PART III: COMPANY AS COMPARED WITH OTHER UNITS OF ASSESSMENT

CHAPTER-5: IMPACT OF BODIES CORPORATE ON CORPORATE TAXATION

1. General

Two bodies corporate, a partnership firm and a Hindu undivided family are recognised as taxable entities by virtue of the definition of 'person' in section 2(31) of the Income Tax Act, 1961. Since trading with limited liability has its own characteristics, such partnerships or Hindu undivided families interact with the corporate form of organisation very often.

The Committee on Industrial Licensing Policy had initially to address itself to the task of evaluating the concept of a 'house'. The term 'House' has long been in vogue, used to describe a business concern initially developed as family concern. It is observed in the report of the Industrial Licensing Policy Enquiry Committee 1969 as under:

"The joint family tradition which, to some extent continues to

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1. On such advantages of trading with limited liability, Buckley, J., observed in In Re London and Globe Finance Corporation (1903) 1 Ch 728, 731:

"The statutes relating to limited liability have probably done more than any legislation of the last 50 years to further the commercial property of the country. They have allowed and encouraged aggregation of small sums into large capitals which have been employed in undertakings of great public utility largely increasing the wealth of the country ortho.


3. The names of important family concerns which played a prominent part in the industrial histories of different countries are well known. These include Morgan & Rockfeller in U.S.A., Krupp in Germany, Rothschilds in U.K. and France, and the Zaibatsu families in Japan. In India too, many industrial concerns developed as family concerns.

have significant influence in India even today, and other social factors have also helped in maintaining close connection among different branches of business families and, therefore, among concerns which are developed and managed by an expanding family and their relations...

The Managing Agency System significantly helped the maintenance of the hold of family groups over an increasing number of business concerns.

The report of the Committee on Distribution of Income and Levels of Living, 1964 specifically drawn attention to the fact that industrial licensing was an important instrument for preventing the emergence of industrial monopolies though this objective has to be constantly balanced against the equally imperative need of promoting efficiency and productivity.

1. Legal Aspects

The prevalent modes of conversion from a partnership to a company are:

a. Either selling the business item by item or exchanging such assets for value against the shares of the company;

b. Transferring the entire business as a going concern for a lump-sum price, such lump-sum price being adjusted against the allotment of shares;

c. Firstly company joining firm as a partner, subsequently dissolving the firm, thus company continuing the business.

One of the inevitable implications of the first mode could be that they being two transactions, first, involving sale of the firm’s assets to the company, and the second, involving a contract by virtue of which shares being exchanged in satisfaction of the liability to pay the price. Thus the difference between the real market value of

5. Mahalanobis Report: Report of the Committee on Distribution of Income and Levels of Living, part I, 1964, 54 - "Despite all the countervailing measures taken, concentration of economic power in the private sector is more than what could be justified as necessary on functional grounds".
such assets and their written down value could be charged to gift tax as 'deemed gift' under section 4(a) of the Gift Tax Act. Moreover, in such a sale, the element of 'goodwill' of the firm is also involved. The recent Supreme Court judgment in CIT v. Srinivas Shetty only refers to that aspect when the cost of acquisition becomes indeterminable or inconceivable in a newly created asset. On the other hand, the Gujarat High Court took the view in CIT v. Mohanbhai Pamabhai that section 45 is not confined only to those cases where the capital assets has cost something to its owner at the time of its acquisition.

Out of the aforementioned three modes, the third one is the most prevalent method. Since there is no charge of capital gains tax on the dissolution of a firm, as envisaged in section 47(ii), induction of a company into a partnership as a partner, and dissolving the firm thereafter, such a process would not give rise either to balancing charge or capital gains tax.

Considering other taxation aspects, while there is a conversion from a partnership firm into a company following method of computation of the business income comes into process:

a) In the case of a company the remuneration to the director-employee, commission or interest payable to the director or shareholder.

6. Section 29 of the Gift Tax Act, 1958 states that primarily the liability for the payment of tax shall be on the donor, that is, on the partners of the firm.

7. Various High Courts are of this opinion that goodwill being a self-generated intangible asset, the cost of acquisition is indeterminable, hence capital gains tax cannot be levied on the transfer of 'goodwill'.

9. (1973) 91 ITR 393 (Guj)
is allowed, while computing the business income of the company; whereas in a partnership business such salary, commission, interest or other remuneration to the partners are not allowed, while computing the business income of the firm.

b) No deduction is allowed to a firm on the pattern of 'inter-corporate investment'.

c) In the case of a company, there are specific tax concessions under the Income Tax Act, 1961 on account of royalties, etc., received from any concern in India, deduction in respect of dividends received from certain foreign companies, deduction in respect of royalties, etc., from certain foreign enterprises.

11. Socio-Economic Aspects

While discussing a process of conversion, the substance rather than the form is imperative to be recognised. The erstwhile partners of the firm becoming the shareholders of the company and their liability to tax accordingly changes. In CIT, Gujarat v. B.M.Kharwar the machinery of the factory belonging to the partnership firm was transferred to the company. The question involved was, as to whether such a transfer entails 'balancing charge' on the transferor-firm.

Shah, J., speaking for the Supreme Court pointed out:

"The assets of a business may be sold at a fixed price to a company promoted by a person who carried on the business; if

11. Section 40(b) Income Tax Act, 1961 states:

In the case of any firm, any payment of interest, salary bonus, commission or remuneration made by the firm to any partner of the firm shall not be deductible while computing the business income of the firm.


15. (1969) 72 ITR 603 (SC)

the price paid for or attributable to an asset exceeds the written down value of the asset; proviso (ii) to section 10 (2)(vii) of the Indian Income Tax Act, 1922 would be ex-facie be attracted... A person carrying on business may agree with a company that the assets belonging to him shall be transferred to the company for a certain money consideration and that in satisfaction of the liability to pay that money consideration shares of a certain face value be allotted to him. In that case there are in truth two transactions, one a transaction of sale and the other a contract under which shares are allotted in satisfaction of liability to pay the price.

It is important to note that the firm had not transferred its entire business to the limited company. It was held, therefore, on the facts of the case that provision to section 10(2)(vii) of 1922 Act were applicable.

It is common knowledge that the written-down value of some of the capital assets including land, building, machinery and plant is often less than the book-value and as sometimes, the company also pays for the goodwill, there is a surplus between the price paid by the company and value of the assets as per the income-tax records. Section 41(2), Income Tax Act, 1961 brings to tax such surplus arising on the sale, discarding, demolition or destruction of any building, machinery, plant or furniture which is owned by the assessee and which was or has been used for the purpose of business or profession.

Sometimes, the company in its own records adopts the higher value of any of these assets by getting them revalued and claim further depreciation on the revised valuation of assets. In CIT v. West Coast Chemicals & Industries Ltd., the Supreme Court had held that where business is sold as a going concern and the sale of assets is a 'realisation sale', the difference between the written-down value and the price attributable to the assets which were admitted to depreciation was not taxable under proviso (ii), Section 10(2)(vii), Income Tax Act, 1922.
In order to plug the aforementioned loopholes, Explanation 3 to Section 43(1) and Explanation 1 to Section 43(6) have been inserted. Moreover, the Supreme Court’s decision, CIT v. West Coast Chemicals & Industries Ltd., rendered under the 1922 Act is superseded by this gamut of legislation.

Two views have had been prevalent on this issue. If the partnership business is transferred as a whole, as a going concern, to a company, such a process would not attract the incidence of balancing charge or capital gains. On the other hand, if the capital assets have been transferred item by item, so called in an itemised manner, then it would attract such an incidence.

When an undertaking as a whole is transferred as a going concern, together with its goodwill, what is transferred is not the individual itemised property but the business as a whole, and any tax attracted in such a transaction with respect to the book value would be merely capital gains. That was precisely indicated by the Privy Council in Doughty v. Commissioner of Taxes and by the Supreme Court in CIT v. Mugeeram Banqur & Company. It is submitted that the Supreme Court’s judgment in CIT v. B.M. Kharwar is not affected by this premise at all, since in Kharwar’s case out of the total assets of the business only machinery was transferred as a result of which

18. Explanation 3 to section 43(1) states:
   "Where, before the date of acquisition by the assessee, the assets were at any time used by any other person for the purposes of his business or profession and the ITO is satisfied that the main purpose of the transfer of such assets, directly or indirectly to the assessee, was the reduction of a liability to income tax (by claiming depreciation with reference to an enhanced cost), the actual cost to the assessee shall be such an amount as the ITO may, with the previous approval of the IAC, determine having regard to all the circumstances of the case."

Explanation 1 to section 43(6) states:
"When in a case of succession in business or profession an assessment is made on the successor under sub-section (2) of section 170, the written-down value of any asset shall be the amount which would have been taken as its written-down
section 41(2), Income Tax Act, 1961 (corresponding) to Proviso (ii) to section 10(2)(vi), Income Tax Act, 1922) became attracted.

In fact, in the Privy Council's judgment in Doughty's case, two partners transferred their business to a limited company, of which they were the only shareholders and the sale was of the entire assets of the partnership. Lord Phillimore held that sale of whole concern which could be shown to be a sale at a profit as compared with the price given for the business or at which it stands in the books does not give rise to a profit taxable to income tax.

In fact, the Supreme Court in Kharwar's case did not follow its earlier decision in CIT v. West Coast Chemicals & Industries Ltd., as there was no finding by the Tribunal that the transfer was a "realization sale" or in the course of winding up of the business. It is submitted, therefore, that such a transfer may not be involved for purposes of capital gains tax, more so, when transfers on account of dissolution of a firm are outside the purview of capital gains tax.

An insertion in section 47, Income Tax Act, 1961 may be made, as under:

"Any transfer of capital assets by firm to the succeeding company, provided it is taken over as a going concern as a whole".

Such a step would be a positive one towards the rationalisation of the tax laws as well as it would help in providing a fillip to the business and industry, since corporate form of organization is the best suited for the promotion of business and industry.

18 contd. value if the assessment had been made directly on the person succeeded to".

19. Ibid.
20. (1927) AC 327 (PC)
21. 57 ITR 299 (SC)
22. (1969) 72 ITR, 603 (SC)
23. Ibid
24. Ibid
25. Ibid
26. The Supreme Court further relied on the observations by the Revenue Authorities that only the manufacturing side of the business was closed and not the business of purchasing and
II. **Techniques of Capital Formation**

1. **Partnership Succeeded By a Company**

   The technique of capital formation is a sine qua non of a viable industry. It is common knowledge that a corporate form of business organization throws open more avenues for capital formation than a partnership business. A positive approach in this direction is exhibited by sub section (7) of section 32A. With this very premise, that the corporate form of organization has more resilience to absorb the business losses, the above mentioned submission becomes a fortiori, that the transaction of a firm as a going concern succeeded by a company could be within the purview of section 47 of the Income Tax Act, 1961. Of course, courts have always the jurisdiction to scrutinise such techniques of capital formation, if they are ultimately for the purposes of tax avoidance.

   28. In *Wood Polymer Ltd. v. In re* an important question of law was involved, as to whether the court is competent to examine the exchange value of the shares as between the transferor-company and the transferee-company, in the scheme of amalgamation. The scheme of amalgamation envisaged extinguishment of the capital of the transferor-company on its dissolution to be brought about by exchange of its equity shares in the ratio of 20 equity shares of Rs 100 each fully paid of the transferor-company for 900 equity shares of Rs 10 each credited as fully paid of the transferee-company, as well as 170 convertible debentures bearing 8% interest each of Rs 100 credited as fully paid to be issued by the transferee-company.

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26 contd. selling the cloth, and the entire business carried on by the firm was not taken over by the company.

27. This sub section states that a succeeding company taking over a firm would be entitled to avail investment allowance which could not be fully availed by the firm.

28. (1977) 109 ITR 177 (Guj)
A member of the transferor-company was given a further option on his desire in lieu of the entitlement for exchange of shares or debentures to receive payment at the rate of Rs 800 in respect of every equity share of Rs 100 each fully paid of the transferor-company.

On examining the practical working of such an exchange scheme, the Gujarat High Court observed:

"...But it may be noted that the equity share of Rs 10 fully paid of the transferor-company was quoted in share market at Rs 4.50 per share and one has no idea as to how the debenture would fair when put on stock exchange list".

Having examined the ratio in which the shares were to be exchanged, the Gujarat High Court stated that once it is shown to the court, while presenting a petition under section 391 (2) for according sanction to the scheme of amalgamation, that the requisite statutory formalities were duly carried out, even then the court would not merely act to rubber-stamp the scheme. Quoting one of its earlier judgments, the Bank of Baroda Ltd. v. Mahindra Ugine Steel Co. Ltd., Desai, P.D.J., delivering the judgment of the Gujarat High Court observed as under:

"...The court cannot abdicate its duty to scrutinise the scheme with vigilance and act as a mere rubber-stamp simply because the statutory majority has approved it and there is no opposition to the scheme in the court. So much weight cannot be attached to the views of the statutory majority, as to require the court to mechanically put its imprimatur on the scheme. The court is not bound to treat the scheme as a 'fait accompli' and to accord sanction merely upon a casual look at it".

11. Incentives on Succession of a Firm by a Company

An important question is whether in such a conversion, the company could be made liable for the amount of Income Tax to be paid by the firm. In Dashmesh Transport Co. (P) Ltd. v. CIT, the Punjab & Haryana.

29. Ibid, 182
30. (1976) 46 Comp Cas 227, 244 (Guj)
31. (1974) 93 ITR 275 (P&H)
High Court held that the successor company in business would be entitled to claim the tax paid by it on behalf of the predecessor as its business expenditure under section 37(1). The Bombay High Court held in W.T.Suren & Co. Pvt.Ltd. v. CIT that in respect of the pension amount paid by the company for the services rendered by the employees to the firm is an allowable expenditure, while computing the business income of the succeeding company. On the other hand, the Allahabad High Court held in J.K.Woollen Manufacturers Ltd. v. CIT that the liability for gratuity payment in respect of the services of the employees prior to the date on which the business was taken over by the company, could not be deducted under section 37(1), for the purpose of computing the company's business income. It is submitted that the Allahabad High Court's judgment was not rendered on a pragmatic basis, as any expenditure exclusively and wholly laid out for carrying on the business would be, necessarily, a permissible deduction. It is with specific regard to the business rather than the assessee, whether a firm or taking-over company, that such an expenditure is permissible.

As regards the remission of liability or cessation of liability section 41(1) states that where an allowance or deduction has been made in respect of loss, expenditure or trading liability 'incurred by the assessee' and subsequently 'the assessee has obtained' any amount by way of remission or cessation of liability, the amount shall be a 'deemed business profit', whether the business or profession is in existence or not. It is submitted that in the case of a firm being taken over by the company, the assessee becomes different as a result of which any such benefit by way of remission of liability or cessation of liability would not be a 'deemed business profit'.

32. (1971) 80 ITR 603
33. (1962) 46 ITR 1123
submission is supported by a Supreme Court decision in CIT v Mohan Lal, where the sales tax paid in excess by the partnership firm was refunded subsequently to the company, the assessee being different, the company was held not liable to income tax in respect of such an income.

Incentives like 'tax holiday' under section 80J are available on such a conversion in favour of a company. The position was not clear till 1963 but a circular issued by the CBDT made it clear that the tax holiday benefit is attached to the new industrial undertaking and not necessarily to the owner of the business. On the same analogy, the incentives under sections 80HH and 80 HHA would operate. In other words, in the case of a newly established industrial undertaking or small scale industrial undertaking in backward areas, formerly in the form of a firm being taken over by a company, the incentives may be availed by the taking-over company. It is important to note that the scheme of section 80HH or 80 HHA is different from section 80J, in as much as under the former two sections the deduction is 20% of the yearly profits.

iii. HUF And Company

It is settled by now that when the Hindu undivided family's nucleus is invested in a company, then the benefits arising out of such an investment are the income of the joint family. At the same time, Karta of the family or a member thereof might be a director-employee, then such fees or remuneration is held as income of the family, provided there is a real connection between such fees or remuneration and the investment made to the detriment of family funds. At the same time, if the services rendered by the Karta or a member of the family partake

34. (1971) 82 ITR 624.
the nature of services rendered in his individual capacity, may be due to his personal skill or professional ability, then it will be regarded as his personal income.

The leading pronouncement on this subject remains to date the Supreme Court's decision in *Raj Kumar Singh Hukam Chand v. CIT*, where the Supreme Court held as under:

"In our opinion from these subsidiary principles, the broader principle that emerges is whether the remuneration received by the coparcener in substance though not in form was but one of the modes of return made to the family because of the investment of the family funds in the business, or whether it was a compensation made for the services rendered by the individual coparcener".

The Supreme Court further held:

"...If the income was essentially earned as a result of the funds invested, the fact that once coparcener has rendered some service would not change the character of the receipt. But if on the other hand, it is essentially a remuneration for the services rendered by a coparcener, the circumstance that his services were availed of because of the reason that he was a member of the family which had invested funds in that business or that he had obtained the qualification shares from out of the family funds would not make the receipt, the income of the Hindu Undivided family".

In a recent judgment of the Delhi High Court, *CIT, Delhi v. Shri Prem Narain Agarwal*, the assessee was managing director of a company. He held shares of the same company in his name but in his capacity as the Karta of a HUF. The company issued certain right shares on these shareholdings. The ITO treated the benefit received as income under section 2(24)(iv) of the Income Tax Act, 1961, and consequently added it to the income of the HUF. The addition was subsequently deleted by the Tribunal and then by the High Court. The Delhi High

36. **(1970) 78 ITR 33 (SC)**
37. Ibid, 43
38. Ibid, Headnote
39. **(1982) Tax 64 (3)-103**
Court observed as under:

"As even in the personal assessment of a director or managing director right or bonus shares received by him in respect of his own shares will not be a perquisite, the same cannot be taxed in the hands of the HUF".

It is another matter that under the prevailing law the bonus shares or right shares are not taxable, but the Delhi High Court followed the ratio of the Supreme Court's decision in Rajkumar Singh Hukam Chandji's case, which is primarily based on the 'doctrine of substance'.

The legislature has been constantly seized of the problem of transactions involved between a Hindu Undivided family through its Karta on one hand and the company on the other. In CIT v. L. Alamundaram Chettiar, the assessee was the managing director of a company in which one was an employee. During the assessment year 1961-62, the company advanced to a business carried on by a Hindu Undivided family, of which K was the Karta, a sum of Rs 14,41,500 out of which the family advanced a sum of Rs 7,81,500 to the assessee as a loan. The assessee paid interest at 8½% on the loan advanced to him by the family while the family paid interest at 8% to the company on the amounts received by it.

41. Even under the 1922 Act, section 2(6A)(e) was there to control such transactions. It included three different transactions:
   1) any payment by a company of any sum by way of advance or loan to a shareholder;
   2) any payment by any such company on behalf of a shareholder;
   3) any payment by any such company for the individual benefit of a shareholder.
   The second and third cases contemplate payment by a company not to the shareholder but to a third party, either on behalf of the shareholder or for the individual benefit of the shareholder.
42. (1977) 109 ITR 508 (Mad)
The Madras High Court held as under:

"1. That the word 'payment' in section 2(6A)(e) of the Act means the act of paying and does not either expressly or by necessary implication restricted to payment of a sum of money towards a pre-existing liability or by way of discharge of an existing obligation or by way of payment to a person by way of hire or wages to which the payee was already entitled... Therefore, the transactions clearly fall within the third contingency contemplated by section 2(6A)(e)".

Keeping in view the galore of case-law, though quite permuted, one could easily conceive the enormity of this conduit of Hindu Undivided family through which the genesis of corporate taxation is directly affected. In Radha Debi Jalan v. CIT, West Bengal, a public limited company transferred a majority of the shares held by it in another company to eight ladies of a certain Hindu Undivided family. This family owned a substantial number of shares in the transferor company, and the transfer was effected to avoid liability to Excess Profits Tax of the company. The transfers were on blank forms and were not registered for three years. Two years after the shares were registered in their names, all the ladies sold away their shares at a huge profit.

It was held that none of the ladies were share dealers, nor had they sold any shares in the past. Hence, the profits were not taxable. The evidence, however, in order that it may support the finding, must be evidence covering all the essential points, but if all such points are covered, the quality or sufficiency of such evidence is not a matter for the court. A single transaction will not be a trading adventure unless it bears clear indicia of 'trade'. A transaction is not necessarily in the nature of trade because the purchase was made with the intention of resale. When a person invests his capital in landed property or in shares not with a view to holding on to the

43. Ibid, Headnote.
44. (1951) 20 ITR 176 (Cal)
investment but with a view to resale, and he does this on one occasion only and not habitually, the speculation may be on capital account and in that event the profit would be an accretion of capital.

iv. Controlling Families

The following statement made by a leading Indian economist made in 1964 remains as valid today, as it was two decades before:

"The controlling families in most cases, make relatively small investments in a principal company, or companies which initiate a breeding process—in some groups an inbreeding process—that takes care of nearly all subsequent controlling investments of significance without calling forth further substantial investments from the families".

According to Dr. Hazari, a corporate group consists of units which are subject to the decision-making power of a common authority. It is, however, not always a closed circle, it can rather be compared to a series of concentric circles. The innermost circle is said to consist of a hard core of bodies which are largely or wholly owned by and are under the sole control of the decision-making authority. Next to the inner-most circle, there is a circle formed by the majority companies in which one or more interests outside the group have a share in control, but the majority vote is retained with the group; up to this point can be included the sole control, which forms the 'inner circle'. Beyond this develops the concept of an 'outer circle', in which the decision-making authority has a voice and material influence—but not the controlling voice.

In Bharat Development (P)Ltd v. CIT, the opinion of the ITO, revealed the enormity of the transactions between 'inner groups' inter se, as under:

"The transactions could not be held to amount to a business


46. (1982) 133 ITR 470 (Del)
for the following reasons:

1. The shares are of private limited companies in which no person can have any dealings;

2. Even Dalmia Dadri Cement Ltd., which is a public limited company is controlled by R. Dalmia and the question of anyone dealing in these shares does not arise;

3. None of the shares are quoted at stock exchange. All the shares are treated as investments in the balance-sheet;

4. Purchases and sales of shares during the years under appeal were only to those companies which were controlled by R. Dalmia and most of the purchases and sales were either to or from R. Dalmia or to or from his nominees or to and from the employees of the companies controlled by him. Even shares sold by the assessee to R. K. Radhan & Co. and to M/s Rajpal Chadha & Co. had been passed to R. Dalmia on the same date, and the account books of the assessee-company and those of the two share brokers were utilised only for the purpose of arranging sale of those shares to R. Dalmia".

Even the AAC and the Tribunal held that the income from the sale of shares was liable to be treated as income from other sources.

The AAC held as under:

"The assessee could not be held to be a dealer in shares in as much as the transactions in shares were only acts of financial jugglery by R. Dalmia who was said to be at the back of all the companies".

Surprisingly enough, negating the contention of the Tribunal the Delhi High Court held:

"The mere fact that they were transactions between interconnected companies did not take away the character of business from those transactions. Nor was there anything to show that it was D who imposed the transactions on the assessee or the other companies belonging to the group. The contracts were agreed upon by the various companies. It might be that the agreement was arrived at because D had a say in the matter. But this did not mean that the transaction was a compulsory one or that the element of an agreement between the parties was absent in regard to these transactions. The income arising out of the share transactions was the result of sales and the income was liable to be taxed as business income and not as income from other sources".

47. Ibid, Headnote.
It is submitted that this decision of Delhi High Court is an incorrect decision, in as much as, even after admitting the fact that D had a material influence in all such transactions. The opinion of the ITO aforementioned exhibits the dimensions of such transactions directly affecting the corporate taxation. It is submitted that the doctrine of 'lifting the corporate veil' is not merely a ritualistic doctrine; it has the sanctity even of codified law.

In CIT v. Hindustan Industrial Agencies (P) Ltd., all the shares of the assessee-company were held by D and his wife. The company dealt in electric motors, diesel oil engines, etc. It was managed by a firm. That firm also managed another electric company. The assessee purchased some shares of the electric company in 1956, and some more shares after five years, bringing the total number of shares held by it to 4,165 and the amount invested was merely Rs 4.5 lakhs. In December, 1961, the electric company issued fresh capital by allotting one right share for every two shares held. The assessee did not take up all the right shares but retained only 772 out of 2,082 right shares and the rights in respect of the remaining right shares were sold by the assessee-company for a sum of Rs 61,449 in the assessment year 1963-64, its financial year being the one which ended on 31st May, 1962.

In the accounting year ending on 31st May, 1963, the assessee sold 2,500 shares of the electric company earning a surplus of Rs 39,175. The Tribunal found that the shares of the electric company did not form part of the assessee's stock-in-trade; the shares were not purchased in several lots but were acquired on the same day and the 2,500 shares were also sold in bulk; and that the purchases and sales only brought about a redistribution of the holding of a 'closed group'.

48. It is this very concept which is embedded in the mechanism of section 104, Income Tax Act, 1961.
49. (1982) 135 ITR 436 (Bom)
The Bombay High Court observed as under:

"The right shares were in the nature of capital and the mere fact that on the balance-sheet it is possible to say that a certain profit was made by the sale of the right to obtain the right shares, will not indicate that the activity was an adventure in the nature of trade. A transaction was not necessarily in the nature of trade because the purchase was made with the intention of resale. Nor was there a finding in this case that it was the intention of the assessee to resell the shares or to dispose of the rights to obtain the fresh shares. The 2,500 shares which were sold by the assessee were sold to persons who were interested in the assessee-company. The sales only brought about a redistribution of the holdings in a closed group having regard to the persons in whose favour these transactions had been made. Hence, the income earned in 1963-64 and 1964-65 as a result of the sale of the right to subscribe for shares and the sale of shares, could not be treated as the assessee's business profit and could be considered only for purposes of computing capital gains".

The manner in which the corporate sector has grown in our country owes much of its vitality to the concept of managing agency, which was eventually discarded in 1970. Subsequently, those big business houses which were working as managing agents adopted many other innovated devices for the purposes of tax-avoidance notably the device of investment companies, which were already existing as a kind of company, but were not taken much advantage thereof till the existence of 'managing agency'. In a leading Supreme Court judgment, Sassoon J. David & Co. (Pvt) Ltd v. CIT such contrived devices were present, but the Supreme Court leaned in favour of the company, more on the 'doctrine of form' rather than the 'doctrine of substance'.

50. These family-based big business houses having wider ramifications, raised 83% of the contribution from investment and industrial companies, 12% from trusts and only 5% from individuals, during the period 1951-58; Cf., Report of the Committee on Distribution of Income and Levels of Living, Part I, para 40,42.

Thereafter, the share of public financial institutions as loans to monopoly houses amounted to Rs 782.3 crores, till June 30,1980. The leading among them have been the Industrial Development Bank of India, the Industrial Finance Corporation of India and the Industrial Credit & Investment Corporation of India; Cf., Economic Times dated 22nd November, 1980.

51. (1979) 118 ITR 261 (SC)
The relevant facts were that shares of the appellant, an investment company were held by the Davids. Its assets were worth Rs 155 lakhs as on December 31, 1955. On December 2, 1955, its directors proposed that the services of 22 employees, the managing director and a director be terminated and that they be paid compensation, and on January 25, 1956, the shareholders accepted the director's proposal.

Under an agreement dated March 23, 1956, the Davids agreed to sell to the Tatas all the shares in the appellant company for Rs 155 lakhs, the sum voted for payment of compensation to the employees being deductible therefrom.

After the take-over, the appellant re-employed 9 of the 22 employees. The appellant claimed deduction of the sum of Rs 1,64,899 as business expenditure under section 10(2)(XV). The findings of the Tribunal are pertinent, as under:

"The expenditure had been incurred by the appellant not for the purpose of the business but purely as a result of the bargain between the Davids and the Tatas and that, even assuming the payments were beneficial to the appellant, no deduction could be allowed since they had been made to benefit third parties".

On a reference, the Bombay High Court held:

52 "Only the two amounts of Rs 21,200 and Rs 16,188 were allowable as deductions and that the balance of Rs 1,27,511 paid to the employees and a director was not allowable as a deduction, since the expenditure had not been incurred by the company for commercial reasons".

On appeal by the appellant to the Supreme Court, Venkataramiah J., while delivering the judgment of the Supreme Court observed:

"In the instant case, it is necessary to bear in mind that the company was neither dissolved nor was its business undertaking sold. It continued to exist as a juristic entity even after

52. Rs 21,200 was paid towards compensation for termination of pension allowance.
53. Rs 16,188 was paid to the managing director in lieu of six months notice.
54. Ibid, 270."
the transfer of its shares by Davids to Tatas. On account of such transfer of shares, the transferees no doubt gained control of the company. But one important fact of the case which was lost sight of by the High Court and the Tribunal was that neither Davids nor Tatas derived any direct benefit out of the payment of retrenchment compensation to the employees even though such retrenchment might have facilitated the transfer of shares. As a matter of fact, the High Court held that the consideration of reduction of the wage bill was foreign to the decision taken by the company to terminate the services of the employees and to pay them retrenchment compensation and observed that the purpose of the payment so far as could be ascertained from the contents of the resolutions of the board of directors and the company when read with the relevant contents of the agreement for sale was the carrying out of the obligation arising under the agreement.

On this, the Supreme Court further observed:

"Even assuming that the motive behind the payment of retrenchment compensation was that the terms of the agreement of the sale of shares should be satisfied, as long as the amount had been laid out or expended wholly and exclusively for the purpose of the business of the assessee, there appears to be no good reason for denying the benefit of section 10(2) (xv) of the Act to the company, if there is no other impediment to do so".

It is submitted that the Bombay High Court's judgment brings out the entire factual position more clearly, whereas the Supreme Court lost sight of the contrived device whereupon the business of the controlling family of Davids, an investment company was being taken over. The writer does not question the amplitude of section 37(1) of the Income Tax Act, 1961 (corresponding to section 10(2)(XV) of the 1922 Act); rather the transactions through the conduit of investment company have become increasingly innovated forms of tax avoidance. It is submitted that an insertion may be made in section 56(2) Income Tax Act, 1961 to the following effect:

"56(2)(ic): income from dealing in shares, by an investment company or a company in which public are not substantially

55. Ibid, 273
interested, or by its shareholders thereof.

In United States, the attitude of the courts has been towards judging the effect of a conglomerate acquisition on market concentration as opposed to assets concentration. Unfortunately, in India it is the other way round. Even the Monopolies Restrictive Trade Practices Act, 1969, lays stress on the assets concentration. It is submitted that market concentration is equally, if not more, as important as assets concentration. It is common knowledge that this increasing use of the conduit of 'investment company' has become one of the most potent factors for the spurt in 'black money'. For the reasons aforementioned the writer is of this opinion that the submission aforementioned would go a long way in curbing the inflationary tendencies.

III. Incongruities

Since dividend may be paid to a registered shareholder only and a Hindu Undivided family or a trust cannot be a shareholder in a company, very anomalous situation exists, as regards the interaction of companies Act, 1956 and Income Tax Act, 1961. Even though the investment may be made out of the family funds, but only the Karta or whosoever's name appears on the register of shareholders would be entitled for dividends. In CIT. Bombay v. Shakuntala & Others the Supreme Court emphatically held that dividend paid to a registered shareholder, being a member of a Hindu Undivided family cannot be


57. (1961) 43 ITR 352 (SC); AIR 1966 SC 719. In the instant case the joint family's shares were standing in the names of co-partners.
included in the income of the Hindu Undivided family on the ground that the beneficiary is the Hindu Undivided family.

It is an established principle of taxation laws that even the artificial or notional income can be included in the total income of the registered shareholder alone; it could not be included in the total income of the beneficial owner of shares where the shareholder is found to be merely a benamidar or representative. The inevitable implication is that as regards dividends the benefit of credit for the tax deducted at source could be claimed under section 199 only by a 'registered shareholder', and not by a beneficial owner of shares.

It is common knowledge that proclivity of the Hindu Undivided families making investment in companies, particularly in closely held companies or investment companies has made the legislature ever conscious to combat the tax-avoidance practices. But it is equally true that by such prevailing incongruities, the worst-effected is the Revenue itself.