporation tax, its shareholders are charged to income tax and surtax on distributions received from the company. The Royal Commission on Taxation of Profits and Income considered this to be double taxation.

But the 'wobbling flexibilities' of the celebrated doctrine of 'corporate personality' proponounced by the House of Lords in the leading case of Salomon v. Salomon & Co.Ltd., could not sustain it for long, and the 'Imputation System' which does not warrant a rigid distinction between the company and its shareholders, had to

3. (1952) 22 ITR 158
5. Royal Commission on Taxation of Profits and Income Cmd 9474, para 27
6. Ibid, para 544
7. (1897) AC 22(HL)
be revived again in 1973, which is in practice even today in the U.K.

In India, the question of 'double taxation' was not at all there under the 1886 Act, because 'dividend' income was not taxable. In 1916, for the first time, the concept of double taxation was made applicable; since refund of income tax to shareholders of companies was granted as a 'small income' relief on account of difference between the rate applicable to the company and the personal rate of the shareholder.

Section 14(2)(a) of the Income Tax Act, 1922, before the Income Tax (Amendment) Act, 1939 stated that 'any sum which the assessee receives by way of dividends as a shareholder in a company', and section 16(2), before the Amendment Act, 1939, stated a 'grossing up' of the dividend 'received', and the inclusion on the 'grossing' basis in the total income of the shareholder. This 'receipt basis' was given up by the Income Tax (Amendment) Act, 1939, which enacted that "any dividend shall be deemed to be the income of the previous year in which it is paid, credited or distributed or deemed to have been paid, credited or distributed". Section 16(2) after the amendment by virtue of this 1939 amendment ran as under:

"16(2)-For the purposes of inclusion in the total income of an assessee, any dividend shall be deemed to be income of the previous year in which it is paid, credited or distributed or deemed to have been paid, credited or distributed to him and shall be increased by the amount of income tax (but not super tax) payable thereon calculated at the rate applicable to the total income of a company for the financial year in which the dividend is paid, credited or distributed or deemed to have been paid, credited or distributed.

Provided that when any portion of the profits and gains of the company out of which such dividend have been paid, credited or distributed or deemed to have been paid, credited or distributed was not liable to income tax in the hands of the company, the income tax to be added under this section shall be calculated upon only such proportion of the dividend as the amount of the profits and gains of the company liable to income tax bears to the total profits and gains of the company".

8. Section 5(1)(f) of the 1886 Act provided:
"Nothing in section 4 shall render liable to tax any income which a person enjoy as a member of a company...when the company... is liable to the tax".

9. Of course, there was no super tax till 1917.
It is important to note that even this mode enunciated by the 1939 amendment of 'paid, credited or distributed' has been replaced by 'declared, distributed or paid' under the 1961 Act.

Income Tax (Amendment) Act, 1939 also added section 49B as under:

"49B: Where a shareholder has received a dividend from a company which has paid income tax imposed in British India or elsewhere, he shall be deemed, in respect of such dividend, himself to have paid the income tax (exclusive of super tax), paid by the company on so much of the dividend, as bears to the whole, the same proportion as the amount of income on which the company has paid such income tax bears to the whole income of the company."

In other words, by virtue of section 49B, Income Tax Act, 1922 the shareholder was 'deemed' to have himself paid income tax in respect of his dividends to the extent to which the company had paid. The same principle underlay sections 16(2) and 18(5) of the 1922 Act, by the combined operation of which, income tax payable by the company on the dividends was treated as a payment made on behalf of the shareholders, and they were given credit therefor, in their individual assessments.

Thereafter, the yearly Finance Acts from 1948 to 1955 laid down a scheme of giving a rebate of one anna in the rupee to companies on the balance of income left to them after paying their taxes and the dividends declared by them. This system of rebate of 1 anna in the rupee brought in its wake the levy of 'additional income tax' on 'excess dividend' distributed. The objective behind this measure was to induce the companies to plough back profits instead of distributing them away, so that the 'capital formation' in the corporate sector may be geared up.

Immediately thereafter, three cases came up on the legality of this levy of 'additional income' tax on 'excess dividend' distributed.

1. CIT v. Jalgaon Electric Supply Company Ltd.

10. By virtue of section 48, Income Tax Act, 1922, a shareholder was further entitled to obtain a refund of any extra income tax (i.e., extra as compared to appropriate tax on his total income) levied on him in respect of his dividends, because, within the meaning of section 48, the payment by the company of income tax was one deemed to be made by him or on his behalf.

11. (1960) 40 ITR 184 (SC)
2. CIT v. Khatau Makanii Spinning & Weaving Co., Ltd. 12
3. CIT v. Elphinstone Spinning & Weaving Mills Co., Ltd. 13

This levy was declared to be illegal by the Supreme Court in the aforementioned cases, since any tax under the 1922 Act had to be on the 'total income' and what the Finance Act, 1948 sought to tax was something, which never formed part of the 'total income' of the company. Where owing to the adjustment of depreciation allowance, the 'total income' of the company is reduced to nil or there is a loss, no additional tax could be levied. The word 'additional' betokened that there was a tax levy in the first instance and what was sought to be levied was in addition thereto. Accordingly, the scheme of 'additional income tax' was abolished by the Finance Act, 1956. Finally, Finance Act, 1959 scrapped sections 16(2), 18(5) and 49B from the Income Tax Act, 1922. In other words, the 'grossing-up' method was given up.

After the last of these three, Khatau Makanii Spinning and Weaving Co., Ltd., the department made a last desperate bid to rescue the ruins of section 16(2) by amending the proviso to it by virtue of the Finance Act, 1956, as under:

"Provided that when the sum, out of which the dividend has been paid, credited or distributed or deemed to have been paid, credited or distributed includes:

i) any profits and gains of the company not included in its total income, or

ii) any income of the company on which income tax was not payable, or

iii) any amount attributable to any allowance made in computing the profits and gains of the company,

the increase to be made under this section shall be calculated only upon such proportion of the dividend as the said sum after deduction of the inclusions enumerated above bears the whole of that sum."

Section 12 of the 1922 Act was suitably amended immediately after the judgment in CIT v. Ahmuty & Co., Ltd., by adding subsection 12(1A) with effect from 1.4.1955. It was held in this case

12. (1960) 40 ITR 189 (SC)
13. (1960) 40 ITR 142 (SC)
14. (1955) 27 ITR 63
of Ahmuty & Co Ltd., that under the general law, where an assesseee receives dividends in respect of shares held by him as his stock-in-trade, the dividend income would be part of the business, profits and not income from other sources. Thus the Finance Act, 1955 superseded this judgment, and it provided that "income from other sources shall include dividends".

Under the 1961 Act, the scope of 'dividend' has been amply broadened. For example:

a) Dividends are taxable as income of the year in which they are declared.

b) Interim dividends are taxed in the year in which the shareholder receives them.

c) The entire amount of dividend is taxable even when the company pays it from its tax-free income.

d) Dividends received from a domestic company, which has made the prescribed arrangements for 'distribution of dividends within India' are taxable on the basis of gross income.

Gross income from dividends is the total of the amount actually received by the shareholder and the income tax deducted by the company at source.

e) Dividends received from a foreign company are assessed on a 'net' basis; and not on 'gross' basis.

The principle propounded by the Supreme Court in Kishin Chand Chellaram v. CIT, Bombay (1962) 46 ITR 640, 645 though under the 1922 Act, remains valid even under 1961 Act. Making any ambiguity, if any, in the terms 'declaration' or 'distribution' clear, the Supreme Court held: "The Income Tax Act did not contemplate an enquiry into the propriety of a dividend-declaration before taxing the receipt as dividend. It may be that the shareholders agree to refund the amounts received by them or to treat them as loans repayable to the company. These circumstances would not alter the character as dividend attaching to the distributions at the time they were originally made. The tax-liability attached as soon as the dividends were distributed or declared, as the case may be".

It is important to note that 'interim dividends' do not fall under the category of 'deemed dividends'. Article 86 of Table A of Schedule I of the companies Act, 1956 clearly states: "The Board may from time to time pay to the members such interim dividends as appear to it to be justified by the profits of the company".

Interim dividends have nothing to do with the year in which the company in general meeting ratifies the act of the Board. The Supreme Court held in Kishinchand Chellaram v. CIT Bombay (1962), 46 ITR 640(SC) as under:
11) Concept of 'Deemed Dividends'

The doctrine of fiction plays an important role in the legal drafting. Generally, a fiction is intended to escape the consequences of an existing, specific rule of law. The purpose of any fiction is to reconcile a specific legal result with some premise. The concept of deemed dividends include in its company the concepts of 'distribution', 'accumulated profits' and 'capitalisation of profits'. The scheme of taxing such receipts was introduced for the first time by the Income Tax (Amendment) Act, 1939. It included in the concept of dividend four kinds of 'distributions', which correspond to clause (a) to (d) of section 2(22) of the 1961 Act.

These were distributions which were not comprehended as dividends under the companies Act, 1913, but which were nevertheless included as dividends under the provisions of the Income Tax Act, 1922. These were fictitious or artificial dividends created by the statute for the purpose of raising the revenue. Later, by the Finance Act, 1955, a fifth kind was added to the list of 'dividends', corresponding to clause (e) of section 2(22) of the 1961 Act. The common denominator in all these five kinds of 'deemed dividends', was that such sums were attributable to the 'accumulated' profits of the company.

The Income Tax Act, 1961, has erased the distinction between distribution out of current profits and distribution out of past profits. The insertion of Explanation 2 to section 2(22) removes the distinction between 'dividend out of accumulated profits' and 'dividend out of current profits'. In essence, the only condition for the attraction of any of the clauses of section 2(22) today is, that if there are adequate profits in the company at the time the 'distribution' is made, these fictitious dividends would come into motion.

16 contd. "Whatever rights a shareholder might possess against the company by reason of subsequent resolution of the company recalling the dividend, those rights cannot affect the computation of the dividend income in the year of its actual receipt".

17. T. Sundaram Chettiar v. CIT, Madras (1963) 49 ITR 287, 290

18. It signified the profits of past years, which had been carried to reserve. The artificial concept was related to the profits of the past years, since the law ordains dividends being paid out of the current year's profits.
In one of the leading pronouncements, P.K. Vadiani v. CIT, the Supreme Court analysed the concept of 'accumulated profits' of the company. The question involved in this case was as under:

Whether for the purpose of assessing to tax, the amounts advanced by a private company to the appellant, who was a major shareholder and also its managing director, as 'dividend' under section 2(6A)(e) of the Income Tax Act, 1922, development rebate reserve created out of the company's profits constituted part of the accumulated profits of the company.

The Supreme Court held:

"The expression 'accumulated profits' occurring in clause (e) of section 2(6A), or for that matter in any other clause, means profits in the commercial sense, and not assessable or taxable profits liable to tax as income under the 1922 Act".

In Palmer's company law, the distinction between profits, divisible profits and profits available for dividend has been very clearly pointed out. Sometimes, the term 'profits' means assessable profits and sometimes the commercial profits.

The attention of the Supreme Court was also directed to a new facet of the question under consideration. Whereas in clauses (a) to (d) of section 2(6A) of the 1922 Act, so also in the corresponding clauses of section 2(22) of the 1961 Act, the expression 'accumulated profits' is qualified by the expression 'whether capitalised or not', but the latter phrase is conspicuously absent in clause (e). On this, the Supreme Court itself raised the following question:

What is the purpose of this difference in the phraseology

19. (1976) 105 ITR 642 (SC)

20. Ibid, Headnote. The gravamen of the argument of the assessee was that development rebate deductible from the assessable profits of the company is a type of outgoing expenditure or out-of-pocket cost which is deductible while ascertaining the profits of the company in the commercial sense. It is in the nature of depreciation allowance and is identical with initial depreciation, and should be deducted from the commercial profits of the company, as held by the Gujarat High Court in CIT v. Viramgam Mills Co., Ltd. (1961) 43 ITR 270 (Guj)

of the various clauses of sub-section (6A)?

While answering this question, the Supreme Court observed:

"...Clauses (a) to (d) were intended by the legislature to cover the cases of accumulated profits even though they may be capitalized. But the legislature did not intend to rope in the capitalized profits in clause (e) if money is paid to a shareholder of a private company by way of advance or loan after the accumulated profits have been capitalized in accordance with the law and the articles of association, then such payment, although it may represent a part of the assets of the company or otherwise, cannot be correlated to the capitalized profits of the company. To the extent the profits have been capitalized the company cannot be said to possess any accumulated profits".

Their Lordships of the Supreme Court also observed that

"it appears that the expression 'capitalised or not' was added in clause (c)" after the judgment of the Bombay High Court in Seth Haridas Achrat Lal v. CIT.

Thus holding in favour of the revenue, in P.K.Badiani v. CIT, the Supreme Court held as under:

"The allowance of initial depreciation or development rebate, unlike normal depreciation, is in no sense a deductible item of cost or expenditure in the process of settlement of the commercial profits; although it does not form part of the assessable profits, undoubtedly it does form part of the commercial profits.

Mere transferring of an amount from the profit and loss account to the development reserve account does not amount to capitalization of profits".

Ibid, 650. In the instant case the Supreme Court also held

"The profits of a company can be capitalized in accordance with the articles of association and the law. On the capitalization of the profits they cease to be profits in the hands of the company. The nature of the asset is changed although it does not make any difference in the total assets of the company. But profits stand transmuted and transformed into capital. The most common example of capitalization of profits is by issuance of bonus shares to the shareholders...".

(1955) 27 ITR 684 (Bom). Chief Justice Chagla of the Bombay High Court said in the instant case (Ibid, 690)

"But when we compare the language used by the legislature in sub-clauses (a), (b) and (d) and when we note the omission of the qualifying words in sub clause(c), then it is clear that the legislature advisedly did not intend to subject to tax those accumulated profits which had been capitalized".

Ibid, Headnote.
The Madras High Court gave a critical analysis of the concept of 'accumulated profits' in CIT v. G. Narasimhan, as under:

"What is the concept of accumulated profits. The profits of the year of accounting which will be taxed in the assessment year, 'till the date of distribution' is also included in the term 'accumulated profits' as defined in section 2(22) by virtue of the Explanation thereto... Even assuming that the general reserves of the company may reflect accumulated profits, whether the entirety of the general reserves would be accumulated profits cannot be discerned by merely looking at the balance-sheet of the company. In the absence of specific reserves for taxation or other liabilities of the company in relation to its performance in the past years, those liabilities may have to be met from the general reserves. To take the figures from the balance-sheet, therefore, with regard to the accumulated profits would not in all cases be a correct procedure, for the quantum of the general reserves need not represent the accumulated profits. If the liabilities that accrued from year to year had been taken into account year by year and the accumulated profits had been depleted year by year by writing down the accumulated profits and only the balance carried over, the total of the accumulated profits in any given year will be less than in cases where there has been no deduction made for accrued liabilities".

Section 2(22)(a) enumerates that if the 'distribution' entails the release of all or any part of the assets of the company, then such a distribution of accumulated profits, whether capitalised or not, shall constitute 'dividends'. In essence, the scheme of deemed dividends envisages effective capitalization of profits in order to get out of the mischief of 'release of assets'. In other words, if there is no release of assets by the company to the shareholder, there is no dividend. The release of assets may arise in any of the following situations:

1. **ISSUE OF DEPOSIT CERTIFICATES**

These certificates are issued by a company to its shareholders undertaking to pay them the amount of the principal and interest after a certain period. When such certificates are issued by way of dividend, the question arises whether such certificates constitute income in the hands of the shareholders. 

The Madras High Court held in CIT, Madras v. M.P. Viswanatha Reddy.

26. (1979) 118 ITR, 60,63(Mad)
26A. (1950) 18 ITR 68
that such a certificate was not income in the hands of the shareholder. It was merely a promise to pay at a future time and cannot be regarded as income in the hands of the shareholder. No portion of certificate money left the coffers of the company, hence no release of assets. But to supersede this view, the Finance Act, 1955 included deposit certificates, debentures as dividend, though carrying no present right to the payment of the principal sum mentioned in the deposit certificate or debenture certificate.

2. DISTRIBUTION ON LIQUIDATION

It is a fundamental of company legislation that the liquidator's duty is simply to distribute assets, he has no power in law to distinguish between capital and income. But this principle has been departed from in section 2(22)(c). The accumulated profits distributed by the liquidator would constitute dividends. Before the amendment by virtue of the Finance Act, 1956, the words 'whether capitalised or not' were not there in the clause. It was in contrast to the language of clauses (a), (b) and (d) which had this expression 'whether capitalised or not'. On this, the Bombay High Court held in Seth Haridas Acharatlal v. CIT, Bombay, that if any portion of a company's free reserves had been capitalized before liquidation, they ceased to be accumulated profits and, therefore, distribution thereof by the liquidator would not be dividend. Finance Act, 1956 superseded this view by inserting the words 'whether capitalised or not' in clause (c) as well, thus giving uniformity to all the four clauses. Another important amendment made by virtue of Finance Act, 1956 was that any profits earned up to the commencement of liquidation shall form part of the 'accumulated profits', whereas previously a proviso to this clause (c) limited the accumulated profits only during the six years preceding the liquidation. Yet another amendment of far-reaching importance was the insertion of the words

27. As regards the valuation of such deposit certificate or debenture certificate, it may be done on the basis of the market value, and if there is no market then the recognised principles of valuation may be invoked, for example:
   a) solvency of the debtor company,
   b) rate of interest mentioned in the certificate as compared to the market rate,
   c) period mentioned for redemption, etc.

28. (1955) 22 ITR 684
'distribution is attributable to the accumulated profits'. The effect of this word 'attributable' is, that even though the shareholder might have received much less than the capital subscribed by him, on liquidation, nevertheless to the extent to which the 'distribution' is 'attributable' to accumulated profits, it is dividend. It is important to note that the profits earned by the liquidator by carrying on business during the course of the winding-up cannot form part of such 'attributable' profits by virtue of the words 'immediately before its liquidation'.

3. DISTRIBUTION ON REDUCTION OF SHARE CAPITAL

Clause (d) of section 2(22) defines that any distribution to the shareholders on the deduction of capital would be dividends. The Madras High Court held in CIT v. G.Narasimhan:

"Even deemed dividend under the Income Tax Act, we conceive, cannot be paid out of the capital and once the law is such that certain payments must be deemed to be payments of dividend, for all purposes it has to be treated as dividend, and the restriction that the payment of dividend should not be from capital will attach to such payment as well".

In CIT v. G.Narasimhan, the assessee held seventy shares out of 24,000 shares of Rs 1,000 each in a private limited company. During the accounting period ending on March 31, 1962 relevant to the assessment year 1963-64, the capital of the company was reduced, as a result of which the value of each share of Rs 1,000 became Rs 210. Consequent upon this reduction, a distribution of money to the shareholders took place. On the other hand, sums totalling Rs 64,577 had been advanced to the shareholders in the previous years, and these were assessed in the hands of the shareholders as deemed dividend in those years. The question referred to the Madras High Court was as under:

Whether a sum of Rs 64,577 being the deemed dividends assessed in the hands of the various shareholders in the past assessment years, should be deducted from the surplus, while determining the 'accumulated profits' in the hands of the company?

29. (1979) 118 ITR 60,67
30. (1979) 118 ITR 60 (Mad)
The Madras High Court following the Bombay High Court's decision in CIT v. P.K. Radhani, held:

"The will of the legislature having been embodied in section 194 and section 205 of the companies Act, 1956, the cumulative effect of these statutory provisions was to make any deemed dividend under section 2(22)(e) also flow out of the accumulated profits of the company. At any rate, that is the only legal way of paying dividend as envisaged by section 2(22)(e) and it must be taken that they have been so paid unless for other purposes it is established that there has been a contravention of the law."

In other words, if there was no accumulated profits in the company, the fiction would not be attracted and if the accumulated profit in the company is less than the value of the assets or moneys distributed, the fiction will be applied only to the extent of the available accumulated profit. In brevity, if the reduction of capital be to a greater extent than the accumulated profits, it is a case of a genuine reduction of capital. Any capital so returned is really a capital receipt in the hands of the shareholder.

4. DISTRIBUTION BY WAY OF LOAN

Section 2(22)(e) states that any 'payment' by a 'controlled company' by way of a loan to a substantial-interest holder is a deemed dividend. It is to be noted that the first four sub-clauses use the word 'distribution' but this clause uses the word 'payment'. The implication of this is that the act of 'appropriation' is not a pre-requisite for sub-clause(e).

31. Ibid, 66
32. Companies Act, 1956 resolves an important doubt prevailing under the Income Tax Act, 1961. The accounting year in which the distribution takes place, for the purpose of inclusion of such deemed income in the total income of the shareholder is neither:

   i) the year in which the resolution for reduction is passed by the company, section 100 of the companies Act, 1956;
   ii) the year of the court's confirmation of the resolution reducing the share capital, section 101(1) of the companies Act;
   iii) the year when the Registrar of Companies, on production of the High Court's order, registers the order, section 103(1) of the companies Act.

This is so, because section 103(2) of the companies Act states that the resolution for reducing the share capital as confirmed by the order of the High Court shall take effect 'on the registration of the order and minute".
On the other hand, it is entirely irrational, it is submitted, that proviso (ii) to section 2(22) saps away the working of clause (e) to section 2(22). The proviso reads as under:

"(ii) Any advance or loan made to a shareholder by a company in the ordinary course of its business, where the lending of money is a substantial part of the business of the company."

It is submitted that this mechanism underlined in proviso (ii) could very well avoid the tax, particularly in the case of investment companies. Proviso (ii) and as a consequence of it proviso (iii) to section 2(22) may be omitted.

c. Taxability of Bonus Shares

Section 205(3) of companies Act, 1956, clearly states that for the purpose of issuing fully paid-up bonus shares, the capitalization of profits or reserves of a company may be made and then such dividends may be payable in kind. Section 2(22)(b) refers to 'any distribution to its preference shareholders of shares by way of bonus', that only such distribution to the preference shareholders would constitute dividends. This insertion was made only by the Act of 1961.

The writer fails to appreciate the basis of distinction, if any, made between preference shareholder and equity shareholder on this account. It is often said that the transaction involving issue of bonus shares would take nothing out of the company's coffers and put nothing into the pockets of the shareholder. Perhaps the very language of sub-paragraph (2) of Regulation 96, Schedule I of the Companies Act, 1956, admits this traditional fallacy. It says that the sum resolved to be capitalised 'shall not be paid in cash, but shall be applied' in paying up amounts for the time being unpaid on the old shares or new shares to be issued, which

32 contd. The word 'on' occurring in section 103(2) and in section 2(22) (d) implies 'after' as held in Punjab Distilling Industries Ltd. v. CIT, Punjab (1963) 48 ITR 288

33. Section 205(3) inserted by virtue of the companies (Amendment) Act, 1960 states:

"No dividend shall be payable except in cash:
Provided that nothing in this sub-section shall be deemed to prohibit the capitalization of profits or reserves of a company for the purpose of issuing fully paid-up bonus shares or paying up any amount for the time being unpaid on any shares held by the members of the company".
denotes that there is no release of any of the assets by the company in such a process of issue of bonus shares.

It is submitted that the traditional law enacted in Schedule I, Table A of the Companies Act, 1956, along with the Paragraph I, Regulation 96, Paragraph 2 of Regulation 96 may be suitably changed, in order to accommodate this modern view of company legislation that the issue of bonus shares definitely entails 'release of assets' of the company, whether it relates to the preference shareholders or the equity shareholders. As a consequence of it, the word 'preference' in the expression 'any distribution to its preference shareholders of shares by way of bonus' may be omitted.

The writer is aware of this fact that the leading case law, for example Blott's case would be otiose, where it was held by Rowlatt, J., that if the company first applies the dividends in payment of the new shares to be issued or in payment of the unpaid capital on its already issued shares and then distribute only such new shares or call for the old certificates and endorse thereon the increased amount of paid-up capital, then there is no distribution of dividend in any sense. In essence, the answer to this problem is found in the real intention of the company. Often it could be said that the intention of the company is not to raise its share capital through the device of issue of bonus shares, but to avoid the tax for its shareholders. It is a travesty of law by saying that the 'substance' is being considered by laying down the norms of Bouch v. Sproule as under:

a) the amount of the profits to be distributed is exactly equal to the amount of the new capital created,

b) the resolution of the company is to this effect that the bonus dividend and the calls for new shares are to be payable on the same day,

c) the new shares should stand on an equal footing with the old, as from a date prior to the date of the resolution,

d) the ambient actions of the company, for example, account books, minutes and resolutions, show that the company regarded that the entire sum to be distributed would remain in its hands as paid-up capital.

34. IR v. Blott 8 TC 101 (HL)
35. 12 AC 385, 398, 403
A declaration of bonus shares in these circumstances would be a bare machinery for capitalizing the profits of the company. Of course, the same analogy applies, if instead of issuing bonus shares, the company declares in the shape of stock-dividends.

It is submitted that the above mentioned norms could be managed by the controlling companies very conveniently, whereby it could be inferred that nothing went out of the coffers of the company. Professor Gower, an acknowledged authority on corporate legislation states on the nature of bonus shares as under:

"It may admittedly, be used for more dubious purposes; e.g., to conceal the fact that dividends are being increased for if the number of shares is increased the amount distributed by way of dividend will also be increased, although the rate per share remains the same."

In order to circumvent this practice, there are two ways:

One, to include such distributions in the category of deemed dividends by omitting the word 'preference' from the expression 'any distribution to its preference shareholders of shares by way of bonus' occurring in section 2(22)(b), and second, to include the words 'bonus shares' after the word dividend in the definition of income in section 2(24)(ii). An Explanation may be added as under:

The expression 'bonus shares' shall not refer to those employees of the company whose chargeable total income from 'salary' does not exceed Rs 18,000 per annum.

Serious doubts can arise on the present traditional practice, for example, a company can utilise its accumulated profits for the purpose of starting a subsidiary company by issuing fully paid-up bonus shares of the subsidiary to its own shareholders. Would it not be a case of release of assets by the parent company? Since in law, a subsidiary and a parent company are two different entities, what goes to a subsidiary company is really lost to the parent company, though it can be said that technically there may be no loss to the individuals behind the parent company. It is more a question of commercial accountancy that the company may do several things with the reserve fund representing profits. In the

36. Per Viscount Cave in IRC v. Blott 8 TC, 101, 135 (HL)
process of capitalization of profits, on the assets side, there would still remain all these assets; on the liabilities side, instead of a reserve fund, there would be a large amount of share capital. What actually happens is that the company gets rid of these assets and there is nothing in the shape of 'capital' (except the tangibility of these bonus shares) to represent the assets.

Moreover, a fortiori, when clause (b) of section 2(22) includes 'preference shareholders of shares by way of bonus', by way of a statutory exception to the general principle underlined in section 78, companies Act, 1956, then full force should be given to such a statutory exception. It is submitted that to this extent the provisions of section 78 reading as 'in paying up unissued shares of the company to be issued to the members of the company as fully paid bonus shares' may be consequently, omitted.

Even by way of an analogy, it can be said that bonus shares are not by way of gifts from the company. The traditional law has lost its vestiges. Though the writer is aware of this proposition in law that 'bonus payment' to an employee of the company cannot be equated with 'bonus shares' to a shareholder, but the 'law in the making' shall have to derive its colour from one class of income to the other class. Whatever may be true in the case of salary-earner may be true about a shareholder in certain respects. The Madras High Court held in CIT v. India Radiators Ltd., as under:

"...The recent development relating to the labour laws showed a change in the understanding of the nature of payment of bonus. It is no longer considered as a share of profits or gift or bounty made by an employer under his sweet will and pleasure. The employee by reason of his contribution or participation in the business of the employer is considered to be entitled for payment of the same, though the exact amount payable may depend on various circumstances...".

38. Section 78 of the Companies Act, 1958, enacts that the share premium account of a company may be utilised 'in paying up unissued shares of the company to be issued to the members of the company as fully paid bonus shares'. But for this statutory exception on preference shares, the general principle is that, by virtue of the Companies Act, 1956 any dividend declared out of the 'share premium account' would cease to be a 'dividend', since issue of bonus shares does not entail any release of assets.

39. (1976) 105 ITR 680, 683 (Mad)
It is submitted that if the employee contributes or participates in the business of the employer, then it may equally hold good in the case of a shareholder, who contributes, though the participation may be passive rather than active.

The writer is also of this opinion that by introducing 'imputation system' for the taxability of dividends, it becomes imperative to tax the bonus shares received by equity shareholder. The two learned Law Lords, Lord Sumner and Lord Dunedin, in their dissenting judgments in Blott's case characterized the bonus shares as a 'profit' or 'gains'; wherein it was stated that in order to effect the issue of the bonus shares, two steps are necessary:

1. The distribution by imputation of a sum of money to the shareholders;
2. The application of the money so imputed to the payment of the bonus shares.

d. VALUATION OF BONUS SHARES

The principle evolved over the years for computing capital gains in case of transfer of bonus shares may be equally applicable in calculating the value of bonus shares received from the company i.e., the 'cost of acquisition' of bonus shares. The leading pronouncement remains the majority judgment of the Supreme Court in CIT, Bihar v. Dalmia Investment Company Ltd. The relevant facts were as follows:

The assessee held shares by way of investments and also as stock-in-trade of its business as a share dealer. In 1944, the assessee acquired 31,909 ordinary shares in Rohtas Industries Ltd at a cost of Rs 5,84,283 and was holding them in January, 1945. In that month the Rohtas Industries Ltd distributed bonus shares at the rate of one ordinary bonus share for each original share. Between that time and December 31, 1947, the assessee sold 14,650 of the original shares with the result that on January 1, 1948 it held the following shares:

a) 17,259 original shares acquired in 1944,
b) 31,909 bonus shares issued in January, 1945,
c) 59,079 newly issued shares acquired in the year 1945 after the issue of the bonus shares, and,
d) 2,500 further shares acquired in 1947.

40. (1921) 2 AC 171
41. 52 ITR 567 [SC]
The total holding of the assessee on January 1, 1948 thus came to 1,10,747 shares which in its books had been valued at Rs 15,57,902. In arriving at this figure the assessee had valued the bonus shares at the face value of Rs 10 each and the other shares at actual cost.

On January 29, 1948, the assessee sold all these shares for the total sum of Rs 15,50,458 that is at Rs 11 per share and in its return for the year 1949-50 claimed a loss of Rs 7,444 on the sale.

On these facts the Supreme Court applied the 'spreading method'. In the majority judgment of the Supreme Court, delivered by Hidayatullah, J., as the learned judge then was, it was observed as under:

"Where bonus shares were issued in respect of ordinary shares held in a company by an assessee who was a dealer in shares, their real cost to the assessee could not be taken to be nil or their face value. Those old had to be valued by spreading the cost of the shares over the old shares and the new issue viz., the bonus shares, taken together if they ranked pari passu and if they did not, the price might have to be adjusted either in proportion of the face value they bore (if there was no other circumstances to differentiate them) or on equitable considerations based on the market price before and after issue".

e. NEED FOR IMPUTATION SYSTEM

In essence, the first principle of 'imputation system' is that the shareholder is 'deemed' to have himself paid income tax in respect of his dividends to the extent to which the company had paid. In other words, the shareholder would not be subjected to taxes on dividends again, unless the 'total income' of the shareholder falls in a 'higher bracket', as compared to the 'appropriate bracket' applicable to the income of the company. As a matter of fact, English Law has had been toiling hard with the precepts of Salomon v. Salomon & Co., Ltd. and Trevor v. Whitworth, particularly after the enactment of English Companies Act, 1948, and what seemed invincible has been entirely departed from with the passage of an invigorating enactment, English Companies Act, 1980.

42. This principle was reiterated by their Lordships of the Supreme Court in CIT v. Gold Mohore Investment Co., Ltd., 74 ITR 624. The Gujarat High Court has also followed this principle in CIT v. Arvind Narottam Dalbhai Dalpatbhai vada (1976) 105 ITR 378 (Guj)
43. (1897) AC 22(HL)
44. (1887) 12 App.Cas 409
which lays down to purchase its own shares by the company. It can
be very well said that the imputation system which has been enacted
again in 1973 in British fiscal legislation after having an experi­
ment with classical system for eight years, has attained an
invulnerable place for it.

Few questions of cardinal importance, therefore, arise in
this regard:

a) Does the company pay either income tax, or in a loose
sense tax on its distributable profits (dividends) on its own or
as an agent on behalf of its shareholders ?
b) Does the amount of income tax form part of the
expenditure ? Would it entail a total or partial credit for the
tax paid on dividends by the company ?
c) In case the premise of maintaining a so-called rigid
distinction between the company and its shareholders is dispensed
with, then what would be the implications likely to affect the
texture of tax law ?

In Accountant-General, Baroda State v. CIT, Bombay and
Lilita v. Tata Iron & Steel Co., it was held that a company being
a corporate body and having a legal existence apart from its
shareholders, when it pays tax, it does so on its own behalf and
in respect of its own profits. It is not an agent of its share­
holders, nor can it be said to pay tax as an agent of its
shareholders.

The above position at common law was departed from under
the Income Tax (Amendment) Act, 1939. In order to avoid economic
double taxation, this Act, by virtue of section 49B 'deemed' the
shareholder to have himself paid income tax in respect of his
dividends to the extent to which the Company had paid. Section
16(2) and 18(5) provided for the grossing up of dividend income
and treating the amount by which the dividend was grossed up as
the tax paid on behalf of the shareholder.

It could be said that the Income Tax (Amendment) Act, 1939,
introduced the concept of 'imputation system' in India. Thereafter,
the Finance Act, 1948 laid down a scheme of giving a rebate of one
anna in the rupee to companies on the balance of income left to

45. (1948) 16 ITR 78, 87
46. (1940) 8 ITR 337
them after paying their taxes and the dividends declared by them. This was by way of inducement to companies to 'plough back' profits instead of distributing them away. Conversely, additional tax was levied where the dividend declared by the company was in excess of its reduced total income (after paying taxes). This levy was declared to be illegal by the Supreme Court in CIT, Bombay City v. Khatau Makanji Spinning & Weaving Co.Ltd., since any tax under the 1922 Act had to be on the 'total income' and what the Finance Acts sought to tax was something which never formed part of the 'total income' of the company. Accordingly, the scheme of 'additional income tax' was abolished by the Finance Act, 1956.

Perhaps by declaring the additional levy illegal, the Supreme Court did hit the nail in the coffin, and ultimately the departure from the common law was given up by virtue of the Finance Act, 1949. In other words, the 'grossing-up' was given up, or to say, the 'imputation system' was given up. Since then, the position remains, even today under the 1961 Act, that the shareholder and the company pay income tax on their respective income.

f. IMPLICATIONS OF THE 'IMPUTATION SYSTEM'

The foremost and inevitable implication of 'imputation system' according to the recent theories of public finance is that the income tax would be allowed as a part of the expenditure. In essence, the amount 'deemed to be imputed' is that amount, of which even the amount of income tax does not form a part.

On the other hand, the Income Tax Act, 1961 rigidly follows this hypothesis that income tax does not form part of the expenditure. Moreover, any rate of tax levied on the profits of a business or profession, whether the same is calculated at a proportion of the

47. (1960) 40 ITR 189 (SC)
48. It is pertinent to note that when the 'imputation system' had no 'gene' in the fiscal legislation the court of appeal held in Ashton Gas Company's case (1906 AC 10) and the Chancery Court in Johnston v. Chestergate Hat Manufacturing Co's Case (1915, 2Ch 338), that income tax being one payable on the profits is not a deductible expense. Income Tax is the state's share of the profits and it is an application of a portion of the profits after the same are ascertained. The amount of income tax cannot, therefore, be regarded as an expenditure incurred in earning the profits.
profits or otherwise on the basis of such profits is not deductible by virtue of section 40(a)(i), Income Tax Act, 1961. It would be, perhaps, appropriate to trace the history of this provision, and while doing so, two important cases come across viz., Travancore Titanium Products Ltd. v. CIT, Kerala and Indian Aluminium Co. Ltd. v. CIT, West Bengal.

In both the aforementioned cases, the claim related to the deductibility of wealth tax on assets held by the assessee for the purpose of his business, while computing the assessee's income from business. While in Travancore Titanium, the Supreme Court held in favour of the Revenue, in Indian Aluminium it held against the Revenue. The most forceful contention of the Revenue in Indian Aluminium was the difficulty in separating that part of the wealth tax which was levied on that part of the net wealth, which could be said to be used 'wholly and exclusively' for trade, from the rest of it.

Within a few months of the decision in Indian Aluminium case, the Income Tax (Amendment) Ordinance, 1972, was promulgated to amend the Income Tax Act, 1961, barring the amount of Wealth Tax as a deduction in the computation of total income. The Ordinance was later repealed and replaced by the Income Tax (Amendment) Act, 1972, by virtue of which the position established in Travancore Titanium was restored, thus a new sub clause (iia) in clause (a) of section 40 of the 1961 Act was inserted.

49. (1966) 60 ITR 277 (SC)
50. (1972) 84 ITR 735 (SC). In Indian Aluminium case, the Supreme Court expressed the view that the test adopted in Travancore Titanium case, that to be a permissible deduction there must be a direct and intimate connection between the expenditure and the business, i.e., between the expenditure and the character of the assessee as a trader, and not as owner of assets, even if they are assets of the business "needs to be qualified by stating that if the expenditure is laid out by the assessee as owner-cum-trader, and the expenditure is really incidental to the carrying on of his business, it must be treated to have been laid out by him as a trader and as incidental to his business".

51. On this contention the Supreme Court observed: "Mr Chagla appearing for the assessee drew our attention to the division into two heads, one of business assets and another of the 'other assets', which is found in form 'A' prescribed by the rules for the Wealth Tax
It is interesting and important to note that despite this amendment, the Supreme Court has emphatically made it clear that the principle laid down in *Indian Aluminium* is not vitiated. Hence the immediate question is, with the introduction of 'imputation system' when once the shareholder is 'deemed' to have himself paid income tax in respect of his dividends, whether he would be 'deemed' to pay income tax in respect of the property (his shareholding) which is being used 'wholly and exclusively' for the purpose of trade.

To my mind, there is only one answer, and that is in the affirmative. It is the shareholder who is the owner of the property and the trade is merely being carried on his behalf. The thesis of *Indian Aluminium* - 'owner-cum-trader', is to be viewed in this perspective. In the case of income tax even that difficulty which was envisaged by the Revenue in *Indian Aluminium* could have no place; it is the entire shareholding which generates income in the carrying on of a trade on behalf of the shareholders.

Law in its own strides could have a pace with the emerging socio-dynamic under-currents in the society. Shareholders are to be regarded as having equitable interests in the company's assets. It is pertinent to extract the following passage from the classic statement on the characteristics of a 'share', made by Farwell, J., in *Borland's Trustee v. Steel Bros & Co, Ltd.*:

"A share is the interest of a shareholder in the company measured by a sum of money, for the purpose of liability in the first place, and of interest in the second, but also consisting of a series of mutual covenants entered into by all the shareholders inter se".

In essence, 'imputation system' warrants the deductibility of the dividends and income tax, while computing the total income of the company. It is another matter, keeping in view the exigencies of public finance and 'commercial expediency', that the

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51 cont'd. Return. This means that the Wealth Tax Act itself makes that part of the net wealth separable which can be utilized 'wholly and exclusively' for trade from the remainder of it".

52. The Supreme Court has made it clear in one of its subsequent judgments, *Mitsui Steamship Co., Ltd. v. CIT, West Bengal* (1975) 99 ITR 7 (SC)

53. (1901) 1 Ch. 279, 288
practice of tax legislation varies on this subject from country to country. In France, with the advent of 'imputation system', legislation on 'corporate taxation' invigorated; a number of taxes like payroll tax, social security tax, business licence tax are deducted to compute taxable profit. Tax credit, either equal to one-half of the tax on dividends borne by the company, or any reasonable percentage thereof, may be availed by the shareholders. Factually, 'imputation system', would be in the interests of the small shareholders.

Consequently, income tax forms part of the expenditure; moreover, provisions on non-deductibility of taxes, for example, wealth tax or any such tax could be dispensed with. Howsoever ambivalent the concepts of 'income' and 'dividend' may appear to be, but both the concepts are mutually co-terminus.

To hold the brief that the mechanism of 'imputation system' could help the 'evasion practices' is completely unfounded. The machinery of 1961 Act already takes enough care of 'distribution' of dividends. Much has been poured into the vitality of section 2(52).

It is true that U.S. Tax legislation has yet to witness the 'imputation system', but its need may not be acutely felt, for the obvious reason, that Subchapter S Corporations already safeguard the interests of shareholders. Moreover, the vitality of the Macomber decision has dissipated over the years, and most commentators believe that the decision no longer reflects the modern position. Indeed, it appears that U.S. Congress regarded the Macomber's case as having been sapped off all its vitality on the following three

54. Upponi, Tax Jurisprudence (Taxmann's), 42
55. Even in U.S. Federal Law, the concept of 'disguised' and 'constructive' dividends have firm roots. A shareholder may have dividend income, even though there has not been a direct 'distribution of property' to him. A 'disguised' or 'constructive' dividend may arise, where a closely-held corporation confers an 'economic benefit' on a shareholder.
56. Eisner v. Macomber, 252 U.S. 189, 40 S.Ct. 189, 64 L.Ed. 521 (1920)
57. Cf., 'A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to shareholders, 52 Col.L.Rev 1,10 (1952)
more important determinants made by the court in Macomber:

1. That the term 'income' refers to a gain which, if earned from capital, must be severed or separated from the capital before it will be realized by the taxpayer. This is the doctrine of realization.

2. That the requirement of realization will be applied strictly and narrowly.

3. That corporations and shareholders are to be treated as separate persons.

As a result, Congress substantially amended the statutory treatment of stock dividends in 1969. The Tax Reform Act, 1969 imposed income tax on several types of transactions, which do not satisfy the strict 'realization test' propounded in Macomber's case.

Next, it is often said that the introduction of 'imputation system' discourages 'retention of profits'. This apprehension is completely unfounded. The prevailing law already takes enough care of such a situation. To contend this that, with the introduction of 'imputation system', the mechanism of section 104 would lose much of its utility has some justification, but there would be nothing in contradiction with the existing law.

Even in such an affluent economy like U.S., Sections 531-537 of the Internal Revenue Code, 1954 are devoted to the accumulated earnings tax provisions, which are aimed at exactly this problem of 'retention of excess profits'. It is important to note that section 532(a) of the Internal Revenue Code, 1954 states that even unreasonable accumulations in the taxable year will not be taxed unless earnings were retained for the purpose of avoiding income tax to its shareholders or to the shareholders of any other corporation.

Indian law on the levy of 'additional tax' on 'undistributed profits' does not provide that degree of pragmatic consequences as in U.S. law. While it is difficult to enunciate any inclusive list of purposes for accumulating earnings, which will comply with the 'business needs' test, U.S. Treasury Regulations Section 1.537-2 (b) lists the following as examples of grounds which, if corroborated by sufficient facts, will qualify accumulations for the business needs credit:
1. To provide for bonafide expansion of business or replacement of plant;
2. To acquire a business enterprise by purchasing stock or assets;
3. To provide for the retirement or bonafide indebtedness created in connection with the corporation's trade or business;
4. To provide necessary working capital for the business, such as for the procurement of inventories; or,
5. To provide for investments or loans to suppliers or customers, if necessary, in order to maintain the corporation's business.

Keeping in view the aforementioned U.S. practice, the writer fails to agree with the recommendations made by the Wanchoo Committee in its Final Report in December, 1971 to repeal the additional tax enumerated in section 104, Income Tax Act, 1961.

58. It is to be noted that the 'business' of the corporation includes activities which it has not previously carried on but which it may undertake, depending upon its Memorandum of Association (U.S. Treasury Regulations Section 1.537-3(a), U.S. Internal Revenue Code, 1954). In other words, the reasonable contemplation of either horizontal or vertical expansion is a legitimate business ground for accumulating earnings.

59. The recommendation was based on the following grounds: (Direct Taxes Enquiry Committee Report (Final Report, Dec, 1971) popularly known as Wanchoo Committee Report, after the name of its Chairman Wanchoo, K.N. Ex-Chief Justice of the Supreme Court, 123-24)

"The provisions of section 104 of the Income-tax Act are intended to plug avoidance of tax by shareholders of closely-held companies. In practice, however, the provisions do not seem to have achieved their intended purpose. Subjective standards are applied for judging the adequacy of dividends or whether the company was justified in not declaring any dividend. As the additional income-tax payable under this provision is in the nature of a penal levy, the onus is on the department to show in every case that the provision is attracted. The result has been that very few of the orders passed under this provision are sustained in appeal. In recent years, the definition of a widely-held company has been liberalised and the field of exemption from the levy of additional income-tax has been considerably circumscribed. We have further, recommended certain concessions in respect of the distributed profits of companies, which will encourage them to distribute reasonable dividends. The capital levy proposed by us will also discourage unreasonable accumulation of profits. We, therefore, recommend that section 104 of the Income-tax Act be omitted".