PART I
HISTORY AND IMPLICATIONS OF CORPORATE TAXATION AS A UNIT OF ASSESSMENT

CHAPTER I
HISTORY OF CORPORATE TAXATION IN INDIA

POSITION UNDER THE INCOME TAX ACT, 1961

The legislation of 1961 was not only important because it made more or less a 'clear cut' with the past but it contained the gems of the general structure of the subsequent Income Tax Act, including the Income Tax Act of 1961. The legacy of the past was inherited, for example, compounding of taxes for a period of years. The power to make rules which is vested now in the Central Board of Direct Taxes, for speedy implementation.

1. The first Income Tax Act in India was introduced in 1860 under the stress of financial difficulties, consequent on the mutiny, and it was enacted to be in force for a period of five years. Sources of income were enumerated under schedules together with Rules under each Schedule. The taxes could be compounded during the first, second or third year after the commencement of the Act for a period of five, four or three years respectively. The tax was revived in 1867 in the form of a "License Tax" on trades and professions on the basis of annual income. This technique of licensing was adopted for simplifying the tax levy, since difficulty was experienced in finding the requisite machinery to work the complicated schedules of the Act of 1860, based upon the complicated English system. In 1868, the legislature introduced what was known as a "Certificate Tax", which was not materially different from the "license tax" of the previous year. A ceiling was fixed to the amount of the licence tax or the certificate tax.

In 1869, the certificate tax was converted into a general income tax. This Act was in force for one year and during the next 4 years, annual legislation was resorted to for levy of tax. When the financial situation again improved, Income Tax was abolished in 1873. Then in 1876-78 the outcome of great famine was the revival of direct taxation. The concept of 'licence tax' of 1867 was again revised for the businessman.

The concept of Central enactment took its roots in 1880. When the disaster of 1876 was tried to be revamped, at that time the tax laws were adapted as local Acts in Bengal, Madras and Bombay Presidencies, along with the Central Act for North-Western Frontier Province and Panjab. These local Acts were amended in 1880, so as to bring uniformity in the prevailing exemption limits.-Cf., Iyengar, Law of Income Tax, 5th Edn, Vol. 2, 485-486.
of tax laws, was vested in the Governor-General in Council. The concept of total income was unknown to the 1886 Act. The income from various sources were aggregated merely for determining the minimum taxable limit.

The Income Tax Act, 1886 has been described as "an Act for imposing a tax on income derived from sources other than agriculture".

POSITION UNDER THE ENGLISH INCOME TAX ACT, 1842

In the English Income Tax Act, 1842, income was classified according as it is derived from property in land (Schedule 'A'), occupation of land (Schedule 'B'), dividends (Schedule 'C'), professional and trade profits (Schedule 'D'). The first case in schedule 'D' dealt with duties on trade profits. It was headed:

"Duties to be charged in respect of any trade, manufac-
ture, adventure or concern in the nature of trade not contained in any other schedule of this Act".

This first case in Schedule 'D' was evidently the source from which the definition of business in the Indian enactments came. Even in the 1961 Act, the term "business" has been defined as:

"business" includes any trade, commerce or manufacture or any adventure or concern in the nature of trade, commerce or manufacture".

Income in each part of the Schedule was assessed separately and without reference to any income following in other parts. Thus the concept of 'total income' was totally foreign to the 1842 Act. It is also significant to note that

4. Four sources of income were set forth in the Second Schedule to the Act, namely 'Salaries and Pensions', 'Profits of Companies', 'Interest on Securities and Other sources of income'.
5. Forbes v. The Secretary of State for India(1915) ILR 42, Cal 151.
6. Section 2(13)
no tax was levied on a shareholder in respect of profits of companies which already paid tax.

The concept of normal depreciation has been in vogue all along from the English Income Tax Act, 1842, which was accordingly brought in the Indian Income Tax Act, 1888. Though it was based upon the principle of a Capital charge-compensation for wear and tear, but it was granted every year measured by the rates fixed by the Rules framed under the Act. These rules were, as the Government thought "just and reasonable as representing the diminished value by reason of wear and tear during the year of any machinery or plant used for the purposes of the concern, and belonging to the person or company by whom the concern is carried on".

Even today under the 1961 Act the concept of depreciation remains the same.

CASE LAW UNDER THE 1886 ACT

At the outset it is important to note that under the Act of 1886 and prior thereto, there was no obligation on the part of the tax payer (except a company), to submit a return of income.

The only leading case decided under the 1886 Act was Purbhotam v. The Central India Spinning, Weaving & Manufacturing Co. Ltd. This case raised an important point on which there was apparently no authority in India. This question of law was:

Whether the preference shareholders were entitled to have their preference dividends paid free of income tax, as between fixed preference and ordinary shareholders, in a case where there were no express words to that effect in the contract regulating the rights of the parties.

9. (1918) 1 LR 42 Bom 579; 19 Bom LR 665.
Two leading English judgments were already there on this question of law, viz Ashton Gas Co. v. The Attorney General and Johnston v. Chestergate Hat Manufacturing Co., Ltd. The ratio decidendi of these judgments was that 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. It cannot be regarded as an expenditure incurred in earning the profits.

In Ashton Gas Co. v. The Attorney General the facts were that the special Act under which the company was incorporated provided that the profits of the company to be divided amongst the shareholders in any year should not exceed the rate of 10 per cent per annum on the ordinary share capital. The question which arose was whether that 10 per cent included the Income Tax. All the courts including the House of Lords held that the company had been wrong in paying the shareholders 10 per cent free of income tax. Thus, two important propositions of law were laid down, which were followed by the High Court of judicature at Bombay as well in Purshottam v. The Central India Spinning & Manufacturing Co., Ltd. These propositions were:

1. The company pays taxes on behalf of its shareholders.
2. Income Tax paid by the company is not part of the expenditure.

In the court of Appeal, Lord Justice Romer said as follows:

"If such a company as we have to deal with pays income tax..."

10. (1906) AC 10
11. (1915) 2 Ch 338.
12. Even under the 1961 Act the position remains the same, since Section 40(a)(ii) lays down that any rate or tax levied on the profits of a business or profession, whether the same is calculated at a proportion of the profits or otherwise on the basis of such profits is not deductible. Thus, income tax being one payable on the profits is not a deductible expense.
13. Ibid.
14. Ibid.
15. (1904) 2 Ch. 621 at 629.
tax on its profits, the income tax, as has been pointed out, is payable out of the profits, and is part of the profits; and if the profits, after deducting the income tax, have subsequently to be distributed amongst the members of the company, that income tax is not payable again by those members so far as they receive their share of the profits, because the income tax is to be taken as having been paid out of their profits, and on their behalf. If, for example, a company such as this had preference shareholders as well as ordinary shareholders, and the preference shareholders were only entitled to receive out of the profits a fixed sum, say 5 per cent, then when income tax is paid by the company out of its profits, the company must be treated in respect of so much of the profits as is going to the preference shareholders as having paid their income tax in respect of their 5 per cent. Accordingly, to my mind, it is clear on principle in such a case that there ought to be deducted from the dividend warrants payable to the preference shareholders the income tax on the 5 per cent which had been previously paid on their behalf by the company. The same principle, of course, applies to the shareholders in the present case who are restricted by the provision of the Act, so that they are only to share a limited amount of the profits.

This decision was affirmed by the House of Lords.

It was urged for the plaintiff that the provisions of the English Income-Tax Acts are entirely different from the Indian Income Tax Acts; that under the Indian Income-Tax Acts the shareholder is under no liability for the tax; and that the company pays the tax on its own account and not on behalf of the shareholder.

16. (1906) AC 10. It was further urged for the plaintiff that the Indian Income Tax Act is really very similar to the new excess profits tax in England. Two decisions of Peterson, J., namely Collins v. Sedgwick (1917) 1 Ch. 179 and Condran, In re (1917) 1 Ch 639 were cited that excess profits tax is not paid on behalf of the shareholder and that consequently it must be deducted before arriving at the net profits available for distribution amongst the shareholders. But two conflicting decisions William Hollins & Co., Ltd. v. Paget (1917) 1 Ch 187 and Thomas v. Hamlyn & Co., Ltd. (1917) 1 KB 527 were also available where a different result was arrived at in calculating the commission to be paid on the net profits of a company or business. There Mr. Justice Eve in the one case and Mr. Justice Rowlatt in the other held in effect that Excess Profits Duty stands very much on the same footing as income-tax and ought not to be deducted before arriving at the profits on which such commission was to be calculated.
Marten, J., of the High Court of Judicature at Bombay, observed:

"The alleged points of dissimilarity are that there is no express power under the Indian Acts for the company to deduct the tax on the dividends as is contained in section 54 of the English Act. Further, and this is especially important, that under Section 5(1) (f) of the 1886 Act, the shareholder is expressly exempted from liability for the tax on any income which he enjoys as a member of the company provided the company is liable to the tax. And, thirdly, that until the Act of 1916 no right of exemption was given to the shareholder, however poor, and on the other hand it was the company which was entitled to exemption under section 5(1)(j) of the 1886 Act, in cases where its income from all sources was less than a particular sum, that sum being under the 1886 Act Rs. 500 per annum and under the amending Act of 1903 Rs. 1,000 per annum".

Considering the alleged points of dissimilarity, Marten, J., further observed:

"Now as regards the first point, no doubt this express power of deduction given by the English Acts was largely relied on in the Ashton Gas Company's case in all the courts as showing that the company paid the dividend on behalf of the shareholder. But the answer made here is that the express power is really unnecessary, and for this reason...Clause 49 of the Indian Income Tax Act of 1886 was not referred to in argument. That section provides that, "every person paying any tax in pursuance of this Act in respect of income belonging to another person is hereby indemnified for the payment thereof". If the words "income belonging to another person" include income referred to in clause (5)(1)(f), viz., "income which a person enjoys as a member of a company", then the company would be expressly indemnified for the payment of tax in the present case. In that event there would be no substantial difference between the Indian and English Acts on the important point as to the company's right of deduction or indemnity and it would be very difficult for the plaintiff to distinguish the Ashton Gas Company's Case...".

On the other hand, it was forcibly urged on behalf of the defendants that having regard to the use of the word "refund" in clauses 6 and 7 and in the proviso to Part-II of the Second Schedule of the Act of 1916, the Indian legislature

17. 1 ITC 14.
18. Ibid.
must have contemplated that the tax was paid if not by, at any rate on behalf of the shareholder, for otherwise there could be no "refund" to him.

Delivering the judgment of the High Court of Judicature at Bombay, Marten,J., held:

"In my judgment, the true view is that under the Indian Acts as well as the English Acts the income-tax is in effect paid on behalf of the shareholders. I think one must look at this matter from a broad point of view. In a narrow technical sense it may be said that the company being a separate legal entity the net profits belong to the company and not to the shareholders, at any rate until a dividend has been actually declared. But in effect these net profits do belong to the shareholders. If, therefore, any sum has to be paid out of those net profits to the crown for tax, in effect it is the shareholders who have to pay. The provisions of the Income-Tax Acts as to assessment on and payment by the company are in effect mere machinery for the collection of the tax and, as was said by Lord Halsbury in the Ashton Gas Company's case, the matter is made much clearer if one sweeps away this machinery and regards the matter as between the Crown and its subject".

It is important to note that the above mentioned two propositions remain valid even today under the 1961 Act.

**GENERAL FEATURES OF THE 1918 ACT AND 1922 ACT**

The year 1918 was the second landmark in the history of Indian taxation. It aimed at defining more precisely the method for calculating income and profits of various categories. The concept of 'total income' was introduced for the first time, where the scheme of aggregating income from all sources for the purpose of determining the rate was launched. The assessment was made in the first instance, on the basis of the income of the previous year and later when the actual income of the assessment year was ascertained, an adjustment was made.

19. 1 ITC 15.
20. Ibid
21. Section 2(13) of the 1918 Act defined 'total income' to mean total income from all sources to which the Act applied.
Though the 1918 Act had many common features with the 1886 Act, the 1918 Act was very much nearer to the Act of 1922, in its general features.

a) The terms 'company' and 'Previous Year' were defined.
b) Income chargeable to tax was divided into 6 classes; namely 'Salaries', 'interest on Securities', 'Income derived from House Properties', 'Income derived from Business', 'Income derived from Professional Earnings' and 'Income derived from other sources'.

The most disturbing feature of the 1918 Act was that loss incurred under one charging head could not be set off against profits accruing under another head. Taxable income was defined under section 14(1) as the aggregate amount of the assessee's income under each of the heads in Sections 6 to 11.

Under the Act of 1918 the language for allowance of expenditure in relation to "other sources" ran:

"any expenditure...incurred solely for the purpose of making such income or earning such profits".

There was no similar provision in the Act of 1886. Under the Act of 1922, right up to 1961 the corresponding Section ran:

"any expenditure...incurred solely for the purpose of making or earning such income, profits or gains".

The 1961 Act has dropped the words "incurred solely" and substituted, instead, the words:

"laid out or expended wholly and exclusively".

This was done on the recommendation of the Law Commission "in order to secure uniformity" with the language of the allowance clause in "business or profession", otherwise,

22. Section 11(2) of the Act of 1918.
23. Section 12(2) of 1922 Act.
it retained the words "for the purpose of making or earning such income". Thus the quality of the expenditure for its deductibility under "other sources", as being "for the purpose of making or earning such income" is a distinctive feature that has descended from the Act of 1918.

The draftsman of the 1918 Act, as they had to write on a clean slate, might have taken the help from Lord Davey’s speech delivered in the House of Lords in Strong v. Woodfield. Adverting to the expression "wholly and exclusively laid out or expended for the purpose of such trade, manufacture, adventure or concern" a language similar to the one in the Indian Income Tax Act his Lordship remarked:

"These words... appear to me to mean for the purpose of enabling a person to carry on and earn profits in the trade, etc. I think the disbursement permitted are such as are made for that purpose. It is not enough that the disbursement is made in the course of, or arises out of, or is connected with the trade, or is made out of the profits of the trade. It must be made for the purpose of earning profits".

Section 9(2)(ix) of the 1918 Act ran:

"In respect of any expenditure (not being in the nature of capital expenditure) incurred solely for the purpose of earning such profits", and section 11(2) of the 1918 Act ran:

"Any expenditure... incurred solely for the purpose of making such income or earning such profits".

Thus the scope and ambit of the allowance covered by the phrase "for the purpose of making or earning such income" was the same as that covered by "for the purposes of the business or profession". Section 9(2)(ix) of Income Tax Act, 1918 may be said the precursor of Section 37 of 1961 Act.

26. (1906) 5 TC 200, 215 (HL)
27. In the "Notes on clauses" appended to the statement of objects and reasons published by the Imperial Government with the draft Income Tax Bill referring to this Act of 1918, as regards Section 9(2), the following note had been expressly published.

"The allowances which can be claimed in computing profits are specifically stated to prevent the diversity of practice which had occurred in the past" - Bombay Income Tax Manual 1918, page 37 Cf., (1922) 1 LR 46 Bom 567.
It allowed deduction on account of expenditure of general nature. In *Tata Iron and Steel Company*, In Re, the company increased its capital by Rs. 7 crores by the issue of 7,00,000 second preference shares of the value of Rs. 100/- each. The whole issue was under-written by certain individuals at 4% payable exclusively out of the profits of the Company. Moreover, the underwriters would take up such shares as would not be subscribed for by the shareholders in proportion to the total number of shares applied for by them.

The company claimed amount of this 4% discount paid to the under-writers as an item of expenditure under section 9(2) (ix) of the Act. It was an expenditure not on account of 'Capital Expenditure' but ordinary expenditure from which no return could be directly expected, being in the nature of preliminary expenses of the company. The High Court of Judicature at Bombay held that the expenditure was for the future benefit of the business for all years to come, hence it was a capital expenditure.

The court relied on the judgment in *Texas Land & Mortgage Co. v. The Surveyor of Taxes*. In this case the cost of raising capital by the company by paying commission to brokers for placing an issue of debentures, was not allowed to be deducted in ascertaining profits, even if such expenses were written off as preliminary expenses by a company. It was also held that it was within the spirit and intention of the Income Tax Act to tax the commission in the hands of the brokers.

A forceful contention was taken up by the company in *Tata Iron & Steel Company's Case*, that under the Articles of Association such an item could not be debited to its capital account. The Court observed:

"But the fact is that one has to look to the Income Tax Act and not the Articles of Association to find out what can be allowed and what cannot be allowed for

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28. (1921) 1 LR 45 Bom, 1306.
29. (1894) 63 LJ QB 496.
30. Ibid.
income tax purposes... There are many items which public accountants treat as items of trade expenses (e.g., payment of income tax) but which the Income Tax Department cannot allow under the Income Tax Act. There is nothing in the Act to prevent the same amount of money being taxed again and again when it changes hands.

Furthermore, the Court Substantiated its reasoning as follows:

"As long as the law allows preliminary expenses and goodwill to be treated as assets, although of an intangible nature, the money so spent is in the nature of capital expenditure just as much as money spent in the purchase of land and machinery... the expression 'capital expenditure' is not defined and the words in the nature of capital expenditure make the meaning of the expression more elastic in its application, to the facts of each case".

Turning to the conceptual analysis, the admissibility of deduction by virtue of Section 9(2)(ix) is dependent on the exposition of the word 'profits'. The learned Judge, Fletcher Moulton, L.J., described the term 'profits' in this context as follows:

"Profits implies a comparison between the state of business at two specific dates annually separated by the interval of a year. The fundamental meaning is the amount of gain made by the business during the year. This can only be ascertained by comparison of the assets of the business on the two dates. For practical purposes, these assets in calculating profits must be valued and not merely enumerated. Even if the assets were identical at the two periods, it would by no means follow that there had been neither gain nor loss, because the market value in exchange of those assets might have altered greatly in the meanwhile; a stock of fashionable goods is worth much more than the same stock when the fashion has changed".

What the learned judge meant was clearly that to ascertain the profits of a concern for any particular year, we must take the market value of the total assets (including fixed capital, circulating capital and stock-in-trade) at the beginning and end of the year and the difference between the two valuations would represent profit or loss for the period.

31. In re Spanish Prospecting Company Ltd., (1911) 1 Ch. 92.
In essence, applying this test of evaluating 'profits' the expenditure made in Tata and Iron steel Company did not fulfil the requisites, hence it would be necessarily an expenditure capital in nature; since only those expenditures could be deductible which were incurred 'solely for the purpose of earning such profits'.

The Supreme Court held in *Eastern Investment Ltd. v. CIT, West Bengal* that the test of commercial expediency applicable to expenditures "wholly and exclusively incurred for the purposes of the business or profession" would be equally applicable to expenditure "incurred for the purpose of making or earning such income".

Thus the decisions rendered under the former language in section 37(1) of the Income Tax Act, 1961, corresponding to section 10(2) (xv) of the 1922 Act, would be equally relevant under the latter language in Section 57(iii) of the 1961 Act, corresponding to section 12(2) of the 1922 Act.

The Bombay High Court held in *Ormerods (India) Pvt.Ltd. v. CIT, Bom.*, that the term "purpose" does not mean "motive"; much less, can it mean the ulterior motive or the ultimate object of the purchase of the shares. The governing words in section 12(2) of the 1922 Act ("Corresponding to Section 57(iii) of the 1961 Act) are, "for the purpose of"; and if the purpose be present, the circumstance that no profit has resulted as a result of the expenditure would not disentitle the allowance of the expenditure.

The facts of *Ormerods (India) Pvt.Ltd.* were that the private limited company purchased shares in public limited companies by raising monies by borrowings and later transferred the shares to its controlling shareholder for a price, it may be that the company in buying the shares was intending to ultimately benefit its controlling shareholder. That might have been the motive. Yet the "purpose" was in fact

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32. Ibid.
33. (1951) 20 ITR I, SC
34. (1959) 36 ITR 329
35. Ibid.
to purchase and make or earn money. The two concepts ought not to be mixed up.

Another notable feature of the 1918 Act was that the method of compounding tax for a series of years was given up. It is important to note that the Act of 1886 allowed compounding of taxes for a period of four years, a legacy which it inherited from the past. The 1918 Act contained no detailed provisions for the computation of income as now under the 1961 Act, and it left to the Governor-General in council the power to make rules for the purpose.

A general feature of the 1918 and 1922 Acts was that all incomes "from whatever source it is derived, if it accrues or arises or is received in British India, or is, under the provisions of this Act, deemed to accrue or arise or to be received in British India", such incomes would be taxable.

Under the present Act of 1961, unlike the Act of 1918, the income of the "previous year" is treated not as a measure of the income of the "year of assessment" but it is itself the subject of charge. Under the Act of 1918, which followed the English Acts levy was made upon the income of the year of assessment, i.e. of the current year, part of which was unexpired at the time of assessment, taking the income of the previous year as a standard or as a measure. After the actuals were ascertained at the close of the year, corrections and adjustments were made in the next year's assessment. But by the Act of 1922, this principle was changed, which remains so even under the present Act of 1961. Now what is assessed in the tax year is the 'actuals' of the previous year.

36. Section 31 of 1886 Act read: "If a company or person desires to compound for the tax assessable under Part II or Part IV, as the case may be, the Collector may, subject to such rules as may be prescribed in this behalf agree with the company or person for a composition for the tax on such terms and for such period as he thinks fit."
In the Act of 1918, Section 25 enacted that if for any reason income chargeable had escaped assessment in any year, or had been assessed at too low a rate, the Collector could at any time 'in the year next following', assess or reassess such income. Under section 34 of the 1922 Act also, as it stood up to 1939, if for "any reason" income, profits or gains chargeable to income tax had "escaped assessment" in any year, or had been assessed at too low a rate, the ITO could proceed to assess or reassess such income by serving the requisite notice "at any time within one year" of the end of that year. The ground for reopening an assessment under section 34, as would be observed from the above, was very wide; it was enough that the ITO on the information which he had before him in good faith considered that he had grounds for believing that the assessee's profits had for some reason escaped assessment or had been assessed at too low a rate. No preliminary enquiry had to be held by the ITO to arrive at such a belief by convening the assessee and granting him a hearing.

In order to offset the longer period enacted for reopening an assessment, a curb was put on the time, within which the assessment could be completed, the limits being the self-same 8 years or 4 years as for initiation. In respect of the grounds on which the ITO could reopen, section 34 of the 1922 Act ran:

"If in consequence of definite information which has come into his possession, the ITO discovers...". The opening words in the above extract were put in to make it clear that the ITO could not use the section for making "purely fishing enquiries with no basis at all". As interpreted by courts, these words meant that three conditions must be satisfied before the ITO could take action under Section 34:

1. There must be 'definite' information which has come into his possession, that is to say, the information must be definite and it must be of new facts;

38. Madhya Pradesh Industries Ltd v. ITO (1965) 77 IT 268 (SC)
2. There must be 'discovery' that income, profits or gains have escaped assessment or have been under-assessed; and

3. The discovery must have been the result of that definite information.

In other words, notwithstanding the extension of time limits for back assessment under Section 34, the provisions were much more restrictive in scope than before 1939.

Section 34 was recast in 1948. This amended section made a distinction between (i) an escape due to the assessee's "failure to make a return of his income... or to disclose fully and truly all material facts necessary for his assessment"; and (ii) escape in other cases. In the former case, the ITO was empowered to reopen within 8 years after recording his reasons, and after obtaining the sanction of the CIT. The conditions regarding 'definite information' and 'discovery' were omitted. For escapement, due to any other cause, the ITO could reopen the assessment within 4 years of the end of the relevant assessment year, if 'in consequence of information in his possession' he had reason to believe that income had escaped assessment. The 1948 Amendment also laid down that the time-limits of 8 years and four years did not apply to any reassessment made "in pursuance of" any appellate or revisional or High Court order.

The said freedom from time-bar was extended in 1953 to "an assessment or reassessment made on the assessee or any person in consequence of or to give effect to any finding or direction contained in", an appellate or revisional or High Court order. The Amendment Act of 1953 made it clear that Section 34 as amended in 1948 was applicable to earlier assessment years.

The dropping of the words "if in consequence of definite information which has come into his possession, the ITO discovers..." (words which were introduced by the Amendment Act of 1939) and the substitution therefor, by the
Amendment Act of 1948, of the present phraseology "if the ITO has reason to believe" indicates that short of a charge of fraud on power against the department (the ITO who started the proceedings and the Commissioner who accorded his approval), the initiation of the proceedings for additional assessment cannot easily be challenged.

Comparing the language of the pre-1948 Act, with that of the post 1948 Act - i.e., the present Act-, it would be found that the following changes have been effected:

i) the word "definite" qualifying 'information' has been dropped;

ii) the words "information which has come into his possession" have been replaced by the words "information in his possession"; and,

iii) the word "discovers" has been deleted and in its place, the words "has reason to believe" have been substituted.

The dropping out of the words "has come" in the phrase "in consequence of information which 'has come' into his possession (words which imply coming in of information a new), leads to the inference that even if information had all along been with the ITO and did not come to him anew, still power arises for back assessment.

Another general feature of the 1918 and 1922 Acts is the concept of normal depreciation. Two methods were adopted for allowing normal depreciation-

a) the straight line method, and 

b) the written-down value method.

These methods are in vogue all along even under the present 1961 Act. The straight line method is applied only to ships plying on high seas. In respect to all other ships and to all buildings, machinery or plant, the written down value method is adopted. The straight line method makes it a matter of great difficulty to keep track of the various items of plant or machinery purchased on different dates and of the years in which they should drop out of the depreciation computation, by reason of the full hundred per cent allowance, having been already made.
The written-down value method on the other hand automatically secures that the aggregate allowances can never exceed the hundred per cent.

In essence, depreciation allowance is in the nature of a capital charge, but it has been recognised due to 'wear and tear' caused to the machinery or plant. In *Coltness Iron Co. v. Black*, the coal was getting exhausted by working a mine. The Court said that the general principle underlying the Income Tax Law is to levy assessment on profits or income without making any allowances or deductions on account of any capital which gets exhausted, while yielding income. To this somewhat hard principle of taxation, there is an exception, and that is for depreciation caused by wear and tear. Thus, a coal mine being worked and getting exhausted by the constant removal of coal, no deduction is permissible on account of the exhaustion of coal.

Certain inroads have been made in the above-mentioned principle, for example, Taxation Laws (Amendment) Act, 1970 inserted, Section 35 E in the Income Tax Act, 1961 allowing deduction on amortised basis for expenditure on prospecting etc., for certain minerals.

DEFINITION OF INCOME AND ITS IMPLICATIONS

It is pertinent to examine the implications of the term 'income' as the Income Tax Act, 1918 left the law much where it stood under 1886 Act. If the "source"- the originating cause, is one vanishing the moment it is born and abstract in its quality, it can hardly be labelled as such. An isolated transaction of a purchase and sale resulting in some profit cannot be attributed to any source. The observations made by the Privy Council on the concept of income are as valid today, as they then were. A windfall has no source. That is the reason why a casual and non-recurring receipt is made exempt from charge. Having regard to this concept under the 1922 Act,

38. ITC 287, 307
Sir George Lowndes in *Shaw Wallace's case* held that there was no source for a solatium granted by a principal to his agent on the compulsory winding up of the agency and therefore, the solatium was exempt. To overcome the effect of this decision, the Finance Act of 1955 inserted sub section (5A) to Section 10 of the 1922 Act, including such compensation payments in the net of taxable income. These provisions have been reproduced in the 1961 Act as Section 17(3) (i) and Section 28(ii) respectively.

The concept enunciated in *Shaw Wallace's Case* that a windfall has no source, and therefore windfall income is not taxable has been watered down to a great extent by virtue of the Finance Act, 1972 inserting Section 2(24)(ix).

In the Indian scheme of taxation a residuary head of income chargeable to tax under "other sources" has been specially devised. Such a scheme is not there in the English Scheme of taxation. The 1961 Act, in recognition of the general principle of the requirement of a source during the accounting year, has specifically enacted in relation to the five particular kinds of receipts mentioned in Sub-Section (4) of Section 176 and sub-sections (1) to (4) of section 41, that despite the absence of a source for these receipts during the relevant accounting year, or their source having ceased to exist from before the accounting year, such receipts, nevertheless, be brought to charge in the year of receipt. Thus, these exceptions superseded the well-grounded general rule.

The concept of income is demonstrable from this Supreme Court's judgment, CIT, Kerala v. West Coast Chemicals and Industries Ltd. (in liquidation). The facts were that the assessee company was wound up at least in so far as its match manufacture was concerned. The business of the company was sold

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41. Ibid
42. It reads: "any winnings from lotteries, crossword puzzles... of any form or nature whatsoever".
43. (1962) 46 ITR 435 SC
as a going concern and, in fact, worked by the assessee-company on behalf of the buyer till the entire consideration was paid. The prices of the raw materials became ascertainable by virtue of an earlier sale of the assets, excluding the raw materials and a later sale including the raw materials. The difference between the two prices represented the price of the raw materials. The Supreme Court remarked that but for the earlier transaction, the price of the raw materials was not identifiable. No portion of the consideration can be split up as attributable to the stock of raw material sold and be chargeable as business profit. This was a winding-up sale with a view to realising the capital assets of the assessee company and not a sale in the course of business operations, which alone would have attracted tax, if profits resulted.

The Supreme Court further observed:

"There is a great danger of extracting a principle from the reported cases, divorced from the facts. The cases illustrating the questions arising in such circumstances can be divided into two categories, first, those where the sales formed part of trading activities, and second, those where the realization was not an act of trading. This distinction is a sound one. The difficulty is in deciding whether a particular case belongs to one category or the other."

As to the rule of construction in taxing statutes, Lord Blackburn said in the case of Coltness Iron Company v. Black:

"No tax can be imposed on the subject without words in an Act or Parliament clearly showing an intention to lay a burden on him. But when that intention is sufficiently shown, it is not open to speculate on what would be the fairest and most equitable mode of levying that tax."

In essence, the Supreme Court's judgment in CIT, Kerala v. West Coast Chemicals and Industries Ltd. (in liquidation) clearly affirm Lord Blackburn's dictum mentioned above.

44. Ibid.
45. (1881) 6 AC, 315.
The words "accruing or arising" used in 1886 Act remain as much a baffling concept, even under 1961 Act as at its stage of inception. Section 3(5) of the Income Tax Act, 1886 laid down 'income' as 'income or profits, accruing and arising or received in British India'. It is clear from Lord Macnaghten's judgment in Colquhoun v. Brooks that "accrues or arises" was not the same as "is received".

Perhaps, it would be pertinent to quote from Wharton's conflict of laws, where the learned author says:

"The power of taxation of any State is of necessity, limited to persons, property or business within its territorial jurisdiction".

The learned author further states:

"That the principle is so fundamental that it has been declared that an act of State legislation in violation thereof would be as much a nullity as if in conflict with the most explicit constitutional inhibition".

It is this earnest zeal of raising their resources by way of revenue, which tempted the state to legislate these words 'accrue or arise'. Lord Herschell pointed out in Colquhoun v. Brooks:

"The Income Tax Acts, however, themselves impose a territorial limit: either that from which the taxable income is derived must be situated in United Kingdom or the person whose income is to be taxed must be resident there".

The same principle is traceable in the provisions of the Indian Income Tax Acts, which is in vogue since 1886 Act till the present 1961 Act. There is no reason for imputing to the Indian legislature an intention to depart from this principle. The Madras High Court observed in Ramanathan Chetty's case that the words "accruing or arising" are words of a general nature descriptive of a right to receive.

46. (1889) 14 AC 511.
47. Wharton's conflict of Laws, Vol.1, Section 80(a), Cf., (1919) 1 LR 43 Mad. 75.
48. CIT v. Ramanathan Chetty (1919) 1 LR 43 Mad 75.
On the basis of the afore-mentioned two considerations, one being a guide to the principle of legislation, two being a guide to the construction of the language of the tax statute, the Scheme of chapter IV of the 1918 Act was devised to amplify the principle of taxability. Section 3(1) of 1918 Act laid down:

a) incomes actually accruing or arising or received in British India shall be taxable; and
b) certain incomes are deemed to have accrued, arisen or received in British India.

The scheme was intended to affect two classes of persons—persons who were not sui juris, but who were resident in British India and carried on business through an agent or guardian or the Court of Wards; and persons Sui Juris who were not resident in British India but who conducted their business in British India, through an agent. It stated a notional rule of law, the object aimed at being that the owner of the income could not escape liability either because he was not Sui Juris or because he was not a resident in British India, provided he received the benefit of transactions in British India through somebody who represented him.

Hence, it is by virtue of a fiction that certain incomes were made taxable under the 1918 Act for the first time in the history of Indian tax jurisprudence. This concept of taxing income on the basis of 'fiction' has attained insurmountable heights under the 1961 Act.

The concept of 'business connection' owes its origin to this historical perspective, which was introduced in the Indian Tax code by virtue of Section 33 of the 1918 Act. It could be ascribed in two parts:

a) one relates to profits or gains accruing or arising to such a person whether directly or indirectly through or from any business connection in British India;
b) income which 'shall be' deemed to be income, accruing or arising within British India.
Keeping in view the complexity of innovations embedded under the concept of business connection, the legislature did not define the term 'business connection' under the 1918 Act, and it remains undefined even under the 1961 Act.

In Board of Revenue v. Madras Export Company the company purchased shares at fixed prices and shipped them in accordance with the directions of the Head Office. It was agreed that no part of the profits would be remitted to Madras. The Board took the contention that under Section 33(1) read with Section 3(1) of the Income Tax Act, 1918, the profits were taxable.

Schwabe, C.J., observed:

"If this contention is right, it would result in all foreign purchases of goods in India for the purpose of manufacture or resale elsewhere being liable for Indian Income Tax on any ultimate profits made in the countries to which the goods are exported. This would be a startling innovation and quite contrary to the established principle of taxation in England".

In Greenwood v. Smith & Co., the House of Lords affirming the decision of Rowlatt, J., in Smith & Co. v. Greenwood observed:

"Section 31(2) of the Finance Act, 1915 (analogous to Section 33(1) of Income Tax Act, 1918) though in terms wide enough to bring into tax non-residents in respect of profits earned abroad through direct or indirect dealing through an agency in England did not bring into tax profits unless they were earned or received in Great Britain. That Section was a machinery Section and not a charging section".

49. (1921) 3 K.B., 583.
50. Section 33(1) laid down that all profits or gains accruing or arising to any person, resident out of British India directly or indirectly through or from any business connection in British India shall be deemed to be income accruing, or arising in British India and shall be chargeable to income tax in the name of the agent of the non-resident person etc.
51. Per Schwabe, C.J., in Board of Revenue v. Madras Export Co. (1921) 3 KB 583.
52. (1922) AC 417.
53. (1920) 3 KB 275.
Lord Buckmaster stated the principle in the following words:

"It is important to remember the rule which the courts ought to obey that when it is desired to impose a new burden by way of taxation it is essential that the intention should be stated in plain terms. The Courts cannot assent to the view that if a section in a taxing statute is of doubtful and ambiguous meaning it is possible out of that ambiguity to extract a new and added obligation not formerly cast upon the tax payer."

Another important principle emerges from In re Aurangabad Mills Ltd. In the absence of a credit appearing in the books of accounts owing to a right to demand payment on a certain date with a corresponding liability on the part of the third person to pay, the mere fact that credit entries are made in the assessee's books of account would not result in a receipt in the eye of law, as for instance, entries made by way of inter-domestic transactions.

The Aurangabad Mills Ltd. was registered at Bombay and whose Board of Directors also resided there, but the working textile mill was in the then Nizam's territory. The Board of Directors maintained at Bombay the account books of the mills. The bulk of the profits of the company were not received in British India, but only a portion of the annual profits was received in British India for distribution by way of dividends among shareholders of the company who resided in Bombay.

The main question which arose was:

Whether income can be said to accrue or arise in British India within the meaning of section 3(1) of the Income Tax Act, 1918, if the seat of the management is in British India?

It was on record that the Bombay office had the general supervision and control of the company's affairs and carried out the orders of the Board of Directors on questions of general policy like representations to government, increase of capital.

54. Ibid, 423.
55. 1 ITC 119; AIR 1921 Bom 159; (1921) 1 LR 45 Bom, 1286.
raising of loans, allotment of shares and debentures, transfer of shares. The company was paying tax on a part of its income which was supposed to represent profits made in British India, as required under Section 11 of 1886 Act.

The Chief Revenue Authority taxed on the whole of the profits of the company under 1918 Act, relying on section 17(1) of the 1918 Act which called upon the company for an annual return of its total income. The High Court of judicature at Bombay held that by reason of such credit entries the profits earned in the Nizam's territories could not be said to have been received in the then British India.

The High Court considered the judgment of Commissioners of Taxation v. Kirk in this connection. The question which arose in this Australian case was:

Where the profits of a company could be said to have been derived, because four processes in the earning or production of income were involved:

1) The extraction of the ore from the soil,
2) The conversion of the crude ore into a merchantable product, which is a manufacturing process,
3) The sale of the merchantable product,
4) The receipt of the moneys arising from the sale.

The House of Lords held that as regards the manufacturing process, the income to that extent was held to arise or accrue in New South Wales. Their Lordships did not attach any special meaning to the word 'derived' which they treated as synonymous with arising or accruing, since under Australian Commonwealth Law, the word 'derived' was used there instead of "arising or accruing".

Whereas under the 1886 Act, the Statement of the net profits made in British India was to be made.

Undoubtedly, under English law it could have been taxed because in England a Company is to carry on its business where it has its registered office irrespective of where its profits are derived.

Ibid, 592.
Thus the High Court of Judicature at Bombay came to this conclusion in *Aurangabad Mills case* that all the processes were carried out in the territories of His Exalted Highness the Nizam.

Yet another important principle of law emerged from the judgment in *Secretary, Board of Revenue v. Ripon Press & Sugar Mills* 60. If the funds be transferred by the recipient from one place to himself at another place, it would be a domestic operation and the transfer would not yield a receipt much less an "income". The same sum cannot be received as income a second time. This principle has its merits, firstly, in determining the year of receipt and, secondly, for ascertaining the incidence of taxation where it depends purely upon receipt of income.

The Ripon Press & Sugar Mills was incorporated in 1882 and registered under the Indian Companies Act. More than 3/4ths of the shareholders and the Directors were in British India. The Head Office was in Bellary, Madras Province. This company owned a cotton pressing factory in Raichur, Hyderabad Native State. Customers who brought cotton for pressing, paid money in Raichur some of which were later remitted to Bellary.

The Dividends were declared and warrants of payment issued in British India. Ever since the formation of the company they had been assessed to income tax in British India and they did not object till this case came up. The High Court of Judicature at Madras held that money so remitted to Bellary was only part of the money already paid to the company at Raichur as profits; and cannot be received again as profits.

Taking the ratio of the judgment in *Aurangabad Mills case* into consideration, Oldfield, J., said:

"The identity between the shareholders and the company is not material for the present purpose, since

60. AIR 1923 Mad 574; 1 ITC 202; (1923) 1 LR 46 Mad 706.
61. 1 ITC 119.
62. Ibid, 713.
the assessment is not of the income as the income of the individual shareholders, but as the income of the company, and we have nothing to do with the shareholders in their individual capacity*.

**THE SUPER TAX ACTS 1917 AND 1920**

The first world war led to an increase in income tax rates in 1916; in the year 1917 super tax was levied in India for the first time by a separate Act. In U.K. it was introduced in 1910 by the famous Lloyd George Budget of 1909. The main features of Super Tax Act, 1917, were as follows:

a) It was levied with the same rates applicable to a company, individual or HUF on incomes above Rs. 50,000/- However, in the case of a company the income subject to super-tax was its undistributed profits.

b) Shareholders, if otherwise liable, paid tax on dividends.

This system of charging super tax on company's undistributed profits led to an evil, in as much as there was no incentive to retain the profits in the business and plough them back into it.

The Super-Tax Act, 1920 brought another most important change that super-tax on companies was levied on its entire profits less Rs. 50,000/- charged at a flat rate of one anna in the rupee, and not on any graduated basis as in the case of other assessees; shareholders were not given credit for super tax paid by the company and in this sense the super tax levied on the companies was, but for the name, a corporation profits tax i.e. a tax levied upon corporations as such (because of the statutory privilege of limited liability) and not on their income though measured by reference to it.

With this legislative backdrop, the corporation profits tax was not allowed as a deduction in computing taxable income for income tax purposes. It is important to note that when the Income Tax Act of 1918 was amended in 1922, the super Tax Act, 1920 was made a part of it and since then, income tax and super tax levies were being made under a single enactment.
The whole scheme of income tax and super tax in this country was based on the principle that the tax was assessed at the beginning of the year on an anticipated income and was paid in anticipation on the assessment, but when the year was over and the actual earnings had been discovered, there was not a fresh assessment but an adjustment. As regards super tax, it was nothing but an additional duty of income tax.

Few important cases arose on the implications of these Acts. In *Imperial Tobacco Co. v. Secretary of State*, the following two main points were referred for the decision of the High Court:

1) Whether the company could be treated as an agent for the non-resident shareholders under section 34 of the Income Tax Act, 1918.

2) If so, whether the company could be assessed to super tax on their account in respect of the dividends payable to them?

The Calcutta High Court held:

"A company incorporated according to law is an artificial legal person having an existence separate from its corporators. There is, therefore, no legal impediment to a company being agent for any of its shareholders".

**EXCESS PROFITS DUTY ACT, 1919**

The Income Tax Act, 1918 was the precursor to 1919 Act on Excess Profits Duty. The definition of 'business' in the Income Tax Act was reproduced verbatim in the Excess Profits Duty Act. Section 2 of the Excess Profits Duty Act, 1919 laid down:

"Business" includes any trade, commerce or manufacture or any adventure or concern in the nature of trade, commerce or manufacture".

The excess profits duty was imposed only on excess profits arising out of certain businesses, not on certain sources of income. The basis for determining the average profits of the standard year was the average capital employed

63. (1922) 1 LR 49 Cal 721; AIR (1922) Cal 454.
in the business. Again proviso to section 1(c) to Schedule II to the Act laid down that accumulated profits would be treated as capital, if they were employed in the business. A duty of 50% was charged on the excess amount by which the profits of the accounting year exceeded the standard profits.

Section 6(1)(a) and (b) prescribed various methods for calculating standard profits. Proviso to Section 6(1)(b) stated that if the average capital employed in the business in the year adopted for determining the standard profits was less or more than the capital, so employed at the end of the accounting period, there would be made to or from the standard profits, an addition or deduction as the case may be, which shall bear to the standard profits the same proportion as such decrease or increase of capital bears to the average capital so employed in the year adopted. To take an example, if the standard profits were one lac on an average capital of ten lacs, and the capital at the end of the accounting period was 20 lacs, then the standard profits would be increased to two lacs. It was obvious that the more the capital at the end of the accounting period, the greater the addition to the standard profits, with a compounding decrease in the amount on which the excess profits duty could be levied.

Schedule II to the Act prescribed the mode of ascertaining capital. The amount of capital would, so far as it does not consist of money, be taken to be:

a) so far as it consisted of assets acquired by purchase, the price at which these assets were acquired subject to any proper deduction for depreciation or for unpaid purchase money,

b) so far as it consisted of assets being debts due to the business, the nominal amount of those debts subject to any deduction, which had been allowed or was allowable in respect of those debts under the Indian Income Tax Act, 1918, and,

64. First Proviso to Section 6, Excess Profits Duty Act, 1919.
65. Section 4, Excess Profits Duty Act, 1919.
c) so far as it consisted of any other assets which had not been acquired by purchase, the value of the assets at the time they became assets of the business subject to any proper deduction for depreciation.

In Bombay & Persia Steam Navigation Co. In re the main question to be considered under the Excess Profits Duty Act, 1919, was:

Whether accumulated profits of the company could be treated as capital so employed in the business.

The company made very large profits during the war and invested a large amount of them in securities. The company claimed that the securities were assets of the business and 'capital employed in the business'. If it were liquidated, these securities would be used to meet the liabilities.

The High Court of Judicature at Bombay analysed the entire scheme of the Excess Profits Duty Act, 1919. It held:

"Accumulated profits would be treated as capital if they were employed in the business. Looking to the scheme of Schedule II, the words 'employed in the business' prima facie bear their natural meaning. If the words 'intended to be employed in the business' had been intended, these would presumably have been used, just as they were used in Schedule D, cases 1 and 2, rule 3(f) of the English Income Tax Act, 1918 which specifies "any sum employed or intended to be employed as capital in such trade, profession, employment or vocation".

Another important question arose in the case of CIT v. Eastern Etc Telegraph Co. Whether the amount of income tax and excess profits duty payable in England was to be deducted

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66. (1921) 1 LR 45 Bom., 881.
67. (1921) 1 LR 44 Mad., 489.
in arriving at the 'total profits'. The Madras High Court held that the excess profits duty referred to in 1919 Act was that paid in British India in respect of the Indian profits and that it had no bearing on the excess profits duty payable or paid in England.

Wallis, C.J., delivering the judgment of the High Court of Judicature at Madras held:

"The rule (Rule 2 under section 43(2)(c) of Income Tax Act, 1918) in question merely provides the formula for ascertaining the income arising out of the business in British India, which is so mixed up with the income arising out of the business carried on outside British India that you cannot estimate it with mathematical accuracy. By the very nature of the case the rule is artificial and provides a rough and ready method of arriving at a taxable income".

68. The company took up this contention that the taxes paid on account of 'business connection' was to be deducted. The pertinent rules under sections 33 and 43 (2)(c) of the Income Tax Act, 1918 were:

In any case in which the profits accruing or arising or deemed to accrue or arise in British India to any person residing out of British India, whether directly or indirectly through or from any business connection in British India cannot be accurately ascertained, the amount of such profits for assessment purposes may be calculated on such percentage of the turnover of the business carried on in British India as the collector, having regard to all the circumstances of the case may consider to be reasonable.

69. Ibid, 510.
"Where any Act of the Indian Legislature enacts that income tax shall be charged for any year at any rate or rates applicable to the total income of an assessee, tax at the rate or those rates shall be charged for that year."

The Act of 1922 made a departure by abandoning the system of specifying the rates of taxation in its own schedules. The rates of taxation were to be fixed every year by the annual Finance Act. The machinery provided by the 1922 Act had to be vitalised each year by injecting it with the appropriate Finance Act. This pattern of levying taxes with the regulation of annual Finance Acts has been sustained under the 1961 Act as well. Moreover, the charging Section 4 of the Income Tax Act, 1961 borrows its basic scheme from 1922 Act.

The 1922 Act marked an important and very significant departure from the 1918 Act, namely, by establishing the charge in the year of assessment on the income of the 'previous year', instead of adopting the previous year's income merely as a measure of the income of the year of assessment. Item (iv) under Section 6 was described as "business" instead of "income derived from business" as in the Income Tax Act, 1918. On the other hand, the 1922 Act like the 1918 Act, applied to all incomes, "accruing or arising", or received in British India or deemed so to accrue, arise or be received.

Conceptually, the 1922 Act emphasised the differentiation between "income" and "profits or gains", by virtue of Section 4, which brought out the application of the Act to all incomes, profits or gains. Sections 3 and 4 together of the 1922 Act created the machinery for the charging Section, whereas the characteristics of both these sections have been brought under a single section, Section 4 of the 1961 Act, which is the present charging section.

Of much important significance, the 1922 Act made another departure from the 1918 Act, that it enabled losses under one head of income to be set off against profits under any other head, so that, the tax was chargeable only on the net income.
Later, the Amending Act of 1939 brought considerable and far-reaching changes into the Act of 1922. It incorporated in its provisions the levy of super tax, which till then was being assessed as a separate tax, first, by the super tax Act, 1917, and later by the super tax Act, 1920. The super tax was defined to this end as an additional duty of income tax.

The Amending Act of 1939 was based on the recommendations of an Expert Income Tax Committee, 1935. The most important feature of the 1939 Act was that it marked a departure from the past by bringing to charge the foreign income of "residents" in British India, wherever accruing or arising, notwithstanding that such income was not remitted into British India. It granted to a business, for the first time, relief by way of carry forward of loss for a period of 6 years.

In essence the most important feature of the Amending Act of 1939 was that the position at common law was departed from under this Act. By virtue of Section 49B (inserted by virtue of this Amending Act, 1939), the shareholder was "deemed" to have himself paid income tax in respect of his dividends to the extent to which the company had paid.

**INCOME AND ACCRUAL OF INCOME**

The twin concept of 'income' and 'accrual of income' is one of the most baffling concepts in tax jurisprudence. Section 2(24) of the 1961 Act defines 'income'. This clause is more systematically drafted and is far wider in scope than the corresponding clause in the 1922 Act. This definition is not exhaustive but only inclusive, which itself highlights the 'variable content' of the concept of income. On the other hand,

Economist's definition defies a set definition.

The Courts have not lagged behind, and on certain occasions the concept of 'real income' has been stretched to its stereoscopic manifestations. Of course, this concept could be invoked in its full vigour in cases where the accounts are kept on 'mercantile basis' or on 'earnings basis', as it is commonly known in England.

In Morvi Industries Ltd. v. CIT, the assessee was the managing agent of its subsidiary company, maintained its accounts on the mercantile system. It was entitled to receive an office allowance of Rs. 1,000 per month, a commission of 12½% on the net profits of the managed company and an additional commission of 1½% on all purchases of cotton and sales of cloth and yarn. In the accounting years ended on December 31, 1954 and December 31, 1955, the managed company suffered losses and the assessee earned only commission on the sale of cloth and yarn for the two years. Under the managing agency agreement, the commission was due to the assessee on December 31, 1954 and December 31, 1955, respectively and payable immediately after the annual accounts of the managed company were passed in general meetings. By resolutions of its board of directors, the assessee relinquished its commission on sales and office allowance because the managed company had been suffering heavy losses in the past years. But, this relinquishment was done, after the commission had become due, and before it had become payable in terms of clause 2(2) of the agency agreement.

71. Irving Fisher, Professor of Political Economy, Yale University, described income as a series of events, of psychic experiences, measurable in terms of enjoyment. He equated income with consumption over a certain period and propounded, in a way, a subjective evaluation of income with reference to its enjoyment which, naturally enough, would vary from person to person and from time to time.

This definition, despite its demerits, certainly highlights the "expenditure" aspect of income. This subject itself is of crucial importance; whether "expenditure" should form the base of "income". Surely enough, Income Tax Act, 1922 made a beginning in this direction and the 1961 Act has reached to, more or less, an optimum point.

72. (1971) 82 ITR 835 (SC)
The Tribunal held that the relinquishment by the assesse of its remuneration after it had become due was of no effect and also rejected its claim that the amounts relinquished were allowable under section 10(2)(xv) of the Indian Income Tax Act, 1922 because, as a result of the relinquishment, the financial position of the managed company did not become stronger while that of the assesse company became weaker and, therefore, the relinquishment was not for the benefit of the assesse. On a reference, the High Court agreed with the view taken by the Tribunal. On appeal, the Supreme Court affirmed the decision of the High Court.

Khanna, J., delivering the judgment of the Supreme Court, quoted a passage from the judgment of the same court in *Shoori Vallabhdas and Co. v. Khanna* in support of the conclusion reached by the court. That passage reads thus:

"Income tax is a levy on income. Though the Income Tax Act takes into account two points of time at which the liability to tax is attracted, viz., the accrual of the income or its receipt, yet the substance of the matter is the income. If income does not result at all, there cannot be a tax, even though in book-keeping, an entry is made, about a 'hypothetical income', which does not materialise. Where income has in fact, been received and is subsequently given up in such circumstances that it remains the income of the recipient, even though given up, the tax may be payable. Where, however, the income can be said not to have resulted at all, there is obviously neither accrual nor receipt of income, even though an entry to that effect might, in certain circumstances, have been made in the books of account".

The Bombay High Court had the occasion to examine the concept of "real income" in *H.M. Kashir Parekh and Co. Ltd v. Khanna*. The assesse, managing agent of a paper mill company maintained its accounts on the mercantile system. Under the managing agency agreement it was under a duty to forego up to one-third of its

73. (1962) 46 ITR 144, 148
74. (1960) 39 ITR 706 (Bom)

This decision of the Bombay High Court was cited with approval by the Supreme Court in *Poona Electric Supply Co. Ltd. v. CIT* (1965) 57 ITR 521; (1965) 3 SCR 619.
commission where the profits of the managed company were not sufficient to pay a dividend of 6%. For the accounting year ending March 31, 1950, the assessee earned a commission of Rs. 1,17,644, but as a result of the resolutions passed by the managed company and the assessee-company the assessee gave up a sum of Rs. 97,000 in December, 1950. The Appellate Assistant Commissioner held that the maximum amount the assessee was bound to forego was only Rs. 39,215 and included the balance of the amount forgone, viz. Rs. 57,785, in the taxable income. The Appellate Tribunal, however, found that the sum of Rs. 57,785 was also given up for reasons of commercial expediency.

Affirming the decision of the Tribunal, the High Court held:

"In ascertaining the real income the fact that the assessee followed the mercantile system of accounting did not have any bearing. The accrual of the commission, the making up of the accounts, the legal obligation to give up part of the commission, and the foregoing of the commission at the time of making up of the accounts were not disjointed facts; there was a dovetailing about them which could not be ignored."

Finally, rejecting the contention of the revenue, that merely because the assessee maintained its accounts on the basis of the mercantile system, the income must be held to have accrued at the end of the accounting year, the Bombay High Court succinctly stated:

"The principle of 'real income' is not to be so subordinated as to amount virtually to a negation of it when a surrender or concession or rebate in respect of managing agency commission is made, agreed to or given on grounds of commercial expediency, simply because it takes place some time after the close of an accounting year. In examining any transaction and situation of this nature the court would have more regard to the reality and speciality of the situation rather than the purely theoretical or doctrinaire aspect of it. It will lay greater emphasis on the business aspect of the matter viewed as a whole when that can be done without disregarding statutory language".

It is the mercantile system of accounting which has animated the concept of 'accrual of income'. The basis of charge was on 'accrual or arrisal basis' by virtue of sections 4(1)(b)

75. Ibid, 720
76. Ibid, Headnote
or 4(1)(c) or 4(1)(a) under the 1922 Act, corresponding to sections 5(1)(b) and 5(2)(b) and 5(2)(a) of the 1961 Act. In respect of a resident, it is immaterial where his income accrued, whether in India or outside India, the position being the same under 1922 or 1961 Acts. It is only in respect of a non-resident, that his income accruing within India alone is chargeable.

In CIT, Bombay v. S.K.F. Ball Bearing Co., Ltd., 1960 40 ITR 444(SC), the commission agent entered into an independent agreement with the non-resident, that he would remit to the non-resident the sale value of the goods, after deducting his commission therefrom, within a stated period from the date of the arrival of the goods, irrespective of whether he could be able to effect a sale of the goods or able to receive the price from the buyer. The agent, in compliance with the agreement remitted the sale price to the non-resident within the stipulated period.

The Supreme Court held, reversing the decision of the Bombay High Court(SKF Ball Bearing Co., Ltd. v. CIT, Bom 29 ITR 479) that that circumstance would not prevent the chargeability of the non-resident on receipt basis to the extent to which the commission agent did sell and did receive any sale proceeds in India within that period.

In Turner Morrison & Co. v. CIT, West Bengal, (1953) 23 ITR 152, SC, a non-resident despatched his goods to a commission agent in India on consignment sale on the terms that the property in the goods should remain in the non-resident, empowering the commission agent to sell the goods at stated prices, offering him a commission for his services.

The Supreme Court held (ibid, 160) that in such a case, the commission agent would be receiving the sale price for and on behalf of the non-resident and there would be 'embedded' in each receipt an element of profit. Such profit embedded in the receipt would be received in India on behalf of the non-resident and be chargeable on receipt basis under Section 4(1)(a) of the 1922 Act.

The Federal Court has succinctly stated on the doctrine of territorial nexus in Wallace Brothers & Co., Ltd. v. CIT AIR (1945) FC 9; (1945) 13 ITR 39 in the following words:

"The Indian Legislature is not bound to frame its income tax legislation on the same lines or on the same basis as have been adopted or found convenient in England. The imposition and assessment of the tax must necessarily vary according to the exigencies
The context of comparison between income accruing or arising in India and that accruing or arising outside, in order to determine the status of a company has been abolished with effect from 1.4.1958. Till then the position was that the company was to be a resident company only if its income accruing or arising within India exceeded that arising outside India.

The Supreme Court has many a times, cited with approval the definition given to the words "accrue" and "arise" by Makerji, J. in Rogers Pratt Shellac and Co. v. Secretary of State for India. His Lordship of the High Court of Judicature at Calcutta held:

"...both the words are used in contradistinction to the word "receive" and indicate a right to receive. They represent a stage anterior to the point of time when the income becomes receivable, and connote a character of the income which is more or less inchoate."

In E.D.Sassoon & Co.Ltd. v. CIT, the Supreme Court, while dealing with the concept of "accrual of income", held as follows:

"The three expressions 'accrues', 'arises' and 'is received' having been used in the section, strictly speaking 'accrues' should not be taken as synonymous with 'arises' but in the distinct sense of growing up by way of addition of increase or as an accession or advantage; while the word "arises" means comes into existence or notice or presents itself. The former connotes the idea of a growth or accumulation and the latter of the growth or accumulation with a tangible shape so as to be receivable. It is difficult to say that this distinction has been throughout maintained in the Act and perhaps the two words seem to denote the same idea or ideas very similar, and the difference only lies in this that one is more appropriate than the other when applied to particular cases."

77 contd. of Public Finance here, and the methods of doing business found to prevail in this country, if the conditions of today require or justify other methods of taxation.

Taking the scheme as a whole, sections 4(1), as amended in 1939, they are not in their operation extra-territorial in the strict legal sense of that term. The provisions in the impugned clauses that the company will be regarded as resident in British India only when its British Indian income exceeds its income arising without British India, ensures that the connexion between the assessee and the state is real and not illusory.

Of course, this criteria of determining the status of a company was abolished with effect from 1.4.1958.
These words 'accrues' and 'arises' amplifying the distinguishing features of the mercantile method of accounting brings many anomalies in its sweep. The Supreme Court has not approved of the English doctrine of reopening of accounts with regard to the relating back of profits to the date of transaction, instead it has applied the test of time when the right to receive the amount had accrued. The following passage extracted from the judgment of the Supreme Court in CIT v. Vazir Sultan and Sons brings out the propensity of the situation.

"While considering the case, it is necessary to bear in mind that the Indian Income Tax Act is not in pari materia with the British Income Tax Statutes, it is less elaborate in many ways, subject to fewer requirements and in arrangement and language it differs greatly from the provisions with which the courts in England have had to deal. Little help can, therefore, be gained by attempting to construe the Indian Income Tax Act, in the light of decisions bearing upon the meaning of the Income Tax legislation in England. But, on analogous provisions, fundamental concepts and general principles unaffected by the specialities of the English income-tax statutes, English authorities may be useful guides".

The importance of the English doctrine of reopening of accounts with regard to this 'relating back of profits' to the date of transaction could be narrated with the help of an English case, commissioners of Inland Revenue v. Newcastle Breweries Ltd. The respondent company carried on the business of brewers and wine and spirit merchants, and in the course of this business kept large stocks of rum which had to be reduced and blended before sale. In January 1918, the Admiralty acting under the Defence of the Realm Regulations took over about one-third of the stocks in question then owned by the respondent company. Payment of £ 10,315 was offered by the Admiralty, based on the actual cost of the rum and allowing a profit of about 1 Sh per proof gallon, and this amount was accepted on account by the respondent-company, without prejudice to its claim for a larger amount. The balance of £ 5,309 was accordingly,

80. CIT v. A. Gajapathy Naidu (1964) 53 ITR 114 (SC)
81. (1959) 36 ITR 175, 179 (SC)
82. (1927) 12 TC 927 (HL)
paid by the Admiralty in January, 1922.

The further payment of $5,309 was credited under the same head (Sales of Rum) in the accounts for the half-year ended 30th April, 1922, but was charged to excess profits duty by an additional assessment for the accounting period ended 30th October, 1918. The original payment of $10,315 was credited in the company's accounts for the year ended 30th October, 1918 and was included in an excess profits duty assessment for that accounting period.

On ultimate appeal to the House of Lords, it was held that the payment in question was a profit arising from the company's trade, and that it must be included for excess profits duty purposes in the profits for the accounting period ending on the 30th October, 1918, in which the rum was taken over. So far as the decision of the House of Lords in this case is concerned, it is based on the fact that the right to receive the amount accrued when the bottles of rum were requisitioned. Could it be denied that such a right to receive the amount did not accrue at that time? Whereas, under Indian Law, the chargeability could have operated on the basis of a later accounting year. It is submitted that the test of time when the right to receive the amount accrues is based on illusory considerations, since the right to receive springs up on the date of the transaction itself. There is no rationale, either in logic or law, to depart from the English practice. The economic conditions and the exigencies of public finance of the past prevailing in this country do not warrant the continuance of this test at present in this country.

In order to examine the entire scope of this test, it is imperative to examine its implications. Since the concept of income includes losses, the concept of 'accrual of liability' is intertwined with it, and it is this 'accrual of liability' where far-fetched repercussions emerging out of this test appear. Indubitably, the Supreme Court while stating the distinguishing feature of mercantile method, has held in Keshav Mills Ltd. v. CIT.

83. (1953) 23 ITR 230, 239
"That system brings into credit what is due, immediately it becomes legally due and before it is actually received and it brings into debit expenditure the amount for which a legal liability has been incurred before it is actually disbursed".

In CIT v. Swadeshi Cotton and Flour Mills Private Ltd., the assessee paid a sum of Rs. 1,08,325-9-3 by way of profit bonus to its employees for the calendar year 1947 in terms of an award made on January 13, 1949, under the Industrial Disputes Act. It debited the amount in its profit and loss account for the year 1948 but in fact paid it to the employees in the calendar year 1949. It was held that it was only in 1949 that the claim to profit bonus was settled by an award of the Industrial Tribunal and the only year to which the liability under the award could be properly attributed was 1949 and that, therefore, the sum of Rs. 1,08,325-9-3 had to be deducted in the calendar year 1949 relevant to the assessment year 1950-51.

Consequently the right of the worker to receive the bonus accrued only when the settlement was arrived at or award made, and not at that time when the work was actually done.

Accrual of liability is co-terminus with the quantification of liability. The income-tax law makes a hazy distinction between an actual liability 'in praesenti' and a liability 'de futuro'. Such a liability 'de futuro' is being treated as contingent. Thus a contingent liability being non-ascertainable, it does not constitute an expenditure.

In Indian Molasses Co.(P) Ltd. v. CIT, the liability was held to be non-deductible. The facts were:

The Managing Director of the company was due to retire at the age of 55 years on September 20, 1955, having served the company for 13 years by 1948. The Company executed a trust deed on September 16, 1948 for providing pension to the director after his retirement. The trustees took out a policy providing for different sums of annuity, depending upon the facts that the

84. (1964) 53 ITR 134 (SC)
85. (1959) 37 ITR 66 (SC)
director and his wife be living on the date of retirement, or either of them dies before that date.

There were two special provisions in the policy. Clause-III of the second schedule to the policy provided for the return of all premiums paid to the Insurance Company in case both die before September 20, 1955; clause IV provided for the trustees right to surrender the annuity policy at any time before that date for a cash surrender value, after giving notice.

The assessee-company claimed deduction of the sum settled upon the trust and then further, the yearly insurance premiums from its profits, by virtue of section 10(2)(xv) of the 1922 Act.

Hidayatullah, J., (as the learned judge then was), speaking for the Supreme Court, observed as follows:

"Side by side with these principles, there are others which are also fundamental. The income tax law does not allow as expenses all the deductions a prudent trader would make in computing his profits. The money may be expended on grounds of commercial expediency, but not of necessity. The test of necessity is whether the intention was to earn trading receipts or to avoid future recurring payments of a revenue character. Expenditure in this sense is equal to disbursement which, to use a homely phrase, means something which comes out of the trader's pocket. Thus, in finding out what profits there be, the normal accountancy practice may be to allow as expense any sum in respect of liabilities which have accrued over the accounting period and to deduct such sums from profits. But the income tax laws do not take every such allowance as legitimate for purposes of tax. A distinction is made between an actual liability 'in praesenti' and a liability 'de futuro' which, for the time being, is only contingent. The former is deductible but not the latter".

The Supreme Court, after considering the special provisions of the annuity policy, in particular, held:

"...there was a possibility of there being a resulting trust in favour of the company, the sums paid should be treated as set apart to meet a contingency, the payment of those sums was not a paying out or away of those sums irretrievably and did not amount to 'expenditure' and a deduction could not be made in respect thereof under Section 10(2)(xv)".

86. Ibid, 75-76
87. Ibid, Headnote
The Supreme Court has often referred, with approval, to the House of Lord's judgment in Southern Railway of Peru Ltd. v. Owen (Inspector of Taxes). The facts of this case were that under the legislation of Peru, an English company operating a railway there, was bound to pay its employee's compensation on the termination of their services, the legislative provisions being deemed to be incorporated into all contracts of service. The right arose on dismissal or on termination of the employment by the employer by proper notice, or on such termination by the death of the employee or on the expiry of the term of employment. There were, however, certain exceptions when such benefits were not payable.

The company claimed to be entitled to charge against each year's receipts the cost of making provision for the retirement payments which would ultimately be thrown on it, calculating what sum would be required to be paid to each employee if he retired without forfeiture at the close of the year and setting aside the aggregate of what was required in so far as the year had contributed to the aggregate.

The House of Lords held that the company was not entitled to make the deductions sought to be made because the company had ignored the factor of discount. On the other hand, it was accepted, in principle, that the company was entitled to charge against each year's receipts the cost of making provision for the retirement payments, which would ultimately be payable as it had the benefit of the employee's services during that year, provided the present value of the future payments could be fairly estimated.

During the course of the judgment, Lord MacDermott observed as follows:

"My Lords, as a general proposition, it is, I think, right to say that, in computing his taxable profits for a particular year, a trader, who is under a definite obligation to pay his employees for their services in that

88. (1957) 32 ITR 737 (HL)
89. Ibid, 747
year an immediate payment and also a future payment in some subsequent year, may properly deduct, not only the immediate payment, but the present value of the future payment, provided such present value can be satisfactorily determined or fairly estimated. Apart from special circumstances, such a procedure, if practicable, is justified because it brings the true costs of trading in the particular year into account for that year and thus promotes the ascertainment of the annual profits or gains' arising or accruing from the trade*

The Supreme Court considered Southern Railway of Peru ease in CIT v. Gemini Cashew Sales Corporation, where the principle set out in extenso by the House of Lords was approved. The facts are that the firm consisted of two partners came to be dissolved by reason of the death of one of them on 24th August, 1957. Thereafter, the business was taken over by the surviving partner on his own account without any interruption in the services of the employees or alteration in their terms of employment. In settling the accounts of the firm as on 24th August, 1957, a sum of Rs. 1,41,506 was taken into account as retrenchment compensation payable to the employees under section 25 FF of the Industrial Disputes Act, 1947.

The Supreme Court considered the liability and concluded that it would arise for the first time after the closure of the business and not before and that such liability arose not in the carrying on of the business but on account of the transfer of the business.

The Supreme Court observed:

"Broadly stated, the present value on commercial valuation of money to become due in future, under a definite obligation, will be a permissible outgoing or deduction in computing the taxable profits of a trader even if in certain conditions the obligation may cease to exist because of forfeiture of the right. Where, however, the obligation of the trader is purely contingent, no question of estimating its present value may arise, for to be a permissible outgoing or allowance, there must in the year of account be a present obligation capable of commercial valuation".

90. (1967) 65 ITR 643 (SC). Though this case concerned a firm, but the principles are equally applicable to a company.

91. Ibid, 649
In precise, the resultant of the Supreme Court's decisions on this subject is that where the liability is of a contingent nature, and it has not crystallised, then it is not allowed as an admissible deduction. On the other hand, if the present estimation on certain scientific basis of a future liability could be done, then such present estimation of a liability 'de futuro' can be an admissible deduction. In essence, this existing position of law has been one of the vexed subjects of litigation.

It is submitted that 'liability' can be differentiated; either immediate liability or a deferred liability. If such a deferred liability is a legal liability to be discharged in future by reason of a present obligation, then such a liability could be treated as an admissible deduction.

Conceptually, the doctrine of reopening of accounts is the only solution to this problem of 'accrual of income' or 'accrual of liability'. If reopening of accounts is adopted at various other places in the income tax legislation, for example, in 'income escaping assessment', there seems to be no reason to depart from it in this case.

II CONCEPT OF BUSINESS CONNECTION

The expression 'business connection' was undefined under the 1922 Act and remains so even under the 1961 Act. The legislature had deliberately chosen words of wide though uncertain import. The concept of 'business connection' under section 42 of 1922 Act was substantially amplified, since it used the expression 'business connection or property' in place of the words 'business connection' under section 33 of 1918 Act. Thus, if the value of the property of a non-resident appreciated yielding profits or gains, such a property being situated in British India, then Section 42(1) brought those profits or gains

92. Cf., Metal Box Co., of India Ltd. v. Their Workmen (1969) 73 ITR 53 SC
93. Hira Mills Ltd. v. ITO (1946) 14 ITR 417
within the net of taxability, as if deemed to have accrued or arisen within British India. Another significant amendment by virtue of sub section (2) to Section 42 along with an Explanation brought to charge as to which income would be deemed to be received into British India.

There is a galore of case law on this subject of 'business connection'. Before having historical retrospect through case-law, it would be worthwhile to mention one of the leading judgments by the Supreme Court on this subject CIT v. RD Aggarwal & Co., which is the judicial hallmark on this subject. The facts were that the assessee at Amritsar in India canvassed orders from India out of his own sweet will and pleasure, there being no obligation on his part to do so, and he had not been appointed as an agent by the non-resident and there was nothing to bind the non-resident manufacturer, either to accept the orders so canvassed; no operation such as procuring raw-materials or manufacture of finished goods took place within the taxable territories. The assessee was entitled to certain commission on these sales.

It was held by the Supreme Court that there was no business connection within the meaning of section 42(1) of the 1922 Act, and the assessee could not be treated as the agent of the non-resident. The connection between the Indian canvasser and the non-resident manufacturer would be a loose one, lacking any firm basis. Such a connection cannot be regarded as business connection, though it may be that the non-resident manufacturer accepts the orders from the Indian paying him a varying rate of commission.

Thus, no business connection would arise by sale of Indian goods abroad purchased from India, unless the sale is organised by the non-resident by virtue of some contract involving continuous operations and organized business activity between the non-resident abroad and the supplier in India. This

94. (1965) 56 ITR 20 (SC)
principle has been embodied now by the 1961 Act in Section 9(1)(i), Explanation (b).

It is important to mention in this regard that the Central Board of Direct Taxes issued a circular enumerating the tests laid down by the Supreme Court, in CIT v. R.D. Aggarwal & Co. The main test is that if a transaction of the sale and purchase between the non-resident and the resident is on principal to principal basis and at arm's length, then prima facie no liability to tax arises or accrues to the resident, who acts on his own.

The galore of case law reflects the position under the 1922 law, which was subsequently enacted in the 1961 law as well. In Rogers Pyatt Shellac & Co. v. Secretary of State for India

95. Section 9(1)(i), Explanation (b) reads:

9(1) The following incomes shall be deemed to accrue or arise in India:

i) All income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India...

Explanation: for the purposes of this clause-

a) ...

b) In the case of a non-resident, no income shall be deemed to accrue or arise in India to him through or from operations which are confined to the purchase of goods in India for the purpose of export.

Circular No. 23, dated 23rd July, 1969

Ibid

The writer has given a detailed account of the concept of 'business connection' in JILI, Vol 21, 4(1979) 559, entitled 'Taxation of foreign Income and Foreign Investments'.

(1925) 1 LR 52 Cal 1; AIR(1925) Cal 34, 1 ITC 363.

The analysis of facts of Rogers Pyatt Shellac & Co. v. Secretary of State for India resemble with that of CIT Burma v. Messrs Steel Brothers & Co. Ltd, AIR 1926 Rang 97, 2 ITC 119. Steel Brothers & Co. Ltd. were incorporated under the English Companies Act, their head-quarters being in London. They owned rice mills in Burma. Their rice business consisted in purchase of paddy in Burma, milling the same in their mills and transporting and selling the same in London.

The Rangoon High Court held that the process of conversion or transformation of paddy into rice constituted a manufacture. "According to the definition of 'business' in section 2(4) of the Indian Income Tax Act, 1922, Messrs Steel's activities in British India in connection with the produce from which the profits in question arise amount to
the assessee, a company incorporated in the USA, with branches and agencies at various places, had a branch office in Calcutta for the purchase of gum, S-hellac and other Indian products. It had a factory in the United Provinces, where the raw produce purchased locally was worked into a form suitable for export to America. No sales were conducted in India by the company. The goods purchased were sold in America.

The company was assessed to income tax and super tax on the basis of apportionment of profits arising through the 'business connection' in India, by computing the profits at a percentage of the world profits corresponding to the Indian turnover to the world turnover.

Upholding the assessment, the High Court of Judicature at Calcutta held, judgment delivered by Chatterjee, J.

"So far as the factory at Wyndhamganj (United Provinces) is concerned, it clearly comes within the Act. Admittedly there is a manufacturing branch of the company at that place, and under Section 2, clause (3) of 1918 Act, 'business' including among other things any 'manufacture'. The income therefore from such manufacture would be income from 'business' and as such taxable under section 3 and 5 of the Act".

1. The question as to how the profits or gains attributable to business connection in British India are to be ascertained was answered by the Board of Inland Revenue in exercise of the powers conferred by Section 59 of the 1922 Act, wherein Rule 33 runs as follows:

"In any case, in which the Income Tax Officer is of the opinion that the actual amount of the income profits or gains accruing or arising to any person residing out of British India whether directly or indirectly through or from any business connection in British India cannot be ascertained, the amount of such income, profits or gains for the purpose of assessment to income tax and may be calculated on such percentage of the turn-over so accruing or arising as the Income Tax Officer may consider to be reasonable or an amount which bears the same proportion to the total profits of the business of such person (such profits being computed in accordance with the provisions of the Indian Income Tax Act) as the receipts so accruing or arising bear to the total receipts of the business, or in such other manner as the Income Tax Officer may deem suitable".

This rule was drawn from English Statutes.
It would be worthwhile to mention the English position in this regard. In Sullev v. Attorney General, the facts resemble those of Rogers Pyatt Shellac Company. An American firm carried on business in New York which consisted in the resale there of goods purchased on their account in England. No money was received in England except from New York for purchasing the goods.

The observations of the learned Judge, Cockburn, C.J., sum up the position at common law, which are as follows:

"It would be very inconvenient, if this were otherwise. If a man were liable to income tax in every country in which his agents are established, it would lead to great injustice... It would be most impolitic thus to tax those who come here as customers. The subjects of a foreign State, not resident here, cannot be made amenable to our laws. How then are their profits to be made amenable to the fiscal law?"

Yet in another English case, Smith & Co. v. Greenwood, the appellants were a Danish firm resident in Copenhagen manufacturing and dealing in cement-making machinery and other similar machinery, which they exported all over the world. They had an office in London in order to execute the contracts which were made in Copenhagen, the goods being shipped f.o.b. Copenhagen.

Delivering the judgment of the king's Bench, the learned judge, Rowlett, J., held:

"The place where a trade was exercised was the place where the transactions forming the alleged business were closed in the case of a selling business by the sale of the commodity and the profit thereby realised".

2. 1 ITC 363. As stated earlier, there is no difference between Acts of 1918 and 1922 on this subject. In CIT v. North Ananthapur Gold Mines Co. Ltd. 1 ITC 133, the Gold Mining Company had its registered office in London, earned its profits from the sale in Great Britain of Gold mined in Ananthapur district in the Madras Presidency. Wallis, C.J., held: 1 ITC 136

"The Commissioner has rightly based his claim on the language of the Indian Section".

3. (1860) 5 H&N, 711
4. Ibid, 714
5. (1920) 3 KB 275
Thus, it becomes clear that the conceptual scope of the expression 'business connection' was much wider under Indian Law, as compared to English Law. The fundamental principle of the English Statutes, which was enunciated by Lord Herschell in *Colquhoun v. Brooks* stated as follows:

"The Income Tax Acts themselves impose a territorial limit; either that from which the taxable income is derived must be situated in the UK or the person whose income is to be taxed must be resident there."

This fundamental principle of the English Statutes does not appear, either in the Indian Income Tax Act, 1918 or in the Indian Income Tax Act, 1922. The question of residence does not arise nor are any territorial limits recognised by the charging sections of the said Acts. By the very terms of Section 33(1) of 1918 Act and Section 42(1) of 1922 Act, such profits would be deemed to have accrued or arisen in British India for the purpose of making the resident agent responsible for the tax.

The High Court of Judicature at Calcutta remarked in *Rogers Pyatt Shellac & Co., v. Secretary of State for India*:

"The English Income Tax Acts lay down a territorial limit; the Indian Act, 1886 followed the English Law, but in 1918 Act and 1922 Act the Indian Legislature appears to have gone beyond that limit. Whether that is politic and whether it contravenes the comity of nations, it is not for us to consider."

In *CIT, Bombay v. Remington Typewriter Co. Ltd.*, Remington Typewriter Co. New York, manufacturers of typewriter machines, incorporated three companies in India:

1) Remington Typewriter Co. (India) Ltd.,
2) Remington Typewriter Co. (Madras) Ltd., and,
3) Remington Typewriter Co. (Bombay) Ltd.

The object of the formation of these companies was to take over from the American Typewriter Company of New York its goodwill

6. (1889) 14 AC 493, 503
7. Ibid
8. AIR 1931 P.C. 42; 5 ITC 177
in the territories of Madras, Bombay and the rest of India in lieu of shares issued to the American Company. The American Company held all the shares except three issued to its nominees. The three Indian Companies bought all their requirements of typewriter machines in New York, from the American Company. The sales to the subsidiary companies were made at New York. They paid the price in dollars in New York to the American Company and took over all the machines in New York, and they themselves exported the machines from New York. The price charged was the regular export price of the American Company as fixed for all dealers throughout the world. The profits of the American Company were realised in America.

The profits from the Indian Companies, less income tax were distributed as dividends to the American Company i.e., the holding company. It is these profits which were charged to tax on account of 'business connection'. The Commissioner forcefully contended, taking help from the additional words contained in Section 43 of 1922 Act, "or through whom such person is in the receipt of any income, profits or gains" which did not find a place in the former Act of 1918.

The High Court of judicature at Bombay decided in favour of the American Company. It held:

"The relation between a company and its shareholders is not a business connection under section 42(1) or 43 of the 1922 Act. As regards deduction of tax on dividends at the source, provision is made in the Act."

On an appeal from this judgment of the High Court, the Privy Council upholding the assessment and thus the Commissioner's contention held:

"That having regard to the flow of business and the ultimate and complete control by the New York Company, a business connection existed between the companies, whereby the Bombay Company, could be held to be 'agents' of the New York Company under Section 43 of 1922 Act, and that the Bombay Company was properly assessed as agents under Section 42(1) in respect of the profits or gains in question, which accrued or arose to the New York Company directly or indirectly from the business connection in British India."

9. AIR (1931) PC 42
Another appeal was heard by the Privy Council in CIT, Bombay v. Bombay Trust Corporation from the same High Court of Judicature at Bombay on more or less, the same legal issues. The Hong Kong Trust Corporation in China and the Bombay Trust Corporation, Bombay and E.D. Sassoon & Co. of Bombay all were controlled by the Sassoon family. Monies were lent out at interest by the Hongkong Trust Corporation to the Bombay Trust Corporation, while Sassoon & Company acted as bankers. The interest was paid through Sassoons, Bombay to the non-resident Company at Shanghai.

The Commissioner charged this 'interest' income accruing to the non-resident in the hands of their agent, the Bombay Corporation. The Bombay High Court, simply referring to Section 42(1) of 1922 Act, held that the 16 crores and odd of rupees which the Hongkong Trust Corporation kept here in British India as a fixed deposit is nothing but property in British India belonging to the non-resident. Even then the assesses could not be assessed under section 43 of the Act - "Deemed to be an agent" as they were not in receipt of any income on behalf of the Hongkong Corporation, the relation between the two companies being that of a borrower and a lender.

On an appeal, the Privy Council held, upholding the assessment:

"The interest was profit or gains accruing or arising to the non-resident company from a business connection in British India within the meaning of Section 42 and that the assesses were chargeable thereunder as agents of the non-resident company. The term 'agent' in Section 42 of the Act including a person "deemed to be an agent" under Section 43 is not confined to agents in receipt of profits or gains".

10. 4 ITC 312 PC; AIR 1930 PC 54
11. (1928) 1 LR Bom 702; AIR 1928 Bom 448
12. Ibid
The Privy Council analysed the deeming Provisos in Section 43 with an analytical approach. If a statute enacts that something shall be "deemed" to have been done which in fact and truth was not done and that is the purpose of "deeming", the Court is entitled as a matter of construction to discover and ascertain for what purposes and between what persons the statutory fiction is to be applied and full effect must be given to the statutory fiction and it should be carried to its logical conclusion.

The most celebrated dictum, in regard to the scope of 'fiction' or deeming provisos has been of Lord Asquith of Bishopstone in the judgment of the House of Lords in East End Dwellings Co. Ltd. v. Finsbury Borough Council, which is as follows:

"If one is bidden to treat an imaginary state of affairs as real, one must surely, unless prohibited from doing so, also imagine as real the consequences and incidents which, if the putative state of affairs had in fact existed, must inevitably have flowed from or accompanied it... The Statute says that one must imagine a certain state of affairs. It does not say that having done so, one must cause or permit one's imagination to boggle when it comes to the inevitable corollaries of that state of affairs".

Thus, in Bombay Trust Corporation case, it was held by the Privy Council that the non-resident business and the resident business may be two separate legal entities, as for instance, two independent incorporated companies, but they may be closely associated either by reason of an effective common control or by the objects of formation, e.g. the non-resident company having been formed to finance the resident company, both of them being controlled by the same shareholders. In this manner, the 'inevitable corollaries' are to be examined in its true perspective, arising out of the application of a fiction or deeming provision of law.

Indubitably, the concept of 'business connection' has many manifestations. But an agent is business connection personified.

13. (1952) AC 109; 1951, 2 ALLER, 587, HL, 599
In CIT, Bombay v. Evans Medical Suppliers Ltd., the assessee, a manufacturer of drugs in UK sold a quantity of drugs in UK to its agent in India. The delivery of the goods and the payment of the price for the same took place in UK and the title to the goods also passed in UK. The transactions were found to be as between principal and principal. The Bombay High Court held:

"Nevertheless, there was a business connection by virtue of the fact that the buyer was appointed as the sole selling agent in India in respect of the entire territory granted to it and the agent was deriving commission in respect of all sales in his territory, whether made directly to the customers or through the medium of his agents".

Whereas in CIT v. R.D. Aggarwal & Co., the Supreme Court held the transactions as between principal and principal; neither the resident was appointed as an agent or a sole-selling agent, nor any authority as such was vested in him by the non-residents.

It is important to mention at this stage that the revenue made very emphatic suggestion to the Direct Taxes Administration Enquiry Committee, 1958-59 to recommend the adoption of provisions corresponding to sections 363 to 373 of the UK Income Tax Act, 1952. According to these provisions, the scope of the term 'business connection' was restricted by defining the mode of transaction, for example, factorship, agency, receivership branch or management. The Direct Taxes Administration Enquiry Committee, 1958-59 declined to recommend the adoption of any such provisions. It stated:

"We are of the view that in the present context of economic conditions obtaining in this country, there can be no question of adopting provisions, similar to those in the U.K. Income Tax Act for taxing non-residents, ..."

15. 1959, 36 ITR 418; AIR 1959 Bom 448
16. (1965) 56 ITR 20 (SC)
17. The Direct Taxes Administration Enquiry Committee Report 1958-59, 62, para 3.84
CIT vs. Provident Investment Co. Ltd. [1953] 24 ITR 33

18. Section 2(24) (vi) reads:

"any capital gains chargeable under Sec. 45".

19. Section 2(42A) of the 1961 Act, lays down that 'short-term capital asset' means a capital asset held by an assessee for not more than 36 months immediately preceding the date of its transfer.

20. (1953) 24 ITR 33
Chagla, C.J., delivering the judgment of the Bombay High Court, observed:

"The authorities make it clear that it is not competent to the court to look to the substance of the matter independently of the real transaction arrived at between the parties. If a transaction creates certain legal rights and obligations, then the court must give effect to those legal rights and obligations and must not, overlooking those rights and obligations, try and fathom what was in substance the nature of the transaction entered into by the parties. The court is not confined merely to looking to the form of the transaction. It is open to the court to ignore the form and ascertain the real nature of the transaction. But while it is open to the court to ignore the form, it is not open to the court to overlook or to ignore the true legal position that arises out of a document or documents in which the parties have chosen to embody the transaction or transactions".

In precise, the doctrine of substance has validity only if thereby one means that the nomenclature given by the parties to a particular transaction is of no avail. Form cannot be ignored. Thus, by virtue of this fact that under section 12 B(1) of the 1922 Act, "relinquishment" was not mentioned as one of the modes of transactions as a transfer of capital asset, the Supreme Court held in CIT. Bombay v. Provident Investment Co Ltd., confirming the decision of the Bombay High Court on appeal, that no capital gains arose on relinquishment.

During the same period, two cases CIT. Bombay v. Asiatic Textile Co Ltd., and Calcutta Electric Supply Corporation Ltd. v. CIT, West Bengal were decided. The former related to surrender of a capital asset, a managing agency, and the latter 'compulsory acquisition' of the capital asset under the law. In both, the judgment went in favour of the assessee, since the words 'relinquishment' of the asset or the 'extinguishment of any rights therein', or the 'compulsory acquisition thereof under any

21. (1957) 32 ITR 190 SC. The observations of Chagla, C.J., mentioned above were approved by the Supreme Court (Ibid, 197)
22. Ibid
23. 1955, 27 ITR 315
24. 1951, 19 ITR 406
law' were not there in section 122B (1) of the 1922 Act at that time.

122B (1): The tax shall be payable by an assessee under the head 'capital gains' in respect of any profits or gains arising from the sale, exchange, relinquishment or transfer of a capital asset effected after the 31st day of March, 1956, and such profits and gains shall be deemed to be income of the previous year in which the sale, exchange, relinquishment or transfer took place.

In the case of CIT, Madras v. Madurai Mills Co. Ltd., the question for consideration was, whether the distribution of assets of the company amongst its shareholders which had gone into voluntary liquidation resulted in a transaction which amounted to sale, exchange, relinquishment or transfer within the meaning of section 122B of the 1922 Act, as amended in 1956. While answering that question in the negative, the Supreme Court held:

"The act of the liquidator in distributing the assets of the company which had gone into voluntary liquidation did not result in the creation of new rights. It merely entailed recognition of the legal rights which were in existence prior to the distribution—when a shareholder receives money representing his share on distribution on the net assets of the company in liquidation, he receives that money in satisfaction of the right which belonged to him by virtue of his holding the shares and not by operation of any transaction, which amounts to sale, exchange, relinquishment or transfer".

It is important to note that the term 'relinquishment' was inserted in section 122B (1) of the 1922 Act, in view of the Bombay High Court judgment in Provident Investment Co.Ltd. v. CIT, Bombay, thus superseding this judgment. As already mentioned, when Madurai Mills Co.Ltd. v. CIT was decided by the Madras High Court, the term 'relinquishment' was there in section 122B(1).

While observing that the term 'relinquishment' has not been defined in the Income Tax Act or other Direct Tax Laws,

25. (1973) 89 ITR 45; AIR 1973, SC 1357
27. (1969) 74 ITR 623
the Madras High Court stated:

"Relinquishment implies that the person ceases to own the asset concerned by some act on his part. The property continues to exist, but the interest therein of the owner is either given up or abandoned. In the distribution or refunding of the assets of a company in liquidation, the liquidator performs only a statutory function. In the case of liquidation, the property of the company does not vest in the liquidator and, therefore, no relinquishment arises".

Approving this view of the Madras High Court, the Supreme Court thus held in CIT, Madras v. Madurai Mills Co. Ltd., that distribution of the assets of the company in liquidation does not amount to a transaction of sale, exchange, relinquishment or transfer, so as to attract section 12B of the 1922 Act.

Immediately after this approval, the Madras High Court had to consider in the case of C.A. Natarajan v., that question that if a liquidator of a company finds that the assets of the company are not adequate even to pay off the secured creditors, and the value of the equity shares held by the shareholders gets reduced to nil in this process, would it imply as if an act of 'relinquishment' took place on part of the equity shareholders. The Madras High Court held, following its earlier judgment, that the equity shareholders cannot be regarded as having effected transfer by way of relinquishment of their shares by virtue of their shares reduced to nil.

It is important to note at this stage that even this judgment has been superseded by 1961 legislation enacting by virtue of section 46, Income Tax Act, 1961, that the shareholder is deemed to have made a relinquishment of his interest in the capital assets, namely shares, when the company goes in for liquidation.

In CIT v. Gillanders Arbuthnot & Co., the question to be decided by the Supreme Court was whether the transaction entered into under the agreement for sale was a 'sale' or 'exchange' or

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28. Ibid
29. (1973) 92 ITR 347
30. AIR 1973 SC 989; (1973) 87 ITR 407
merely a re-adjustment.

The material facts were that the assessee-firm was carrying on business mostly as managing agents of a number of companies. The assessee-firm, through its partners, entered into an "agreement for sale" of some of the shares and securities held by it in favour of the company, Gillanders Arbuthnot & Co., in consideration of the allotment of the shares in the company.

The Supreme Court discarded the 'doctrine of substance' and once again affirming their decision in CIT v. B.M. Kharwar held:

"It is now well settled that the taxing authorities are not entitled in determining whether a receipt is liable to be taxed to ignore the legal character of the transaction which is the source of the receipt and to proceed on what they regard as "the substance of the matter". The taxing authority is entitled and is indeed bound to determine the true legal relation resulting from a transaction. If the parties have chosen to conceal by a device the legal relation, it is open to the taxing authority to unravel the device and to determine the true character of the relationship. But, the legal effect of a transaction cannot be displaced by probing into the "substance of the transaction". This principle applies alike to cases in which the legal relation is recorded in a formal document and to cases where it has to be gathered from evidence - oral and documentary - and conduct of the parties to the transaction".

It may be that because of the allotment of the shares of the company in satisfaction of the sale, price, the assessee-firm got certain benefits but that does not convert the sale into an exchange.

Hegde, J., delivering the judgment of the Supreme Court referred to one of its earlier judgments, CIT v. R.R. Ramakrishna Pillai, and observed as follows:

"In CIT v. R.R. Ramakrishna Pillai this court, distinguishing an exchange from a sale observed that where the person carrying on the business transfers the assets to a company in consideration of allotment of shares, it would be a case of exchange and not of sale and the

31. (1969) 72 ITR 603 (SC)
32. (1967) 66 ITR 725
true nature of the transaction will not be altered because for the purpose of stamp duty or other reasons the value of the assets transferred is shown as equivalent to the face value of the shares allotted. On the other hand, a person carrying on business may agree with a company floated by him 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 the money consideration shares of certain face value shall be allotted to the transferor. In such a case, there are in truth two transactions, one transaction of sale and the other a contract under which the shares are accepted in satisfaction of the liability to pay the price. The fact that as a result of the transfer of the shares of the "company" to the assessee-firm, the latter obtained considerable profits, will not alter the true nature of the transaction.

After arriving at this conclusion, that the transaction evidenced by the "agreement for sale" between the company and the assessee was a sale, the court considered the impact of Section 12(B) (2) on that transaction.

33. Sub Section (2) of Section 12 B says:

"The amount of a capital gain shall be computed after making the following deductions from the full value of the consideration for which the sale, exchange, relinquishment or transfer of the capital asset is made, namely:

1) expenditure incurred solely in connection with such sale, exchange, relinquishment or transfer;
2) the actual cost to the assessee of the capital asset, including any expenditure of a capital nature incurred and borne by him in making any addition or alternations thereto, but excluding any expenditure in respect of which any allowance is admissible under any provision of sections 8, 9, 10 and 12;

Provided that where a person who acquires a capital asset from the assessee, whether by sale, exchange, relinquishment or transfer is a person with whom the assessee is directly or indirectly connected, and the Income Tax Officer has reason to believe that the sale, exchange, relinquishment or transfer was effected with the object of avoidance or reduction of the liability of the assessee under this section, the full value of the consideration for which the sale, exchange, relinquishment or transfer is made shall, with the prior approval of the Inspecting Assistant Commissioner of Income Tax, be taken to be the fair market value of the capital asset on the date on which the sale, exchange, relinquishment or transfer took place".

(The remaining portion of section 12-B is not relevant for present purposes).
What exactly is the meaning of the expression "full value of the consideration for which sale is made"? Is it the consideration agreed to be paid or is it the market value of the consideration? In the case of sale for a price, there is no question of any market value unlike in the case of an exchange.

On this point, the Supreme Court referred to one of its earlier judgments, CIT v. George Handerson & Co. Ltd. Therein, the court observed:

"In case of a sale, the full value of the consideration is the full sale price actually paid. The legislature had to use the words “full value of the consideration” because it was dealing not merely with sale but with other types of transfer such as exchange, where the consideration would be other than money. It is evident that the legislature itself has made a distinction between the two expressions “full value of the consideration” and ‘fair market value of the capital asset transferred’ and it is provided that if certain conditions are satisfied as mentioned in the first proviso to Section 12 B(2), the market value of the asset transferred, though not equivalent to the full value of the consideration for the transfer, may be deemed to be the full value of the consideration...”.

Yet another important aspect pertaining to capital gains concerned the question, whether liability to capital gains tax was attracted by the shareholder, when he was allotted shares in the amalgamated company in consideration of the shares held by him in the amalgamating company. The Bombay High Court held in CIT v. Rasiklal Maneklal (HUF) that in such a process there was neither an exchange nor a relinquishment of the capital asset represented by the shares of the amalgamating company and, therefore, no liability to capital gains tax was attracted by the shareholder.

The Bombay High Court pointed out:

"The words 'exchange' and 'relinquishment' have not been defined in the Income Tax Act. The word 'exchange'..."

It may be noted that in George Handerson's case the market value of the shares which were allotted at Rs. 136 per share was Rs. 620 per share.

34. (1967) 66 ITR 622, 627 (SC)

35. (1974) 95 ITR 656
as defined in the Transfer of Property Act understood in ordinary parlance connotes the following: existence of different properties owned by different persons as a result of the transaction of exchange, both properties continue to exist, the properties continue to be owned by two different parties but the ownership of one is transferred to the owner of the other and vice versa. In a transaction of relinquishment, the interest of a person in a property is either given up, abandoned or surrendered; but the property in which interest is relinquished continues to exist and the property continues to be owned by some person or persons after the transaction of relinquishment”.

The High Court went on to observe:

"With the completion of the scheme of amalgamation, the old company stood dissolved and thereafter the shares of the old company had no value. Hence, the receipt of shares in the new company in lieu of shares in the old company did not constitute either exchange or relinquishment of the old shares. Therefore, no capital gains arose to the assessee as a result of the transaction".

However, the Calcutta High Court has taken a contrary view in Central India Industries Ltd. v. CIT that the difference in the value of the shares immediately before and after the amalgamation could be treated as a capital loss arising from the transfer of the shares. It is important to mention that both these judgments rendered under the 1922 Act did not consider, whether the interest of the shareholder in the capital asset, namely shares, could be regarded as having been extinguished as a result of amalgamation of the amalgamating company, since the term 'extinguishment of any rights therein' was not there in section 12 B(1).

iv ONE MAN COMPANY-‘LIFTING THE VEIL’

In effect the magic of corporate personality enables one to be master and servant at the same time. This omnibus blessing of Salomon & Co. Ltd. tempted the individuals to create ‘one man

36. (1975) 99 ITR 211
37. Gower, Modern Company Law, 3rd Edn, 1969, 202
38. Salomon v. Salomon & Co. Ltd; (1897) AC 22 (HL)
company' in order to avoid taxes, but at the same time the legislature and equally the courts, have met the challenges steadfastly.

The main advantage of shifting the securities in the name of such 'one man company' was that in India, limited liability companies were liable to super tax at a much less rate than the rate of super tax on the income of an individual. The legislature, seized of this maneuvering introduced super tax, as a further levy of tax on income by virtue of the Super Tax Act, 1917. Shortly thereafter the Super Tax Act, 1920 replaced it, and then the Income Tax Act, 1922 adopted it by defining it as "an additional duty of income tax".

In England, prior to the Act of 1922, limited liability companies were not liable to super-tax. It was found, however, that in some cases they avoided payment of income tax by omitting to declare a dividend on their profits. Consequently, the Act of 1922 was passed in England which enabled the revenue authorities to declare, what should have been a proper dividend for the company to have declared for the purposes of assessment of income tax.

The Bombay High Court came across with a case on 'one Man Company' – D.M. Petit v. CIT, where the doctrine of 'lifting the veil' was applied in order to determine the genuineness of the company. The material facts were that the assessee holding shares and securities of considerable value formed four limited private companies with whom he agreed to sell the said shares in various lots in return for the allotment of their shares. By a

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39. Super Tax levied on limited liability companies was at the flat rate of one anna in the rupee after allowing for the statutory deduction of Rs. 50,000. On individuals super-tax was levied at scale rates of one anna rising to six annas, starting with one anna for the first Rs. 50,000 after allowing for the statutory deduction of Rs. 50,000 and rising by half an anna for each subsequent Rs. 50,000 up to a maximum of six annas.

40. 2 ITC 255; AIR 1927 Bom 371
contemporaneous indenture the assessee executed a declaration of trust which recited an agreement that the shares and securities sold should not be transferred until the companies should call upon him to do so and that in the meantime he and his nominees should hold them as trustees for the companies, hand over the income to them and transfer them whenever called upon to do so. No formal transfer of the shares which continued to remain in the assessee's or his nominee's name was called for by the companies. The entire subscribed capital of 30 to 40 lacs for each company was held by the assessee.

Under the articles of association, the assessee was given complete control over the companies as the Governing Director. As soon as the dividend and interest on the shares and securities were received by the assessee, a book entry was made in the books of the companies crediting them with the amount and on the same date a debit entry was made debiting the assessee with the same amount as a loan made to him by the companies at 6% interest with no security or voucher.

Though the memorandum of association contained 38 objects, the companies did no business beyond ostensibly receiving the dividends and interest on the shares and securities, and lending them over to the assessee as loans and no dividend was declared by those four limited companies since their formation six years ago.

Of course, the assessee on an assessment to super tax in respect of the income from the said shares and securities as forming part of his total income contended that the income was the income of the companies.

Ibid, The Bombay High Court held: "On the facts of the case, the income belonged to the

41. Ibid, The Bombay High Court referred to one of the Scotland Court of Sessions (equivalent to the British Court of Exchequer) judgment in Jacobs v. Commissioners of Inland Revenue 4 TC 543 A similar question arose in that case. Five limited companies were formed to avoid super-tax and the assessee drew profits by way of loans, which he had no intention to repay. He posed to be a mere borrower of money from them. The court of sessions held that the loans were not genuine loans and he himself was liable to super tax thereon as part of his income.
assesses personally, there being no genuine transfer or declaration of trust in favour of the companies and that the alleged loans to the assessee from the companies were not genuine loans but were mere withdrawals of income disguised as loans.

Furthermore, the interesting contention put forward by the learned counsel for the assessee in Petit's case was concerned to accumulated profits. Purportedly, in the balance-sheet of the company, Rs. 6 lacs were set aside to a depreciation and Reserve fund account - a wise provision 'for a rainy day'. In support of this contention, Burland v. Earle was cited as an authority for the proposition that in general a company is entitled to place profits to a depreciation or to a reserve fund, and that dissentient shareholders in the absence of a declaration of dividends or bonus or a winding-up cannot challenge the decision of the majority, provided the powers are exercised bona fide.

Brushing aside all these contentions, the accumulated profits were held to be the income of the assessee.

Few other important cases on 'one man company' pertinent on this subject are Gramophone and Typewriter Ltd. v. Stanley; Apthorpe v. Peter Schoenhofen Brewing Company Ltd.; Kodak Ltd. v. Clark.

In Kodak Ltd. v. Clark a company was formed in England for the purpose of bringing under single control all the Kodak companies spread all over the world. In order to do this, 98% of the shares of the Eastman Kodak Company of USA were acquired. The Eastman Kodak Company continued to carry on business in manufacture of Cameras under the control of and in obedience to the English Company and its nominees, and sold the goods to the

42. (1902) AC 83, 97
43. (1908) 2 KB 89; 5 TC, 358
44. (1899) 4 TC 41
45. (1903) 1 KB 505; 4 TC 549
The court held that though the English Company controlled the American Company, the business which the American Company carried on was not the business of the English Company. The American Company carried on business for its 100% shareholders; 98% English Company and 2% others. Nor could it be said in those circumstances that the American Company was carrying on business as an agent of the English Company.

The judgment in Kodak Ltd., delivered by the court of King's Bench is not free from doubts. The facts clearly answer the relationship of an agent. In *Anthorne v. The Peter Schoenhofen Brewing Co. Ltd.*, an English Company bought all the shares except three and all the property, plant and business of an American Company. As the laws of the state of Illinois prevented alien corporations from holding real property in the State, it was agreed that the American Company should be kept on foot. By agreement between the two companies, it was provided that the American Company was to do all things required for vesting the management of the American Company in the English Company. Subsequently, the English Company raised the working capital, the Board of Directors of the English Company were to have the entire right of control and entire directing power over the affairs of the American Company.

The court held that in the circumstances, the English Company was really carrying on the American business.

The warning of younger, L.J., in *Commissioner of Inland Revenue v. Sansom* in this context is more emphatic, which is as follows:

"Now speaking for myself, I do in the light of these considerations, deplore in connection with what are called one man companies, the too indiscriminate use of such words as simulacrum, sham or cloak-the terms found in this case - or indeed any other term of polite invectiv

46. 4 TC 41, (CA)
47. (1921) 2 KB 492, 514; 8 TC 20
Not only do these companies exist under the sanction, even with the encouragement of the legislature, but I have no reason whatsoever to doubt that the great majority of them are as 'bona fide' and genuine as in a business sense they are convenient and suitable media for the provision and application of capital to industry. No doubt, there are amongst such companies as amongst any other kind of association, black sheep...".

CONVERSION OF AN ENTITY INTO A COMPANY

Apparently, section 26 of the 1922 Act had semblance of ambiguities, but it is important to note that section 170 of the 1961 Act did take into account the concept underlined in it.

Section 26 which dealt with change in ownership of business laid down:

"Where any change occurs in the constitution of a firm or where any person has succeeded to any business, profession or vacation, the assessment shall be made on the firm as constituted or on the person engaged in the business, profession or vocation as the case may be, at the time of making of the assessment".

The Allahabad High Court had the occasion to construe section 26 in the case of Begg Sutherland & Co. Ltd. The material facts were that a registered firm was converted into a limited company. Under the 1922 Act, a registered firm was exempted from super-tax and its partners were made liable on their shares in the profits at the scale rates of one to six annas. If section 26 be taken to mean something more and requiring that the tax be levied at rates applicable not to the firm which made the profits but to the company which succeeded it, an additional super-tax would be payable by the company. Thus, the partners of the registered

48. Section 170: Succession to business otherwise than on death:
1) Where a person carrying an any business or profession (…) has been succeeded therein by any other person (…) who continues to carry on that business or profession-
   a) the predecessor shall be assessed in respect of the income of the previous year in which the succession took place up to the date of succession,
   b) the successor shall be assessed in respect of the income of the previous year after the date of succession, ...

49. 2 ITC 30
firm would have paid super-tax, a result which the Allahabad High Court rightly described as:

"Sufficiently startling to cause surprise and to lead one to look for language absolutely unambiguous and positive in its terms to create a special liability of that sort which it would be unlikely that any legislature would intend to impose if it really understood what it was doing".

The Allahabad High Court further said:

"The intention of the legislature appears merely to substitute for assessment purposes the person carrying on the business and in all other respects to allow the assessment to be made as if there was no change of ownership. The rate or rates of tax and the amount of income all remain the same; only in place of the old owner, the person carrying on the business at the time of the assessment is made liable by this section 26. Any other view may lead only to the most anomalous results".

vi: GENESIS OF SECTION 23 A(2)

As already mentioned under the caption "One Man Company - lifting the veil", the shareholders adopted a device to avoid payment of super-tax, in as much as the rates of super-tax for the companies were lower, as compared to an individual. If a company decided not to make any distribution by declaring any dividend and accumulated it, then there were several modes available to a shareholder to obtain benefit of the company's income in a non-taxable form, for example, issue of bonus shares, by way of a loan, liquidation or reduction in capital, issue of redeemable shares or debentures, or sale of existing shares at a price reflecting the income accumulated. It was to plug these artifices and force such companies under the control of five or fewer members (companies in which public were not substantially interested), to declare the minimum statutory dividends, that Section 23A(2) was enacted in the 1922 Act by virtue of Section 4 of the Income Tax (Amendment) Act, 1930. Chandrachud, J., (as the

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50. Ibid
"Section 23A was enacted in terrorem against private companies. The object of the section is to prevent evasion of super-tax by the shareholders of a company in which the public are not substantially interested. The shareholders of a private company could avoid the high incidence of super-tax by allowing the profits of the company to accumulate in its hands so that the accumulated profits could be distributed eventually in the form of bonus shares which are not assessable as income in their hands".

Quoting from an English authority Willis v. Thorn, Chandrachud, J., as the learned Judge then was, remarked:

"When the legislature imposes a penalty the words imposing it must be clear and distinct".

In England too, the legislature was confronted with the same problem, and section 21 was enacted by virtue of the U.K. Finance Act, 1922, being subsequently amended in 1927 and 1928. Section 23A(2) of the Income Tax Act, 1922 as enacted in 1930, required the Income Tax Officer to make an order including the 'undistributed income' of the company in the total income of the shareholders, whenever he was satisfied:

i) that the company's profits and gains were allowed to accumulate beyond its reasonable needs, existing or contingent, having regard to the maintenance and development of its business, and,

ii) that such accumulation or failure to distribute was for the purpose of preventing the imposition of tax upon any of the members in respect of their share in the profits and gains so accumulated or not distributed.

Obviously section 23A(2) was enacted to discourage private businesses or family concerns to accumulate the profits.

51. (1975) 101 ITR 764, 773 (SC)
52. (1949) 17 ITR 493, 495 (Bom)
53. (1875) LR 10 QB 383, 386
54. Ibid, 773
In other words, only those companies controlled by five or fewer shareholders, popularly known as 'closely held' companies, were affected by the mechanism of Section 23A(2).

Quite a few important cases came up before the Supreme Court as to when the company could be labelled as a 'closely held' or 'in which public are not substantially interested', so as to bring it within the meaning of Explanation to Section 23A(2). The controversy existed because the term 'company in which public are substantially interested' was not defined in the 1922 Act. It is important to note that under 1961 Act this term has been defined by virtue of Section 2(18).

The applicability of the terms "unconditionally" and "beneficially" were discussed by the Supreme Court in the case of Raghuvanshi Mills Ltd. Bombay v. CIT. The Explanation in Section 23A (as it stood prior to 1955 Amendment) laid down, interalia, the minimum interest which could be called 'substantial', that shares of the company carrying not less than 25% of the voting power must be allotted unconditionally to, or acquired unconditionally by the 'public' being held 'beneficially' by the public.

The Supreme Court observed:
"The word 'public' is used in contradistinction to one or more persons who act in unison and among whom the voting power constitutes a block. If such a block exists and possesses more than 75% of the voting power, then the company cannot be said to be one in which the public are substantially interested".

55. Under the law prevailing in 1936, a company was deemed to be a company in which the public were substantially interested (so to say, a widely-held company), if the shares of the company (not being shares entitled to a fixed rate of dividend, whether with or without a further right to participate in profits) carrying not less than 25% voting power had been allotted unconditionally to or acquired unconditionally by and were at the end of the previous year, beneficially held by the public (not including a company to which the provisions of section 23A apply), and if any such shares had in the course of such previous year, been the subject of dealings in any stock exchange in the taxable territories or are, in fact, freely transferable by the holders to the other members of the public.

56. AIR 1961 SC 743
In CIT, Bombay v. The Jubilee Mills Ltd., Bombay holding that the words 'unconditionally' and 'beneficially' mean that the voting power arising from the holding of those shares should be free and not within the control of some other shareholder, and the registered shareholder should not be a nominee of another, the Supreme Court observed:

"It is true that the Managing Agents are the servants of the company in a manner of speaking and not its masters and also that the object of a firm of Managing Agents is to carry out certain administrative duties concerning the company under the control of the directors of the company. That, however, is irrelevant and, in any case, is far from the truth in the present case. Here the partners of the Managing Agency practically own the company. It has not to be proved as a fact that the persons constituting the group which owns shares carrying more than 75% of the voting power were acting in unison. The test is not whether they have actually acted in concert, but whether the circumstances are such that human experience tells us that it can safely be taken that they must be acting together. It is not necessary to state the kind of evidence that will prove such concerted acting."

In CIT, Madras v. Amrutnian Ltd., the Supreme Court held:

"Normally, a company would be deemed to be one in which the public are substantially interested, where more than half of the voting power is vested in the public. But the legislature by virtue of the express provision in Section 23A has raised a conclusive presumption in those cases where shares of the company carrying not less than 25% of the voting power are held by persons other than the controlling group."

An interesting question arose in Shree Krishna Agency Ltd. v. CIT, whether the assessee-company could be regarded as one in which public are not substantially interested within the meaning of Explanation to section 23A(2), since the directors had absolute discretion to refuse to register the transfer of shares. The Supreme Court held:

"The said Article does not confer any uncontrolled or unrestricted discretion upon the Directors to refuse to

57. (1963) 48 ITR 9 (SC)
58. (1964) 8 SCR 9; AIR (1964) SC 1804.
register the transfer of shares in a given case. In other words, the directors cannot act arbitrarily or capriciously. It is a power which has to be reasonably exercised for protecting the interests of the company. The discretion which has been conferred for being exercised in the interest of the company cannot take away the tendency of the free transferability of the shares in the absence of cogent material or other factors.

It is true that courts enunciated the various tests to find out the nature of a company - widely held or closely held, but the 'motive element' mentioned earlier at page 90 in item (ii) came in the way of practical application of section 23A (2). The operation of this section was examined by the Income Tax Enquiry Committee, 1935 which stated as follows:

"We are informed that in practice section 23A(2) of the Act, which is designed to deal with non-distribution of profits by companies under the control of not more than five of its members is virtually a dead letter, only one order (it is in the case of A Harvey v. CIT) having been passed under that sub-section from its insertion in 1930 up to the end of the year 1935.

The major difficulty in the way of the application of the sub-section may lie in the fact that before an Income Tax Officer can pass an order thereunder, he must be satisfied that a company's profits and gains are allowed to accumulate beyond its reasonable needs, existing and contingent having regard to the maintenance and development of its business and that such accumulation or failure to distribute is for the purpose of preventing the imposition of tax upon any of the members in respect of their shares in the profits and gains so accumulated. This task, involving as it does not only in assessing of motives, but also an estimation of the future possibilities of an individual business may well deter an Income Tax Officer. The Section would, we think, be made more effective if the criteria for the application of the section are made more specified".

In the opinion of the Income Tax Enquiry Committee, 1935, "the fairest test is that ratio of the amount distributed to the

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total income of the company. The ratio must obviously be less than 100% and we suggest that the section should apply only to cases where the profits distributed (grossed up to include income tax) are less than 60% of the assessable income of the company. The Ratio mast obviously be less than 100% and we suggest that the section should apply only to cases where the profits distributed (grossed up to include income tax) are less than 60% of the assessable income of the company. The Income Tax Enquiry Committee expressed very strong views, that either section 23 A should be repealed or certain modifications should be made.

62. Obviously, the committee was using the phrase 'assessable income' as a synonym for 'total income'. In the amended section 23A(1) the former phrase was used and the Bombay High Court saw, curiously enough, a distinction between the two in the case of CIT v. Homi Mehta & Sons Ltd. (1962) 46 ITR 1135.

63. Following were the views expressed by the Income Tax Enquiry Committee, 1935, few of which are as valid today as they were five decades before; of course, few of them have been already taken note of either under the 1922 Act or 1961 Act.

"a) Section 23A should be repealed and all companies placed on the same footing in regard to the treatment of their undistributed profits and of their dividend distribution policies;

b) In case this suggestion is not accepted at least the following modifications should be made in the present treatment of section 23 A companies;

1. Instead of compelling the distribution of a fixed proportion of their 'distributable profits', the law should insist on the distribution only of such portion of the profits, as is arrived at after taking into account the reasonable needs of the business, as in the UK and USA. Such reasonable needs should also take into account a reasonable provision for offset of future losses. In case, however, the Income Tax Officer is not satisfied that a reasonable distribution has been made, he might then deem 30% of the profits, computed according to accountancy practice, to have been distributed.

2. The present virtual ban on the accumulation of undistributed profits beyond 100% of their paid-up capital and loan capital or cost of fixed assets (whichever is greater) should be removed;

3. The company's 'assessable' profits should not be made the basis for action under section 23A. These profits may and do differ from 'accountancy profits'. Such variations may be due either to difference of opinion on admissibility of certain items of expenditure or to additions made by the ITO on the ground that the reported profits have been under-stated. Examples of the former are taxes and other public charges that the company has to pay from its distributable profits, but which are not
As a sequel to these recommendations, in 1939 the law was re-cast. The most important amendment by virtue of Income Tax (Amendment) Act, 1939 was that the company itself was made liable to pay the additional super tax at a flat rate of 25% of the undistributed income, hitherto the shareholder was liable. The

63 contd, admissible for income tax purposes, such as property tax. The suggestion is that the order under section 23A should take into account the actual cash available with the company and that it should not be based on a notional estimate of its income.

4. The limit of 55% for distribution below which the penal clause of 100% distribution now applies automatically, should not be so apply, when the deficiency is due to differences between book profits and assessable profits resulting from the non-admissibility of certain items of expenditure;

5. The exemption now accorded to subsidiaries of companies from the operation of Section 23A should not be confined to 100% subsidiaries of companies in which the public are substantially interested, but should be extend to those whose share capital or voting power to the extent of more than 50% is held by such parent companies;

6. In case, distribution by a company falls short of 60% required by section 23A, only the difference between the said 60% and the amount actually distributed should be deemed to be distributed and not the entire distributable profits of the company;

7. Where a company has distributed more than 60% in any year the excess over 60% in that year should be allowed to be carried forward to the subsequent year before Section 23A is made applicable to the company for that year;

8. Sometime limit should be prescribed in the Income Tax Act, 1922, within which the Income Tax Officer should initiate and complete proceedings under Section 23A. At present, he can do so without any limit of time which creates difficulty for shareholders to meet additional liability for tax or for the companies to find cash for the additional distribution involved a long time after the completion of their normal assessments";

The Income Tax Enquiry Committee, 1935 also suggested, in this connection, for altering the definition of a 'company in which the public are substantially interested'. The Committee pointed out two important defects, which needed rectification:

"1. The first is the test of voting power which is utilized for the purpose of bringing the companies into the net of Section 23A, popularly known as 'controlled companies'. The test can, however, be defeated by holding
privilege of set off in case distribution in excess of the statutory percentage was made, in subsequent years was allowed. The element of motive which had to be gathered out of the following condition, mentioned earlier too, was dropped.

"ii) that such accumulation or failure to distribute, was for the purpose of preventing the imposition of tax upon any of the members in respect of their share in the profits and gains so accumulated or not distributed."

As regards the first condition, the accumulations made for 'the current needs and possible future requirements of the company for expansion', these words were dropped. Thus the Income Tax (Amendment) Act, 1939 adopted a simple test: whether a certain minimum percentage of the distributable income, 60% generally and

63contd. shares in 'benami' names so that although the voting power will be technically held by a member of the public, yet in fact, it will be exercised according to the directions of the controlling shareholders. More so, the law prevailing in 1936 only requires to manage the necessary voting power on a particular date, namely the last day of the accounting year concerned;

2. The Second vulnerable point in the present definition of a company prevailing in 1936, in which the public are substantially interested, is the interpretation of the word 'public'. The Income Tax Act, 1922, does not define this word anywhere. Although, the word 'public' seems to have been used in this Section in contradistinction to the directors of a company (who may be said to control it), the shares held by their nominees and their relatives as their 'benamidurs' may yet be treated as held by members of the 'public' unless it can be proved by the Income Tax Officer that such persons are really under the control of the Directors. It will be necessary in each particular case for the Income Tax Officer to come to a finding of fact that, a Director exercises 'de facto' control over a shareholder."

The Committee suggested that the test of voting power should be relatable to any day in the year; instead of a particular day, as it was then; 25% voting power to be held by the members of the public should be raised to 50%, and the majority of the shares (i.e. over 50%) should not be held by less than 6%.
100% in certain cases, had or had not been distributed as dividends.

The Supreme Court held in CIT, Bombay v. Jubilee Mills Ltd:

"The object of the Section is to collect super tax from the shareholders which would be payable if the company had distributed its income by way of dividends and to discourage avoidance of tax by failing to distribute its income."

An amount of latitude was being vested in the Income Tax Officer, so as to reconsider or withhold the order under section 23A(2), keeping in view the financial position of the company, for example, past losses or the 'smallness' of income of the current year.

As already pointed out, the Income Tax Enquiry Committee Report, 1935 recommended the alteration in the definition of 'company in which public are substantially interested' since section 23A(2) order could be passed only against 'controlled companies' - 'company in which public are not substantially interested'. As regards the 1939 Amendment, this definition remained untouched. At least two most vulnerable points mentioned in this regard by the Income Tax Enquiry Committee, mentioned earlier, were rectified by virtue of the Finance Act, 1955, but the

64. The first proviso to section 23A(1), after the 1939 amendment, ran:

"When the reserves representing accumulations of past profits which have not been the subject of an order under this sub-section exceed the paid-up capital of the company, together with any loan capital which is property of the shareholders, or the actual cost of the fixed assets of the company, whichever of these is greater, this section shall apply as if instead of the words 'sixty percent', the words 'one hundred percent' were substituted."

65. AIR 1968 SC 883; 68 ITR 630.

66. The Snags: i) 'benami' holdings ii) voting power on the last day of the accounting year, iii) concept of the term 'public' were all taken care of by the Finance Act, 1955, that a company in which the public are substantially interested would be defined as that:

a) at least 50% of the voting power was in the hands of the public,
Committee's strong views went unnoticed, for the simple reason that the Taxation Enquiry Commission 1953-54 (popularly known as Mathai Committee) virtually recommended on the same lines.

Indubitably, section 23A was procedural in nature before 1955, but with the Finance Act, 1955, an in-built mechanism for imposition of liability to additional super-tax was provided—a concept which sustains even today under the 1961 Act.

**CONTROLLED COMPANIES: SECTION 23A COMPANIES**

An important question of law came in appeal before the Supreme Court in CIT, West Bengal v. Abdul Rahim Osman & Co. The assessee, a private company declared dividends after 12 months following the accounting year, but before the order levying the super tax was made under Section 23A(1). The super tax was imposed on the ground that the declaration was made after 12 months following the accounting year.

The question was, whether in the matter of calculation of undistributed balance of the total income, the dividend declared by the Company after the period of 12 months immediately following the expiry of the previous year should have been taken into consideration relevant to the assessment years 1958-59 and 1959-60.

66contd. b) the shares of the company were at some time during the previous year dealt with in any stock exchange in India;

c) The shares carrying 'more than 50% of the total voting power were controlled or held by at least six persons (an individual along with his relatives and nominees being treated a single person), and,

d) such dispersal of 'controlling' and 'voting' power present throughout the previous year.


68. AIR 1972 SC 2469; 86 ITR 436
The Tribunal came to the conclusion that the material portion of section 23A(1) after it was recast by the Finance Act, 1955 provided that in computing the undistributed balance of the total income not only the income-tax and super-tax payable by the company but also any other tax levied by the local authority, etc are to be deducted but also "dividends actually distributed, if any".

Jaganmohan Reddy, J., while speaking for the Supreme Court observed:

"Though the Income Tax Officer has jurisdiction to pass an order under sub section (1), he has to make a regular assessment on the company under section 23 which he cannot do if in fact a dividend had been declared before the making of that order, as otherwise the company's undistributed balance which is assessed by the Income Tax Officer would exceed its commercial profits. There is also a likelihood of double taxation because not only the company is charged with super tax for not distributing the dividends, but also it will be assessed on the dividends it has in fact distributed to income tax and once again to super tax. Such a result was not intended".

One of the most prolific areas of litigation on this subject of 'Controlled Company' had been the expression 'smallness of the profits'. This expression existed in the 1922 Act and even now it is there in the 1961 Act. In CIT v. Bipin Chandra Maganlal & Co., Ltd the assessee had sold certain assets on which it had obtained depreciation in the relevant income-tax assessments. The difference between the original cost of the said assets and the written-down value was brought to tax by applying the second proviso to Section 10(2)(vii) of the Income Tax Act 1922.
The question before the Supreme Court was whether this difference between the original cost of the assets and their written-down value should have been included in the assessee's profit for the purpose of determining whether the payment of a larger dividend than that declared would be reasonable.

The Supreme Court held:

"The legislature has deliberately used the expression "smallness of the profits" and not "smallness of assessable income" in Section 23-A, and there is nothing in the content in which the expression "smallness of the profits" occurs which justifies equation of the expression "profit" with "assessable income". Smallness of the profits in section 23A has to be adjudged in the light of commercial principles and not in the light of the total receipts actual or fictitious".

The Supreme Court further observed:

"The test whether it would be unreasonable to distribute a larger dividend has to be adjudged in the light of the profit of the year in question".

The Supreme Court had again to consider the scope and scheme of Section 23A in CIT v. Gangadhar Banerjee and Co. (Pvt., Ltd.). In this case the assessee had a commercial profit of Rs 1,28,112. After providing for taxation, the profit left was Rs 72,000 out of which it had declared Rs 44,000. Though the provision for taxation was only Rs 66,000, the actual tax assessed was Rs 79,400, requiring a further provision of Rs 13,400. After the said payment, the company was left with only a sum of Rs 4,000 and odd. The assessed income was, however, much larger, and the company should have distributed Rs 64,000, being 60% of the assessed profit less tax.

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70 contd... the payment of a dividend or a larger dividend than that declared within the period of 12 months referred to in sub-section (1) would be unreasonable;

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71. (1961) 41 ITR 290 (SC); AIR 1961 SC 1040
72. Ibid, 296
73. Ibid, 296
74. (1965) 57 ITR 176 (SC)
The Supreme Court held that as the balance of the commercial profit left was only Rs 4,000, it was not possible to hold that the assessee should have distributed larger dividend. Very succinctly, the Supreme Court enunciated the test of reasonableness:

"The reasonableness or the unreasonableness of the amount distributed as dividends is judged by business considerations, such as the previous losses, present profits, the availability of surplus money and the reasonable requirements of the future and similar others."

Much reliance was placed by the revenue on the words, 'the availability of surplus money' in the above-mentioned passage extracted from the judgment of Ganagdhar Banerjee's case in the Madras High Court case, CIT v. Amalgamations (P) Ltd., that when the company had certain surplus available from the earlier year's profit, it would have to be taken into account in considering the reasonableness of the distribution. The Madras High Court did not accept this contention. It observed:

"In our opinion, the words "availability of surplus money" in the passage mentioned above have to be taken as drawing attention to the liquidity of the resources of the company."

Another aspect in CIT v. Amalgamations (P) Ltd., was whether the sum of Rs 3,35,011,76 being the profit on sale of investments could be taken as available for distribution? The contention of the assessee was that this profit being capital profits was not available for distribution.

The Court held:

"There are two answers to this submission. The first is that the company itself had credited the amount to the profit and loss account as if it was commercial profit..."
and distributed the said amount also as dividend. The point raised is, therefore, academic. Secondly, even assuming that this point deserves to be considered, it is concluded by a decision of this court in Factors (P) Ltd. v. CIT, wherein it was pointed out that unless the constitution of the company restricted the distribution of capital profit or gain, nothing would stand in the way of the distribution of the capital gains or capital profits also.

It is submitted that even though the assessable income of a company may be large, the commercial profits may be so small that compelling distribution of the difference between the balance of the assessable income reduced by the taxes payable and the amount distributed as dividend would require the company to fall back either upon its reserves or upon its capital which in law it cannot do. Perhaps the Supreme Court judgment, CIT Bombay v. Jubilee Mills Ltd. becomes a fortiori to this reasoning that the 'assessable income' is of not much utility in the operation of section 23A. The question to be decided by the Supreme Court in this case was regarding the losses, incurred by the company in the earlier years. The Supreme Court observed:

"The losses incurred prior to the reconstruction having been adjusted are no longer shown in the books of the company. It does not, however, mean that the losses cease to have their affect on the financial position of the company in subsequent years. It cannot, therefore,

81. (1975) 98 ITR 105 (Mad)
82. AIR 1968 SC 883; 68 ITR 630

In Birla Brothers (P) Ltd. v. CIT (1964) 54 ITR 344 (Cal) the Calcutta High Court held: "A company cannot deduct capital expenditure from its profits as shown in the profit and loss account, and the department would be justified in adding to the profits shown in the profit and loss account the capital expenditure of the company during the relevant accounting year, for the purposes of determining its business profits..."

This decision of the Calcutta High Court has not been approved by the Allahabad High Court in CIT v. Janana Mandal Ltd. (1977) 106 ITR, 976, 979 (All). The court held:

"This case is no authority for the preposition that after the distributable surplus has been determined by applying correct criteria, the ITO while considering the reasonableness of the assessee's action in not declaring dividend cannot take into account its object in not distributing dividend, if it happens to be to appropriate the profits for expenses of capital nature".
be said that the losses prior to reconstruction do not fall within the ambit of the expression "losses incurred by the company in the earlier years" for the purposes of the application of section 23-A of the Act. Such losses are relevant to be considered even though they may not be surviving in the books of the company as unadjusted or carried forward losses.

Even appropriation of the profits for expenses of capital nature, or expenses to be incurred by the company in the near future could be taken into account in considering whether it would be reasonable to declare a dividend from out of its profits. In essence, 'consideration of the nature and purpose of the object for which the assessee proposes to utilise its profits would be very material'.

REVENUE LOSS OR CAPITAL LOSS:

Unlike the English Act, there is not specific provision for the allowance of business losses under the Indian Income Tax Act, but the Courts have allowed such losses under section 10(1) of the 1922 Act (Corresponding to Section 28 of the 1961 Act) on the ground that what is chargeable to tax is the profit computed on sound commercial principles, and if the loss is actually incidental to the carrying of the business, no true profit can be ascertained without deducting that loss.

It is important to note that loss is not the something as expense or disbursement. Whereas the former has no element of volition but the latter may have an element of volition sometimes. The Jammu and Kashmir High Court made out a distinction between a business expenditure and a business loss. In Chenah Forest Co. v. CIT, the Court observed:

"It appears that there is a clear distinction between a business expenditure and a business loss, the former is indicative of a volition but in loss it comes upon him, so to speak as ab extra and ... that non-capital expenditure

83. CIT v. Janana Mandal Ltd. (1977) 106 ITR 976, Headnote (All)
84. (1974) 96 ITR 568
incurred for the purpose of business would fail to be deducted under the omnibus residuary Section 37".

On the other hand, Section 10(2)(xv) of the 1922 Act (corresponding to Section 37(1) of the 1961 Act) allows the expenditure or disbursement on account of 'commercial expediency', so to speak, expenditure laid out or expended 'wholly and exclusively' for the purposes of the business.

Trustee's Corporation Ltd. v. CIT, decided by the Privy Council remains the judicial hallmark on this subject of 'trading loss' or 'revenue loss'. Though the facts, as mentioned in the original report, are difficult to comprehend, but they were as follows:

The appellants, an Indian Company, were incorporated under the Companies Act, 1913, with a nominal capital of seven crores of rupees, divided into 3,50,000 shares of Rs 200 each. Promoted as a private company by two English companies, the Share Guarantee Trust Ltd., and the Inter Continental Trust Ltd., all the issued shares of the Indian Company, with the exception of one share, taken by each of the two nominee subscribers to its Memorandum of Association, have throughout been held by one or other English Companies. Their joint control of the Indian Company has thus been in every respect and at all relevant times complete. That company was, really established, that it might acquire from the English Companies, as a single block of 312, 817 shares; two separate holdings in Burma Corporation Ltd. of 134,705 shares belonging to the Share Guarantee Trust, and of 178, 112 shares belonging to the Inter Continental Trust. The nominal value of each of these Burma Corporation shares was £ 1. They were all fully paid, and they stood in the London market at the high price of £ 14 each.

The terms of their acquisition by the Indian Company were contained in two sets of agreements. The first of these two agreements resulted in a simple contract for the purchase by the Indian Company of the whole block of the Burma Corporation shares.

AIR (1930) P.C. 151
in consideration of the issue of an equal number of shares in Indian Company credited as fully paid; and, as some form of reconstruction of the Burma Corporation was apparently then in prospect under which each share in the Corporation would be due course be exchanged for 14 shares in Burma Corporation (India) Ltd., the agreement contained a provision that if this exchange took place, prior to completion, the sale and purchase should apply to the shares so exchanged.

Subsequently, the second agreement, out of the 312,817 shares of the Indian Company representing the then consideration for the Burma shares, one-half or 156,408 shares were to or by direction of the respective English Companies to be allotted immediately, while the remaining shares were to be allotted at the rate of one share for each two shares of the Burma Corporation as delivered to the Indian Company.

The question before the Privy Council was whether the Indian Company, the appellants, were liable to pay Indian Super Tax for the year 1924-25 on the footing that at the least they made no loss, since they were entitled to no credit in respect of the realisation of a certain block of shares in the Burma Corporation (India) Ltd.

Lord Blanesburgh, delivering the judgment of the Privy Council held:

"And upon the facts, as just detailed, that liability is, in their Lordship's judgment, fixed upon the English Companies by the application to this case of the principle enunciated by the Court of Appeal in the case of Moseley v. Koffyfontein Mines Ltd., where it was held that if an arrangement for the issue of shares is such that in the course of its due working out there is as much as a possibility that in the result the shares will have been issued at a discount, then the issue of the shares as fully paid cannot be justified. Here such a discount has in the result actually materialised; its very amount has been ascertained, and their Lordships, applying as they do the principle just stated, reach the conclusion that the Indian Company's alleged loss has not been proved and that its present appeal on this simple ground must fail."

86. Ibid, 1541
87. (1904), 2Ch 108
Two further questions were stated by the CIT:

a) whether the alleged loss in question (if any) was a capital loss or revenue loss; and

b) whether the alleged loss in question (if any) can be taken into account in view of the fact that it has accrued and arisen outside British India, in view of the provisions of Sections 4(1) and (2), Income Tax Act, 1922.

The Privy Council enunciated the basic concept, as to the relationship between shareholders and the company, and held that the alleged loss was not a revenue loss. The sole question was what was the real value objectively of the fully paid shares issued to the English Companies by the Indian Company at the date when they were in fact parted with. It was not disputed by the appellants, the Indian Company, that the intrinsic value of these shares, if it had then exceeded their nominal value, would have had to be returned as their value. But their contention was that if, although judged by the same tests, their intrinsic value was then less than their nominal value, that last value, and no less, must be returned as their true value.

It was held:

"Their Lordships can only suppose the answer to be that the view is subconsciously assumed that a company by the issue of a share credited with a definite sum as paid thereon, becomes in some sense a debtor to its shareholder in respect of that full amount. But of course that is not so. A company is in no sense debtor to capital. The amount credited upon a share may, as between one shareholder and another, while the company is a going concern, determine the proportion of profits receivable by him as dividend, and, in a winding up, his proportion of surplus assets. But it has no influence to extend or increase the aggregate amount available for division in due course of administration amongst the whole body of shareholders; nor does it make the company a debtor for any sum at all".

88. Ibid, 157-58
89. Lee vs. Neuchatel Asphalte Co.,(1889) 41 Ch.D 1; Verner v. General Trust (1894) 2 Ch. 239
In order to appreciate this judgment of the Privy Council in *In Trustee's Corporation Ltd. v. CIT*, the facts can be succinctly described as follows:

The assessee company being promoted by two English private companies, entered into an agreement with those English Companies for the purchase of a large block of shares held by the English Companies in Burma Corporation Ltd., in consideration of allotting to the English Companies an equal number of its own shares of the face value of Rs 200, and in pursuance thereof allotted to them half its total number of shares. The Burma shares were sold in London market by the English Companies, the sale proceeds being kept by them on behalf of the assessee. The assessee-company claimed the difference between the face value of its shares and the sale price of Burma shares as a revenue loss. Thus, on an assessment to super-tax in respect of the income by way of dividends from Burma shares along with income by way of 'interest', the assessee-company claimed to set off this alleged revenue loss.

The main point for consideration by the Privy Council was whether the law required that when the purchase price of shares was not paid in cash, but by allotting shares in a company, whether the nominal value of the shares allotted or their market value could be ascertained in order to determine the cash equivalent of the purchase price paid.

The learned counsel on behalf of the assessee-company relied very strongly upon the following passage in the judgment in *In re Wragg Ltd*:

"The 'nominal' value of a share in a company cannot be the same as its intrinsic value except by accident. A share may be worth ten times as much or only one-tenth of its nominal value. The financial position of a company and the rates of dividends have much to do with the intrinsic value of its shares. The ordinary meaning of the word 'nominal' when used with reference to the value or price of a thing is 'existing in name only, not real or actual', as given in the Concise Oxford Dictionary."

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90. Ibid
91. The point, whether purchase price for shares can be in 'kind' instead of 'cash' was not in issue, because Lord Macnaughten clinched the issue in *Larocque v. Beauchemin* (1897) AC 358. (1897) 1 Ch. 796, 835.
Thus the question verges on a single point, whether there is anything special in this case requiring the intrinsic value of the allotted shares to be taken to be equal to its 'nominal' value.

The most important fact was that the agreement was made between the two English Companies (promoters) and the Petitioner Company, whereby one share in the Burma Corporation Ltd of the face value of £ 1 was to be exchanged for one share in the petitioner company of the face value of Rs 200. Formerly, £ 1 Burma share were having an intrinsic value of £ 14 each in February, 1920, and the intrinsic value came out to be only £ 5 12 Sh for each £ 1 share in January 1924, when they were sold in England. There can be no doubt that the English Companies, by entering into the agreement with the Indian Company, sustained in England a very serious loss which they would have been spared had they in February, 1920, disposed of their Burma shares upon the open market.

The House of Lords had already settled this point as well in Coromram Gold Mining Co. v. Poper that shares may be lawfully issued as fully paid up for consideration which the company have agreed to accept as representing in money's worth the nominal value of the shares.

On the other hand, the learned Counsel for the Revenue relied on another passage - observations made by Smith, J., in In re Wragg Ltd.

"Again, if in a registered contract, a money value less than the face value of the share be placed upon the consideration which the company had agreed to accept as representing in money's worth the nominal value of the share, I should think, would not be fully paid up, for instance, as was put in arguments a contract to supply to a limited company 100 tonnes of coal, valued at 10 Sh per ton as a consideration for 100 shares of £ 1 each - these shares would not be, I think, fully paid up".

93. (1892) AC 125; per Lord Watson
94. Ibid, 836
Even modern company law ordains that it is necessary to prevent frauds inherent in a transaction of such kinds by over-valuing the assets transferred to the company. Where the consideration is grossly inadequate, or illusory or colourable or apparently less than the value of the shares allotted, the agreement in set aside and the allottee is ordered to pay for the shares in full. But in the absence of a fraud in valuation, the court may not interfere only on the ground of inadequacy of consideration.

Where nothing like 'fraud' or 'illusory' was there in Trustee's corporation (India) Ltd. v. CIT, yet the Privy Council relied on the principle enunciated by the Court of Appeal in Moseley v. Koffyfontein Mines Ltd., that 'if an arrangement for the issue of shares in such that in the course of its due working out there is as much as a possibility that in the result the shares will have been issued at a discount, then the issue of the shares as fully paid cannot be justified'.

It is submitted that such a 'due working out' does not seem to be proved in Trustees Corporation Case, whereas in Koffyfontein Mines Case there was clear evidence that the company gave each debenture-holder the right to convert debentures into shares. The debentures were being issued at a discount, such a scheme was held to be a 'colourable' scheme and, therefore, not legal.

96. In re Wragg Ltd. (1897) 1 Ch 796
97. Ibid
98. Ibid
1. Ibid
It is often difficult to distinguish between night and day or between red and orange, as graphically put by Lord Denning. Fiscal jurisprudence cannot be reduced to a science and we cannot manufacture cut and dried formula for distinguishing capital from income.

That the differentiation between a capital receipt or revenue receipt remains as much a baffling concept even today, as it was at the stages of its inception. Though the Courts have met the challenges squarely, but sometimes it has been an uphill task for the judges to wade through these rudiments of tax jurisprudence. One of the examples, too glaring to ignore, is the decision of the House of Lords in Moriarty v. Evans Medical Supplies Ltd., where five learned Law Lords took part, two of them holding that the payment in question represented a capital receipt; two other learned Law Lords holding that it was an income receipt; and the fifth Learned Law Lord holding that the sum was in part a capital receipt and in part income receipt.

In order to appreciate the entire labyrinth, the facts can be succinctly described as follows. The company was incorporated in November, 1925, to carry on business as manufacturing chemists, wholesale druggists, drug grinders, importers and manufacturers of pharmaceutical, medicinal, bacteriological and chemical preparations and articles. In the pharmaceuticals field, the company occupied a leading position in the world, and produced, in addition to a number of proprietary products, about 6,500 products of known compositions and mixtures for the preparation, storage and packing of which the company had also evolved many secret processes.

The company carried on its trade in a number of foreign countries, either through subsidiary companies or through foreign agencies. It had one such agency in Burma. In 1953,

2. Upponi, D.A., Tax jurisprudence (Taxmann) 232
3. (1959) 35 ITR 707 (HL); 37 TC 540
the Burmese Government itself decided to set up a factory in Burma to produce pharmaceuticals and other products. Finally an agreement was reached between the company and the Burmese Government. The most important, among the operative part of the agreement, inter alia, read as follows:

"In consideration of the payment to Evans by the Government of the capital sum of £ 100,000 payable in the United Kingdom free from any deduction whatsoever ... Evans hereby undertake that during the currency of this agreement the facilities hereby agreed to be furnished to the Government under the preceding sub-clauses of this clause shall be exclusive to the said government and shall not during the currency hereof be furnished to any other person or corporation in Burma".

It was further provided that as remuneration for the services provided for, the government would pay to the company a fee in respect of each year of the continuance of the agreement of either 5% of the value of all products, or the sum of £ 25,000 which-ever sum should be the greater.

It was also provided that the agreement should remain in force for 7 years, but might be renewed as mentioned, and the Government would not export the products to any other country, except as mentioned. Another very important term was that the government would not divulge to anyone the information conveyed to them by the company, without the written consent of the company. It was on evidence by the lower Courts that the company did not make any such agreement earlier with any person.

The question was whether this sum of £ 1,00,000 was an income receipt or a capital receipt. On behalf of the Crown, the most important contention was that the said sum was received in the course of carrying on its trade as wholesale druggists and the disposal of secret processes by the company was neither sale nor assignment of property of the company, but a method of developing and exploiting its business, since it was not the grant of a license in consideration of a capital payment. On appeal to the High Court, Upjohn, J., upheld the claim of the company for £ 1,00,000. His Lordship observed:

4. Ibid, 551
...But it was parting for ever with part of a valuable asset and was doing so to enable an entirely new and competing industry to be set up there. That industry established by the skill and 'know how' of the company, could embark on the export trade which could compete with the company's own products in other countries. In that sense the company was dissipating its asset and it must be remembered that the secret process once communicated to another is in jeopardy; if it gets into the wrong hands, the grantor has no protection...

Further, the Court of Appeal held that the matter required further investigation by the Commissioners as to what portion of the sum of £1,00,000 should be attributed to capital income and what portion to revenue income. Ultimately, both sides appealed to the House of Lords. Viscount Simonds, L.J., held:

"...It is manifest that a secret process, whether in composition or methods of storing and packing, is something which can be disposed of for value and that by imparting the secret to another, its owner does something which could not fairly be described, rendering a service (vide Handley Page v. Bitterworth 19 TC 328). The whole value of the secret might conceivably not be lost at once to the original owner, but that its value must be greatly diminished is obvious; in the present case it is doubtful whether within a measurable time it will have any value at all, at any rate so far as the Burmese market is concerned. I adopt, with respect, the apt words of Lord Fleming in Trustees of Earl Haig v. IRC (22 TC 725 at page 735):

'...the transaction here in question was not merely a use of the subject Salve rei substantia but necessarily involved the realisation of a considerable part of its capital value'.

The revenue vehemently contended that it was natural in such an 'agency business', that there should be fluctuations in the number of agencies held from time to time. It was an incident of this type of business that determination or modification or alteration of agency agreements should occur from time to time and hence, any compensation paid by the principal to the agent for such termination or modification was one arising in the course of the trade of the tax payer, and hence was a trading receipt.
On the other hand, the argument put forward on behalf of the tax-payer to combat the above view was that the trading agency was a capital asset of the tax-payer, and that the compensation received in respect of its extinction or modification should be regarded as a capital receipt. The answer afforded to this argument was that the loss of one agency did not extinguish his agency business altogether. It might be that the particular agency extinguished was a very valuable asset, a 'key agency', so to say, producing a major part of the tax-payer's income. But what all that would add up to was that the business of the tax-payer suffered a shock and a disaster by reason of the withdrawal of patronage by one of his principals. Beyond this, it was not right to state that the tax-payer's undertaking as a sales agent was wholly or partially destroyed. On the other hand, it might be that the rest of the agencies still subsisting might be more vigorously exploited so as to yield more profits to the tax-payer. The very structure of this kind of agency business was such as to provide for absorption of shocks caused by the cancellation of one or some of the agencies held by it, albeit an important one.

It may be remarked at this stage that section 28(11) of the 1961 Act takes care of such a situation, and provides that the compensation paid to a tax-payer would not cease to be a trading receipt, merely because the same was paid not by the other party to the contract, but by a third person.

Lord Denning dealt with the whole issue in the following words. The learned Law Lord observed:

"The consideration (of £1,00,000) was the imparting of information and technical data, all of which may be summed up in the new and expressive word 'know how'. The court of Appeal would seek to divide it into two parts: (i) information about secret processes; (ii) information about other things...I can see no sensible distinction between money paid for information of secret processes..."
and money paid for the other information. The only difference is that in the one case the money was paid for information which up till then had been secret, being obtainable only from the one firm; whereas in the other case it was paid for information which was scarce, being obtainable from three or four firms. But the money was paid for the same sort of things in either case. At any rate, the parties to this agreement did not seek to draw any distinction between the two.

$1,00,000 was paid for the 'know how' in the Evans Medical Supplies Ltd. case. The judgment of Denning, L.J., in the case of Moriarty v. Evans Medical Supplies Ltd., answers that vehemtc contention of the Crown that the payment was received only in the course of trade. The learned Law Lord observed:

"The law never gives judgment in favour of a plaintiff when the only finding is equally consistent with liability or non-liability. The Crown have themselves to thank for this result because of the way they formulated their contentions. They are hoist with their own petard. They can do away and ponder again the words of Lord Cairns in Partington v. Attorney - General, LR 4 HL 100, 122: 'If the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free'."

In summation the majority judgment in Evans Medical Supplies Ltd. was that where a single amount received by the assessee is partly on capital account and partly on income account, it should be apportioned and the part which is of a revenue nature should be brought to charge. Of course, that portion of the consideration which is for imparting the know-how, whereby dissipation in the value to the owner takes place, such portion of the consideration would be on capital account - a capital receipt.

Indian Courts have been applying these well-established principles, and one such case regarding payment of compensation came up in Messrs Shaw Wallace & Co. v. CIT. The assessee was

7. Ibid, 587
8. Ibid
9. AIR (1931) Cal 676
acting for some years as agents for two oil companies. The agency was terminated by virtue of an agreement and the assessee received a sum of Rs 15½ lacs as compensation for loss of the agencies. The Calcutta High Court held that the sum in question was in the nature of a capital receipt and not income, profits or gains within the meaning of the Income Tax Act, 1922.

It is important to note that all such decisions have been superseded by the 1961 Legislation.

In Turner Morrison and Company v. CIT, the assessee had 3/5 ths interest in the capital of the company which was in liquidation and accordingly the sum was received by the assessee. The contention of the assessee throughout was not that the receipt was a capital receipt, but that it had no connection with business at all, the sum received being either in the nature of a voluntary gift or testimonial, and, therefore, not income, profits or gains.

It was also contended that the case was not in principle different from the Glenboig Union Fireclay Co., Ltd. v. Commissioners of Inland Revenue, where it was held that compensation paid to a lessee of mineral rights for the abandonment of his right to work the minerals was a capital receipt. The Court discarded this contention in the following words:

"By virtue of the controlling interest in the company, the assessee got passed the resolution regarding the payment of 2½ lacs to them. The payment would never have been made to them had they not been the managing agents of the company, hence it accrued to them by virtue of their office".

10. Section 28(ii) (a) reads:

"(ii) any compensation or other payment due to or received by-

a) Any person, by whatever name called, managing the whole or substantially the whole of the affairs of an Indian Company, at or in connection with the termination of his management or the modification of the terms and conditions relating thereto,"

11. 3 ITC 214
12. 12 TC 427 (HL)
In order to appreciate the principle enunciated in Glenboig Union Fireclay Co.Ltd. v. Commissioners of Inland Revenue, the facts were as follows:

The assessee-company carried on business as manufacturers of fireclay goods and as merchants of raw fireclay. Part of the property of the company consisted of mining rights over certain beds of fireclay at Gartverrie, Glenboig, and in the course of the working of these fields the company was approaching the line of the Caledonian Railway. Due notice of this fact was given to the Railway Company of the intended extension of the working. The Railway Company being apprehensive as to the result, asked the company to desist from working the mine further. A dispute arose as to whether or not the fireclay in question was a mineral. In the meantime, the Railway Company obtained interdicts, but upon the recall of the interdict, the Railway Company became liable to pay a sum of £ 4,500 to the company, by way of damages.

Thereafter, in a bid to prevent the company from working the mine any further, the Railway Company agreed to pay suitable compensation to be fixed by an Arbitrator. Thus, an amount of £ 15,316 was paid to the company. The assessee-company entered in its books these receipts on revenue account, and distributed dividends out of the same. The Inland Revenue accordingly charged the receipts as business receipts and while in relation to the levy of Excess Profits Duty, took the stand that for the purpose of computing the pre-war standard of profits, the receipt should be regarded only as a capital receipt. Lord Wrenbury raised the question and observed as follows:

"It is unnecessary for your Lordships to express any opinion whether, as a matter of honest administration by the Inland Revenue authorities or as a matter of law, the Inland Revenue could have maintained the contention that they could take and retain income tax and then claim Excess Profits Duty on the ground that the sum was not income...".

13. Ibid
The House of Lords held in favour of the company. The mode of book-keeping followed by the company was not conclusive of the true character of the receipt, which was capital in nature. Lord Buckmaster held:

"...It appears to me to make no difference whether it be regarded as a sale of the asset out and out, or whether it be treated merely as a means of preventing the acquisition of profit that would otherwise be gained. In either case the capital asset of the company to that extent has been sterilised and destroyed and it is in respect of that action that the sum of £ 15,316 was paid."

Rejecting the contention of the Crown that the payment in fact represented the actual profit for 2\frac{1}{2} years received in one lumpsum, Lord Buckmaster observed:

"There is no relation between the measure that is used for the purpose of calculating a particular result and the quality of the figure that is arrived at by means of the application of that test. I am unable to treat this sum of money as anything but capital money..."

Hence both the receipts, viz of £ 4,500 and £ 15,316 were held to be capital receipts. The observations by Lord Wrenbury are more pertinent:

"...As to the sum of £ 15,316, this was compensation for being precluded from working part of the demised area, which otherwise, the appellants might have worked and thereby made profit. Was that compensation profit? ...It was the price paid for sterilising the asset from which otherwise profit might have been obtained. What is true of the whole must be equally true of part. Again, a further point of view is this: had the working not been interfered with, the profit by the working would have extended over, say, three years; it would have been an annual sum. The payment may be regarded as a redemption of that annuity. Is the redemption of an annuity itself an annuity? If the currency of the annuity had been, say, ten years, and the beneficiaries were A for three years and B for seven years, could A have claimed all the compensation money on the ground that it was the income of the first year? Clearly not."

Thus, neither income tax could be charged by virtue of those receipts as capital receipts, nor the receipts could be taken as capital receipts for the purposes of computing the pre-war standard of profits for the purpose of levy of Excess Profits Duty.
An important principle of law emerges from this judgment of Glenboig Union Fireclay Co Ltd. v. IRC that for the purposes of levies under different direct taxes, the receipt could not change its nature or character.

On the other hand in Turner Morrison and Company v. CIT, the company did not take up the contention based on 'compensation', instead it contended for the sums received as 'voluntary gift' or 'testimonial'. Being the controlling shareholders, this contention of theirs could not be sustained.

Tracing the historical perspective, it may be said that the contention taken up by the assessee-company in Turner Morrison becomes the precursor of Section 28(iv) in the Income Tax Act, 1961.

There is another important principle underlying the distinction between a capital sale and an adventure in the nature of trade. The 'motive' is never irrelevant in any of these cases. The line between capital sales and sales producing income has been drawn in a Scottish case, by Lord Justice Clark in Californian Copper Syndicate v. Harris in the following passage which has become classical:

"It is quite a well settled principle in dealing with questions of assessment of Income Tax that where the owner of an ordinary investment chooses to realise it, and obtains a greater price for it than he originally acquire it at, the enhanced price is not profit... assessable to income tax. But it is equally well established that enhanced values obtained from realisation or conversion of

15. Ibid
16. Though Section 28(iv) which came much late by virtue of Finance Act, 1964, has far fetched implications, that any receipt coming by virtue of business or profession shall be taxable.
   It reads:
   28(iv): "The value of any benefit or perquisite, whether convertible into money or not, arising from business or the exercise of a profession".
17. 5 TC 165
securities may be so assessable where what is done is not merely a realisation or change of investment, but an act done in what is truly the carrying on, or carrying out of a business... what is the line which separates the two classes of cases may be difficult to define, and each case must be considered according to its facts; the question to be determined being - Is the sum of gain that has been made a mere enhancement of value by realising a security or is it a gain made in an operation of business in carrying out a scheme for profit-making? 

If a transaction is in the assessee's ordinary line of business, there can be no difficulty in holding that it is in the nature of trade and, therefore, an income receipt. But the difficulty arises where the transaction is outside the assessee's line of business and then, it must depend upon the facts and circumstances of each case. Whether the transaction is in the nature of a trade an adventure in the nature of trade. The dominant or even sole intention to resell is a relevant factor and raises a strong presumption, but by itself is not conclusive proof, of an adventure in the nature of trade.

In CIT, Nagpur v. Sutlej Cotton Mills Supply Agency Ltd., the assessee, a public limited company controlled by Birlas Group of Companies, purchased certain shares of the Gwalior Rayon Silk Manufacturing (Weaving) Co. Ltd., also a company being controlled by the same group of Birlas. The purchase was authorised by a resolution of the assessee company as per its Memorandum of Association. Subsequently, the assessee sold a part of its stock at a profit.

For the assessment year 1956-57, the receipt was sought to levy of income tax on the basis that it was profit in the nature of 'adventure in the nature of trade'. The Tribunal, while concluding in favour of the revenue, marked out certain important findings of fact: a) The assessee was authorised by its memorandum of association to buy and sell shares; (b) There were specific resolutions of the company authorising a director

18. Venkata Swami Naidu & Co. v. CIT (1959) 35 ITR 594 (SC)
19. Ibid, 610, 622
20. (1975) 100 ITR 706 (SC); AIR 1975 SC 2106
of the assessee-company to purchase and sell these shares;
(c) The assessee had included the profit of Rs 2,13,150 in the profit and loss account without taking it to any reserve account or specifically set it apart for any other purpose;
(d) The assessee had purchased the shares from borrowed funds and not with money readily available to it; (e) The assessee did not make the sales on account of any pressing necessity to meet existing liabilities but had in fact kept a part of the sale-proceeds as liquid cash in the Bank; (f) Lastly, nevertheless the most crucial, the assessee had, in the past, dealt in shares as business transaction and had claimed for the assessment year 1951-52 losses on account of dealing in shares of M/s Titagarh Paper Mills Ltd., and on account of devaluation of the shares of M/s Pilani Investment Corporation, though that was not allowed. Thus the question which the Tribunal had to consider was a mixed question of law and fact, namely, whether the profit from sale of the shares in question was a revenue or a capital receipt.

Mathew, J., while delivering the judgment of the Supreme Court referred to the acknowledged authority in England on fiscal jurisprudence Rowlatt, J., in Thew v. South West Africa Co., Ltd., as under:

"...For the purpose of ascertaining whether profits made upon a sale of an article are taxable profits, the question to be asked is: "Is the article acquired for the purpose of trade"? If it is, the profit arising from its sale must be brought into revenue account and that the profit is chargeable as capital gains if the sale is of a capital asset, and as business profit if the sale is in the course of business or the transaction constitutes an adventure in the nature of trade.

Mathew, J., thus upholding the findings of the Tribunal, observed:

"Ultimately, it is a matter of first impression with Court whether a particular transaction is in the nature of trade or not. It has been said that a single plunge
may be enough provided it is shown to the satisfaction of the court that the plunge is made in the waters of the trade but mere purchase/sale of shares-if that is all that is involved in the plunge may fall short of anything in the nature of trade. Whether it is in the nature of trade will depend on the facts and circumstances".

x. STATUTORY DEDUCTIONS

The concept of depreciation has undergone many important changes. In essence, it is a capital charge but it has been recognised as an allowance on account of 'wear and tear' suffered by the machinery or 'plant'. It is much pertinent to quote the following words from the judgment of the Allahabad High Court in Virmani's case:

"...That is so, because a depreciation allowance is essentially a deduction allowable out of the gross profits of a business. If there is no business, there can be no depreciation allowance".

In 1926, when the case of Mangalagiri Rice Factory v. CIT came up before the High Court of Judicature at Madras, the provisions of section 10(2)(vi) were:

"in respect of depreciation of such buildings, machinery, plant or furniture being the property of the assessee a sum equivalent to such percentage on the original costs thereof to the assessee as may in any case or class of cases be prescribed".

The Rice Factory was a limited company incorporated under the companies Act, 1913. The question was, whether the lessor or the lessee was entitled for depreciation allowance. Of course, the authority to lease out plant and machinery was given under the memorandum of association of the company. Under the lease the lessees were to do the necessary repairs and to hand back the mills in good working order, while the lessors were to bear the loss by depreciation by wear and tear caused by the working of the mill.


23. AIR (1926) Mad 1032
The Commissioner stated as follows. As the question involves the interpretation of Section 10(2)(vi) of the Act read with Section 10(2)(iv); in order to make an assessee eligible for the allowance under Section 10(2)(vi), two conditions have to be satisfied, namely:

1) that the buildings, machinery, plant, etc in respect of which depreciation is claimed are the property of the assessee; and,

2) that they are 'used for the purposes of the business'.

In the present case the first condition is satisfied but the second is not. The three judges bench (Courts Trotter, C.J., Krishnan, J., and Beasley, J.) gave judgment in favour of the lessor company. Krishnan, J., held:

"...Though the direct cause of the wear and tear may be the working of the mill by the lessees such working is authorised by the lease and is part of the business of the lessee; that part of the rent which represents the loss due to depreciation is not really income to the lessors but is meant to make good the loss on capital value of the machinery...".

Beasley, J., held:

"The company could either work the mill itself or could let it out to others to do so. One is the business of milling and the other is the business of letting out the mill for others to do so. Both, in my view, are equally a business...".

When the case of Raj Gokaldas Mills Limited, In Re came before the High Court of Judicature at Bombay, obsolescence allowance was also existing under the Income Tax Act, 1922. Sections 10(2)(vi) and (vii) provided for an allowance for depreciation and obsolescence respectively. The following passage

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24. Section 10(2)(vi), Income Tax Act, 1922
25. Section 10(2)(iv)
26. 2 ITC 254
27. 2 ITC 255
28. 1 ITC 316
brings out the conceptual differentiation between the two

"...In section 10(2)(vi)(c), the legislature distinctly lays down that an allowance on account of depreciation is to be allowed only to the extent of original cost to the assessee. Once the allowance comes up to the original costs nothing more can be allowed. The same principle obviously applies to obsolescence without any doubt as the difference between an obsolescence and depreciation is one of degree only. In the latter, the wear and tear and the consequent loss is gradual. In the former, it is immediate and sudden. The result of both is loss of capital involved...".

The High Court of Judicature at Madras laid down a very important principle of law in Rattan Singh v. CIT:

"The allowances specified in section 10 of the Income Tax Act must be treated as disjunctive and cumulative and not alternative and exclusive. Consequently Section 10(vi) cannot be construed as extinguishing the right to deductions specifically outlined and defined in the other clauses of section".

Section 10(2)(ix) allows any expenditure (not being in the nature of capital expenditure) incurred solely for the purpose of earning the profits or gains of the business. Section 10(2)(v) allows a deduction in respect of 'current repairs' to building, machinery, plant or furniture, the deduction permitted being the amount paid on account thereof. Two questions were referred by the Commissioner to the High Court in Rattan Singh's case:

29. Ibid, 318
30. 2 ITC 294, per Coutts Trotter, CJ and Beasley, J.
31. Ibid. The assessee's business was that of an owner of motor cars plying for hire. The revenue cited the case of Caledonian Railway Company v. Banks 1 TC 487 decided in the Court of Exchequer in Scotland that the assessee could not deduct the actual expenses of occasional repairs and renewals and then proceed to claim an additional deduction under the general section of the statute for the same thing under the guise of wear and tear.

On this the High Court held:
"The position under the Indian Statute is quite different. The Scottish case is inapplicable in India because the Act which the Scottish case interprets was an Act which only contained deductions for depreciation and did not, like the Indian Act, specify under separate heads other deductions differently described."
1) Whether the substitution of new parts in the place of old and worn out ones in a machinery is capital expenditure, or is it in the nature of repairs or revenue expenditure, and

2. Whether such replacements are not in the nature of working expenses under Section 10(2)(ix) of the Indian Income Tax Act.

The High Court of Judicature at Madras held:

"The question whether the substitution and renewal of old and worn out parts of a machine is capital expenditure or current repair is one of degree depending upon the circumstances of each case".

The Court further observed:

"We feel that the legislature has done that which is so often done in Indian Acts and that by enumerating too much and trying to cover every possible case, they have 'per incuriam' given more than one remedy in respect of what is really one ground of deduction. But until and unless the Act is amended, we think that separate heads of reliefs must be treated as disjunctive and cumulative..."

An important question of law came up in Massey & Co.Ltd. v. CIT, whether unabsorbed depreciation allowance of the business could be availed of by the amalgamated company. The Commissioner relied on the provisions of Section 10(2)(vi), that the plant, machinery etc were not, therefore, used in the business of the petitioner-company, nor were they the property of the petitioner-company during the year for which depreciation was claimed. The High Court of Judicature at Madras held:

"The assesses were entitled to carry forward the depreciation allowance of the taken over company not given in the years previous to succession by them, such

32. AIR (1929) Mad 453
33. The Madras High Court based its judgment on Scottish Shire Line Limited v. Letham 6 Tax cas 91, wherein Lord Guthrie's judgment is of much instructive value: ibid, 100

"It appears to me that the argument of the surveyor of taxes has neither probability nor equity in its favour because he proposes to treat the appellant company neither as identical with nor as the successors of the Elderslie Steamship Co., Ltd (The Old Company) for revenue purpose."
depreciation allowance to be worked out on the original cost to the old company and not at the value at which they took them over*.

On the other hand, the Bombay High Court held in David Sassoon & Co., Ltd., in re:

"The entitlement to claim brought forward depreciation allowance is subject to the fulfilment of the condition that the assets in question continue to be used by the assessee and the same business also continues to be carried on by the assessee in the year in which the set off is sought".

This Bombay High Court judgment does not give reasons for the conclusion arrived at therein. However, an important principle of law was enunciated in this case, which is valid even today under the 1961 legislation, that the previous owner cannot claim to carry forward the unabsorbed depreciation allowance of the business which he has assigned to another. It is submitted that the view taken by the Madras High Court in Massey & Co., Ltd., v. CIT was a pragmatic and more sound view; but even under the 1961 legislation position remains the same, that in case of amalgamation of companies, the unabsorbed depreciation of the amalgamating company cannot be carried forward by the amalgamated company. The principle of law followed is that the two entities—'corporate personality'—are different assesses.

The oft-quoted case on unabsorbed depreciation is Sahu Rubbers Pvt., Ltd. v. CIT. This judgment was rendered by the Bombay High Court in the context of the provisions of law relating to the assessment year 1956-57, which are clearly distinguishable from those of section 32(2) of the 1961 Act. The difference in the

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34. (1940) 8 ITR 7
35. Ibid
36. Kanga and Palkhivala states:
"This rule cannot be circumvented in cases of amalgamation falling under section 2(1A) by an Indian transferee company taking over the assets of the merged company at a value higher than the written-down value, since Explanation 2A to Section 43(6) provides that the written-down value to the Indian transferee company of the capital assets in such cases should be taken to be the same as it would have been in the case of the merged company". - Kanga & Palkhivala, Law and Practice of Income Tax, VIIth Edn Vol.1, 385
37. (1963) 48 ITR 464 (Bom)
treatment arose from the fact that under the 1922 Act, the right of Carry forward and set off of unabsorbed depreciation was admissible under the proviso to the main statutory provision (clause (b) of proviso to Section 10(2)(vi) of 1922 Act) and not under an independent substantive provision of law, as in Section 32(2) of the 1961 Act.

The Bombay High Court clearly held in Sahu Rubbers that in order to claim adjustment in the assessment year of unabsorbed depreciation of an earlier year, the assessee must establish that the business in respect of which it was claimed continued in the previous year relevant to the assessment year. Thus, if that business is no more in existence, unabsorbed depreciation cannot be adjusted in the assessment of future years against the profits of a different business.

There was no specific provision for the carry forward of unabsorbed depreciation until the law was amended with effect from 1st April, 1939, to permit the carry forward of the unabsorbed depreciation. Therefore, unabsorbed depreciation allowance attributable to any accounting period which ended on or before 31st March, 1939 cannot be carried forward under law, as has been made clear in CIT v. Isthimian Steamship Lines.

In this case of Isthimian Steamship Lines, the Supreme Court also pointed out that it is because of the legal fiction specifically enacted under law that the unabsorbed depreciation allowance of a preceding year becomes a part of the depreciation allowance of the succeeding year and so on; in other words, in the absence of this legal fiction such a treatment would not have been possible.

The leading pronouncement on the treatment of unabsorbed depreciation is the case of CIT v. Jaipuria China Clay Mines Pvt. Ltd. In that case, the Supreme Court pointed out:

38. Ibid
39. (1951) 20 ITR 572 (SC)
40. (1966) 59 ITR 555 (SC)
41. Ibid, 560
"It is quite clear that the words profits or gains chargeable for that year are not confined to profits and gains derived from the business whose income is being computed".

Accordingly, the entire assessable income of the current year must be taken as the basis to ascertain whether the brought forward depreciation allowance could be set off against the same. Further, the Supreme Court has laid down in *Jaipuria China Clay Mines*

"Apart from authority, looking at the Act as it stood on 1st April, 1952, it is clear that the underlying idea of the Act is to assess the total income of an assesses. Prima facie, it would be unfair to compute the total income of an assesses carrying on business without pooling the incom from business with the income or loss under other heads. The second consideration which is relevant is that the Act draws no express distinction between the various allowances mentioned in Section 10(2). They all have to be deducted from the gross profits and gains of a business. According to commercial principles, depreciation would be shown in the accounts of the profit and loss account reflects the depreciation accounted for in the accounts. If the profits are not much enough to wipe off depreciation, the profit and loss account would show a loss. Therefore, apart from the proviso (b) to Section 10(2)(vi) (corresponding to Section 32(2) of the Income Tax Act, 1961) neither the Act nor commercial principles draw any distinction between the various allowances mentioned in Section 10(2). The only distinction is that while other allowances may be outgoings, depreciation is not an actual outgoing".

An important principle of law was laid down in this judgment, *CIT v. Jaipuria China Clay Mines Pvt.Ltd.*, that the unabsorbed depreciation allowance must be treated as part of the current depreciation and should be set off in the subsequent year against any income under any head without any time-limit.

If the legislature had not enacted the words "subject to the provisions of proviso (b) to section 24(2)" in section 10(2)(vi), the result would have been that depreciation allowance could have been deducted first out of the profits and gainsin preference to any unabsorbed business losses, but as the law stipulates the carry forward only for a period of six years for unabsorbed business losses

42. Ibid, 559
43. Ibid
44. Under the 1961 Act, Section 72(3), this period is eight years now.
under Section 24(2), the legislature in view of this, gave a preference to the deduction of unabsorbed business losses first. Carrying forward of depreciation having been provided in Section 10(2)(vi), and that too, in a different manner, without any time limit, the legislature has made a clear distinction between the concept of unabsorbed depreciation and unabsorbed business losses.

Interesting and very vital questions of law have come to the Courts on the concept of 'Actual Cost' to the assessee, since it would be the base on the basis of which depreciation would be calculated. One of the oldest cases on 'determination of actual cost' decided by the Bombay High Court was CIT v. Poona Electric Supply Co. Ltd., where the Court held that in computing the actual cost, for the purposes of depreciation, it is immaterial whether someone else has recouped the assessee what he has spent on the asset.

The Bombay High Court analysed very critically the

45. (1946) 14 ITR 622; AIR (1947) Bom 263

46. The Bombay High Court followed Birmingham Corporation v. Barnes 1935, 3 ITR Supp 26 (HL); (1935) AC 292 The Appellant Corporation in this Birmingham Corporation case entered into an agreement with a company to lay a tramway track and establish a tramway service to the company's works. By virtue of the work having been completed and the service established by a certain date, the corporation received from the company in accordance with the terms of the agreement, a specified sum. The Corporation also spent considerable sums of money on the renewal of their tramway tracks and received in that connection grants from the Unemployment Grants Committee. These grants were made under certain conditions to local authorities to assist them in carrying out at once approved schemes of public utility on which a substantial number of unemployed persons could be engaged. It was held by the House of Lords that the payment by the Unemployment Grants Committee should not be taken into account in ascertaining the 'actual costs' to the corporation of the tramway track in question for the purpose of computing the allowance due to the corporation for 'wear and tear' of such tracks.

Lord Atkin observed: (19 TC 195)

"What a man pays for construction or for the purchase of a work seems to me to be the cost to him; and that whether someone has given him the money to construct or purchase for himself, or before the event has promised to give him the money after he has paid for the work, or after the event has promised or given the money which recoups him what he has spent..."
provisions of Section 10(5) and Explanation thereto, and held that reimbursement of a capital outlay is a receipt on capital account.

Immediately thereafter an Explanation was added to Section 10(5) by virtue of Income Tax (Amendment) Act, 1953, nullifying the effect of the Bombay High Court Judgment in *Poona Electric Supply Co. Ltd.* It is important to mention at this stage that Section 43(1) of the 1961 Act does not merely supersede the decision in *CIT v. Poona Electric Supply Co. Ltd.*, but further provides that the actual cost of an asset to the assessee should in every case be "reduced by that portion of the cost thereof, if any, as has been met directly or indirectly by any other person or authority. Thus Section 43(1) is wider in scope than the corresponding provision in the 1922 Act which reduced the cost only to the extent to which the assessee was reimbursed by the Government or any public or local authority.

The decision of the Calcutta High Court in *CIT v. Kamala Mills Ltd.*, that the words "depreciation actually allowed" connote the idea that the allowance was in fact absorbed by the profits of the year, was nullified by the Income Tax (Amendment) Act, 1953, which introduced an Explanation further to Section 10(5). This Explanation is now reproduced in the 1961 Act as Explanation 3 to Section 43(6). The words "any allowance

47. "Written-down value" was defined in Sub-Section (5) of Section 10: In the case of assets acquired in the previous year, the actual cost to the assesse, and in the case of assets acquired before the previous year, the actual cost to the assesse less all depreciation 'actually allowed' to him under the 1922 Act or any Act repealed thereby, or under executive orders issued when the Indian Income Tax Act, 1886, was in force.

48. The Explanation read as under:

"Explanation—for the purpose of this sub-section the expression "actual costs" means the actual cost of the asset to the assesse reduced by that portion of the cost thereof, as has been met directly or indirectly by Government or by any public or local authority and any allowance in respect of any depreciation carried forward under clause (b) of the proviso to clause (vi) of sub section (2) shall be deemed to be depreciation "actually allowed"."

49. (1949) 17 ITR 130, 134

50. "Explanation 3: Any allowance in respect of any depreciation carried forward under sub-section (2) of section 32 shall be deemed to be depreciation 'actually allowed'."
in respect of any depreciation carried forward" in the said Explanation refer to a situation where the allowance could not be absorbed owing to the absence of sufficient profits or gains in the year and consequently of having to be carried forward either in whole or in part to a future year.

The Allahabad High Court, following CIT v. Kamala Mills Ltd, explained in the case of Rampur Distillery and Chemical Works Ltd. v. CIT that up to 31st March, 1952, the unabsorbed depreciation allowance due to any taxpayer could not be regarded as part of the depreciation 'actually allowed' to him.

Thus it is important to note, that the concept of 'depreciation' was altogether different upto 31st March, 1952 and with the passage of Income Tax (Amendment) Act, 1953, this concept emboldened.

In Challapalli Sugar Ltd. v. CIT, Hyderabad, the assessee was a public limited company engaged in the manufacture and sale of sugar. The assessee company had borrowed considerable sum of money from the Industrial Finance Corporation of India for the installation of machinery and plant. The case of the assessee was that for the period prior to the commencement of its business, the assessee paid Rs 2,38,614 as interest, and this payment of interest added to the cost of machinery and plant for the purpose of computing depreciation admissible. The Appellate Assistant Commissioner held that during the period of construction when money was borrowed for the purpose of purchasing and installing the machinery, the payment of interest was the 'cost of maintaining the borrowal' and as such could be included as part of the capital cost.

51. (1965) 55 ITR 338

52. (1975) 98 ITR 167 (SC); AIR 1975 SC 97. Two appeals were heard, viz one of CIT, Calcutta v. Hindustan Petroleum Corporation Ltd.
Similar question came up in appeal from the Calcutta High Court in CIT, Calcutta v. Hindustan Petroleum Corporation Ltd., where the amount of interest payment was Rs 23,53,284. In Challapalli Sugar Ltd., the matter related to the assessment year 1959-60; and for Hindustan Petroleum the assessment years were 1955-56 and 1959-60. As regards Hindustan Petroleum (formerly M/s Standard Vacuum Refining Co. of India Ltd), it borrowed Rs 4 crores on debentures at the rate of 5% interest from the public.

The common question which came up before the Supreme Court may be framed as follows:

"Whether the assesses were entitled under the provisions of sections 10(2)(vi), 10(2)(vi-a) and 10(2)(vi-b) read with section 10(5) of the Income Tax Act, 1922 to treat these sums being the amount of interest, paid on monies borrowed as part of the actual cost for the purposes of depreciation allowance.

Khanna, H.R.J., delivering the judgment of the Supreme Court observed that the expression 'actual cost' has not been defined in the Act. So far as the interest after the commencement of production in respect of capital borrowed for the purposes of business is concerned, the same can be deducted under clause (iii) of Sub section (2) of Section 10 of the Act. His Lordship said:

53. (1975) 98 ITR 167 (SC); AIR 1975 SC 97. Two appeals were heard, viz one of CIT, Calcutta v. Hindustan Petroleum Corporation Ltd.

54. In Hindustan Petroleum the AAC went against the assessee. It is interesting to note that in both the said Appeals, Challapalli Sugar Ltd., and Hindustan Petroleum Corporation Ltd., the Tribunals went in favour of the assessee.

55. Development rebate was also in issue along with depreciation on which the legal position for determining the actual cost is the same as for the purpose of depreciation.

56. Before coming to this conclusion, the Supreme Court succinctly analysed the British and Indian Accountancy practice, the sum total being that interest charges on debentures, legal expenses of acquiring property, broker's charges on purchasing investments, etc. would be capitalised.
"...the accepted accountancy rule for determining the cost of fixed assets is to include all expenditure necessary to bring such assets into existence and to put them in working condition... The above rule of accountancy should, in our view, be adopted for determining the actual cost of the assets in the absence of any statutory definition or other indication to the contrary.

Further, section 208 of the Companies Act, 1956 also supports this view of capitalising the interest; indeed, fortiori if such interest is paid on money taken on loan for meeting the preliminary expenses.

Sub Section (2) of section 10 can be very befittingly entitled the 'armoury' of the assessee—the most defensive instrumentality—changing its requirements and developing new innovations according to the socio-economic horizon. This armoury of the 1922 has given rise to numerous provisions under the 1961 Act. For example, section 10(2)(iii) as it stood prior to the Amendment Act, 1939, granted the deduction of interest, when it was "not in any way dependent on the earning of profits". The Amendment Act of 1939 removed this restriction, and since then, interest on capital borrowed and employed in business or profession became deductible even though its incidence and quantum were dependent upon the earning of profits and that is the present law.

57. Section 208 deals with payment of interest on share capital in certain contingencies. Sub-Section (1) of that section reads as under:

"(1) where any shares in a company are issued for the purpose of raising money to defray the expenses of the construction of any work or building, or the provision of any plant, or which cannot be made profitable for a lengthy period, the company may—

a) pay interest on so much of that share capital as is for the time being paid up, for the period and subject to the conditions and restrictions mentioned in sub sections (2) to (7); and

b) charge the sum so paid by way of interest, to capital as part of the cost of construction of the work or building or the provision of the plant".

58. East India Industries (Madras) Ltd. v. CIT Madras 1957 31 ITR, 803, 814

59. Section 36(1)(iii) of the Income Tax Act, 1961 states:

"(iii) The amount of the interest paid in respect of capital borrowed for the purposes of the business or profession explained: Recurring subscriptions paid periodically by shareholders or subscribers in mutual benefit societies which fulfil such conditions as may be prescribed, shall be
The Supreme Court analysed the provisions of Section 10(2) (iii) in Bombay Steam Navigation Co. Ltd. v. CIT Bombay, where capital asset was purchased on a long-term credit with a stipulation for payment of interest on the unpaid balance of the price.

The Supreme Court observed:

"An agreement to pay the balance of consideration due by the amalgamated company does not in truth give rise to a loan. A loan of money undoubtedly results in a debt, but every debt does not involve a loan. Liability to pay a debt may arise from diverse sources, and a loan is only one of such sources. Every creditor who is entitled to receive a debt cannot be regarded as a lender".

Thus the Supreme Court held that a mere purchase of a capital asset on a long-term credit with an agreement for payment of interest on the unpaid balance of the price, does not amount to the borrowing of capital within the meaning of section 10(2) (iii), section 10(2)(ix) of the 1922 Act was relied upon in some cases as one of the most invulnerable deductions, but it proved to be invincible. This sub-section (ix) provided that an expenditure (not being in the natural of capital expenditure) incurred solely for the purpose of earning such profits or gains would be allowed as a deduction. It further provided that such expenditure may be on account of land revenue, local rates or municipal taxes.

In Indian Radio & Communications Co. Ltd. v. CIT the company carried on business of communication by wireless. Two other companies, owned or controlled by Imperial & International Communications Ltd also carried on business of communication by Cable. The company entered into an agreement under which...

59 contd. deemed to be capital borrowed within the meaning of this clause".

60. (1965) 56 ITR 52; AIR (1965) SC 1201

61. In the 1961 Act this provision is incorporated in section 30(b), the marginal heading to section 30 uses the words 'rent, rates, taxes'.

62. 5 ITR 270 PC, AIR (1937) PC 189
Imperial agreed to give possession of the two undertakings to the company to conduct their business in India in consideration of payment of one-half of the net profits of the company. The company claimed to deduct these one-half profits so paid to Imperial as a rent, being an expenditure (not being in the nature of capital expenditure) incurred solely for the purpose of earning profits.

Rejecting the claim of the company, the Privy Council held:

"Their Lordships do not think that there is in the present case any sufficient ground for holding that the sum in question is of the nature of a rent. It is neither described as a rent, nor does the agreement contain several of the clauses which a lease of plant of such a character would naturally contain. Circumstances of greater importance are that the sum payable may be small or great or nothing a most unusual feature in the case of rent and that it is impossible to presume or infer that the half share of profits is being paid only as rent, or as a similar payment, in consideration merely of the use of the plant... The sum is in truth made payable as part of the consideration in respect of a number of different advantages which the appellants derive from the agreement and not all of them can be shown to be of a purely temporary character. The agreement as a whole is much more like one for a joint venture for a term of years between the appellant company and the Communications Company (Imperial) than one for a lease for that period."

63.

In *In re Indian Turpentine & Resin Co.*, the question was whether additional royalty paid on company's excess profits over 15% of the capital of the company was admissible deduction by virtue of section 10(2)(ix) of 1922 Act. In its annual balance sheet this amount was not shown as profit available for distribution to the shareholders. It was to be paid for the cost of crude resin supplied in the previous year.

The Allahabad High Court held:

"The payment by way of additional royalty was not paid to the U.P. Government as 'shareholders', rather it was made on account of resin supplied, hence the additional royalty was a part of the expenditure incurred solely for the purpose of earning the profits of the company."

63. AIR (1929) All 118; 3 ITC 219
Under English law the expression "for purposes of trade" has been the subject-matter of sharp legal debate. The earliest attempt to explain the meaning of this phrase was made by Lord Davey in the case of Strong & Co. of Romsey Ltd. v. Woodfield. In this case the Railway Company claimed an allowance for losses sustained by the company, while compensating the passengers for accidents in travelling over the railways as a deduction.

Lord Davey observed:

"The words "for the purposes of trade" mean "for the purpose of enabling a person to carry on and earn profits in the trade...It is not enough that the disbursement is made in the course of, or arises out of, or is connected with the trade, or is made out of the profits of the trade. It must be made for the purpose of earning the profits".

Though the words of Lord Davey quoted above are the expression most frequently referred to, but the following words of Lord Loreburn, LC., have equal, if not greater, importance. Lord Loreburn, LC., said:

"It does not follow that if a loss is in any sense connected with the trade, it must always be allowed as a deduction; for it may be only remotely connected with the trade or it may be connected with something else quite as much as or even more than with the trade. I think only such losses can be deducted as are connected with, in the sense that they are really incidental to the trade itself. They cannot be deducted if they are mainly incidental to some other vocation or fall on the trader in some character other than that of trader".

Further, an important cautionary note came from the Lord Chancellor, Loreburn, LC., observed:

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64. 5 TC 215, H.L.
65. Ibid, 220
66. 5 TC 215, 219 (HL) this test propounded by Lord Loreburn in Strong's case was applied by the Supreme Court in Trisancore Titanium Co's case (1966) 60 ITR 277 (SC) to disallow deduction of wealth tax in computing profits.
67. Ibid, 219
"Many cases might be put near the line and no degree of ingenuity can frame a formula so precise and comprehensive as to solve at sight all the cases that may arise."

Yet another bulwark of the assessee was section 10(2)(xv) of the 1922 Act which has been reproduced in section 37(1) of the 1961 Act. Section 10(2)(xv) ran as:

"10(2) such profits or gains shall be computed after making the following allowances, namely:

• • •

(xv) any expenditure not being an allowance of the nature described in any of the clause (i) to (xiv) inclusive, and not being in the nature of 'capital expenditure or personal expenses of the assessee laid out or expended wholly and exclusively for the purpose of such business, profession or vocation".

One of the earliest cases to come up on the basis of Section 10(2)(xv) was Tata Hydro Electric Agencies Ltd. v. CIT Bombay. The Tata sons company for their services as agents to the Tata Power Co., Ltd., were entitled to a commission of 10% on the annual net profits of the Tata Power Company, and under the agency agreement, Tata sons company came under an obligation to obtain financial accommodation required for the power company. Accordingly, it raised two loans from D and S agreeing to give them each 12½% of its share of the profits earned under its agency agreement with the Power Company. Subsequently, Tata Sons Company sold its rights and interest in the agency agreement to the assessee along with its obligation to make the payments to D and S from out of the profits received from the Power Company.

The Privy Council held that though the payment of 12½% of the profits earned was one made for the purpose of business and hence deductible in the hands of Tata Sons Company, it would not be so in the hands of the assessee. The obligation to make the payments to D and S was taken over by the assessee as part of the acquisition of the business, and the payments in pursuance of such an obligation were not made, for the purpose of carrying on the trade.

68. (1937) 5 ITR 202 P.C.
In the words of Lord Macmillan, the obligation was undertaken "in consideration of the acquisition of the right and opportunity to earn the profit, that is, of the right to conduct the business and not for the purpose of producing profits in the conduct of business".

This judgment of the Privy Council in Tata Hydro-Electric Agencies Ltd. v. CIT Bombay laid down an important principle of law embedded in the words of Lord Macmillan - "in consideration of the acquisition of the right and opportunity to earn the profit" - principle of 'enduring benefit'.

The most oft-quoted decision of the Supreme Court in Assam Bengal Cement Company Ltd. v. CIT on this subject laid down the same principle of law. In this case, the question was, whether in computing the profits of the appellant the sums of Rs 5,000 and Rs 35,000 paid to the lessor by the appellant could be deducted under section 10(2)(xv) of the Act. This payment was in addition to the rents and royalties which were agreed to be paid by the lessor and was payable for obtaining a right to acquire an asset of an enduring nature which had necessarily to be incurred for initiation of the business or trading activity.

Bhagwati, J., speaking for the Supreme Court, observed:

"If the expenditure is made for acquiring or bringing into existence an asset or advantage for the enduring benefit of the business, it is properly attributable to capital, and is of the nature of capital expenditure. If one the other hand it is made not for the purpose of bringing into existence any such asset or advantage but for running the business or working it with a view to produce the profits it is a revenue expenditure".

Another very important principle of law was laid down by the Supreme Court in Eastern Investments Ltd. v. CIT, West Bengal as follows:

69. Ibid
70. (1955) 27 ITR 34 (SC)
71. Ibid, 45
72. (1951) 20 ITR 1 (SC)
If the payment or expenditure is incurred for the purposes of the trade of the assesses, it does not matter that the payment may enure incidentally for the benefit of a third party.

The facts of Eastern Investments were that the company in reducing its capital took over 50,000 shares of the face value of Rs 50,00,000 from C, a shareholder, and instead of paying him cash, issued fully paid up 5% interest debentures for Rs 50 lacs. The company claimed deduction in the relevant accounting year for the debenture interest so paid. By this process, the shareholder got a 5% return in lieu of the 3½% return on the cancelled shares.

The Supreme Court held that benefit to 'C' is irrelevant in the determination of the allowability of the debenture interest in the assessment of the company. The issue of debentures was an ordinary business method and the interest paid thereon was a deductible expenditure.

At least three important propositions were laid down by the Supreme Court in this case of Eastern Investments Ltd:

1) In order to allow an expenditure, it was not necessary to show that the expenditure was a profitable one or that in fact any profit was earned;

2) It was enough to show that the money was expended not of necessity, and with a view to a direct and immediate benefit to the trade, but voluntarily and on the ground of 'commercial expediency' and in order indirectly to facilitate the carrying on of the business.

73. Ibid
74. The sanction of the High Court for reduction of capital was obtained, and there was no suggestion of fraud. It was also found that at the time of the reduction of capital, the company had sufficient liquid resources to buy up the shares and that by the process of debenture issue, the shareholder got a 5% return in lieu of the three and half percent return on the cancelled shares.
75. Ibid
iii) Most commercial transactions are entered into for the mutual benefit of both sides, or at any rate, each side hopes to gain something for itself. But the test is not whether the other party benefited or whether the transaction was a prudent transaction yielding gain to the assessee, but whether the transaction was entered into as part of the assessee's legitimate commercial undertakings in order indirectly to facilitate the carrying on of its business.

English cases also support the test of 'facilitating the carrying on of the existing business'. This test is itself based on a broader test of 'commercial expediency'.

76. In CIT v. Birla Gwalior (P) Ltd. (1973), 89 ITR 266; AIR 1973 SC 2486 the question was whether the 'profits forgone', which were to be paid as office allowance to the company by Gwalior Rayon and Silk Manufacturing Co., Ltd., could be claimed as a deduction under section 10(2)(xv) on grounds of commercial expediency. According to the finding of the Tribunal, the managed company's financial position was not sound during the relevant accounting years. The Tribunal further found that because of the sacrifices made by the assessee-company, the finance of the managed company improved subsequently, as a result of which the assessee-company was able to earn more profits in the later years. The Supreme Court had no hesitation in allowing the 'profits forgone' on grounds of 'commercial expediency' as a deduction.

77. In an English case where three companies were jointly involved as respondents, IRC v. Patrick Thomson Ltd., (in liquidation); IRC v. J & R Allen Ltd., (in liquidation); IRC v. Pettigrew & Stephens Ltd., (1956) 37 TC 145, the respondent companies in the said cases were subsidiaries of a company called Scottish Drapery Corporation Ltd., the control of which was acquired by the House of Fraser Ltd, changes of organization which were made in accordance with the policy of the House of Fraser Ltd., involved the termination of the contracts of service of the managing directors of the respondent companies and also the eventual liquidation of those companies. Certain sums were paid by the companies to the managing directors in connection with the cancellation of their contracts, the payments being expressed in the first two cases to be in satisfaction of rights to future remuneration, and in the third to be in lieu of notice.

Upholding the findings of the Commissioners, the Lord President observed (Ibid 156) "To succeed in their contention the Crown must establish two matters. In the first place it must show that the liquidation involved a discontinuance of the trade carried on prior to it by the respondent company and the subsequent operation of a new trade carried on by House of Fraser. In the second place it must show that the expenditure in question was laid out for the purposes of the new trade".
The test of 'commercial expediency' is sometimes invincible for the assessee. In Gordon Woodroffe Leather Manufacturing Co. v. CIT, the brief facts were that the resignation of the assessee-company's director was accepted and in appreciation of his long and valuable services to the company, he was paid Rs 40,000 by the assessee-company.

Affirming the decision of the High Court, Supreme Court observed:

"In our opinion the proper test to apply in this case is; was the payment made as a matter of practice which affected the quantum of salary or was there an expectation by the employee of getting a gratuity or was the sum of money expended on the ground of commercial expediency, and in order indirectly to facilitate the carrying on of the business. But this has not been shown and therefore the amount claimed is not a deductible item under section 10(2)(xv)."

In essence, the main question had been to ascertain the true meaning of the expression 'wholly and exclusively laid out for the purpose of the trade' and more particularly with the phrase 'purposes of the trade'. It would be appropriate to analyse the English judgment in Smith's Potato Estates Ltd. v. Bolland. This was a case relating to the deduction of expenses on the preparation and prosecution of tax appeal as a trade expense.

Lord Porter while analysing the view given by Lord Davey in Strong & Co. of Romsey Ltd. v. Woodfield that "these words... appear to me to mean for the purpose of enabling a person to carry on and earn profits in the trade" considered these words as a gloss in reference to the circumstances of that case (Woodfield's case) under consideration and held...

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78. (1962) 44 ITR 551 (SC)
79. Ibid, 555
80. 30 TC 267; (1948) 2 All ER 367
81. 5 TC 215, 220
82. Ibid
"My Lords, that expression has often been referred to and approved but it was used in reference to the circumstances of the case then under consideration and I doubt if it carries the matter to a final conclusion... the adoption of a phrase helpful in analysing the meaning of the words in an Act of Parliament with reference to a particular set of circumstances is not necessarily either useful or conclusive in all cases. It is probably safer to retain the working of the Act itself and by applying it to the facts established, to discover whether the deduction falls within its terms or not...".

Viscount Simon held in Smith's Potato Estates Ltd. v. Bolland:

"Here the expenditure was in my view incurred for the purpose of carrying on and earning profits in the trade, for a reduction in the amount of tax does increase the fund in the trader's hands after tax is paid and so promotes the carrying on of the trade and the earning of trading profits. The incidental consequence that the trader is not taxed so heavily in respect of his profits from trade does not, as it seems to me, alter the fact that the litigation was wholly and exclusively undertaken for the purposes of the trade".

It is submitted that the phrase 'for the purpose of' used in section 10(2)(ix) of 1922 Act and in section 37(1) of the 1961 Act has nuances of law inherent in it. The term 'purpose' contains an ingredient of 'intention'. It is very difficult, may not be impossible, to determine this without some element of subjectivity. Indeed, in many cases the test could be wholly subjective. When deciding whether or not a solicitor is entertaining a client to lunch, the test may be wholly subjective. The solicitor is entertaining; it may be because it is an old client; it may be because it is the only opportunity to discuss the business. The Court has to decide the real purpose, if it is for the trade, vocation or profession, and whether it is independent, i.e. independent of the business purposes to be served.

83. Ibid, 285
84. Cf., Bentleys, Stokes and Lowless v. Beeson (Inspector of Taxes), 33 TC 491, 504-505
Subba Rao, J., speaking for the Supreme Court, observed in CIT v. Malayalam Plantations Ltd:

"The expression 'for the purpose of the business' is wider in scope than the expression 'for the purpose of earning profits'. Its range is wide; it may take in not only the day to day running of a business but also the rationalisation of its administration and modernization of its machinery; it may include measures for the preservation of the business and for the protection of its assets and property from expropriation, coercive process or assertion of hostile title, it may also comprehend payment of statutory dues and taxes imposed as a pre-condition to commence or for carrying on of a business; it may comprehend many other acts incidental to the carrying on of a business."

In the same vein, the following sentence also occurs, which is pertinent:

"However wide the meaning of the expression may be, its limits are implicit in it."

Several tests have been evolved over the years by the English Courts and the Supreme Court, "but the difficulty in matching them with the seeming irreconcilability are perhaps explicable only on the ground that the determination in any particular case is dependent on... the purpose for which the expenditure was incurred and such other factors as in the facts and circumstances of that case would indicate."

Amongst the several tests, the following two tests have been invoked to their maximum:

85. (1964) 53 ITR 140, 150; AIR 1964 (SC) 1722
86. This observation of the Supreme Court in Malayalam Plantations that 'limits are implicit in it' can be further analysed by a subsequent judgment of the same Court, Swadeshi Cotton Mills Co., Ltd. v. CIT (1967) 63 ITR 65. The assessee-company cancelled a contract to purchase machineries due to high prices, and thus wriggled out of the contract. Accordingly, compensation was paid to the suppliers. The company claimed the amount as deduction under section 10(2)(xv). The Supreme Court held: "The payment was, therefore, made to avoid a larger capital expenditure that would not have served the interests of the appellant-company. Hence it could not be claimed as a deduction.
1. Bringing into an asset or advantage of enduring nature would lead to the inference that the expenditure disbursed is of a capital nature.

But the difficulty lies that these terms, such as 'asset' or 'advantage of enduring nature' are, however, purely descriptive rather than definitive and no rule of universal application can be laid down. Ultimately the question will have to depend on the facts and circumstances of each case.

2. An item of disbursement may be regarded as of a capital nature when it is relatable to a fixed asset or capital, whereas the circulating capital or stock-in-trade would be treated as revenue receipt.

Lord Haldane in *John Smith and Sons v. Moore* has aptly and very adroitly explained the terms 'fixed capital' and 'circulating capital':

"Fixed capital is what the assessee turns into profit by keeping it in his own possession and circulating capital is what he makes profit of by parting with it and letting it change masters".

88. In *India Cement Ltd. v. CIT, Madras*, the appellant-company obtained a loan of Rs 40 lacs from the Industrial Finance Corporation by creating a charge on its fixed assets. In connection therewith the company spent a sum of Rs 84,633 towards stamp duty, registration fees, lawyer's fee and claimed this amount as business expenditure. It is important to note that money spent was to obtain a loan-secured by the creation of a charge on 'fixed assets'. It was contended that disbursement may be regarded as of a capital nature because it was relatable to fixed capital.

But the Supreme Court held that the Act of borrowing money was incidental to the carrying on of business and the loan obtained was not an asset or an advantage of enduring nature, and it was irrelevant to consider the object with which the loan was obtained.

88. 12 TC 266, 282
89. (1966) 60 ITR 52 (SC)
It is important to note that in India Cements the company, at the time of raising the loan, was a running concern. Such incidental expenses for raising the loan, before the commencement of business, would have been merely a capital expenditure.

Within two years, after the judgment in India Cements, another leading case, CIT, Bombay v. Ciba (India) Ltd came up before the Supreme Court, in which once again the revenue contended that the assessee-company obtained an advantage of enduring nature. The facts in precise were that the Ciba (India) Ltd., agreed to make the payment to its Swiss Company (Holding Company) in consideration of technical and research contribution pertaining to patents and trade marks. The Supreme Court said that the assessee did not, under the agreement, became exclusively entitled, even for the period of the agreement, to the patents and trade marks of the Swiss company; it had merely access to the technical knowledge and experience in the pharmaceutical field which the Swiss company acquired. The assessee was a mere licensee for a limited period. By making that technical knowledge available, the Swiss company "did not part with any asset of its business nor did the assessee acquire any asset or advantage of an enduring nature". Thus the payment was allowed as a deduction under section 10(2)(xv) of the Act.

In CIT, West Bengal, Calcutta v. Coal Shipment(P) Ltd payments were made to ward off competition in business. On the facts, there was no certainty of duration of advantage, neither the payments were relatable to capital value of the assets and, therefore, held to be deductible. The Supreme Court observed:

"The character of the payment can be determined, ... not by the fact whether it is a payment in a lump-sum or by instalments. It is also an accepted proposition that the words 'permanent' and 'enduring' are only relative terms.

90. It is on this basis that the Supreme Court rendered the judgment in Challapalli Sugar Mills Ltd v. CIT, Hyderabad.
91. Ibid
92. AIR(1968) SC 1131; (1968) 69 ITR 692
93. (1971) 82 ITR 902
94. (1971) 3 SCC 736, 740-741
and not synonymous with perpetual or ever-lasting".

The Supreme Court further held:

"Although an enduring benefit need not be of an everlasting character, it should not, at the same time, be so transitory and ephemeral that it can be terminated at any time at the volition of any of the parties. Any other view would have the effect of rendering the word 'enduring' to be meaningless".

Indubitably, the question whether an item of expenditure was wholly and exclusively laid out for the purpose of assessee's business must be decided on the facts of each case, but the final conclusion is one of law because it involves the interpretation of the scope and meaning of the statute.

Over and above these principles, the principle laid down by the Supreme Court in Indian Aluminium Co., Ltd. v. CIT, West Bengal is much more important. In this case the Supreme Court expressed the view that the test adopted in Travancore Titanium Product Ltd. v. CIT, Kerala, 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'.

95. CIT Bombay v. Greaves Cotton & Co., Ltd., (1968) 68 ITR 200. In this case the managing agency agreement had been terminated with the object of taking over its management by the Board of Directors and there was no evidence to lead to an inference that it was done with the oblique motive or oblique purpose of securing the payment of the said amount of Rs 17 lacs to the managing agents. The Supreme Court held in favour of the assessee. So the managing agency had not changed hands at all; rather upon its termination it was taken over by the Board of Directors.

96. (1972) 84 ITR 735 (SC)

97. (1966) 60 ITR 277 (SC); (1966) 3 SCR 321
Both these cases related to the deductibility of wealth tax paid on assets held by the assessee for the purpose of his business. It was claimed that such an amount of wealth tax could be deducted as a business expense, while computing the assessee's income from business. While in the Travancore Titanium case, the Supreme Court held in favour of the Revenue, and observed:

"The expenditure must be incidental to the business and must be necessitated or justified by commercial expediency. It must be directly and intimately connected with the business and be laid out by the taxpayer in his character as a trader. 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."

Whereas Beg, M.H.J., speaking for the Supreme Court in Indian Aluminium Co. Ltd. v. CIT, West Bengal, Calcutta held:

"On going through the provisions of wealth tax Act as well as the Income Tax Act it was not possible for me to infer that the payment of Wealth Tax must be excluded from the computation of profits under section 10, sub section (1) and (2) of the Income Tax Act. It appears to me that nothing less than express statutory provisions would justify a denial of the right to a deduction which the language of section 10, sub section 2(xv) confers upon an assessee."

It is important to note that within a few months of the decision in Indian Aluminium Company's case, the Income Tax (Amendment) Ordinance, 1972 was promulgated on July 15, 1972 to amend the Income Tax Act, 1961 in order to provide for barring the amount of Wealth Tax as a deduction in the computation.

98. Ibid
1. Ibid. It was rendered by the Supreme Court on March 29, 1972.
of total income. The Ordinance was later repealed and replaced by the Income Tax (Amendment) Act, 1972 containing similar provisions.

It is interesting and important to mention that despite this amendment, Income Tax (Amendment) Act, 1972, the Supreme Court has emphatically made it clear that the principle laid down in Indian Aluminium Company’s case is not vitiated. Gupta, A.C.J., speaking for the Supreme Court in Mitsui Steamship Co. Ltd. v. CIT, West Bengal, I. Calcutta held:

"The amendments introduced do not appear to touch the principle laid down in Indian Aluminium Company’s case that when a person has a dual capacity of a trader-cum-owner, and he pays tax in respect of property which is used for the purpose of trade, the payment must be taken to be in the capacity of a trader".

**METHOD OF ACCOUNTING**

Section 13 of the Income Tax Act 1922 laid down that the income shall be computed in accordance with the method of accounting regularly employed by the assessee. Perhaps the first case on

1A. It related to certain assessment years prior to the assessment year 1962-63.

2. The Amendment Act, as the statement of Objects and Reasons said, the position established in the case of Travancore Titanium Products Ltd. v. CIT (1966) 60 ITR 277 (SC) which was virtually overruled by the later decision in Indian Aluminium Co. Ltd. v. CIT (1972) 84 ITR 735, has been restored. A new sub-clause (iia) in clause (a) of section 40 of the 1961 Act was inserted. It is important to note that to this sub-clause an Explanation was added extending the meaning of the expression ‘wealth tax’ for the purposes of this sub-clause, by virtue of the words ‘or any tax of a similar character chargeable under any law in force in any country outside India’.

3. Ibid

4. (1975) 99 ITR 7 (SC); AIR (1975) (SC) 657

5. Section 13 ran as:
"Income, Profits and gains shall be computed for the purposes of sections 10, 11 and 12 in accordance with the method of accounting regularly employed by the assessee; Provided that, if no method of accounting has been regularly employed, or if the method employed is such that in the opinion of the Income Tax Officer, the income, profits and gains cannot properly be deduced therefrom then the computation shall be made upon such basis and in such manner as the Income Tax Officer may determine".
this subject was CIT v. Ahmedabad New Cotton Mills Co. Ltd. The facts were that the assessee in returning their income for the year ending with 31st December, 1925, put in a profit and loss account and a balance sheet, wherein their opening and closing stock for the year were written down at an under-valuation, the valuation of the opening stock at the beginning of the year corresponding with the value of the closing stock at the end of the previous year. The Income Tax Officer on inquiry found that the closing stock was grossly undervalued and valuing the same at its true value made an assessment accordingly declining to revalue the opening stock accordingly. The case went ultimately in appeal to the Privy Council from the Bombay High Court.

Lord Buckmaster of the Privy Council held:

"The method of introducing stock into each side of a profit and loss account for the purpose of determining the annual profits is a method well understood in commercial circles and does not necessarily depend upon exact trade valuations being given to each article of stock that is so introduced... If the method of altering both valuations is not adopted, it is perfectly plain that the profit which is brought forward is not the real one... when, therefore, there is undervaluation at one end, the effect is to cause both a smaller debit in respect of the stock introduced into the next account and a larger sum for profits realised by the sale, change in market values being immediately reflected in the price obtained for the goods that are sold; in these circumstances to contend that there should be undervaluation at one end and not at the other is to raise an argument which their Lordships cannot accept."

6. AIR (1930) PC 56
7. The justification for the gross undervaluation given by the assessee was that for the last several years, undervaluing the stock continued, not with the object of evading any Income Tax but to safeguard against all heavy fluctuations in the market, and have thereby a special reserve, enabling the company to equalise the dividends which it would otherwise be unable to do.
8. Ibid, 57
The importance of the words 'method of accounting regularly employed' was illustrated in the House of Lords judgment in *Ostime v. Duple Motor Bodies Ltd*.

The facts were that the tax-payer was a company producing motor vehicle bodies to order. The unfinished bodies were valued by the assessees on the 'direct cost' for a long period, and being so accepted by the Inland Revenue, in the assessment year 1951-52, the Inland Revenue desired to change the system of accounting from the 'direct cost' method to the 'on-cost' method. By the application of the direct cost method, the value of the work in progress was £2,000 less at the end of the year than at the beginning, while the employment of the on-cost method would result in the value being £14,000 more.

The House of Lords rejected the 'on-cost method' for two reasons:

1) that the 'direct-cost method' had been applied by the Indian Revenue since 1924 and the department had not discharged the burden of showing good reasons for the change, and,

2) that the on-cost method was something remote from common sense as it sought to give an inflated value to the work in progress, because a dump in trade has reduced the number of articles between which over-head costs can be apportioned.

In this judgment of House of Lords, *Ostime v. Duple Motor Bodies Ltd*, something much more important was also laid down as a principle. Though the method 'cost or market, whichever is lower' runs counter to the cardinal principle of Revenue Law that no loss should be entered in the year of account, unless the loss has been actually realised and suffered—no loss may be anticipated. Nevertheless, this departure has been generally recognised in accountancy practice and has the sanction of custom behind it,

9. (1961) 2 ALL ER 167 (HL)
10. This was due to the fact that a higher proportion of the overheads were attributed to work in progress at the end of the year than at the beginning, owing to a slackening of business during the year, and consequential increased cost of production.
11. Ibid
and Courts of law have upheld the practice though it is illogical.

This system of accounting was to be analysed by the Supreme Court in *Sir Kikabhai Premchand v. CIT, Bombay*. The facts were that the assessee was a dealer in bullion and shares and he withdrew some of the bullion and shares from his business and settled them on trust for the use of certain beneficiaries including his wife, to himself after her life, with ultimate destination to charity after certain other intervening interests. He maintained his accounts on cost basis and credited his business with the cost of the bullion and the shares transferred from the business.

The Supreme Court by a majority (Bhagwat,J., dissenting) held that the method adopted by the assessee to enter cost, not market price, was correct. Bose, J., who spoke for the majority, remarked that he was deciding the case 'a priori', there being 'no case quite in point'.

It is pertinent to quote the observations of Bhagwat,J., on this method of accounting. The learned judge observed:

"The ultimate result of these operations so far as the asset itself is concerned would be no different. Because, if regard be had to the various fluctuations in the market value which have been reflected in the accounts of the intermediate period, what the business actually gains or loses would be the difference between the cost price of the asset when it was brought in and the price at which it was sold, when it was actually realised. The only advantage which the assessee obtains would be that he would be able to anticipate in a particular year the loss that may be made on the asset in the following year or years, which however might have to be rectified in the following year or years if the prices rose again...".

It is submitted that this method of accounting 'cost or market, whichever is lower' is not free from doubts, since rectifications would have to be made in the result of the trading of the previous year, which itself may lead to 'tax evasion' tendency.

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12. Ibid, 173. This system 'cost or market, whichever is lower' is also known as 'market when it is below cost'.

13. (1953) 24 ITR 506, SC

14. Ibid, 511
It is further submitted that the dissenting judgment delivered by Bhagwati, J., places the correct position on the point.

SCOPE OF SECTION 24, SETTING OFF OF LOSSES

The concept of carry forward and set off of losses was examined by the Supreme Court in CIT, Delhi v. Har Prasad & Co (P) Ltd. Sarkaria, R.S.J., speaking for the Supreme Court held:

"The concept of carry forward of loss does not stand in vacuo. It involves the notion of set-off. Its sole purpose is to set-off the loss against the profits of a subsequent year. It presupposes the permissibility and possibility of the carried-forward loss being absorbed or set-off against the profits and gains, if any, of the subsequent year. Set-off implies that the tax is exigible and the assessee wants to adjust the loss against profits to reduce the tax-demand. It follows that if such set-off is not permissible or possible, owing to the income or profits of the subsequent year being from a non-taxable source, there would be no point in allowing the loss to be carried forward. Conversely, if the loss arising in the previous year was under a head not chargeable to tax, it could not be allowed to be carried forward and absorbed against income in a subsequent year, from a taxable source."

The facts in precise in this case, CIT, Delhi v. M/s Harorasad & Co.(P) Ltd., were that the capital loss of Rs 28,662 sustained in September, 1953, that is in the previous year 1953-54 was claimed to be carried forward and set-off against future 'capital gains'. It is important to note that 'capital gains' arising between 1.4.1948 and 31.3.1956 were not taxable as a result of which the capital loss related to that period, which was not allowed to be carried forward.

Some very important questions arose regarding set-off of losses under the 1922 Act, for example:

15. (1975) 99 ITR 118 (SC); AIR (1975) SC 1282, per three judges bench, Chandrachud, Y.B., Sarkaria, R.S.J., and Gupta, A.C.J.
(1) setting-off of losses of one business against the profits of another business;
(2) setting-off of speculative losses; determining the genesis of the speculative transaction itself;
(3) setting-off of unabsorbed depreciation allowance;
(4) setting-off of losses where the return showing losses not filed.

The material part for the question no.(1) which has been stated above, of section 24 ran as:

"Section 24(2)(ii):
Where the loss was sustained by him in any other business, profession or vocation, it shall be set-off against the profits and gains, if any, of any business, profession or vocation carried on by him in that year; provided that the business, profession or vocation in which the loss was originally sustained continued to be carried on by him in that year".

The leading pronouncement on this subject was in Setabganj Sugar Mills Ltd., v. CIT, Calcutta.

The Supreme Court observed:

"In order to determine whether different ventures can be said to constitute the same business what one has to see is whether there was any interconnection, any interlacing, any interdependence, any unity embracing the ventures, whether the different ventures were so interlaced and dovetailed into each other, so as to make them into the same business. These principles have to be applied to the facts before a legal inference can be drawn, that a particular business is composed of separate businesses and is not the same one. No doubt, findings of fact are involved, because a variety of matters bearing on the unity of the business have to be investigated, such as unity of control and management, conduct of the business through the same agency, the inter-relation of the businesses, the employment of the same staff to run the business, the nature of the different transactions, the possibility of one being closed without affecting the texture of the other and so forth. When, however, the true facts have been determined, the ultimate conclusion is a legal inference from proved facts, and it is one of mixed law and fact, on which depends the application of section 24(2) of the Income Tax Act 1922".
Though the Supreme Court laid down a series of tests in the above-mentioned case of Setabganj Sugar Mills, but as regards this test—'the possibility of one being closed without affecting the texture of the other', came up for consideration before the Supreme Court in Hoochly Trust Ltd. v. CIT, wherein this test was held not to be a decisive test in determining whether the two businesses constitute the same business. If one of the two activities cannot be stopped without affecting the framework of the other, it would be a good (though not conclusive) indication that they constitute the same business; but the converse is not true, and the possibility of stopping one without affecting the other is not an indication that they are different businesses.

In essence, the bottom-rock of the decisions on this subject remains the celebrated dictum of Rowlatt, J., in Scales v. George Thompson & Co., Ltd which is as follows:

"Was there any inter-connection, any inter-lacing, any inter-dependence and unity at all, embracing those two businesses?"

In Kirk and Randall Ltd. v. Dunn, the question involved was of setting off losses, as the business remained inactive for many years. The facts were that the assessee company persisted in seeking for the business, but they could not get it. The directors and other secretarial staff drew their fees etc. The directors continued their efforts and they did get something.
Rowatt, J., came to this conclusion that the company carried on business during the relevant period, and such finding arrived at on the basis of the relevant facts was not a finding of a pure fact but an inference of law drawn from specific facts.

The House of Lords had, more or less, with the same nature of facts, the question of set-off of losses during the period of inactivity of business in the case of *CIR v. South Behar Railway Co., Ltd.* Lord Sumner referred to the activities of the company as follows:

"It is obvious that the company’s objects have by no means been accomplished. It is obvious too, that during its present period of dormant life it has very little to do. I do not attach much importance to the domestic operations of declaring and paying dividends, remunerating directors and presenting reports, but the operation of receiving and thus discharging the annuity payments goes on continuously, and however simple, it is not a mere passive acquiescence. It is the transaction of business between debtor and creditor resulting periodically in the discharge of a debt... The important thing is that the old business still continues of getting some return for capital embarked in the line...".

Based on these facts, the learned Law Lord observed:

"Business is not confined to being busy; in many businesses long intervals of inactivity occur... Indeed, I do not think there has been much change. The concern is still a going concern though a very quiet one".

The language of section 24(2)(ii) which granted the carry forward and set-off against any income from the 'same business' was dropped by virtue of the Finance Act, 1955. Hence, the case law on the expression 'same business' is just of academic value under the 1961 Act.

22. *Ibid*, 711-12
23. *Ibid*, 711-12
24. Section 72(2)(ii)(a) runs as:

"(a) it shall be set off against the profits and gains, if any, of that business or any other business carried on by him and assessable for that assessment year " Formerly, the carry forward was confined to six consecutive assessment years; but the period of 8 years was introduced by the Finance Act, 1957 w.e.f. 1.4.1957.
The material part of Section 24 of the question No.,(11)
which has been aforementioned, ran as:

"Section 24(1):...
Provided that in computing the profits and gains
chargeable under the head 'profits and gains of business,
profession or vocation', any loss sustained in
speculative transactions which are in the nature of a
business shall not be taken into account except to the
extent of the amount of profits and gains, if any,
in any other business consisting of speculative
transactions...".

Explanation 1:
Where the speculative transactions carried on
are of such a nature as to constitute a business, the
business shall be deemed to be distinct and separate
from any other business.

Explanation 2:
A speculative transaction means a transaction in
which a contract for purchase and sale of any commodity
including stocks and shares is periodically or
ultimately settled otherwise than by the actual delivery
or transfer of the commodity or scrips.

1) where the loss was sustained by him in a
business consisting of speculative transactions, it
shall be set-off only against the profits and gains,
if any, of any business in speculative transactions
carried on by him in that year;

..."

One of the cases on this subject of 'speculative losses',
quite often referred to, Raghunath Prasad Poddar v. CIT, Calcutta.
The facts of this case were that the company dealing, interalia,
in jute and jute goods, claimed Rs 35,578, Rs 20,665 and
Rs 3,849 as losses in its business in the sale and purchase of
gunny bags, for the assessment years 1957-58, 59-60 and 60-61
respectively. The Income Tax Officer treated these losses as
speculative losses, because the contracts in respect of the gunny

25. (1973) 90 ITR 140 (SC); AIR 1973 SC 2061
26. The entire scheme of set-off and carry forward, either
under the 1922 or 1961 Act being, 'speculative business'
distinct and separate from other businesses, losses
arising out of speculative business could be set-off
only against the profits of speculative business.
bags said to have been sold were settled only by delivery of 'pucca delivery orders' and not by actual delivery of the goods covered by those documents.

The Calcutta High Court, following its decision in Nanalal N. Varma and Co. v. CIT answered the question in favour of the department. The Supreme Court converged the whole issue, and that too very succinctly on the meaning and scope of the words "periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity" in Explanation 2 to section 24(1) of the 1922 Act. The Supreme Court agreed with the contention of the assessee that Nanalal Varma's case was not correctly decided by the Calcutta High Court.

Hegde, K.S.J., speaking for the Supreme Court, observed:

"In our judgment to effect a valid transfer of any commodity, it is not necessary that the transfer in question should be followed up by actual delivery of the goods to the transferee. Even if the goods are delivered to the transferee's transferee, the first transfer also will be a valid transfer".

According to the appellants in Poddar's case, the traditional practice of the transactions in jute or jute gunny bags are usually conducted in Calcutta in the following manner:

"Even transfer of a P.D.O. results in a sale though at the time the intermediate sales take place the title to goods sold is defective for want of delivery of the goods. That title gets perfected as soon as the goods sold are actually delivered".

It would be pertinent to mention the view expressed by the Supreme Court in Rayyana Bhavya v. Government of Andhra Pradesh. Hidayatullah, J., (as he then was) speaking for the

27. (1969) 73 ITR 713 (Cal). Surprisingly enough, an year earlier in CIT v. Pioneer Trading Co., Ltd. (1968) 70 ITR 347, the Calcutta High Court holding in favour of the assessee observed that compensation received for breach of a contract of sale is not receipt from a speculative transaction, the additional reason which justifies this conclusion is that it is not a case of a contract 'settled', which is a requirement of the section 24.

28. (1961) 3 SCR 267, 270. It was a case pertaining to Sales Tax.
Supreme Court, observed:

"A delivery order is a document of title to goods (vide section 2(4) of the Sale of Goods Act), and the possessor of such a document has the right not only to receive the goods but also to transfer it to another by endorsement or delivery..."

On the other hand, as contended for the Revenue, that the property in goods represented by a PDO cannot be said to pass until the actual delivery takes place, in view of Section 18 of the Sale of Goods Act. The Court did not accept this contention. The Supreme Court held that the principle laid down in Butterworth v. Kingsway Motors Ltd., which was the basis of the decision of that Court in Bavvanna Bhimayya's case would equally apply to the facts of this case of Raghunath Poddar. The Court in Bavvanna Bhimayya's case upholding the levy of sales tax on the grounds that though the title to the goods sold did not pass when the delivery order passed from one intermediate dealer to another intermediate dealer, yet those transactions became sales of goods as soon as the goods were actually delivered to the last buyer of the 'delivery order', on the principle of 'feeding back the title'. The Court held that the title acquired by the last purchaser went to feed the previous defective titles obtained by the previous buyers. Consequently, every transfer of the 'delivery orders' became a 'sale' within the meaning of section 3 of the Madras General Sales Tax Act, 1939.

Though the Supreme Court, while deciding Raghunath Poddar's case disapproved Nanalal Varma's case, a decision of the Calcutta High Court, and thus laid down the correct law, but surprisingly enough the Supreme Court, within two years changed its opinion on this vital concept of 'speculative transactions'- vital for the business community. Overruling Raghunath Poddar's decision, the

29. (1954) 2 All ER 694
30. Ibid
31. Ibid
32. Ibid
Court in *Davenport & Co. Ltd. v. CIT* affirmed the following observations of the Calcutta High Court in *D.M. Wadhawa v. CIT*:

"The explanation to section 24(1), however, does not prevent persons from entering into contracts in which the buyers and sellers may not actually hand over the goods physically. The explanation is only designed at aggregating for income-tax purposes loss sustained in transactions of a certain kind. It may be that such transactions are not speculative in the light of Section 30 of the contract Act... In enacting the explanation 2 to section 24(1) of the Income Tax Act, the legislature did not intend to affect any transaction of sale wherein the goods were not physically delivered by the seller to the buyer, but only laid down that if there was no actual or physical delivery, the loss, if any, would be a loss in a speculative transaction which could be allowed to be set off only against a profit in a transaction of the same nature... The object of the explanation is not to invalidate the transaction which are not completed by actual delivery of the goods but only to brand them as speculative transactions so as to put them in a special category for income-tax purposes".

It is important at this stage to examine the facts of *Davenport & Co. v. CIT, West Bengal*. The assessee-company, a private limited company, was carrying on business in tea garden tools and requisites and also acting as agents for selling tea; in fact the bulk of its income was from selling commission on tea. The assessee for the first time in its history entered into certain transactions in jute, in the relevant previous year ending on June 30, 1958. The goods were in the godown of the mills and only the delivery orders addressed to the mills changed hands. On June 18, 1958 the assessee entered into a contract with M/s Lachminarain Kanoria & Co, and this transaction resulted in a loss of Rs 98,534 to the assessee.

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33. (1975) 100 ITR 715; Gupta, J., gave the judgment of the Supreme Court comprising a three judge bench (Krishnaley, J., and Sarkaria, J., concurring) affirming D.M. Wadhawa v. CIT (1966) 61 ITR 154

34. Ibid
It is important to note that while overruling Raahunath Prasad Poddar's case, no substantial reasoning to divert from that judgment was adduced, except to rely upon the observations of the Calcutta High Court in D.M. Wadhawa v. CIT aforementioned.

It is submitted that Davenport & Co. Ltd. v. CIT was erroneously decided. The concept of 'actual delivery' and of 'periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity' was correctly laid down in Raahunath Poddar's case.

Turning to the last question no. (iv)—setting off of losses where the return showing losses were not filed; there was no separate provision in the Income Tax Act, 1922 on this point; of course, section 80 of the Income Tax Act, 1961 deals separately with filing of return of loss.

The law relating to the filing of a return of loss underwent substantial changes in 1953 under the Income Tax Act, 1922 when the provisions of sub-section (2A) were inserted in section 22.

35. Ibid
36. (1966) 61 ITR 154
37. Ibid
38. Ibid
39. Answer to the third question has been discussed already under the heading 'statutory deductions'.
40. Section 22(2A) provided as under:
"If any person who has not been served with a notice under sub section (2) has sustained a loss of profits or gains in any year under the head 'profits and gains of business, profession or vocation', and such loss or any part thereof, would ordinarily have been carried forward under sub-section (2) of section 24, he shall, if he is to be entitled to the benefit of carry forward of the loss in any subsequent assessment, furnish within the time specified in the general notice given under sub-section (1) or within such further time as the ITO in any case may allow, all the particulars required under the prescribed form of return of total income and total world income in the same manner as he would have furnished a return under sub-section (1) had his income exceeded the maximum amount not liable to income tax in his case and all the provisions of the Act shall apply as if it were a return under sub-section (1)".
The leading pronouncement of the Supreme Court on this subject remains the case of CIT v. Kulu Valley Transport Co (Pvt.) Ltd. The question involved in this case was whether in a case of a voluntary return in which the loss has been shown and determined, the ITO can decline to give the benefit under section 24(2) to carry forward the loss on the ground that the assessee did not comply with the provisions of section 22(2A) of the Act. In other words, could the assessee take advantage of the provisions of Section 22(3) and claim that he filed a voluntary return before any assessment has been made.

The argument on behalf of the assessee was:

"That section 24(2) confers the right to carry forward the loss to the following year provided the conditions contained in the sub-section are satisfied. There is no further requirement that has to be fulfilled so far as the substantive law is concerned. Section 22(2A) is merely a procedural provision and it also provides that once a return has been furnished in accordance therewith, all the provisions of the Act become applicable as if it were a return under sub-section (1). That would attract section 22(3) and, therefore, a voluntary return can be filed even after the period mentioned in sub-section (2A) has expired so long as the assessment has not taken place".

Accepting these arguments on behalf of the assessee, the Supreme Court pointed out:

"...supposing a return is filed showing income, but the ITO in the assessment proceedings holds that there has been a loss and the assessee was mistaken in showing a profit, the assessee in such circumstances can certainly claim the benefit of section 24(2). If that is possible, there is no reason or justification for holding that, although he could claim the benefit of section 24(2) by filing a voluntary return in the given illustration, he would be deprived of that benefit if he filed a return voluntarily showing a loss except in compliance with section 22(2A)...."

In the following words lies the essence of the Supreme Court's decision in Kulu Valley Transport Company's case.

41. (1970) 77 ITR 518 (SC)
42. Ibid, 527
43. Ibid, 527
"It is well settled by now that a return can always be filed at any time before the assessment is made. The ITO has to make the assessment on that return and he could not choose to ignore it..."

But the precursor to the provisions of section 139 or certain provisions of the scheme of set off and carry forward for example, section 80 under the 1961 Act, was the Bombay High Court's judgment in *Ranchhodadas Karsondas v. CIT*, wherein the Court observed:

"The return filed voluntarily by the assessee of the loss incurred by him must be regarded as a valid return for all purposes of assessment and the ITO is statutorily bound to assess the quantum of loss for the purpose of its set off and carry forward under the law".

This view of the Bombay High Court was affirmed by the Supreme Court in *CIT v. Ranchhodadas Karsondas*.

Another important precursor to section 79(a) of the 1961 Act had been the recommendations made by the Taxation Enquiry Commission, popularly known as Mathai Commission, 1953-54. It had been the practice of buying of losses in a company to reduce the incoming shareholder's tax liability. This malpractice was stated in the following words:

"Set off of carried forward losses incurred by a company; A company has a legal status, separate from its shareholders, which remains intact although the

44. (1954) 26 ITR 105
45. (1959) 36 ITR 569
Section 79(a) of the 1961 Act runs as:

"Where a change in shareholding has taken place in a previous year in a company in which public are not substantially interested, no loss incurred in any year prior to the previous year shall be carried forward and set off against the income of the previous year unless a) on the last day of the previous year the shares of the company carrying not less than 51% of the voting power were beneficially held by persons who beneficially held shares of the company carrying not less than 51% of the voting power on the last day of the year or years in which the loss was incurred".
shareholders may go on changing from year to year. It is thus possible for a few persons to acquire the shares of companies, which have sustained losses in earlier years, and then commence to carry on profitable business through such companies; they will, in this way, be able to reduce their tax liability, through securing set-off of losses of earlier years made when the shares in the company were held by different shareholders. It has been suggested in order to safeguard revenue against loss arising from transactions of the kind mentioned above, that the set-off of loss against subsequent profits of companies should be allowed only if the shareholders in the year when income is earned are substantially the same as those in the year when loss occurs.

We think there is justification for enacting a provision of this nature. We, therefore, accept the suggestion, subject to the condition that its application should be restricted to companies in which the public are not substantially interested".

EXCESS PROFITS TAX ACT, 1940

The Excess Profits Tax was in force for a period of one year during 1919. It was enacted to mop off the abnormal profit arising to assesses from out of World War I. When World War II broke out, the previous experience gained in World War I dictated an enactment of a similar measure, and accordingly, the Excess Profits Tax Act, 1940 was enacted so as to apply to profits made by businesses during the period commencing 1st September, 1939, when the War broke out and ending 31st March, 1946, when peace was signed.

The object of the enactment was to abstract from businesses a substantial percentage of their excess profits—the excess being the excess of profits made during the war years over the normal or 'standard profits'. This normal or standard profit was fixed at a minimum of Rs 36,000.

The term 'business' as defined in section 2(5) of the Excess Profits Tax Act included, amongst others, any trade, commerce or manufacture or any adventure in the nature of trade, commerce or manufacture. As a matter of fact, the first part of the definition of 'business' in the Excess Profits Tax Act was the same as the definition of 'business' in section 2(4) of the Income Tax Act, 1922.
As mentioned in the preceding paragraph, the object of the Excess Profits Tax Act was to tax profits of a business, when they overflow a certain level. The level was determined as follows:

A certain period, called the 'standard period' was taken, for which the capital employed and the profits for that period were ascertained. These two factors were taken to be the standard parameters, for 'capital employed' and the 'standard profits'. Then the capital actually employed in the business during the chargeable accounting period was ascertained. If that capital would be the same as employed in the standard period, than there could be no further addition or deletion out of the standard profits; but if the capital employed was more or less, then the standard profits could be increased, or reduced proportionately.

It was this distinguishing feature of the Excess Profits Tax Act, 1940; with this machination it became one of the most important and arduous tasks in the ascertainment of taxable profits under the Act. The most crucial differentiating aspect was, that whereas a deduction under section 10 of the Income Tax Act was claimed by the assessee having the effect of reducing the taxable profits; under rule 2 of schedule II to the Excess Profits Tax Act, 1940 the deduction was claimed by the department having the effect of enhancing the liability of the assessee by reducing the capital under Rule 1.

It is with these cobwebs, that the machinations of Excess Profits Tax Act were seriously noticed by the Supreme Court in Commissioner, Excess Profits Tax, West Bengal v. Ruby General

47. That certain level was known as 'standard' profit fixed at a minimum of Rs 36,000
49. Though the Excess Profits Tax Act, 1940 was, in essence, a 'War Tax', so to say, but its concept as regards the 'capital employed' and then ascertaining the 'chargeable profits' has been retained subsequently in the super Profits Tax Act, 1963 and then finally in the companies (Profits) Sur Tax Act, 1964, which has created by now a permanent berth for it in the direct tax code.
"It will be quite unsafe to adopt the principles laid down for the purpose of assessing business profits under the Income Tax Act to a determination of the question of the capital employed under the Excess Profits Tax Act".

In CEPT, West Bengal v. Ruby General Insurance Co. Ltd., the question was, whether the sums set apart in a particular year as 'reserve' for unexpired risks was liable to be deducted under rule 2 of schedule II to the Act, from out of the capital employed in business for that year, which included the sums received as premiums.

The Supreme Court held:

"When a deduction is claimed under rule 2, what has to be seen is whether the obligation is such that it could be regarded as an asset used in the business, such as could conceivably contribute to its profits. If that is not established, then it cannot be included as capital under Rule 1 and cannot be deducted therefrom under rule 2 as an 'accruing liability'. The liability in question cannot be held to be of the character contemplated by Rule 2. It cannot be said that the 'reserve' for unexpired risk was like borrowed money and debt, part of the real trading assets of the business".

The line of reasoning propounded by the Supreme Court would be more clear with the following passage of the Court:

"The reserve liability could not factually be said to have contributed to the running of the business or the earning of profits. It was something in the air, and could have had no effect in the working of the concern, during the chargeable accounting period. It cannot therefore be held to be an 'accruing liability' within Rule 2 of Schedule II to the Act".

In other words, the claim of the department to consider the 'reserve' for unexpired risks as 'accruing liability' was rejected.

'Excess Profits', as the name itself implies, was a part of the profits itself- a part which was to be deducted in arriving

50. AIR (1957) SC 669; (1957) 32 ITR 82
51. Ibid
at the net profits, that is to say, the divisible profits. The 'net profits' mean the divisible profits and are to be ascertained after deduction of excess profit tax.

The Supreme Court had to decide a similar question in British India Corporation Ltd. v. CIT, U.P. The assessee was a public limited company having several branches and subsidiary companies. The Board of Directors looked after its business. The branches of the company were looked after by managers who were members of the Board of Directors. For a long time and even before the Act came into force, the Corporation had been remunerating its directors, including the managing director and branch managers, by way of commission based on a certain fixed percentage of its 'net audited profits'. This commission was in addition to the director's fees or stipulated monthly salary.

On July 27, 1940, the Excess Profits Tax Bill received the assent of the Governor-General. Thereafter, on July 27, 1940 the phrase 'including provision for taxation' was further clarified by a resolution of the Corporation (the previous resolution was that commission on profits would be payable after depreciation had been allowed for but prior to any appropriation of such profits including provision for taxation) to cover all forms of taxation including the Excess Profits Tax and other like impositions.

The corporation paid the commission of the nature under consideration even before the Act came into force, and such commission was being allowed in its entirety for purposes of computing profits under Section 10 of the Income Tax Act, 1922. Though this was so under the Income Tax Act, the Excess Profits Tax Officer on the facts of the case and having regard to rule 12 of the Schedule to the Act, took the view that since the commission in the respective chargeable accounting periods were paid out of the profits which could not be retained by the corporation, a portion of the commission attributable to the Excess Profits Tax

52. CIT v. Delhi Flour Mills Co., Ltd. (1959) 35 ITR 15
53. (1972) 87 ITR 436 (SC)
Act earned in the peculiar circumstances of a national calamity was not 'reasonable and necessary' within the meaning of the said rule.

Rule 12(1) of schedule I, which was relevant, was as follows:

"(1) In computing the profits of any chargeable accounting period no deduction shall be allowed in respect of expenses in excess of the amount which the Excess Profits Tax Officer considers reasonable and necessary having regard to the requirements of the business and, in the case of director's fees or other payments for services, to the actual services rendered by the person concerned:

Provided that no disallowance under this rule shall be made by the Excess Profits Tax Officer unless he has obtained the prior authority of the Commissioner of Excess Profits Tax".

The Supreme Court explained the object of this rule 12, Schedule I. Jaganmohan Reddy, J., speaking for the Supreme Court observed:

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54. (1972) 87 ITR 436 (SC). In this Supreme Court case, British India Corporation Ltd. v. CIT, U.P. it comprised a bench of three judges, Hegde, J., Reddy, J., and Dua, J.

The Court referred to one of its earlier judgments on the point, Ahmedabad Manufacturing and Calico Printing Co. v. CEPT (1960) 38 ITR 675. This was a case where the question was whether in determining the profits on which the percentage had to be determined for payment of bonus to five of its employees and the contribution to provident funds of 53 employees, deduction of depreciation, Income Tax and Super Tax in respect of the first category and deduction of income-tax or excess profits tax in respect of the second category could be made before arriving at the profits.

The Excess Profits Tax Officer came to the conclusion that the payments were unnecessarily large and unreasonable having regard to the requirements of the business and without taking up each individual case he held, applying rule 12, that it was not necessary for the assessee-company for the purpose of its business to calculate the bonus or the contribution on that basis of net profits before the deduction of excess profits tax. He, accordingly, disallowed the excess of the payment calculated without deduction of that tax.

In upholding the disallowance, the Supreme Court held that there was material on which the Excess Profits Tax Officer could arrive at a finding and on which the Tribunal could confirm that finding.
"This rule is designed to prevent the dissipation of the excess profits by inflating expenditure which has no relation to the requirements of the business. The test is, whether the expenditure is unreasonable and unnecessary having regard to the requirements of the business and in the case of director's fees or other payments for services to the actual services rendered. There is of course no reference in this rule to commercial expediency or commercial practice in considering whether an expenditure is unreasonable and unnecessary having regard to the requirements of the business. But, that is another way of saying that all relevant factors must be taken into consideration by the Excess Profits Tax Officer in considering whether that expenditure is reasonable and necessary. What it means is that the Excess Profits Tax Officer could not apply the rule to increases that can be justified on ordinary commercial principles because an increase in profits may in certain cases be due to increase in the activity of the management or increase in the establishment justifying a corresponding increase in the expenditure".

The following passage extracted from the judgment in this case of British India Corporation Ltd. v. CIT exhibits conceptual analysis on the mechanism of Excess Profits Tax Act, 1940.

"It is obvious that when huge profits are earned not due to any activity of the managers but due to war situation, the Government is entitled to a certain share of the Excess Profits computed under the Act. Any commission paid on the excess profits for which the managers or employees made no sort of contribution would ex facie be unreasonable and unnecessary and the Excess Profits Tax Officer was perfectly justified...".

54contd. The Excess Profits Tax Officer gave sufficient reasons for disallowing the amounts, which was affirmed as follows:

"As a result of war conditions the profits of the corporation have gone up tremendously from about Rs 10 lacs in the pre-war period to about Rs 2 crores during the relevant chargeable accounting period and the commission to management on the basis of net profits has risen in the same proportion. Since the Excess Profits Tax, which is intended to prevent the owner of a business from making a large fortune out of what is a national danger, is not deducted out of net profits in calculating commission, 'an employee stands to benefit from the national emergency to a greater extent than an employer' (Walchand & Co., Ltd. v. Hindustan Construction Company Ltd. (1944) 12 ITR 104). It, therefore, appears both unnecessary and unreasonable to pay more than the agreed proportion of the profits after deduction of Excess Profits Tax".

55. Ibid
It is significant to note that the general principles of the Income Tax Act, 1922, were made equally applicable to the Excess Profits Tax Act, 1940. Moreover, some of the provisions under the Income Tax Act, 1961 owe their genesis to the Excess Profits Tax Act, for example, section 40(c) of the 1961 Act has the semblance of Rule 12 of Schedule 1 of the Excess Profits Tax Act, 1940.

The Supreme Court based its judgment in the case of CEPT v. Lakshmi Silk Mills Ltd on the general principles of the law of Income Tax. The assessee-company was a manufacturer of Cotton

Narottam Moraji & Co. v. CEPT (1977) 109 ITR, 69. In this case theassessee firm was the managing agents of a shipping company. Under the terms of managing agency agreement the assessee was entitled to 10% of the net profits of the company. Ships belonging to the company were requisitioned by the government during the Second World War. The terms of compensation were not settled but it was clearly understood between the parties that the government would pay the additional amounts.

The quantum of the additional dues were finally determined in the year 1947-48, but the chargeable accounting period of the Shipping Company ended on 31 March, 1946, by virtue of section 2(9) of the Act. The assessee contended that irrespective of the position qua the managed company, the order of enhancement was not valid, as the profits accrued subsequent to the chargeable accounting period. The High Court held:

"Right from the inception it was anticipated both by the managed company as well as the assessee that the quantum of commission payable to the assessee was not the final figure but was subject to adjustment depending upon the future payments that may be received from the government by the managed company. If the net profits of the managed company were adjusted in view of future receipts from the government, then automatically a right accrued to the assessee under the terms of the managing agency agreement to ask for additional amounts."

Section 40(c) states that in the case of a company-

i) any expenditure which results in the provision of any remuneration or benefit or amenity to a director or a substantial-interest holder, or

ii) any expenditure or allowance in respect of any assets of the company used by the director or a substantial-interest holder for his own purposes is excessive or unreasonable having regard to the legitimate business needs of the company, then so much of such expenditures shall not be deducted.

(1951) 20 ITR 451; AIR 1951 SC 454
Textiles and Silk cloth. Part of its business consisted in dyeing of silk yarn. Since it had no quota for silk yarn during the war, its dyeing plant remained idle. Consequently, it let out the dyeing plant at a monthly rental.

The question for determination was, whether rental income from machinery let out would be chargeable to excess profits tax. The Supreme Court held that the rental constituted income from business. An asset acquired for, and used for, the purposes of business would not cease to be an asset of that business merely by reason of its being temporarily put out of use or temporarily let out to another. Therefore, it was not correct to hold that the dyeing plant had ceased to be a 'commercial asset' of the assessee.

**BUSINESS PROFITS TAX ACT, 1947**

After the termination of the Excess Profits Tax, the Business Profits Tax Act was enacted in the year 1947. Its object was similar to that of the Excess Profits Tax Act to levy taxes on profits earned by businesses during the chargeable accounting periods commencing from 1st April, 1946, after an 'initial abatement' varying with the class of the assessees. It expired in 1949.

The scheme of the Act was that the 'business profits tax' would be charged on the amount of the 'taxable profits', which meant the amount exceeding the 'abatement'. Section 5 of the Act stated, in its substantive part, that the Act 'applies to every business of which any part of the profits made during the chargeable accounting period is chargeable to income tax by virtue of the provisions of sub-clauses (i) or (ii) of clause (b) of sub-section (1) of section 4 of the Indian Income Tax Act 1922, or clause (c) of that sub-section'.

The quantum of tax would be equal to $16\frac{2}{3}\%$ of the taxable profits in respect of the chargeable accounting period ending on or before March 31, 1947 and in respect of any other chargeable accounting period the tax would be equal to such percentage of the taxable profits as may be fixed by the Annual Finance Act.
Since section 5 in its substantive part makes the Income Tax Act 1922 applicable, the profits of the business would be taxable under this Act, whether the profits accrued or arose in India or outside India. In CIT Ahmedabad v. Karamchand Premchand (Pvt.) Ltd., an interesting and vital question concerning the first principle of tax laws arose. The question was, whether the assessee-company could deduct the losses incurred by it outside British India against the profits made in the taxable territories, for purposes of business profits tax Act, 1947.

The department contended that in the context of the third proviso to section 5, of which the material part has the effect of exempting 'income, profits and gains' of the business 'unless such income, profits or gains are received in or brought into the taxable territories; obviously, losses cannot be brought into the taxable territories except in an accounting sense, and the expression 'income, profits or gains' in the context cannot include losses.

The Supreme Court observed:

"Under the business Profits Tax Act, 1947, the unit of taxation is the business that is any business to which the Act applies; and if a person carries on more than one business, to all of which the Act applies, all the businesses carried on by the same person shall be treated as one business".

In other words, the assessee company was entitled to deduct the losses incurred by it in Baroda business against the profits made in the taxable territories, since the different businesses being taken as one unit, losses could be set off against the profits of another.

One of the most formidable concepts introduced in the Business Profits Tax Act, 1947 was of the term 'reserve'. It was not defined in the Act and one had to resort to the ordinary natural meaning as understood in common parlance. It would be perhaps, befitting to say that it is the enormity of this dynamic

60. (1960) 40 ITR 106; AIR 1960 SC 1175
concept, even today under the companies (profits) surtax Act, 1964 which remains a baffling one-a concept which could not have been conceived to assume such an important place in the litigative aspects.

Few important cases came up under this Act on the meaning and scope of the term 'reserve'. In CIT Calcutta v. Standard Vacuum Oil Co., the question for determination by the Supreme Court was, whether the sum for the respective years appearing in the balance-sheets of the assessee-company as 'earned surplus' would be treated as reserve within the meaning of Rule 2(1), Schedule II of the Act. The Supreme Court had to trace inevitably the American practice of system of accounting, with particular reference to the 'earned surplus'. The court held:

"Under the American System of accounting, the accumulated profits of the assessee-company at the end of the year were allocated to the account 'earned surplus' which was intended for and was used in subsequent years for the purposes of the business of the assessee-company. The balance of 'earned surplus' at the end of the year did not merge into the account of the subsequent year. It represented a specific account into which were added the net profits of the year and appropriations were made out of it and the balance was regarded as 'earned surplus' at the end of the year...the conditions which are regarded as essential for constituting the fund into reserve are fulfilled. Thus the 'earned surplus' represented reserves within the meaning of Rule 2(1) of Schedule II of the Act".

The Supreme Court has very succinctly described the 'essentials' which constitute 'reserve' in the aforementioned case of Standard Vacuum Oil Co. In another case, First National City Bank of New York v. CIT, Bombay, the question for decision was the meaning of the word 'reserves' in Rule 2(1) of Schedule II of the Business Profits Tax Act, 1947. The appellant contended that in computing the amount for the purpose of 'abatement', it was entitled to include what is termed in the United States 'Undivided Profits'.

61. AIR 1966 SC 1393; (1966) 59 ITR 585
62. Ibid
63. (1961) 42 ITR 17, AIR 1961 SC 812
The Supreme Court once again established sanctity of
the 'doctrine of Substance', and held:

"Nature and character of a sum disputed as reserve is to
be determined with the true reference to the substance
of the matter. The reserve may be a general reserve or
a specific reserve, but there must be a clear indication
to show whether it was a reserve either of the one or
the other kind. A reserve in the sense in which it is
used in Rule 2 can only mean profit earned by a company
and not distributed as dividend to the shareholders but
kept back by the Directors for any purpose to which it
may be put in future. Therefore, the amount designated
as 'undivided profits' is a part of the reserve".

Quite earlier to these two cases, Standard Vacuum Oil
Company's case and Bank of New York's case, perhaps the first
64. Ibid
65. Ibid
66. (1953) 24 ITR 499; AIR 1953 SC 501
Rule 2(1) of Schedule II.

The Bombay High Court held that the sum of Rs 5,08,637 must be treated as a 'reserve' for the purpose of Rule 2, but the profit made by the assessee during the period 1st January, 1946 to 1st April, 1946 could not be included in the reserves.

On appeal to the Supreme Court, it was held that the sum of Rs 5,08,637 as well as the profits earned by the assessee during the period 1st January, 1946 to 1st April, 1946 did not constitute 'reserves' within the meaning of Rule 2(1) of Schedule II of the Act.

The Supreme Court held:

"what is the true nature and character of the disputed sum must be determined with reference to the substance of the matter and when this is borne in mind, it follows that the 1st of April, 1946 which is the crucial date, the sum of Rs 5,08,637 could not be called a reserve for nobody possessed of the requisite authority had indicated on that date the manner of disposal or destination. It remained on the 1st of April as a mass of undistributed profits, which were available for distribution and not earmarked as 'reserve'. Far from showing that the directors have made the amount in question a reserve, it shows that they had decided to earmark it for distribution as dividend".

The words 'for nobody possessed of the requisite authority had indicated on that date the manner of disposal or destination' have become a classic in the history of this field of tax jurisprudence. The Supreme Court, has many a times, approved this dictum in the mechanism of Companies (Profits) Surtax Act, 1964.

Quite a good number of provisions of the Business Profits Tax Act, 1947 have been incorporated in the Companies (Profits) Surtax Act, 1964. One of the important provisions in Explanation to Rule 2, Schedule II ran as follows:

"A reserve or paid-up share capital brought into existence by creating or increasing (by revaluation or otherwise) any book asset is not capital for the purposes of ascertaining the abatement under this Act in respect of any chargeable accounting period".
This principle has been statutorily recognised, and such reserve is excluded from capital. In essence, the precursor of this principle is the decision of the Court of Session in Scotland in *Westburn Sugar Refineries Ltd. v. CIR* where it was held that 'it is illegal to declare a dividend out of any surplus shown on revaluation of the fixed assets of a company so long as the surplus is unrealised. Any capital reserve created on the liabilities side of the balance-sheet to represent the surplus on revaluation of fixed assets would be merely a 'paper reserve'. The legislature did retain this provision in the Super Profits Tax Act, 1963 and subsequently in the Companies (Profits) Surtax Act, 1964. The provision serves a very important purpose. Since any capital reserve created on the liabilities side of the balance-sheet to represent the surplus on revaluation of fixed assets would be merely a 'paper reserve', and authorisation of distribution of dividend from out of such paper reserve would involve opening the door to dangerously premature distributions of the funds of a company, which a change in economic or trade conditions might prove to be disastrous after the lapse of a few years, since, nowadays, the values of the fixed assets may fluctuate heavily. This illegality would attach not merely to distribution of a cash dividend but also to a distribution by issue of bonus shares in the company to the existing shareholders.

67. 39 TC 45,56
68. Explanation 1 Rule 1, Schedule II, Super Profits Tax Act, 1963 ran in identical terms:
   "A paid-up share capital or reserve brought into existence by creating or increasing (by revaluation or otherwise) any book asset is not capital for computing the capital of a company for the purposes of this Act".
Since the Amendment Act, 1939, a spate of amendments were introduced in the fabric of Income Tax legislation, but the ingenuity of the human brain overcame these amendments too often. Not only this, sometimes these amendments were framed without considering the 'basic scheme' upon which the bottom rock—the Income Tax Act, 1922 rested. The resultant of these amendments was a creeping degree of obscurity in law.

Consequently, the Income Tax Act, 1922 was referred to the Law Commission in 1956. In the meantime, the Direct Taxes Administration Enquiry Committee had been appointed by the Government of India to consider measures designed to minimise the inconvenience to assesses, and to prevent evasion of income tax. Moreover, the recommendation of Professor N. Kaldor were also ready to be considered.

The Income Tax Act, 1961 is the product of these aforementioned suggestions and recommendations. Indubitably, this Act made significant and far-reaching changes touching almost every aspect of the Income Tax legislation. The object of this Act was that, all the relevant 'ability indices' were taxed. The Direct Taxes being more equitable in nature having the resilience of 'ability to pay', the Income Tax Act, 1961 has come out to stay as one of the major bulwarks in the armoury of fiscal legislation. The writer would make an attempt to deal herewith some of the major changes introduced by this Act.

1. Direct Taxes Administration Enquiry Committee, 1958-59, popularly known as Tyagi Committee, after its chairman.

2. Professor N. Kaldor of the London School of Economics, a wizard on public Finance, was invited by Pandit Jawahar Lal Nehru (the First Prime Minister of India) in 1953 to study the tax structure in India and recommended suitable measures for an integrated tax structure.
CONCEPT OF DEEMED INCOME

With the advent of 1961 Act the concept of 'deemed income' became more emboldened. At least six important exceptions to the following general rule of regarding the receipt as of capital nature were enunciated.

One of the leading general principles in tax jurisprudence was propounded by an acknowledged authority in tax jurisprudence 3 in England, Rowlatt, J., in Bennett v. Ogston. The principle is that the closing entries in the books of account, whether kept on the basis of bookings or on the basis of receipts, would provide for taking into calculation the outstandings due to or by the business or profession, on estimate or otherwise, and if the actuals fall short of or exceeded the estimates, there would arise a capital loss or a capital receipt with which the Revenue is not concerned.

This well-grounded general principle of tax laws has been entirely whittled down under the 1961 Act. The inroads created are as follows:

a) The words "at any time during the previous year" have been introduced in section 28(1) of the 1961 Act. The obvious implication is that if the business or profession ceased before the commencement of the accounting year, there could be a charge in respect of the arrears, if any, of such defunct business.

Section 28(11) renders any compensation paid at or in connection with the termination of any agency or in connection with the modification of the terms thereof chargeable as profit.

b) Section 41(1) of the 1961 Act lays down that where an allowance or deduction had been made in the assessment of any business or profession for any year, and, in a later accounting year any amount is received in cash or in kind in respect of such an allowance or deduction, such sum or benefit is deemed to be the income of the business or profession in the year in which the sum or benefit was obtained, whether or not the business or profession was in existence in that year.

3. 15 TC 374, 378
c) Section 41(2) of the 1961 Act brings out one of the most vulnerable provisions, which lays down that where any depreciable asset of a business or profession is sold, discarded, demolished or destroyed in any year, resulting in any excess over its written down value, the said excess shall be chargeable in the year in which the money (in respect of the sale or demolition, etc) became due, though the depreciable asset had ceased to be used from before the accounting year, with a view to its sale. The said charge would arise even if the sale of the depreciable asset took place at a time when the business or profession was no longer in existence. The business or profession would be fictionally regarded as in existence in the previous year of sale for the purpose of this charge, which is popularly known as 'balancing charge'.

Thus section 41(2) abrogates the important decisions like CIT, Bombay v. National Syndicate; Liquidators of Purna Ltd. v. CIT, Bhubaneswar; CIT, Madras v. Ajax Products Ltd. The facts of Ajax Products were that the assessee adopted the calendar year as its accounting year, went into voluntary liquidation on 30.10.1954. The liquidator carried on business till December, 1954. Thereafter in March, 1955, the liquidator sold the machinery, plant and buildings. The Tribunal charged to tax the excess realised over the written down value of the machinery and buildings, for the assessment year 1956-57. The High Court went in favour of the assessee.

The Supreme Court held that as no business was carried on in the calendar year 1955, proviso 2 to section 10(2)(vii) as amended in 1949 (corresponding to section 41(2) of the 1961 Act) did not apply. Section 10(2)(vii), second proviso to it, ran as follows:

"10(2)(vii): In respect of any such building, machinery or plant which has been sold or discarded or demolished or destroyed, the amount by which the written down value thereof exceeds the amount for which the building, machinery or plant, as the case may be, is actually

4. (1961) 41 ITR 225 (SC)
5. (1954) 25 ITR 265(SC)
6. (1965) 55 ITR 741
sold or its scrap value...

Provided further that where the amount for which any such building, machinery or plant is sold, whether during the continuance of the business or after the cessation thereof, exceeds the written down value, so much of the excess as does not exceed the difference between the original cost and the written down value shall be deemed to be profits of the previous year in which the sale took place....".

The Supreme Court pointed out that in the absence of a fiction deeming the business to be in existence when it was not, the second proviso to section 10(2)(vii) could not help the department. Thus, it is important to note that though the words "whether during the continuance of the business or after the cessation thereof" were there in the proviso, but they could not be sustained, so as to go so far in favour of the department.

That position of law has been entirely superseded by the 1961 legislation by enacting in section 41(2) an Explanation reading as follows:

"Where the moneys payable in respect of the building, machinery, plant or furniture referred to in this sub-section become due in a previous year in which the business or profession for the purpose of which the building, machinery, plant or furniture was being used is no longer in existence, the provisions of this sub-section shall apply as if the business or profession is in existence in that previous year".

Furthermore, the provisions of section 41(2) would apply whether the sale is voluntary or compulsory, since the term 'sale' has been defined for this purpose as including:

"...a transfer by way of exchange or a compulsory acquisition under any law for the time being in force but does not include a transfer, in a scheme of amalgamation, of any asset by the amalgamating company to the amalgamated company where the amalgamated company is an Indian Company".

Thus this change in law supersedes the Supreme Court judgment in Farilka Electric Supply Co., Ltd. v. CIT, Delhi where the Supreme Court held that an acquisition by the government based upon a standing and irrevocable offer by the assessee to sell would not constitute a 'compulsory sale'.

7. (1962) 46 ITR 127, 133(SC)
d) Where a deduction has been made in an assessment of any year in respect of a bad debt due to the business, and in any later year, the whole or a portion of the debt so allowed is recovered, such sum recovered shall be deemed to be the income of the previous year in which it is recovered, though the business or profession was not in existence in the year of recovery.

Beyond this aforementioned forms of 'deemed income', yet another variegated form 'Business connection', which had already its firm roots in the 1922 Act - a sapling under that Act-came out to have its manifold ramifications in the 1961 Act. This gradual shift in the concept of 'business connection' lends much of its credence to one of the Bombay High Court's judgment, Caltex (India) Ltd. v. CIT, Bombay, decided under the 1922 Act. The question in this case was whether the dividends paid to a non-resident by an Indian company would be deemed to accrue in India under section 42(1) of 1922 Act (Corresponding to sub-section (1), clause (i) of section 9 of the 1961 Act), when such dividends were declared outside India.

The Bombay High Court held that dividends paid by an Indian company, which accrue abroad because they were declared and made payable abroad, may nevertheless be deemed to accrue in India under this clause, since the source of the income, viz. the

8. Section 41(4). It virtually amounts to super-imposition over the qualifications laid down in section 36(1)(vii)

9. (1952) 21 ITR 778. The Bombay High Court held in this case of Caltex (India) Ltd that the general conception as to the scope of income tax is that given a sufficient territorial connection or nexus between the person sought to be charged and the country seeking to tax him, income tax may properly extend to that person in respect of his foreign income.

10. Under section 9(1)(i), which reproduced a part of section 42(1) of the 1922 Act, income is deemed to accrue in India, if it accrues, directly or indirectly a) through or from any business connection in India or b) through or from any property in India; or c) through or from any asset or source of income in India, or d) through or from any money lent at interest and brought into India in cash or in kind, or e) through the transfer of a capital asset situate in India.

It is important to note that due to contradictory
shareholding was situated in India. Since the company carried on
business in India and paid dividends out of profits accruing and
taxed in India, the dividends arise directly from a 'source of
income' in India, for the source of the dividends is the same as
the source of the profits made by the company, therefore, in
respect of the dividend income of a non-resident shareholder, the
company may be deemed as an 'agent' of the shareholder.

It is important to note that such cases would now be
covered by a separate and specific provision, 9(1)(iv) which reads:

"a dividend paid by an Indian company outside India".

Therefore, it is doubtful, whether the judgment in
Cal-tax (India)Ltd was rendered correctly, for the simple reason
that such a provision was not there in the 1922 Act.

Palkhivala says:

"It is submitted that this decision overlooks the
principle that the source of dividend income is the
shareholding. The decision requires reconsideration
as regards companies which are incorporated abroad,
which declare dividends abroad (though out of Indian
profits) and the situs of whose shares is abroad".

Therefore, the dividend income of a non-resident
shareholder may be deemed to accrue in India under 9(1)(iv) where
the dividend is paid by an Indian Company, and in respect of such
dividends the company may be assessed as an 'agent' of the
shareholder. Thus, the 1961 law makes the position more clearer
and precise on this point. The agent need not be in receipt of
income on behalf of non-resident, even then it may be treated as
an agent under section 9(1) and a vicarious liability is imposed

10contd. effect of clause (d) viz. "through or from any money
lent at interest and brought into India in cash or
in kind", it was deleted with effect from 1st June,
1976, being in contradiction to the government policy
of earning foreign exchange.

The provisions of this clause impose liability
on the basis of sufficient and real territorial
connection.

Kapila and Pahlavani: The Law and Practice of Income Tax,
vol 1, 203-204.
on the agent by virtue of section 161.

Section 163 of the 1961 Act (corresponding to section 43 of the 1922 Act) clearly lays down that for the purposes of the Act 'agent' in relation to a non-resident is any person in India 'who has any business connection with the non-resident'. This provision takes out any obscurity, if any, from the concept of 'business connection'. The most difficult form of 'business connection' has been in the case of a resident broker, who could not be regarded as an agent in respect of transactions, which he does not carry on directly with a non-resident principal, but carries on only with a non-resident broker who is acting in the usual course of his affairs, on behalf of an undisclosed principal. Obviously, under such circumstances, the resident broker could not know the profit which the principal makes on any transaction. Consequently the resident broker could not deduct the proper amount of tax.

It is pertinent to quote the following remarks of the Income Tax Investigation Commission Report, 1948:

"...We agree that this must be dealt with like any other question of fact and cannot be met by any change in the law. The ITO may examine the correspondence between the parties, make enquiries from Broker's Associations here and abroad and pursue any other clue that the circumstances of each case may furnish. Even if the assessing officer is misled on this point, there need not necessarily be a loss of revenue; the non-resident principal, if only he could be reached, will be liable, provided the conditions of section 42 are satisfied...".

Proviso to section 163(1) of the 1961 Act makes the position quite clear that such a resident broker shall not be

12. Section 161 of the 1961 Act is the only section in the Act which imposes a substantive liability on the representative assessee.

13. ITIC Report, 1948, Para 47, 21
deemed to be an agent.

It is pertinent to note that section 92 of the 1961 Act, which is a considerable improvement over the language of its forerunner, section 42(2) of the 1922 Act, takes complete regard of such transactions which are popularly known as transactions 'at arm's length'. It is to be noted that 'profit' is not a pre-condition for the application of section 92. The Supreme Court held in Mazagaon Dock & Co., Ltd. v. CIT, Bombay that where the resident company was engaged in the business of marine engineering and ship repairing, and it was a subsidiary of a non-resident shipping company engaged in the business of freight on high seas, the resident company undertook repairs of the ships of the non-resident company at cost, according to the contract between them, not charging any profit; the conditions of section 42(2) (corresponding to section 92 of the 1961 Act) are fulfilled and the Income Tax Officer may determine the amount of profits which may reasonably be deemed to have been derived therefrom.

Inevitably, there had been a gradual shift in the concept of 'business connection' throughout the life of 1922 Act and then with the advent of the Finance Act, 1976 the conspectus of clauses (v), (vi) and (vii) of section 9 of the 1961 Act created a change on the foreign income. The only variegated form at best is based

14. Proviso says:

"Provided that a broker in India who, in respect of any transactions, does not deal directly with or on behalf of a non-resident principal but deals with or through a non-resident broker shall not be deemed to be an agent under this section in respect of such transactions, if the following conditions are fulfilled, namely:

i) the transactions are carried on in the ordinary course of business through the first-mentioned broker; and

ii) the non-resident broker is carrying on such transactions in the ordinary course of his business and not as a principal."

15. Section 92 which is a special provision relating to avoidance of tax says that if "the course of business is so arranged that the business transacted between them produces to the resident either no profits or less than the ordinary profits which might be expected to arise in that business", the Income Tax Officer would determine the reasonable 'deemed profits'.

16. (1958) 34 ITR 368 (SC)

17. Neither the term 'foreign income' nor the term 'foreign investment' has been defined anywhere within the province
on the theory of territorial nexus. Subjected to the principle of 'territorial nexus', income by way of royalty on imparting of technical know-how, or income by way of fees for technical services has been brought within the net of taxation. Keeping in view the nature of 'know-how', which had been held to be an intangible asset, it was only to put these conceptual matters beyond any pale of doubt that these clauses (v), (vi) and (vii) of section 9 were introduced.

Kanga and Palkhivala have vehemently criticised this new legislation. The learned authors state as follows:

"Not only are these clauses contrary to the well-settled international norms of taxation of a foreigner in respect of his income accruing, arising and received outside the taxing state, but they are against the letter and the spirit of the various tax treaties entered into by India with foreign countries. Further, it is difficult to conceive of more powerful fiscal deterrents to keep away foreign collaborators".

Indubitably, the Finance Act, 1976 has made deep inroads in the concept of 'deemed income'. As a matter of fact, the judiciary through its successive pronouncements provided impetus to this legislation. In Performing Right Society Ltd. v. CIT the society...

17 contd. of Direct Taxes Code. Hence the same meaning and scope could be assigned to these terms, which is generally ascribed in the Commercial language.


20. Whereas there was no liability on such foreign income under the pre-1976 law, the major effects of the Finance Act, 1976 with regard to the taxability of income of non-residents are as follows:
   a) It deems interest, royalty and technical fees to accrue or arise in India;
   b) It inserted sections 44C and 44D denying deductions, entirely or in part in respect of expenses wholly and exclusively, incurred, for the purposes of the non-residents business;
   c) New section 115A prescribing rate of tax for dividends, royalty and technical fees in the case of foreign companies is inserted.

21. (1977) 106 ITR 11
was an association of composers, authors and publishers of copyright musical works, incorporated as a company in the United Kingdom. The said society entered into an agreement in the United Kingdom with the All India Radio and the royalty on the music played by the All India Radio was payable in the United Kingdom. The society claimed that as the agreement was executed in the United Kingdom and the royalties were also payable there, the royalty income was not liable to tax in India. This contention was rejected both by the Calcutta High Court and the Supreme Court.

It is important to note that the vagaries of Finance Act, 1976 could not influence this decision. Even then, the Calcutta High Court held:

"...The source of income of this society admittedly is broadcasting of western music by All India Radio. That being so, it is quite clear that the royalties which the society receives from All India Radio, should be deemed to accrue or arise in India within the meaning of section 9(1)(i) of the Income Tax Act, 1961".

The international norms of taxation uphold the theory of such a legislation. Barry Spitz quotes an example based on the decision of the German Supreme Tax Court (Bundesfinanzhof) of 4th March, 1970. A United Kingdom company established in London obtained the exclusive right to use particular methods for the manufacture and installation of certain refrigeration and heating plants and to use the patent rights and trademarks which were connected therewith. It subsequently entered into a contract with two German enterprises, whereby it was obliged to disclose all relevant technical, practical and commercial knowledge to the German enterprises and to allow them to use the trademarks in question. Under the agreement, the U.K. company was to receive annual royalties as consideration. The U.K. company did not have a permanent establishment or a permanent representative in Germany.

The issue arose as to whether the royalties received by the U.K. company were taxable in Germany as it constituted income from trade or business. The German Supreme Tax Court held that the royalties paid to a non-resident company were not subject to German Income Tax on the grounds that there was no permanent establishment or permanent representative in Germany.

Immediately thereafter, the German Tax administration stated that the royalties received from a German enterprise by a non-resident enterprise for know-how would, under the circumstances of the above-mentioned case, be subject to German Income Tax, even where such royalties are not received, through a permanent establishment or permanent representative of the non-resident enterprise in Germany. Thus, the decision of the German Supreme Tax Court was superseded immediately by this legislation.

"LEASING OUT 'BUSINESS INCOME'"

The concept of Income has manifold manifestations for example, if the asset remains a commercial asset, then the income would be taxed under the head 'business'; on the other hand, if the commercial nature of the asset is converted into non-commercial, then the income would be treated as being from 'other sources'. Obviously, due to an array of deductions and allowances under the head 'business', the assessee's endeavour would be to label such an income as 'business income'.

A longline of cases goes to show that the dividing line between the two groups of cases is a very narrow one. Section 56(2)(iii) of the 1961 Act itself admits this overlapping distinction. The law does not indicate as to how the distinction

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Section 56(2)(iii) reads:

"Where an assessee lets on hire machinery, plant or furniture belonging to him and also buildings, and the letting of the buildings is inseparable from the letting of the said machinery, plant or furniture, the income from such letting, if it is not chargeable to income tax under the head "profits & gains of business or profession"
24. Under the Income Tax Act, 1922, before its amendment in 1939, question was being debated in courts of law whether an assessee who owned machinery, plant or furniture and who let the same to a lessee, was despite the letting, entitled to depreciation allowance, since such allowance was by the provisions relating to grant of depreciation, (then and even now under the 1961 Act) restricted to an 'owner' who 'used' the machinery, plant or furniture for the purposes of 'his' business. The courts decided, more or less invariably, in favour of the owner on the reasoning that the owner who let should be regarded as engaged in the 'business of letting'.

The Courts were not unappreciative of the strain imposed by such construction on the language of the provisions relating to depreciation, which granted the allowance to the person in whose user the 'wear and tear' occurred (Per Krishnan, J., in CIT, Madras V. M. S. Umamaheswara Gin & Rice Factory Ltd Guntur, AIR 1926 Mad 1032, 1034). The courts wriggled out of this web by holding that the department did not suffer whether the depreciation allowance was granted in the hands of the lessor-owner or the lessee-user, since anyhow, only one total sum would be granted as allowance for depreciation.

The Amendment Act, 1939, gave a quietus to this debate by expressly enacting grant of the following four allowances alone to the lessor out of the several allowances claimable by him on the footing of the rental income being business income;

1) allowance for current repairs, section 10(2)(v) of the 1922 Act;

Reversing the High Court's judgment, the Supreme Court held:

"The yield of income by a commercial asset is the profit of the business irrespective of the manner in which that asset is exploited by the owner of the business. He is entitled to exploit it to his best advantage and he may do so either by using it himself personally or by letting it out to somebody else... cases of undertakings of this nature stand on an entirely different footing and are distinguishable from cases of individuals or companies acquiring lands or buildings and making income by letting them on hire".

In Lakshmi Silk Mill's case, the dyeing plant could not be used during war time, as silk yarn was not being obtained. The company let the plant and the question was whether the sum of Rs 20,005 realised for 5 months was to be computed as profit from business, hence subject to excess profit tax.
The court have developed the theory of intention in finding out whether the commercial asset had been used in the course of business. In New Savan Sugar and Gurr Refining Co., Ltd. v. CIT, Calcutta, the assessee-company was carrying on the business of crushing sugarcane and gur refining. On 5th February, 1946, the Managing Agents, M/s Andrew Yule & Co., informed the shareholders that there was an alarming increase of government interference in the affairs of the sugar industry in Bihar and the increase of wages of the workers, as well as the levy of a cess and deterioration in the cane crop leading to an apprehension that there would be a loss, and hence, the company's affairs could be put on less discouraging basis by accepting an offer of leasing the company as a running concern to M/s Standard Refinery & Distillery Ltd. Then a lease was executed for 5 years with the option to the lessee to continue for a further 5 years with two further options each for 5 years. There was also an option to the assessee company to terminate the lease after the first two years. This lease was not terminated under this option.

24contd. ii) allowance for insurance premia, section 10(2)(iv) of the 1922 Act;

iii) allowance for depreciation with a right to carry forward of unabsorbed depreciation, section 10(2)(vi) of the 1922 Act; and,

iv) allowance in respect of depreciable assets when sold, discarded, demolished or destroyed, section 10(2)(vii) of the 1922 Act.

Thus the Amendment Act, 1939 impliedly negatived the view of 'letting out' business.

25. CEPT v. Shri Lakshmi Silk Mills Ltd. (1951) 20 ITR 451

26. In Narain Swadeshi Weaving Mills v. CEPT (1954) 26 ITR 765 SC, the assessee was a firm engaged in the manufacture of ribbons and laces. A public limited company was floated in order to take over the firm's business.

The public limited company purchased from the firm the buildings and lands in consideration of a certain quantity of shares allotted to the assessee as fully paid-up. As no more fundswere available to the company to enable it to purchase the plant and machinery of the firm, it took over on lease the plant and machinery at an annual rental.

The Supreme Court held that by means of this transaction the assessee's firm business was entirely closed. Consequently, the rental income was not business income; "the intention was to use the income arising from the royalty in its capacity as the owner of the factory".

27. (1969) 74 ITR 7 (SC)
The Supreme Court after examining the terms of the lease came to the conclusion that it was not the intention of the assessee to treat the factory and the machinery as a commercial concern during the subsistence of the lease.

On the other hand, one finds much more pragmatic view of the problem in a Bombay High Court judgment in CIT, Bombay v. National Mills Co., Ltd. (in liquidation).

Chagla, C.J., observed:

"Even in such a case, the activity of the assessee would be a business activity. It would be carrying on the same business through a different instrumentality. It is not necessary that in order that the income of the assessee should be business income, it should be produced by the assessee utilising the business assets itself, so long as these assets are used as business assets, it is irrelevant whether the business assets are exploited and used by the assessee itself or someone else".

The Delhi High Court had to consider the catena of all such cases in Addl. CIT v. M/s Rajindra Flour & Allied Industries (P) Ltd. The private limited company which was in the process of erecting a factory for running a flour mill at Moradabad right up to 31st August, 1964, even after the installation, the company was unable to commence actual production due to some difficulty in getting the licence for running the flour mill.

On 16th June, 1965, a lease was executed for the entire plant. The question was, whether the intention in leasing the property could be treated as being an extension of the business activities of the assessee.

The Delhi High Court relied on the following findings of the Tribunal and very rightly held in favour of the assessee:

28. (1958) 34 ITR 155(Bom). In this case the owner of a textile mill let out the entire mill at a monthly rental for a period of 3 years (with an option to the lessee to renew the same for a further period of two years), convenanting with the lessee to assist him in the running of the mill and securing quotas, licences etc., and to place at the lessee's disposal such quotas, licences etc., as could be legally transferred. The lessee on his part convenanted to allow the lessor free accommodation in the mill premises for its use as offices and keeping the records.

29. (1981) Tax 60(3)-91 (Del)
The lease agreement was an ordinary lease agreement which did not give to the lessee any enduring or permanent rights on the assets. There is nothing in the deed to suggest that the assessee-company was, for all intents and purposes, abdicating from the business and the lease was only a first step in the process of withdrawal...".

An extremely noteworthy feature of this case was that the assessee had yet to start any manufacturing activity before the lease was granted.

The Courts streamlined the entire precepts of law on this

The facts of the case were that the assessee-company's business consisted partly in the manufacture or processing of goods and partly in an activity of a non-industrial nature. Out of the total income of Rs 37,98,774, the profits of the company available for distribution came to Rs 17,41,814. Out of this Rs 3,36,504 represented industrial profits and Rs 14,05,310 represented non-industrial profits. The company distributed by way of dividends a sum of Rs 4,20,640 claiming that the dividend was declared equally out of the profits of the industrial and non-industrial activities. The profits which were available for distribution but were not distributed came to Rs 13,21,174.

The ITO while making the assessment allocated the dividends declared by the company to the industrial and non-industrial segments in the same proportion as the profits of the two segments bore to the total profits of the company. By this method, out of the total dividend of Rs 4,20,640 declared by the company, a sum of Rs 81,264 was treated as dividend declared out of industrial profits while a sum of Rs 3,39,376 was treated as dividends declared out of non-industrial profits. Holding that under section 23A of the 1922 Act, the company was liable to distribute by way of dividends a sum of Rs 1,51,426 out of industrial profits and a sum of Rs 8,43,186 out of non-industrial profits, the ITO levied additional super-tax on the entirety of the undistributed balance of the total income, that is to say, on Rs 13,21,174.

The Supreme Court held that the High Court and the Tribunal were wrong in interpreting the expression "similarly apportioned", used in Explanation 2 to section 23A, as the learned judge then was held:

Supra, 92-103 \( \text{CIT v. Gangadhar Banerjee & Co.,(Pvt) Ltd.},(1965) \) 57 ITR 176 (SC); CIT v. Williamson Diamonds Ltd (1959) 35 ITR 290 (PC); CIT v. T.V. Sundaram Iyengar & Sons (P) Ltd(1975) 101 ITR 764. An important point was decided by the Supreme Court in this Sundaram Iyengar's case. The question involved was whether where the dividend apportionable to one of the two segments of a composite business was found to be less than the statutory percentage in respect of that segment, the additional income-tax could be leviable on the entire balance of the company's undistributed profits, or whether it could be leviable on the balance of undistributed profits of that segment only in respect of which the shortfall had occurred?
issue under the 1922 Act, and whatever remained to be accomplished has been done under the 1961 Act. For the first time, the 1961 Act imposed a time limit levy for levy of additional super tax on undistributed profits of a company in which the public are not substantially interested, where such a company failed to distribute the 'statutory percentage' of dividends within the prescribed time. Such timelimit is four assessment years from the end of the a assessment year relevant to the previous year, or one year from the end of the financial year in which the assessment is made, whichever is late. Thus, the provisions relating to the levy of additional super-tax on undistributed incomes of controlled companies have been changed by the 1961 Act in several respects. The important among them are:

1) a time-limit has been fixed for the first time by the 1961 Act for the making of an assessment, viz 4 years from the end of the relevant assessment year;

2) for ascertaining "the distributable income", several deductions are admissible which were not granted by section 23-A of the 1922 Act;

3) several further deductions "out of the distributable income" are permitted by the 1961 Act in ascertaining "the chargeable income" under this head;

4) the penalty provisions under section 23 were stringent, as a result of which they have been taken away and provisions with

30contd. ...An assignment as a proper portion of the dividends would mean an assignment in the same or similar ratio as the respective profits of the two segments bear to the total profits of the company. It is thus not open to the company to split up and apportion the dividends to the profits of the two segments in such manner as it finds convenient or thinks fit. The company's freedom to apportion the dividends is conditioned by the ratio which the profits of the two segments bear to the total profits".

Thus on facts, the Supreme Court held, that there was a shortfall in respect of both the segments.


32. Some of the deductions for ascertaining the distributable income are as follows, as enumerated in section 109 of the 1961 Act:

1) amount of income tax
2) amount of any other tax, for example, wealth tax (Finance Act 1983 has inserted wealth tax on closely held companies).
3) donations made to certain approved institutions or
a pragmatic basis have been laid down under the 1961 Act.

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, Treasury Regulations section 1.537-2(b) lists the following as examples of the 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 of bonafide indebtedness created in connection with the corporation's trade or business;

32 contd.

iv) long term capital losses;
v) Bonus or gratuity paid to employees, legal charges; excessive or unreasonable payments or benefit or amenity to a director or his relative.

33. For example, section 108(2)(ii) states:
"The Income Tax Officer shall not make an order under sub-section (1) if he is satisfied-

i) that the payment of a dividend or a larger dividend than that declared within the period of twelve months referred to in sub-section (1) would not have resulted in a benefit to the revenue; or

iii)...
"

34. This U.S. position has been extracted from a paper entitled 'Problems of Corporate Taxation'-Whithering Concept of Corporate Personality' presented by the writer in an All India Seminar on 'Current Tax Problems-Tax Reforms in India' at Poona University, Nov 1983
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.

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. In other words, the reasonable contemplation of either horizontal or vertical expansion is a legitimate business ground for accumulating earnings.

- REMUNERATION TO DIRECTORS AND PERSONS SUBSTANTIALLY INTERESTED IN COMPANIES

The 1961 Act has made rapid strides in context of 'Managerial Remuneration'. Besides sections 40C and 40A(5), the Act expressly defines two terms, viz. "person who has a substantial interest in the company" in section 2(32) and 'relative' in section 2(41). The insertion of section 40C of the 1961 Act (corresponding to section 10(4A) of the 1922 Act) was meant to nullify the effect of Supreme Court and various High Court's judgments that the ITO was not entitled to judge whether the

35. U.S.Treasury Regulations Section 1.537-3(a), U.S.Inland Revenue Code, 1954
36. 2(32)-"Person who has a substantial interest in the company" in relation to a company, means a person who is the beneficial owner of shares, not being shares entitled to a fixed rate of dividend whether with or without a right to participate in profits, carrying not less than twenty percent of the voting power".
   2(41)-"relative" in relation to an individual means the husband, wife, brother or sister or any lineal ascendant or descendant of that individual".
remuneration paid to a director was excessive or unreasonable.

The controversy regarding managerial remuneration has had been raging right through the 1922 Act. The leading pronouncement on this issue under the 1922 Act was Newtone Studios Ltd. v. CIT, Madras. It related to deduction of salary of a director on the assessment of a company. The High Court of Judicature at Madras remarked that any remuneration paid by a limited company to its shareholders or director should not be rejected by the ITO on any subjective standard of reasonableness of the amounts paid. The court added that so long as the reality of the payment was not challenged nor allegation made that the payment was dictated by other than business considerations, the reasonableness of the expenditure should be considered from the point of view of the businessman and not from the point of view of any outsider including the ITO. The Revenue had no power to examine what they thought was reasonable, or to say what expenditure was necessary. A disallowance could be made on the ground that the payment has been made for other than 'commercial expediency', but 'not on the ground that in the opinion of the ITO or other taxing authority, the remuneration was unreasonably high—either because the employee did not in the Authority's opinion deserve so much, or because the assessee could have secured other employees on more favourable terms'.

The Revenue's response to this judgment was promptly to introduce sub-section (4A) to section 10 of the 1922 Act, by virtue of the Finance Act, 1956, with effect from 1st April, 1956. The decision in Newtone Studios Ltd. v. CIT, Madras, in so far as it related to the deduction of salary by a company is not good law being superseded by section 40C of the 1961 Act, corresponding to

37. CIT v. Chari and Chari Ltd (1965) 57 ITR 400 (SC); Raman and Raman Ltd v. CIT (1962) 46 ITR 400, Mad
38. (1955) 28 ITR 378
section 10(4A) of the 1922 Act.

But section 40C stands enlarged as compared to section 10(4A) of the 1922 Act, since it covers a relative also. The said section enacts that in calculating the total income of any company, whether private or public, any expenditure which results directly or indirectly in the provision of any remuneration or benefit or amenity: 1) to a director, or 2) to a person who has a beneficial interest in the company, or 3) to a relative of such director or of such person, could be disallowed, if in the opinion of the ITO, any such expenditure is excessive or unreasonable having regard to:

a) "The legitimate business needs of the company", and,
b) "the benefit derived by or accruing to it, therefrom".

The subjective approach to the deductibility of the expenditure, which was criticised in the Newtone Studio's case has been sought to be validated by the language of section 40C, which enacts the disallowance on the assessment of a company, "if in the opinion of the ITO any such expenditure or allowance is excessive or unreasonable having regard to the legitimate business needs of the company and the benefit derived by or accruing to it therefrom". Notwithstanding the above language, the deductibility, it may be remarked, is justiciable, firstly, for the reason that the ITO in arriving at his decision is required to have regard to two objective standards, namely, 1. the legitimate business needs of the company, and 2. the benefit derived by the company by the expenditure and secondly, for the reason that any opinion has a lways to be arrived at honestly and reasonably and not by extra-

39. The principle, however, holds in respect of expenditures incurred by other entities, such as, individuals, HUFs, firms, etc.

40. 40C: "In the case of any company--
1) any expenditure which results directly or indirectly in the provision of any remuneration or benefit or amenity to a director or to a person who has a substantial interest in the company or to a relative of the director or of such person, as the case may be,...".
judicial considerations or extravagantly. The leading pronouncement on the subject is CIT, West Bengal v. Edward Keventer (P)Ltd subsequently affirmed by the Supreme Court. The Division Bench of the Calcutta High Court held:

"The legitimate business needs of the company must be judged from the viewpoint of the company itself and must be viewed from the point of view of the prudent businessman. It is not for ITO to dictate what the business needs of the company should be and he is only to judge the legitimacy of the business needs of the company from the point of view of a prudent businessman... The term 'benefit' to a company in relation to its business, it must be remembered has a very wide connotation and may not necessarily be capable of being accurately measured in terms of pound shillings and pence in all cases..."

The Supreme Court while affirming the above mentioned decision of the Calcutta High Court, observed that many factors, for example, the turnover, the large number of centres to be supervised shall have to be taken into consideration, having regard to the legitimate business needs of the company, as to whether commission or remuneration paid to the director was excessive or unreasonable.

In a recent judgment of the Calcutta High Court in Eastern Scales Pvt.Ltd. v. CIT, the director of the assessee-company was appointed as the managing director but the vacancy of the director was not filled up. For the assessment year 1973-74 and 1974-75, out of the remuneration of Rs 42,350 paid to the managing director, the ITO allowed a sum of Rs 36,000 and disallowed the excess under section 40C, while making assessment

41. If the company does not produce any evidence in support of its claim in respect of the allowance of expenditure referred to in this section, it is not the duty of the ITO to collect evidence in order to prove that the expenditure was excessive or unreasonable having regard to the legitimate needs of the business, as held by the Supreme Court in Nund and Samont Co,(P)Ltd. v. CIT(1970) 78 ITR 268 (SC). The Supreme Court has held in a recent case, Upper India Publishing House (P)Ltd,v. CIT(1979) 1 Taxmann 365(SC) that whether salary or remuneration paid to a director is reasonable is a question of fact and does not give rise to a question of law.

42. (1972) 86 ITR 370, 381
43. (1978) 115 ITR 149 (SC)
44. (1982) Tax 64(3)-137 (Cal)
on the assessee-company.

The Calcutta High Court, referring to its earlier judgment in Edward Keventer held:

"The term 'benefit' to a company has a very wide connotation and may not necessarily be capable of being accurately measured in monetary terms in all cases".

Much controversy has raged on the issue, as to whether section 40C or 40A(5) of the 1961 Act applies to the director-employee. In order to appreciate this controversy, one has to consider section 40C(iii) which was omitted by the Finance Act, 1968 with effect from 1st April, 1969, and the same Act inserted clause (a)(v) in its place. Thereafter, clause (a)(v) was, in its turn, replaced by section 40A(5) with effect from 1st April, 1972.

Clause (c)(iii) of section 40, when first added by the Finance Act, 1963 with effect from 1st April, 1963, the material portion whereof ran as follows:

45. In CIT v. Tranvancore Chemical Manufacturing Co. (1982) 133 ITR 818 (ker) in the return filed by the assessee-company for 1972-73, the assessee claimed that the remuneration paid to the two managing directors amounting to Rs. 72,000 each was fully allowable deduction. The Commissioner took up the matter in 'suo motu', revision, and applying section 40A(5) of the 1961 Act, disallowed in excess of Rs 60,000. In passing the said orders the Commissioner held that there was an employer-employee relationship between the company and the managing director, hence the provisions of section 40A(5) were attracted. The entire question narrowed down to this issue, as to whether the managing director was an employee of the company or an agent. On this, the Kerala High Court cited the sound authority in the Supreme Court decision in Ram Prasad v. CIT, New Delhi (1972) 86 ITR 122, 127(SC) where the following observations of Jagannmohan Reddy, J., were cited:

"Though an agent as such is not a servant, a servant is generally for some purposes his master's implied agent, the extent of the agency depending upon the duties or position of the servant. It is again true that a director of a company is not a servant but an agent in as much as the company cannot act in its own person but has only to act through directors who qua the company have the relationship of an agent to its capacity. A managing director may have a dual capacity. He may both be a director as well as an employee. It is, therefore, evident that in the capacity of a managing director, he may be regarded as having not only the capacity as persona of a director, but also has the persona of an employee, or an agent depending upon the nature of his work and the terms of his employment. Where he i;
"(iii) Any expenditure which results directly or indirectly in the provision of any remuneration or benefit or amenity to an employee..."

Thereafter, in the very next Finance Act, 1964, the clause was again changed as:

"(iii) any expenditure incurred after the 29th day of February, 1964, which results directly or indirectly in the provision of any benefit or amenity or perquisite whether convertible into money or not, to an employee (including any sum paid by the company in respect of any obligation which but for such payment would have been payable by such employee)"

It may be noted that by virtue of the amendment with the passage of the Finance Act, 1964, the word 'remuneration' was dropped and the words 'whether convertible into money or not' were added after the words 'any benefit or amenity or perquisite'. It is again to be noted that the term 'perquisites' was also missing in the Finance Act, 1963, further the words 'whether convertible into money or not' were placed within commas on both the sides in Finance Act, 1964. This entire legislative format clearly indicated the intention of the legislature that the legislature did not intend to include cash emoluments in any of the words 'benefit', 'amenity' or perquisite', which was further supplemented by a 'fortiori' 'whether convertible into money or not'

The Bombay High Court had an occasion in CIT v. Indo Kem (Pvt.) Ltd., to decide, as to whether for the assessment year 1964-65 (previous year ending March 31, 1964) the amount paid by way of bonus and commission in cash by the assessee-company to its

45contd. so employed, the relationship between him as the managing director and the company may be similar to a person who is employed as a servant for an agent, for the term 'employee' is facile enough to cover any of these relationships. The nature of his employment may be determined by the Articles of Association of a company and/or the agreement, if any, under which a contractual relationship between the director and the company has been brought about, whereunder the director is constituted an employee of the company, if such be the case, his remuneration will be assessable as salary. Thus the Division Bench of the Kerala High Court observed:

(Ibid Headnote)

"where under the terms of a contract of employment, the remuneration or recompense for the services rendered by an employee is determined at a fixed percentage of the turnover in the business achieved by him for the employer, then such remuneration or recompense will partake the character of salary of the employee, the percentage basis
employees was a perquisite and therefore, not deductible as revenue expenditure in computing the income of the assessee-company.

The Bombay High Court observed:

"If the legislature had intended to include in any of the words 'benefit', 'amenity' and 'perquisite', the cash paid to the employees, the question of the cash being convertible into money or not would not arise. Another indication of the intention of the legislature was the fact that in sub-clause (i) of clause(c) of section 40, the word 'remuneration' was retained along with the other words 'benefit' and 'amenity' even after the amendment of sub-clause (iii). This also shows that the legislature was conscious of the distinction between the relevant words, and had deliberately chosen to delete the expression 'remuneration' from sub-clause (iii). All these factors show that the expression 'any benefit or amenity or perquisite', whether convertible into money or not' used in sub-clause (iii) was not intended to include cash or money paid directly to the employees".

In other words, on the facts of the case, for the assessment year 1964-65 the amount paid by way of bonus and commission in cash to its employees was not a perquisite, hence deductible while computing the income of the assessee-company.

The Calcutta High Court also took the same view in CIT v. Kanan Devan Hills Produce Company Ltd., where it was held that the amounts paid as overseas allowance, managing allowance, devaluation allowance, and transport allowance to the employees did not fall within the expression 'benefit', 'amenity' or 'perquisite' used in the said provisions and, therefore, were deductible in computing the business profits of the assessee-company.

45 contd., being the measure of the salary. The same is the legal position when under the terms of the contract of employment the employee is to receive the remuneration at a fixed percentage of the net profits of the company".

46. (1981) 132 ITR 125 (Bom)
47. Ibid, Headnote
48. (1979) 119 ITR 431
The legislature did not think it prudent to mention the words 'whether convertible into money or not' in section 40C, which the legislature devised for a director-employee, whereas for other employees the provisions of section 40A would operate. Moreover, the first proviso to section 40A(5)(a) puts beyond any doubt that the legislature devised section 40C for a director-employee or a person having substantial interest in the company or a relative of the director. The material part of the first proviso funs as follows:

"Provided that where the assesseee is a company, so much of the aggregate of—

a) the expenditure and allowance referred to in sub-clauses (i) and (ii) of this clause; and

b) the expenditure and allowance referred to in sub-clauses (i) and (ii) of clause (c) of section 40,

in respect of an employee or a former employee, being a director or a person who has a substantial interest in the company or a relative of the director or of such person, as is in excess of the sum of seventy two thousand rupees shall in no case be allowed as a deduction."

The Gujarat High Court observed in the case of Tarun Commercial Mills Ltd., that the proviso to section 40C makes it clear that a director-employee is covered by the provisions of section 40C rather than by the provisions of section 40A(5). Wherever there is a special provision, it overrides the general provision. Thus the limit of Rs 72,000 applies to the remuneration or benefit or amenity as against the 'head-wise' limits prescribed for non-director employees under section 40A(5).

113 ITR 745 (Guj)

As already mentioned, the first proviso to section 40A(5) (a) makes it clear that the aggregate expenses and allowances to director-employees referred to in sub-sections (1) and (2) of section 40C and sub-clauses (i) and (ii) of section 40A(5) (a) should not exceed Rs 72,000 and are not further subject to headwise limits which are otherwise applicable under section 40A(5) to non-director-employees, the limits being specified in sub-section (c) of section 40A(5). Gujarat High Court's decision in Bharat Vijay Mills Ltd. 128 ITR, 633 clearly brings out this proposition.
It would be interesting and important to note that section 40A(5) which deals with other employees of the company lays down an upper limit of Rs 60,000 for salary and Rs 12,000 for perquisites. Moreover, Explanation (2) of section 40A(5) defines the terms 'salary' and 'perquisites'. On the other hand, for a director-employee section 40C neither gives the break-up (mentions Rs 72,000 in total) nor any definition of salary or perquisite has been mentioned. An important question of law regarding the interaction of section 40 and 40A came up in N.M. Anniah & Co. v. CIT before the Karnataka High Court. Though the case related to deductibility of bonus and commission paid by the firm to its partner, but the general principles involved are equally applicable to a company as well. The question involved was:

51. This definition of perquisites takes into account the actual expenditure incurred in providing the perk which may be higher in most of the cases, than the value of the perquisites as calculated under section 17(2). It is evident from the difference in the wordings, for example, Explanation 2(b)(i) states "rent free accommodation", whereas 17(2)(i) states "the value of rent-free accommodation". Necessarily, in several cases the actual expenditure incurred for providing the perk to the employee by the company would be higher than the actual value of the perk. It is common knowledge that in metropolitan cities the companies take the flats on lease-basis and provide to their employees.

52. However, there is a common intersection between the operations of sections 40C and 40A(5) and that is why the first proviso to section 40A(5)(a) acknowledges such a phenomena. The Allahabad High Court has held in the case of Hind Lamps Ltd, 122 ITR 451, that where the employer allowed its employees free residence in the quarters and incurred no special expenditure by way of repairs or renovation, the fair annual rent calculated on a notional basis cannot be treated either as an 'expenditure which results, directly or indirectly in the provision of any perquisite or any allowance in respect of any assets of the assessee used by an employee either wholly or partly for his own purposes or benefit'. The Kerala High Court delivered the judgment in Trivandrum Tea Estates Ltd., (122 ITR 557) with more precision on the point and held that since the assessee-company did not incur any expenditure for special repairs to suit the convenience of the employee, no special amenity or benefit was derived by the employees on account of the expenses incurred on the maintenance of the building. Hence the expenses could not be disallowed.

53. (1975) 101 ITR 348 (Kar)
Whether section 40A or section 40 would be applicable in determining the profits and gains of business or profession of the firm, since both the sections deal with non-deductibility of certain sums.

The Karnataka High Court observed:

"A fair reading of section 40A shows that it is enacted with the object of conferring power on the assessing authorities to determine whether the expenditure referred to therein in respect of which deduction is claimable, is excessive or unreasonable and to disallow only so much of such expenditure as is found excessive or unreasonable. Disallowance arises only when an allowance is claimable. If no allowance can be claimed under the other provisions of law, the question of disallowance does not at all arise. Because under section 40(b) amounts paid to a partner by the firm by way of interest, salary, bonus, commission or remuneration cannot be deducted in computing the income chargeable under the head 'profits and gains of business or profession' there is no occasion to apply section 40A to such payments".

The Karnataka High Court further observed:

"If the intention of Parliament was to apply section 40A to matters contained in section 40(b) also, it would have repealed section 40(b) altogether. In the above context it has to be held that the overriding effect given to section 40A is only in respect of matters not covered by section 40(b)".

Therefore, by way of analogy it could be said that even in the case of a company, section 40A(5) can be ascribed an overriding effect, provided section 40(c) does not cover that matter.

Whatever the merits of section 40 and 40A may be, Palkhivala mentions a Cryptic note as follows:

"It assumes omniscience on the part of the assessing officer who has to deal with varieties of businesses and payments

54. Ibid 353

55. Kanga and Palkhivala, The Law and Practice of Income Tax, VIIth Edn Vol,1 523. Of course, this statement has been made in connection with section 40A(2) which says in its proviso that this section shall not apply to director-employee, since 40C applies to the director; but the observations are of general applicability."
which are beyond enumeration, and it attributes to him the capacity to evaluate accurately countless categories of goods, services and facilities for which there is no market quotation. Tax and equity may be strangers but they do not have to be sworn enemies. Since the commercially unacceptable result of disallowance under this section coupled with the tax liability of the recipient might well be a double tax burden exceeding the total amount disallowed, it would be virtually left to the revenue to decide on what terms business between associates should be conducted or a relative should be engaged.

Indubitably, there are certain areas in the fields of sections 40 and 40A where the solutions may be wanting. For example, annuity policies (Single premium or recurring) which are conditional and non-commutable are considered as tax planning measures, thus remunerating the directors or their relatives. It may be debatable, as to whether such payment constitutes perquisite or amenity so as to fall within the mischief of section 40 or 40A. The assessee-company may well claim it to be an entirely business expenditure under section 37.

In essence, 'managerial remuneration' has been one of the most hotly debated and discussed subjects in the Parliament and the commercial world. The protagonists are of this opinion that the upper limits on the allowability of remuneration, amenity or benefit, for the purposes of deductibility, while making assessment on the companies, laid down by virtue of the provisions of sections 40C or 40A(5) are totally unjustifiable and unwarranted. They advocate that the guidelines set by the Central Government in 1983 for the purposes of companies Act, which lay down the limit upto Rs 1.80 lakhs, should be incorporated accordingly in the Income Tax Act as well.

It is submitted that these checks have been imposed under sections 40 or 40A with a very definite object that the corporate sector may be discouraged in dissipating its profits exclusively in the hands of a chosen few.
DEPRECIATION AND THE TERM PLANT

With the spate of industrialisation, the concept of 'depreciation' has definitely become enlarged. There is a galore of case-law on the issue as to whether a particular asset can be termed as 'plant', since the rate of depreciation on the 'plant' is more than on a 'building' etc. Much more important, the 'plant' is entitled for major tax incentives like development rebate or investment allowance, since it is considered at par with a machinery under the Income Tax Act. Alongwith the basic section 32 of the 1961 Act, section 43(3) defines the term 'plant' on which depreciation can be claimed. Section 43(3) states:

"(3) "plant" includes ships, vehicles, books, scientific apparatus and surgical equipment used for the purposes of the business or profession".

It is to be noted that this definition is inclusive by its very nature, hence it is not exhaustive. Neither the legislature could carve out an exhaustive definition for such a term, keeping in view the ever-increasing frontiers of industrialisation. There are two leading pronouncements on this subject, CIT v. Taj Mahal Hotel and CIT v. Elecon Engineering Co., Ltd.

In Taj Mahal Hotel's case, the assessee-company which was running a hotel installed sanitary and pipeline fittings in one of its branches and claimed depreciation allowance under the head 'furniture & fittings'. The question was whether the sanitary and pipeline fittings installed fall within the definition of 'plant'. The Supreme Court relied on the decision of the Court of Appeal in Jarrold v. John Good & Sons Ltd., observing that sanitary fittings, etc. in a bathroom is one of the essential amenities or conveniences which are normally provided in any good hotel in the present times. The Supreme Court observed:

56. (1971) 82 ITR 44 (SC)
57. (1974) 96 ITR 672 (Guj)
58. (1963) 1WLR 214
59. Ibid, 48
"...If the partitions in Jarrold's case could be treated as having been used for the purpose of the business of the trader, it is incomprehensible how sanitary fittings can be said to have no connection with the business of the hotelier. He can reasonably expect to get more customers and earn larger profit by charging higher rates for the use of rooms if the bath rooms have sanitary fittings and similar amenities. We are unable to see how the sanitary fittings in the bathrooms in a hotel will not be 'plant' within section 10(2)(vi-b) read with section 10(2)/(5) when it is quite clear that the intention of the legislature was to give it a wide meaning and that is why articles like books and surgical instruments were expressly included in the definition of 'plant'...".

In Jarrold v. John Good & Sons Ltd., the respondent company carried on the business of shipping agent and to satisfy its fluctuating accommodation requirements, the company made use of a special partitioning which allowed it to subdivide the floor space available in any way that it chose. The partitions were secured by screws to the structure of the building only at the floor and ceiling and it was relatively simple operation to move them from one position to another. It was common ground that the partitioning did not form part of the structure of the building.

The special commissioners held that the partition in question constituted 'machinery' or 'plant' within the meaning of section 279 or 280 of the Income Tax Act, 1952. Thereafter, Pennycuick, J., held in Chancery Division that the setting in which the business was carried on, and the apparatus used for carrying on a business were not mutually exclusive. It was held:

60. (1963) 1WLR 214

61. The statement of the case refers to the following facts which were either proved or admitted:

"1) The work of each department fluctuates from time to time over the years and throughout any particular year, necessitating increases in or a diminution of the staff of such department with the consequent need for more or less, office accommodation to accommodate that department's staff. Moreover, the gain or loss of an agency involves the setting up of a new department or the closure of an existing department.

2) There was, therefore, a commercial necessity for the office accommodation of the respondent as a whole to be highly flexible so that the section thereof devoted to any particular department may be increased or diminished as occasion requires".
"Partitions are fixtures specially designed to enable an appropriate and varying number of employees to perform their duties in an appropriate and varying number of sections, according to the state of the Company's business at the time."

Pennycuick, J., further held:

"It seems to me to be impossible to deny the fixtures possessing this character the title of apparatus used by the company for carrying on its business."

Finally, the Court of Appeal also came to the same conclusion.

Ormored, L.J., held:

"The dividing line between what is 'plant' and what is not is a narrow one, and the facts of this particular case come near to that dividing line. But in my judgment, in the circumstances of this case-and I think each case does depend largely on its own circumstances-the partitions should be regarded as something more than a mere setting for the carrying out of the trade; in other words as coming within the definition of 'plant' as contained in section 279."

Pearson, L.J., posing the question as to whether the partitioning is part of the premises in which the business is carried on, or part of the plant with which the business is carried on, observed, either view could have been taken. The two views were that the so-called partitioning, when erected, constitutes the internal walls of the building, which have the advantage of being movable, but until they are moved will stand firm and solid, fully performing the functions of internal walls and so regarded, the partitioning would be part of the premises and not plant; and the other view was that instead of having internal walls in its office building, needs to have, and does have for the special requirements of its business, movable partitioning, by means of which it can, in response to changing volumes of business in its departments or to the cessation of departments, or the emergency of new departments, rapidly and cheaply and without much interruption of business alter the subdivisions of its office building. On that view, according to Pearson, L.J., the partitioning could undoubtedly be regarded as 'plant'.

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The Gujarat High Court laid down the following test, as to what constitutes a 'plant':

"...The relevant test to be applied is: does it fulfil the function of plant in the assessee's trading activity? Is it the tool of the taxpayer's trade? If it is, then it is plant no matter that it is not very long-lasting or does not contain working parts such as a machine does and plays a merely passive role in the accomplishment of the trading purpose."

In CIT v. Colour Chem Ltd., the assessee was carrying on business in the manufacture and sale of pigments, pigment emulsion, distemper and other chemicals, dyes, etc. In the assessment year 1961-62, the company claimed depreciation allowance on the roadways inside the factory premises. Two questions were referred to the Bombay High Court for opinion, which were as follows:

1. Whether, on the facts and in the circumstances of the case, the Tribunal was justified in holding that the roadways, inside the factory premises of the assessee-company, come in the category of 'building' and as such are entitled to depreciation under section 10(2)(vi) of the Income Tax Act, 1922?

2. If the answer to question No.1 is in the negative, whether on the facts and in the circumstances of the case, the roadways in the factory premises would be entitled to depreciation as 'plant' under section 10(2)(vi) of the Act.

The Division Bench of the Bombay High Court took the view that the roads or roadways, within the factory premises will have to be regarded as adjuncts to the factory buildings or things appurtenant to the factory buildings since these link the various factory buildings lying within the premises and were used for carrying raw materials or finished products.

   In this case the assessee acquired drawings & patterns for the manufacture of gear units and conveyor idlers from foreign collaborators.

63. (1977) 106 ITR 323 (Bom)

64. The Bombay High Court has followed its earlier decision in Colour-Chem again in CIT v. Sandvik Asia Ltd. (1983) 12 Taxman 286 (Bom), where the roads within factory premises have been held to be 'buildings' and not 'plant'.

It could be seen that the Bombay High Court has distinguished the Supreme Court’s decision in *Taj Mahal Hotel’s case*. In the array of all these cases, a leading English authority—*Yarmouth v. France* has been considered as a good guide. Construing the word ‘plant’, as it appeared in the Employer’s liability Act, 1880, Lindley, L.J., observed as follows:

“There is no definition of plant in the Act; but, in its ordinary sense, it includes whatever apparatus is used by a businessman for carrying on his business not his stock-in-trade which he buys or makes for sale, but all goods and chattels, fixed or movable, live or dead, which he keeps for permanent employment in his business”.

Thus the term ‘plant’ does not include stock-in-trade nor does it include the place in which the business is carried on. On the other hand, it would also be appropriate to say, that the term ‘plant’ and ‘building’ are not mutually exclusive.

In *CIT v. Enco Electro Ltd.*, the question was whether the technical know-how sold to the assessee-company under an agreement constituted part of the assessee’s plant within the meaning of the term as defined in section 43(3) and whether the assessee would be entitled to allowance of development rebate thereon.

The Bombay High Court relying on the classic statement in *Yarmouth v. France* held that it would be impossible for the assessee to use that machinery unless he had the technical know-how and that the sum paid for the acquisition of the technical know-how had to be taken into account for the purpose of allowance of development rebate and depreciation as claimed by the assessee.

It could be inferred that the functional test as propounded by the Court of Appeal in *Yarmouth v. France* is the safest guide. Thus the ‘setting’ in which the business of the assessee is carried on cannot be regarded as a ‘plant’ for the purposes of section 32 read with section 43(3).

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65. (1887) 19 WBD 647
66. (1979) 118 ITR 864 (Bom)
67. Ibid
The conceptual differentiation between 'balancing charge' and 'balancing allowance' is dependent upon the difference between the actual cost and the written-down value. In case of a positive figure, when the asset is sold, discarded or demolished, and the amount realised comes to be higher than the written-down value, the excess subjected to a maximum of the actual cost of the asset is fictionally known as 'balancing charge'. Many innovations of far-reaching implications have been injected into the virus of this euphemism. At earlier stages of the 1922 Act, it was necessary in order to levy the 'balancing charge' that the asset must have been used during the relevant accounting year when it was sold, discarded, demolished, or destroyed. Thereafter amendments took place in the rubric of this fiction under the 1922 Act. An Explanation to section 10(2)(vii) was inserted reading as follows:

"Explanation—where the moneys payable in respect of the building, machinery, plant or furniture referred to in this sub-section become due in a previous year in which the business or profession for the purpose of which the building, machinery, plant or furniture was being used is no longer in existence, the provisions of this sub-section shall apply as if the business or profession is in existence in that previous year".

68. Liquidators of Pusa Ltd. v. CIT, Bihar (1954) 25 ITR 265(Sc)

69. The decision in The Liquidators of Pusa in this respect was thus superseded by this legislation. It became immaterial that the asset which has been sold, discarded, demolished or destroyed ceased to be used for the purpose of the business or profession even before the commencement of the accounting year in question or was used only for some portion of the accounting year and not the whole year. Again, it became immaterial that the business in question was no longer in existence at the time of the sale, discard, demolition or destruction, the business might have been wound up in an earlier year and the liquidator in the winding up might be selling the asset long after his appointment and the sale is a 'closing down sale'. Thus the decision in Ajax Products Ltd. v. CIT, Madras (1961) 42 ITR 141, and CIT, Madras/Bom v. Express Newspapers Ltd (1960) 40 ITR 38 were superseded by this legislation.
Subsequently the Supreme Court had to consider the scope of the term 'sale' for the purposes of section 10(2)(vii) of the 1922 Act in Fazilka Electric Supply Co. Ltd. v. CIT, Delhi where it was held that an acquisition by the government based upon a standing and irrevocable offer by the assessee to sell was not a compulsory sale. Thereafter, an amendment took place and the Explanation to proviso 3 to section 10(2)(vii) read as follows:

"Explanation-
(1)...

(2) 'sold' includes a transfer by way of exchange or a compulsory acquisition under any law for the time being in force..."

In this context, much controversy arose where the Revenue became anxious to create balancing charge even on amalgamation of companies. The contention of the revenue was that the difference between the actual consideration value of the shares being given by the transferee company to the shareholders of the transferor company, and their market value constituted a case of 'balancing charge'.

A scheme of amalgamation of companies is governed by section 394 of the Companies Act, 1956. It is very likely that the transferor company would be receiving for distribution amongst its shareholders from the transferee-company money or compensation in excess of the written-down value of the depreciable assets as standing on the date of amalgamation. Such a transaction does not involve a 'sale' for the purpose of section 32 or 41. The reason is that the transfer contemplated under section 41(2) is of depreciable assets and not a universal transfer as in the scheme of amalgamation, namely, of all assets and liabilities and of choses-in-action.

The same would be the position when amalgamation takes place by means of the voluntary winding-up of the transferor-company under section 494 of the Companies Act, 1956.

70. (1962) 46 ITR 127, 133(SC)
71. Thus the line of thought propounded by the Supreme Court in Fazilka Electric Supply Co. was superseded by this legislation
72. Moreover, the title of the asset transferred arises not under the provisions of the Sale of Goods Act or the Transfer of Property Act as in an ordinary case of sale, but by virtue of the Court's order under sub-section(2) of Section 394 of the Companies Act.
It is in line with the foregoing discussion that the Finance Act, 1967 inserted the following words in the term "sold" under the Explanation to section 32(1)(iii).

"(2) ...but does not include a transfer in a scheme of amalgamation, of any asset by the amalgamating company to the amalgamated company where the amalgamated company is an Indian Company".

On the other hand, in the absence of any scheme of amalgamation, the liquidator sells any building, machinery, plant or furniture in the ordinary course of converting goods and articles into cash, the moneys so received by him in excess over written down value of the assets sold would constitute his income within the meaning of section 41(2). It is immaterial that the building, machinery, plant or furniture was or was not used during the accounting year or that the business or profession itself was no longer in existence at the time when the building, machinery, plant or furniture was sold.

Under the 1961 Act, section 41(2) uses the words 'the previous year in which the money payable for the building, machinery, plant or furniture became due' in place of "deemed to be profits of the previous year in which the sale took place" used in second proviso to section 10(2)(vii) of the 1922 Act. This is a radical departure from the 1922 Act. In a recent case decided by the Delhi High Court, CIT v. Rohtak Textiles Ltd., the question was as to when the moneys payable in respect of the sale became due to the assessee. The Delhi High Court held:

"However, where it was not a case of sale but one of receipt of compensation moneys on discardment, demolition or destruction, the excess was "deemed as profits of the previous year in which such moneys were received "as per the fourth proviso to section 10(2)(vii). Under the 1961 Act, however, the previous year in which the balancing charge—as the charge under section 44(2) is called—is to

73. The decision to the contrary in CIT, Madras/Bombay v. Express Newspapers Ltd., (1960) 40 ITR 38 is superseded by the 1961 Act.

74. (1982) Tax 66(3)-7
be levied is not the previous year in which the sale took place but the previous year in which the moneys payable become due. The new Act has deliberately made a departure from the corresponding language of the old Act and this has to be borne in mind in considering the issues before us".

The concept of balancing charge which itself hinges upon law of fiction gets overriden with another fiction in so far as instead of the sums being 'received', under the 1922 Act, now it is the sums being 'due' under the 1961 Act.

Consequently an important question has arisen in many cases as to whether set off of unabsorbed depreciation allowance could be claimed by the assessee, while computing the quantum of 'balancing charge', in a year in which the business is no longer in existence. The courts are unanimous on the following view:

"That in construing the scope of a legal fiction, it would be proper and even would be necessary to assume all those facts upon which alone the fiction would operate and not to restrict it unless the section which created that fiction gave an indication that the fiction was for a limited purpose".

This nature and scope of a legal fiction owes its genesis to the classic statement by Lord Asquith in *East End Dwellings Co.Ltd. v. Finsbury Borough Council* in the following terms:

"It permits one's imagination to boggle when it comes to the inevitable corollaries of the State of affairs introduced by the fiction".

In *Eastern Cold Storage (P) Ltd. v. CIT* the assessee-company during the previous year for assessment year 1972-73 stopped functioning for the last few years, sold away certain items of plant and machinery for Rs 1,21,001. The ITO determined the written down value of the items sold at Rs 90,187 and thus computed a profit of Rs 30,814 under section 41(2) of the Income

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75. Cf. *Reliance Jute & Industries Ltd. v. CIT* 127 ITR 842(Cal). This case related to another fiction enumerated in section 214(1-A) of the 1961 Act dealing with advance payment of tax.

76. (1952) AC 109; (1951) 2 All E.R. 587 (HL)

77. (1981) Tax 62(3)-27(Cal)
Tax Act, 1961. The ITO did not allow any set off in respect of the depreciation allowance of earlier years, which had remained unabsorbed.

The Calcutta High Court observed:

"Section 41(2) enacts a fiction that the business is deemed to be carried on in the year in which the profit which is known as balancing charge, arises out of the sale of depreciated assets. Section 32(2) further deems the unabsorbed depreciation of earlier years to be the depreciation for the year in which it is to be set off. It is not necessary that the business in respect of which the depreciation allowance was originally worked out should remain in existence in the succeeding year nor it is necessary that the business assets to which the depreciation pertains must be used in the business carried on in the succeeding year. All that was necessary was that the assessee must carry on some business in the succeeding year in which the set off of unabsorbed depreciation is claimed. Section 41(2) is not limited only for the purpose of that section but is for all the purposes of the Act".

The Kerala High Court and Andhra Pradesh High Court have also taken the same views.

In order to appreciate the content of fiction, another

78. In CIT v. official liquidator, New Era Mfg. Co., Ltd., (1977) 109 ITR 262, the company went into liquidation in the accounting year 1963-64 and it had an unabsorbed depreciation amount of Rs 1,81,019. In the accounting year 1969-70, some plant and machinery belonging to the company were sold for Rs 1,08,743. In the return filed by the company no profit under section 41(2) of the I.T. Act, 1961 was disclosed but a note was added in the return showing 'value received by sale of plant and machinery is less than book value' and no income was shown. The ITO estimated the written down value of the plant & machinery for the purpose of section 41(2) at Rs 35,692 and adjusted the same against Rs 1,00,000 being the sale price of plant and machinery and thus arrived at a profit of Rs 64,308 which he assessed to tax under section 41(2).

The Division Bench of the Kerala High Court held:

(Headnote).

"Since the business of the assessee should be deemed to be in existence in the accounting year relevant to the assessment year 1970-71, by the fiction introduced by the Explanation to section 41(2), the unabsorbed depreciation of the past years could be carried forward and set off against the profits computed in terms of section 41(2) for the assessment year 1970-71".

79. In CIT v. Warangal Industries Pvt., Ltd., 110 ITR 756 (AP), the assessee, a private limited company, sold its building,
aspect concerning remission of debt may be considered. It is settled law that a debt forgiven cannot be treated as income. In British Mexican Petroleum Co., Ltd. v. Jacks [80] the assessee entered into a contract with an oil producing company for the purchase of petroleum over a period of years. The unpaid price of the oil supplied was debited in the accounts. In view of the adverse effect of business slump on the assessee-company, the Petroleum producing company accepted payment of a part of the debt and released the assessee-company from its liability to pay the balance which was due.

The House of Lords held that the amount remitted could not be included as a revenue receipt in the accounts of the year of remission, and that the accounts of the preceding year, where the whole debt was debited should not be reopened and adjusted by reference to the remission. [81]

Lord Macmillan observed:

"I cannot see how the extent to which the debt is forgiven can become a credit item in the trading account for the period within which the concession is made".

79contd,machinery etc., on 22nd October, 1965 and the title to the immovable property was transferred on 19th February 1966, though the documents of transfer were registered in October, 1970. The assessee closed its accounts every Depavali, that is, in this case on November 22, 1966.

The ITO held that the assessee did not carry on any business during the assessment year 1967-68 on this ground that the plant and machinery and building were sold on 22nd October, 1965, and accordingly included the business income returned by the assessee under the head "other sources". He further computed the income under section 41(2) of the Income Tax Act, 1961 at Rs 43,496 rejecting the claim of the assessee in regard to the unabsorbed depreciation on the same ground that it had not carried on the business during the previous year.

Divan, C.J., speaking for the Andhra Pradesh High Court observed (Ibid 761)

"It is clear that so far as the unabsorbed depreciation from the previous years is concerned it is allowable from any income from any source whatsoever in the subsequent years of account and that principle being clear, it is obvious that notwithstanding the provisions of section 41(5) full effect must be given to the deeming fiction under section 32(2). . . . it is clear that unabsorbed depreciation of past years has to be added to the deprecation of the current year and the aggregate unabsorbed and current year's depreciation has to be deducted from the total income of the previous year".

80. (1932) 16 TC 570 (HL)
This case has been followed by the Indian Courts, but now there is a statutory modification to this well-settled principle of law by virtue of section 41(1) of the Act—the same section under which the euphemism of balancing charge exists.

The conceptual treatment section 41(1) is not at all different from section 41(2). Balancing charge, in essence, a remission by virtue of the abnormalities of inflation. Moreover, the Indian Law has gone far ahead on the basis of formulations wading through the jungle of fictions.

This fictional charge fails when a depreciable asset is partly damaged and the owner of the depreciable asset becomes entitled to receive compensation for loss from the insurer, and the amount of compensation received is utilized partly to restore the plant and machinery to its original working condition, the excess of the amount of compensation over the written down value of the depreciable asset or the cost incurred to restore the plant and machinery to the original working condition would not give rise to any balancing charge under section 41(2), nor any liability to capital gains tax under section 45, since there being no transfer of the capital assets. It has been so held in CIT v. Engineering Works of India Ltd.

In other words, the assessee could be in a better position from the point of view of tax liability in that case where the asset is partly damaged. It is submitted that the entire theory of 'balancing charge' has no valid justification, particularly in the present times of galloping inflation.

81. Ibid, 593
82. Orient Corporation v. CIT 18 ITR 28; CIT v. New Jehangir Vakil Mills Co., Ltd. 37 ITR 136
83. This modification is further subjected to certain conditions CIT v. P Ganesa Chettiar (1982) 133 ITR 103(Mad)
84. (1977) 108 ITR 11 (Cal); On the other hand, if the capital asset is not merely damaged, but also destroyed, there will be a transfer attracting balancing charge as held in Mary Bong Keyl Tea Estates Ltd. v. CIT (1981) 129 ITR 661 (Cal)
The concept of development rebate was first introduced in the Income Tax, 1922 with effect from April 1, 1955 by insertion of Section 10(2)(vi-b) in the 1922 Act. A proviso was added to section 10(2)(vi-b) with effect from April 1, 1960, withdrawing development rebate in respect of road transport vehicles and office appliances.

Development rebate is not a part of depreciation allowance and is granted over and above the full recoupment of the total cost of plant and machinery by way of depreciation allowance and balancing allowance. Provisions of the 1922 Act were incorporated in the 1961 Act with the only significant change that the period of ten years during which the asset could not be transferred was reduced to 8 years under the 1961 Act. Two important ingredients of development rebate are:

1. The amount of the development rebate shall have to be adjusted, set off and carried forward, within a period of 8 years;
2. The rebate is granted subject to the negative obligation on the assessee not to utilise the reserve for prohibited purposes during a period of 8 years.

Consequential to the definition of the term 'amalgamation' in section 2(1A) of the 1961 Act by virtue of the Finance Act, 1967, for the first time necessary insertions were made in section 33 in

85. No development rebate is permitted in respect of 'office appliances' such as typewriter, calculator, duplicator, dictaphone, etc. The decision in CIT, Bombay City v. Lever Bros. (India) Ltd, 1959, 37 ITR 140-141 to the contrary is superseded by this legislation. Similarly, in respect of 'road transport vehicles' such as bicycles, motor cars, buses or lorries no development rebate is permitted. The decision in CIT (Central) Bombay v. Sarspur Mills Ltd, (1959) 36 ITR 580 to the contrary is also superseded by virtue of this legislation. Thus all these cases under the 1922 Act in which it was held that the expression 'plant...installed' includes not only an asset which from its very nature, would be capable of being 'fixed in position' but also other assets incapable of being so fixed, became redundant with the amendment in 1960.

86. The prohibited purposes are:

1) such machinery or plant was not used in India at any time previous to the date of such installation by the assessee;
2) no deduction on account of depreciation or development rebate in respect of the Indian Income Tax Act, 1922, or this Act in computing the total income of any person for any period prior to the date of installation of the machinery or plant by the assessee.
regard to development rebate. The Finance Act, 1968 amended the fifth schedule to the Income Tax Act, 1961 in order to enlarge the scope of priority industries, entitled to development rebate at a higher rate. Such a fiscal policy gives an insight into the patterns of rationalization, that after a period of 14 years two items namely, cotton textiles and jute textiles, were added to the fifth schedule, with the result that new machinery and plant installed in any such industries became eligible for development rebate at a higher rate.

Investment allowance came on the scene of fiscal legislation by virtue of the Finance Act, 1976 making definite improvements on the methodology of development rebate. In essence, initial depreciation, merely provided for 'shifting the tax burden'- a postponement of tax liability due to accelerated depreciation, whereas development rebate granted a deduction over and above the actual cost of the asset, and the investment allowance gave a fillip for innovation, renovation, substitution and replacement of the capital assets in the industry.

87. Carry forward of development rebate in a scheme of amalgamation is continued to the successor on the basis that he does not in any way utilise there reserve fund contrary to the undertaking given by the predecessor or does not dispose of the asset within the stipulated period.

88. Investment Allowance replaced initial depreciation under section 32A(1)(vi), which survived for only 2 years. The definite improvements on the methodology of development rebate are as follows:

1) No deduction shall be allowed under section 32A on account of investment allowance in respect of any machinery or plant, the whole of the actual cost of which is allowed as a deduction (whether by way of depreciation or otherwise) in computing the income of any one previous year (Proviso (d) to section 32A(1). It is important to note that such a provision is not there under section 33 enumerating development rebate.

2) Investment allowance shall be allowed only if the investment allowance reserve account is utilised for the purposes of acquiring, before the expiry of a period of ten years, a new machinery, for the purposes of the business of the undertaking; such a provision regarding utilisation of the reserve for business purposes is not there in section 33.

3) Section 32A(3) lays down that where the total income of the assessee assessable for the assessment year is nil or is less than the full amount of the investment allowance; "(1) the sum to be allowed by way of investment allowance for that assessment year under sub section (1) shall be only such amount as is sufficient to reduce the said total income to nil"; and in this manner the carry forward of the
Howsoever, an anomalous provision exists in section 32A, in as much as it existed, even under the 1922 Act, and now in Section 33 too. When a firm is succeeded to by a limited company, the company is entitled to avail the benefit of development rebate or investment allowance, as the case may be. But three conditions are to be satisfied, the last one being as enumerated in the Explanation to section 32A(7):

"Explanation: The provisions of this sub-section shall apply only where:

i)...

ii)...

iii) all the shareholders of the company were partners of the firm immediately before the succession".

In regard to this condition, section 10(2)(vi-c)(ii) of the 1922 Act extended the benefit of development rebate where a firm was succeeded to by a private company. When the Income Tax Bill of the 1961 Act was considered, the corresponding provision, viz., section 33(4) and Explanation thereto ran in similar language. The obvious result of this condition is that the newly formed company cannot exceed in strength the number of partners in the firm immediately before the succession and no new person can become a shareholder of the company. Any attempt to expand the company into a full-fledged public company is thus thwarted. Since a partnership cannot exceed 20 members, the public company to be formed cannot contain more than 20 members. In case a public limited company is to be formed in such a case, then it shall have to content itself at least for one year with a private limited company, so that the privilege of development rebate or investment allowance may remain intact. It is submitted that this provision defeats the very purpose of fiscal legislation.

Another important condition to qualify for development rebate or investment allowance is the creation of a reserve, known contd. unabsorbed investment allowance is permissible for a period of 8 years. It is important to note that such an express provision is not enumerated under section 33.
as 'development rebate reserve' or 'investment allowance reserve'.
The question of crucial importance, as to whether a separate fund known as development rebate reserve or investment allowance reserve is to be maintained. In Indian Overseas Bank Ltd. v. CIT, the supreme Court had to consider the question whether creation of a reserve in compliance with section 17 of the Banking Companies Act was sufficient compliance with the requirements of section 10(2) (vib), proviso (b) of the 1922 Act. The authorities under the Act as well as the High Court had answered the question in the negative. What happened in that case was that the appellant company had transferred a sum of Rs 6 lakhs from the profit and loss account to the reserve fund which sum was sufficient to meet the requirements of section 17 of the Banking Companies Act, 1949, as well as of Proviso (b) to section 10(2) (vib) of the 1922 Act. But no separate reserve fund as required by proviso (b) to section 10(2) (vib) had been created. The contention of the appellant was that as the transfer to the reserve was sufficient to meet the requirements of section 17 of the Banking Companies Act, as well as of proviso (b) to section 10 (2)(vib) of the 1922 Act, in substance, it had complied with the requirements of law, and therefore, it was entitled to the allowance of the rebate claimed.

The Supreme Court said that the creation of the reserve contemplated by this provision is a condition precedent for obtaining the allowance of development rebate. Admittedly, the appellant therein had not created any such separate reserve. The reserve contemplated by that proviso is an independent

89. Section 32A(4)(ii) of the 1961 Act lays down:

"(ii) an amount equal to seventy-five percent of the investment allowance to be actually allowed is debited to the profit and loss account of the previous year in respect of which the deduction is to be allowed and credited to a reserve account (to be called the 'Investment Allowance Reserve Account') to be utilised...".

90. (1970) 77 ITR 512 (SC)
The Supreme Court quoted with approval the observations of the Madras High Court in CIT v. Veera-swami Nainar (1965) 55 ITR 35 that the object of the Legislature in allowing a development of the assessee's business from out of the reserve fund is apparent from the terms of the proviso. The entries in the account books required by the proviso are not an idle formality. The assessee being obliged to credit the reserve fund for a specific purpose, he cannot draw upon the same for purposes other than those of business and that amount cannot be distributed by way of dividend.

On the other hand, Calcutta High Court has held in two decisions, CIT v. Calcutta Tramways Co., Ltd. and Calcutta Tramways Co., Ltd. v. CIT, that there was no justification in construing section 34(3) as a statutory obligation to maintain a separate fund known as development rebate reserve nor is there any legal bar against the inclusion of such amount in the balance sheet under a separate account such as shareholder's account. If there were funds available in that account, the assessee should be construed to have complied with the statutory requirements. Or, if there were sufficient funds available in another account which could be earmarked for development rebate reserve that would be sufficient for the purpose of compliance with the statutory provisions.

The Calcutta High Court also held that the ratio of the Supreme Court's judgment in Indian Overseas case cannot be applied to construction of section 34(3)(a) because that deals with the reserve under section 17 of the Banking Companies Act. Under section 17 the fund is to be set apart out of the net profits of each year whereas the development reserve account under the Income Tax Act is to be maintained before the profit and loss account is made up or concluded and there was no scope for setting apart a reserve in the nature of one provided in section 17 of the Banking

91. The Supreme Court quoted with approval the observations of the Madras High Court in CIT v. Veera-swami Nainar (1965) 55 ITR 35 that the object of the Legislature in allowing a development of the assessee's business from out of the reserve fund is apparent from the terms of the proviso. The entries in the account books required by the proviso are not an idle formality. The assessee being obliged to credit the reserve fund for a specific purpose, he cannot draw upon the same for purposes other than those of business and that amount cannot be distributed by way of dividend.

92. (1969) 74 ITR 7

93. (1978) 112 ITR 643
One fundamental difference between the provisions of sections 32 and 32A is that in case of the investment allowance the asset must be 'wholly used for the purposes of the business' carried on by the assessee. In the case of leasing agreements, the asset is owned by one person, but it is used by the lessee in his own business. Therefore, the lessor-company cannot satisfy this condition to qualify for investment allowance. It can be argued that 'leasing-out' itself being the business of the lessor-company, it would be entitled for such an allowance. But it would be circumvented by the term 'wholly', since lessee-company would be also using such asset for its business.

It is to be noted that the concept of leasing has become much popular during the past one decade, particularly after 1976 when 'investment allowance' was introduced. It is necessary that in order to make the position of law clear, a clarificatory amendment may be inserted in section 32A, as to whether a lessor-company would be entitled for investment allowance or not.

**EXPENDITURE ON SCIENTIFIC RESEARCH**

Provision for allowing expenditure on scientific research was made in India, for the first time, in 1946 on the pattern adopted by the United Kingdom after the war, but the concession was extended in respect of expenditure on scientific research related to business alone.

The only debatable issue in regard to this allowance had been, as to whether depreciation could be allowed on such scientific assets on which this allowance was also given. This controversy has been finally resolved by amending section 35 retrospectively with effect from April 1, 1962, with the result that on such assets on which, on account of scientific research has been claimed, then

98. The term 'scientific research' has been defined in section 43(4) of the 1961 Act.

99. In Hoechst Dyes and Chemicals Ltd, Penwalt India Ltd, and J.K. Synthetics Ltd. (Cf. 1979 1 Taxmann 202 (Sec.II) the Appellate Tribunal, Bombay Bench held that the provisions of sections 32 & 35 are mutually exclusive.
depreciation cannot be claimed. The reason is that the concept of terminal allowance (or so to say, Balancing Allowance) has been provided in the machinery of section 35 itself.

EXPENDITURE ON ACQUISITION OF PATENT RIGHTS OR COPYRIGHTS

Section 35A is one of those rarest sections, for the enactment of which the credit goes to the Central Board of Direct Taxes. The Board issued a circular, by virtue of which an expenditure on account of acquisition of patent or copyright was to be treated as consolidated revenue expenditure allowed on an 'amortisation basis' over a period of 14 years.

Thereafter, the Finance Act, 1966 inserted section 35A; hence before it no such expenditure was enumerated either under the 1961 Act or 1922 Act.

BAD DEBTS

This allowance ordains the general principle of tax laws that in order to arrive at the true profit of a business, bad debts are to be allowed as a deduction. Till the Income Tax (Amendment) Act, 1939, there was no specific provision in law for such an allowance. This Amendment Act statutorily introduced this deduction by virtue of section 10(2)(xi). But this provision suffered with many anomalies, inequities, and inconsistencies in...

1. Section 35(2)(iv) lays down:

"Where a deduction is allowed for any previous year under this section in respect of expenditure represented wholly or partly by an asset, no deduction shall be allowed under clauses (i), (ii), (iia), (iii) & (vi) of sub-section (1), or under sub-section (1A) of section 32 for the same or any other previous year in respect of that asset".

2. Section 35(2)(ii), (iii). The Finance Act, 1983 has laid down that any sum shall have to be paid to a public sector company with a specific direction that the sum shall not be used for the acquisition of any land or building or construction of any building if the deduction in respect of expenditure on scientific research is to be availed.

its working. Either the debt became bad in an earlier year for which the assessment already became completed, or the claim being premature, and then subsequently holding it to be 'bad' for an earlier year, thus denying the relief altogether. This was on the principle that the doctrine of res judicata and estoppel did not apply to income tax proceedings and that the assessment for each assessment year was a self-contained one, regardless of what might have been decided in earlier assessment years.

To remedy the prevailing situation, the 1961 Act recasted the provisions of section 10(2)(x) of the 1922 Act in what are now section 36(1)(vii) and clauses (i) to (iv) of section 36(2). According to the law, as it now stands, when an assessee claims a debt as having become bad in the accounting year, if the ITO is satisfied that the debt or a part of the debt did become bad in the accounting year, he should grant deduction either in full or in part, as the case may be. Should the ITO find that the debt has not yet become bad and that the claim for 'badness' is premature, then he should permit the deduction of the debt in the assessment of the concerned later year, if in the meantime the debt had not been recovered.

Section 155(6) enacts an outer limit within which the rectification should be made. The language relating thereto is unhappy, as compared with section 154(7). It states that such outer limit shall be "the period of 4 years specified in subsection (7) of that section being reckoned from the end of the financial year in which the assessment relating to the previous

4. The ITO could refuse to grant allowance therefor on the ground that the debt in question had become bad in an earlier year, and there was no power in the assessee to ask for relief in respect of such earlier year, if the assessment had already been made in respect of such earlier year. The ITO could also refuse to grant the allowance on the ground that the debt had not yet become bad in the accounting year and that the assessee's claim was premature. When such later year arrived, it was open to the ITO to hold in such later year, inconsistently, that the debt had already become bad, and refuse to grant relief in such later year too.

5. On the other hand, if the ITO holds that the debt or part of the debt had become bad in an earlier accounting year and that year is within a period of 4 years immediately preceding the accounting year, in which the debt was written off, the ITO should grant the allowance for bad debt for such earlier year and in case the assessment had already been completed in respect of such earlier year, he
year in which the debt is written off is made". Since section 155 carries its own period of limitation, the language of section 155(6) which applies the period of 4 years, the legislature should have enacted section 155(6) as:

"...and the amendment shall be made within a period of 4 years reckoned from the end of the financial year in which the assessment relating to the previous year in which the debt is written off is made".

Further, the language of section 155(6) permits the ITO to reopen the assessment of any previous year, provided "If the assessee accepts such a finding of the Income Tax Officer", that the debt became bad in that particular year. It means that where there is a difference of opinion between the assessee and the ITO, the ITO should hold up the reopening of back assessment till the matter is finally disposed of by the appellate authorities.

The controversy as to the particular year in which the debt became bad is now of secondary importance. Even then, the year in which it is declared to be 'bad debt' becomes material in the following three circumstances:

1. Where the income of the assessee fluctuates from year to year and the grant of the deduction for a year when the income was high, carrying higher slab rates of income tax, would result in a greater loss to the revenue;

2. Where the rates as fixed by the annual Finance Acts fluctuate and the grant of the deduction for a year, when the rates of taxation were high, would result in revenue loss;

3. On the other hand, it can be a loss to the assessee, where the year in which the debt truly became bad is beyond 4 years preceding the accounting year, in which event, no deduction can be granted.

5contd. should reopen the assessment and make the necessary corrections and adjustments (Section 36(2)(iv) read with section 155(6)).

6. A right of appeal for this purpose is now granted by the 1961 Act; section 246(f)
A radical departure has been made from the 1922 Act in as much as under the 1922 Act the relief for 'bad debt' was granted to a business, whereas under the 1961 Act the relief is provided to the assessee who carries on a business, not to the business itself. The 1961 Act lays down two specific requirements for allowance of a bad debt, viz,

i) that a certain assessee should have included the debt in his own total income and paid tax thereon, and

ii) that the same assessee should have written off the debt as irrecoverable by him.

These two conditions are cumulative as shown by the conjunctive 'and' at the end of clause (a) of section 36(2)(i).

DEDUCTION IN RESPECT OF INTER-CORPORATE DIVIDENDS

This deduction has a long-drawn history, and the genesis centres around this crucial point, as to whether deduction in respect of inter-corporate dividend could be calculated with respect to the gross dividend or net dividend received by the assessee-company as inter-corporate dividend.

After the repeal of 1922 Act, section 99 of the 1961 Act exempted certain categories of income from super-tax and one of such categories was inter-corporate dividend received from an Indian Company. A question arose in CIT v. New Great Insurance Co. Ltd., whether the exemption granted under section 99(1)(iv) was in

7. Section 36(2) lays down:
   "In making any deduction for a bad debt or part thereof the following provisions shall apply:
   1) No such deduction shall be allowed unless such debt or part thereof-
      a) has been taken into account in computing the income of the assessee of that previous year, or of an earlier previous year, and
      b) has been written off as irrecoverable in the accounts of the assessee for that previous year...".

8. Sections 70 and 71 in relation to carry forward and set off of losses also enact that losses incurred by an assessee in a year can be set off only against his own income under any other sources or heads.

9. Section 99(1)(iv) read as follows: "99(1) super-tax shall not be payable by an assessee in respect of the following amounts which are included in his total income..."

   (iv)if the assessee is a company, any dividend received by it from an Indian Company subject to the provisions contained in the fifth schedule"
regard to the entire amount of dividend received by the assessee from an Indian Company, or it was limited to the dividend income computed in accordance with the provisions of the Act.

The argument of the assessee based on the words "any dividend received by it from an Indian Company" was that it was the full amount of dividend received by the assessee which was exempt from super-tax, while the revenue relied on the words "amounts which are included in his total income" contending that it was only the amount of dividend computed in accordance with the provisions of the Act and forming part of total income which was entitled to the benefit of exemption under this provision.

Accepting the contention of the assessee, the Bombay High Court emphasised the word "received" following immediately upon the word dividend and observed that the use of the word also showed that the exemption was in regard to the dividend received and not in regard to the "dividend received minus the expenses".

The High Court further observed:
"The words 'amounts which are included in his total income' in the opening part of section 99, sub-section (1), did not have any limitative effect, but they were used merely as a convenient mode of describing the different items of income set out in clauses (i) to (v) of that sub-section clauses (i) to (v) referred to different items of income which were sought to be exempted from super-tax under sub-section (1) of section 99 and it was only if these items of income were included in the total income of the assessee that the question of exemption from super-tax would arise and hence the legislature used the general words "amounts which are included in his total income" in the opening part of sub-section (1) of section 99 as an omnibus formula to cover these different items".

The Supreme Court narrating the history of these legislative provisions has observed:
"These words according to the High Court were descriptive of the items of income included in the computation of the total income and were not indicative of the quantum of the amounts of the different items included in such computation and they did not, therefore, have the effect of cutting

11. Cf., Cloth Traders (P)Ltd., v. Addl.CIT(1979) 118 ITR 243, 249 (SC)
down the plain natural meaning of the words "any dividend received by it from an Indian Company" which represented the quantum of income in respect of which exemption from super-tax was granted under the section. This view, observed the High Court, not only followed logically and inevitably from the words used in the Statutory provision, but was also in consonance with the object of the legislation, which was to prevent double taxation of the amount of dividend with a view to encouraging investment by companies in the share capital of other companies".

Thereafter, by virtue of an amendment by the Finance Act, 1965, section 99, sub-section 1 was omitted and section 85A was introduced. Except for some minor verbal changes, section 85A was almost in the same terms as clause (iv) of section 99(1), the only real difference being that exemption granted earlier was in regard to super-tax, while the deduction allowed under section 85A was in regard to income tax.

Then Finance Act, 1967 deleted the original chapter VI A and certain other sections including section 85A, and a new chapter VIA containing a fasciculus of sections ranging from section 80A to 80 W were introduced. Thus the present section 80M corresponds to the repealed section 85A. Bringing out the distinction between the phraseology of section 85A and 80M, the Supreme Court held:

"There is a difference in as much as section 85A provides for calculation of rebate of income tax on 'income so included', while section 80M provides for deduction of the whole or part of 'such income by way of dividends'. Even if there be any doubt or ambiguity in regard to the meaning of the words "income so included" in section 85A, though we do not think that there is any scope for such doubt or ambiguity. The language employed by the Legislature in section 80M is much clearer and leaves no doubt that the deduction, whether whole or 60% is to be calculated with reference to the entire amount of income by way of dividends received from a domestic company".

12. Chapter VI A was also introduced by virtue of the Finance Act, 1965
13. Ibid 257. The Supreme Court observed regarding these amendments as follows: (Ibid 256), "The object of introducing these amendments was to widen the scope of the tax relief provided under section 99, sub-section (1), clause (iv), and section 85A by making it available to the assessee even though the shares to which the dividend related were registered in the name of a person other than the assessee and not to narrow it down by restricting it to net dividend computed after making deductions allowable under the provisions of the Act".
The Supreme Court further observed:

"If the legislature was of the view that the deduction should not be in respect of the full amount of dividends received from a domestic company, but it should only be in respect of the amount of dividends computed after deducting allowable expenditure, we have no doubt that the legislature would have amended section 80M, sub-section (1), and made its intention quite clear. The legislature in fact amended section 80M several times in respect of other matters, subsequent to the decision of the Bombay High Court in New Great Insurance Co's. case and the decision of the Madras High Court in Madras Auto Service case, but it did not choose to amend the language employed in section 80M, sub-section (1) for the purpose of over-riding the interpretation placed by the Courts."

14. Ibid, 259-60
15. (1973) 90 ITR 348
16. (1975) 101 ITR 589. The Supreme Court's judgment in Cloth Traders (P)Ltd., v. Addl.CIT, Guj(1979) 118 ITR 243 has been followed by the Delhi High Court in Addl CIT v. Seth Vineet Vimani (1982) Tax 64(3)-231, where the High Court observed as under:

"The Supreme Court held that if the gross total income included income by way of dividend from a domestic company, whatever be the quantum of such 'income', the condition for applicability of section 80M would be satisfied and the assessee would be eligible, for deduction of the whole or sixty percent of 'such income', as the case may be. The words 'such income' did not have reference to the quantum of the income included but referred only to the category of the income included i.e. income by way of dividend from a domestic company."

Though the learned counsel for the revenue placed reliance on Cambay Electric Supply Industrial Company Ltd., v. CIT (1978) 113 ITR 84(SC) and suggested that there was a conflict between the principle enunciated in Cloth Traders and Cambay's case. But the court held that "the two decisions of the Supreme Court deal with different situations and there is no real inconsistency". In Cambay Electric Case, the question was, whether unabsorbed business losses could be set off before calculating the deduction under section 80E. The Supreme Court observed: (Ibid,97-98). "It is not possible to accept the view that section 72 has no bearing on, or is unconnected with the computation of the total income of an assessee under the head "profits and gains of business or profession"...In other words the correct figure of total income, which is otherwise taxable under other provisions of the Act, cannot be arrived at without working out the net result of computation under the head "profits and gains of business or profession"."
The entire foregoing discussion has been set at naught by the introduction of section 80AA by virtue of the Finance Act, 1980 having retrospective effect from 1st April, 1968, thus superseding the Supreme Court's judgment in Cloth Traders (P)Ltd. v. Addl. CIT, Gujrat. Thus section 80AA clearly lays down that deduction under section 80M shall be computed "with reference to the income by way of such dividends as computed in accordance with the provisions of this Act (before making any deduction under this chapter) and not with reference to the gross amount of such dividends".

The following discussion would throw light on an important aspect of law that the exemptions and reliefs are provided in a skewed manner, whereby providence imputes its own implications.

The words "not being a building taken on rent or lease" were not there in the old section 15C of the 1922 Act, or even in section 84 of the 1961 Act. It was only in section 80J, which came into force from 1st April, 1968, that the aforesaid words were introduced. The net result was that if a newly established undertaking has been formed by the transfer of a building taken on rent or lease, then the benefit granted by virtue of section 80J shall not be available.

In a recent case, CIT v. Plastics Packaging (P)Ltd, the assessee-company started a new industrial undertaking in an old building. The owners of the building had previously let the premises to GP(P)Ltd, and GP(P) Ltd sublet the premises to the

17. Ibid
18. In the case of Capsulation Services (P)Ltd v. CIT(1973) 91 ITR 566 (Bom), the company was carrying on the business of manufacture and sale of gelatin capsules, in a premises on monthly lease. The Bombay High Court held: "The condition which lays down that the undertaking should not be formed by transfer of a building previously used in any other business, did not make any reference to the ownership of the undertaking which is formed by splitting up or reconstruction of an existing business".
19. (1982) 134 ITR 236(Bom)
assessee-company. The ITO held that the assessee-company was not entitled to relief under section 15C of the Income Tax Act, 1922 for the assessment years 1960-61, 1961-62, and under section 84 of the 1961 Act (now section 80J) for the assessment years 1962-63 and 1963-64.

The Tribunal did not decide the question, whether or not the assessee occupied the premises on leave and licence basis because, according to the Tribunal, even if it was a sub-lease, the assessee could not be denied relief under section 15C of the 1922 Act or section 84 of the 1961 Act, since in view of the Tribunal, a 'lease' of a sub-lease did not constitute a transfer.

The Bombay High Court held:

"If the assessee was a lessee or a sub-lessee, then the decision in Capsulation Services P Ltd. v. CIT" would apply. If the assessee was a licensee, then the decision in CIT v. Bayer Agro Chem Ltd. would apply... Therefore, the Tribunal was not right in holding that the utilisation of the building by the assessee in its new industrial undertaking made no difference to the relief under section 15C of the Indian Income Tax Act, 1922 or section 84 of the Income Tax Act, 1961 (now section 80J)".

In two recent cases, one from the Bombay High Court, CIT v. Indian Expanded Metals (P)Ltd., and the other from Gujrat High Court CIT v. Suessin Textile Bearing Ltd., the judgments of Bombay High Court in CIT v. Suessin Textiles Ball Bearing & Products (P) Ltd., and Capsulation Services (P)Ltd. v. CIT were considered; while the Bombay High Court applied its earlier aforementioned judgments but the Gujrat High Court has dissented from both the Bombay High Court judgments.

In the Gujarat High Court case of CIT v. Suessin Textile Bearing Ltd., applying the principle of 'noscitur a sociis', the court held:

20. (1973) 91 ITR 566 (Bom)
22. (1982) 134 ITR 483 (Bom)
23. (1982) 135 ITR 443 (Guj)
24. (1979) 118 ITR 45 (Bom)
25. (1973) 91 ITR 566 (Bom)
27. Ibid, Headnote
"...unless this object of encouraging the setting up of new industrial undertakings by giving tax relief with reference to the investment of capital in the new business is borne in mind, it is not possible to interpret the condition laid down in section 15C of the Act of 1922 and section 84 of the Act of 1961. Section 84(2) imposes a condition that the industrial undertakings should not be formed by transfer to a new business of building, machinery or plant used in a business which was being carried on before April 1, 1948. "Transfer to a new business", in this context, must be transfer to the new business of the assessee and "a business which was being carried on before April 1, 1948" must mean a business of the assessee. The principle of noscitur a sociis would apply so far as the interpretation of this negative condition is concerned".

The Court further observed:

"Both as a matter of commonsense as well as from the point of view of commercial expediency and the position in the metropolitan cities and major centres of industries it would be impossible to expect that a building should be a space which was not used at all at any previous time by someone else.

Hence, when the other conditions laid down in section 84 are satisfied, the benefit of tax holiday cannot be denied merely because the premises taken on rent or lease for purposes of the new undertaking were previously used for business.

On the other hand, Bombay High Court held:

"The word 'transfer' in section 84(2)(ii) of the Income Tax Act, 1961 cannot be restricted to a case where the full rights of ownership were transferred and that it would include a transfer also of some limited right or interest

Ibid, Headnote. Tracing the subsequent legislative history, the Gujarat High Court observed, reinforces the conclusion arrived at as a pure question of construction. With effect from April 1, 1967, section 84 made it clear that the condition in clause (ii) of section 84(2) would not be deemed to have been contravened if the industrial undertaking is set up in rented premises. In section 80J (corresponding to section 84), the original words, as far as this condition is concerned, were "it is not formed by a transfer to a new business of a building (not being a building taken on rent or lease), machinery or plant previously used for any purpose" and with effect from Ist April, 1976, even the words "a building not being a building taken on rent or lease" have been omitted altogether.

CIT v. Indian Expanded Metals P.Ltd.,(1982) 134 ITR483, The Bombay High Court followed its own judgment in Capsulation Services P Ltd v. CIT (1973) 91 ITR 566(Bom) and CIT v. Suessin Textiles, Ball Bearing & Products (P)Ltd(1979)118 ITR 45 (Bom)
in or to the property and therefore, where a transfer is affected by the creation of a lease in a building in favour of the new business or the person carrying on the new business, it would amount to a transfer within the meaning of that expression. It is not necessary that the building transferred to the new industrial undertaking must have been previously used by the assessee, himself in any other business and a building earlier used for business by a stranger would come within the ambit of section 84(2)(ii)".

It is important to mention the reasoning advanced by the Tribunal in Indian Expanded Metals case, which goes contrary to capsulation case or Suessin case, and getting in line with the Gujarat High Court's case of Suessin Textile.

"The 'Explanation' to the said section 84 showed that the asset transferred would form part of the total block of fixed assets and that under the lease the respondent-company had not acquired any fixed asset but it merely got leasehold rights and it would be contrary to the principles of accountancy to show the value of such leasehold rights as an asset in the balance sheet".

Eventually, the Finance Act, 1976 gave a great sigh of relief to the Corporate assessee, that the words "a building not being a building taken on rent or lease" have been omitted altogether. In other words, the decisions in capsulation services (P)Ltd v. CIT, CIT v. Suessin Textiles Ball Bearing & Products (P) Ltd., and CIT v. Indian Expanded Metals (P)Ltd have been rendered ineffective.

DEDUCTION IN RESPECT OF PROFITS AND GAINS FROM PRIORITY INDUSTRIES

Originally, this topic was dealt with by the original section 80E inserted by the Finance Act, 1966. That section was omitted and in its place the present section 80 I was introduced by the Finance

30. Ibid, 485
31. Ibid
32. Ibid
33. Ibid
34. (1973) 91 ITR 566 (Bom)
35. (1979) 118 ITR 45 (Bom)
36. (1982) 134 ITR 483
Act, 1967. This too was omitted by the Finance Act, 1972. Then again, this section has been inserted by Finance Act, 1980.

Though the marginal heading of section 80 I states "Deduction in respect of profits and gains from industrial undertakings after a certain date, et al." due to the aforementioned omissions and insertions, but in fact, it deals with priority industries. When section 80 I came by virtue of Finance Act, 1967 the quantum of deduction was an amount equal to 8% of the profits from such a priority industry. This quantum has been raised to 20% by the Finance Act, 1980 and to 25% by the Finance Act, 1983. Some caselaw did precipitate around section 80 B—the precursor of section 80 I, due to the use of the words "any profits attributable" to a priority industry occurring in the original section 80E. The leading pronouncement on the nature and scope of the words "any profits attributable" to a priority industry is Cambay Electric Supply Industrial Co Ltd v. CIT.

Section 80 I(2)(iii) runs as "(iii) it manufactures or produces any article or thing, not being any article or thing specified in the list in the 11th schedule...".

(1978) 113 ITR 84 (SC). Thus the Supreme Court overruled the Mysore High Court judgment in CIT v. Balanoor Tea and Rubber Co Ltd, (1974) 93 ITR 115, where it was held that the current year's loss in another business had not to be taken into account for computing the quantum of relief. Similarly the Madras High Court's judgment in CIT v. Diamond Tools (India) Ltd., (1977) 107 ITR 386 (Mad) was overruled in which it was held that since the set off or carry forward of losses under sections 71 and 72 succeeds the computation of profits and gains of the business itself, rebate at the rate of 8% could be allowed before adjusting the brought forward losses and unabsorbed depreciation of the earlier years. The Madras High Court has followed Cambay Electric in CIT v. English Electric Co Ltd, (1981) 131 ITR 277 (Mad). In English Electric Co's case, the ITO determined the profits on which relief was admissible after adjustment of certain losses in other trading transactions which were not 'attributable' to the assessee's activities as a specified industry, rejecting the contention of the assessee that the relief should be granted with reference to the profits attributable to the priority industry before adjustment of other trading losses.

While analysing the ratio of Cambay Electric, the Madras High Court observed:

"Though the question of carried forward losses being eligible for adjustment in the computation of the business income did not arise for consideration in the said decision, the first of the three steps referred to by the Supreme Court shows that the computation of the total income has to be in
The question before the Supreme Court was as to whether balancing charge could be deducted before calculating the deduction under section 80E. Tulzapurkar, J., speaking for the bench of Chandrachud, C.J., and himself, observed:

"On reading sub-section (1) it becomes clear that three important steps are required to be taken before the special deduction permissible thereunder is allowed, and the net total income eligible to tax is determined. First, compute the total income of the concerned assessee in accordance with the other provisions of the Act, i.e., in accordance with all the provisions except section 80E; Secondly, ascertain what part of the total income so computed represents the profits and gains attributable to the business of the specified industry (here generation and distribution of electricity); and thirdly, if there be profits and gains so attributable, deduct 8% thereof from such profits and gains and then arrive at the net total income exigible to tax...Reading these two steps together, therefore, it is obvious that in computing the total income of the concerned assessee the balancing charge arising as a result of the sale of old machinery, and buildings and worked out as per section 41(2), irrespective of its real character, will have to be taken into account and included as income of the business. In other words, the balancing charge as worked out under section 41(2) will have to be taken into account before computing the deduction of 8% under the third step".

The Supreme Court further held that the expression "attributable to" had been deliberately used by the legislature. It was wider in import than the expression 'derived from'. Since the expression of wider import had been used, the legislature intended to cover receipts from sources other than the actual conduct of the business.

38contd. accordance with the other provisions of the Act, i.e., in accordance with all the provisions except section 80E, and this computation would take in the adjustment of losses from other than priority industry also, and hence, there is no escape from the adjustment of those losses.

39. Section 80E provided that:
"In the case of a company to which this section applies where the total income (as computed in accordance with the other provisions of this Act) includes any profits and gains attributable to the business of generation or distribution of electricity or any other form of power or of construction, manufacture, etc."

40. Cambay Electric Supply Industrial Co. Ltd. v. CIT (1978) 113 ITR, 84, 91 (SC)
In a recent Bombay High Court judgment CIT v. Buckan Wolf New India Engineering Works Ltd., the court has relied on Cambay Electric Supply Industrial Co.Ltd. v. CIT.

The facts in Buckan Wolf were that the assessee-company manufacturing and selling machinery used in sugar industry, was a priority industry. For the assessment years 1968-69 and 1969-70 the assessee claimed deductions under section 80-I in respect of profits from machining charges for repairs to machinery sold by it and from interest on the unpaid sale proceeds of machinery manufactured by it.

The Bombay High Court held:
"Section 80-I use the words "attributable to" which are words of wide import and, thus, the section envisages relief being granted in all cases where there is some direct nexus between the income and the priority industry...Therefore, the benefit of section 80-I was available to the assessee in respect of the impugned profits".

However, the new section 80-I introduced by virtue of the Finance Act, 1980 has not used the words "attributable to" and instead uses the words of a narrower compass 'derived from', thus it would be free from such controversies.

A very anomalous sub-section (6) exists in section 80-I, which came into force from 1st April, 1981. It lays down that for the purposes of determining the quantum of deduction, the profits and gains of an industrial undertaking shall be computed as if such industrial undertaking...were the only source of income of the assessee during the previous year. The net result would be that the depreciation allowance, investment allowance, business losses etc., set off against other items of income in earlier years would...

41. (1983) 15 Taxman 267 (Bom)
42. (1978) 113 ITR 84 (SC)
43. Section 80-I of the Act for the interregnum (with effect from 1.4.68 and omitted with effect from 1.4.73) read as follows: "80I: Deduction in respect of profits and gains from priority industries in the case of certain companies -(1) In the case of a company to which this section applies, where the gross total income includes any profits and gains attributable to any priority industry, there shall be allowed in accordance with and subject to the provisions of this section, a deduction from such profits and gains of an amount equal to eight percent thereof, in computing the total income of the company".

44. In this case, Bombay High Court also relied on CIT v. Ashok...
be notionally allowed again against the profits of the new industrial undertaking for the limited purpose of reducing the quantum of 'tax holiday' benefit under section 80I.

It is submitted that in order to make the tax holiday benefit meaningful and more pragmatic, the words "attributable to" may be restored in place of 'derived from' and secondly, sub section (6) may be omitted.

 Sections 80J and 80K are part of the set of provisions in the Income Tax Act, 1961 which provide for, what is popularly known as 'tax holiday'. An important departure was made in section 80J from section 84, which was its precursor, in the following manner.

Whereas under section 15C of the 1922 Act and under section 84 of the 1961 Act, there was no provision for carry forward of this relief, but section 80J(3) provides for carry forward of the entitlements under section 80J(1) to the succeeding year and such carry forward is available for a total period of 8 years.

Leyland Ltd. (1981) 130 ITR 900, where the division bench of the Madras High Court held that the sale of spare parts by the assessee to purchasers of its automobile trucks for the purposes of servicing the same was intimately bound up with the assessee's priority industry.

Tracing the legislative history, the corresponding section 15C in the 1922 Act gave rise to sections 84 and 85 of the 1961 Act. Subsequently, with effect from April 1, 1968, sections 84 and 85 were repealed and sections 80J and 80K were inserted by this amendment coming into force with effect from April 1, 1968, new chapter VI-A was inserted.

Provided that: "(ii) where there is more than one deficiency and each such deficiency relates to a different assessment year, the deficiency which relates to an earlier assessment year shall be set off under this sub-section before setting-off the deficiency in relation to a later assessment year".
Accordingly a change was made "in respect of dividends attributable to profits and gains from new industrial undertakings" by inserting in section 80K the words "in respect of which the company is entitled to a deduction under section 80J for the assessment year commencing on the 1st day of April, 1968, or for any subsequent assessment year". The net result is that in the case of a shareholder, his income in respect of dividends to that extent to which it is 'attributable' to the profits on which deduction under section 80J has been provided to the company, shall be given a deduction.

An important distinction is made under section 80K for the assessment years commencing after 1st April, 1968. Whereas before 1st April, 1968, the relief was granted to the shareholders on the footing of the 'actual relief', but thereafter the relief is granted on the footing of 'entitlements' to section 80J 'tax holiday', even though the new industrial undertaking could not have availed the tax relief. This interpretation lends its support to the words 'as is attributable to' used in section 80K, instead of 'as is attributed to'.

In Union of India v. Coromandel Fertilizers Ltd., it was not disputed that for the assessment year 1973-74 the company's income after deducting depreciation for that year would come to Rs 6,16 crores. This amount would be subject to set off against unabsorbed depreciation and business losses which would exceed Rs 6,16 crores resulting in 'nil' total income with some unabsorbed depreciation and business losses to be carried forward to the next assessment year. It was also not disputed that after setting off the brought forward allowances, the company would not be assessable to any income tax upto the assessment year 1973-74.

On these facts, the question arose whether in respect of dividend amounting to Rs 76,65,608 declared by the company in respect of the previous year relevant to the assessment year 1973-74, benefit of section 80K could be extended to the shareholders.

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47. (1976) 102 ITR 533 (SC)
The High Court of Andhra Pradesh held that the shareholders were entitled to claim deduction under section 80K and directed the ITO under section 197(3) to issue the certificate and not to deduct tax out of the dividend payable to the shareholders.

Goswami, J., speaking for the Supreme Court, held:
"There is another vital distinction. While section 15(4) refers to relief in case of only taxable profits, section 80K provides that in computing the total income of an assessee whose gross total income includes any income by way of dividends, there shall be allowed in computing his total income a deduction from such income by way of dividends an amount equal to such part thereof as is attributable to profits and gains derived by the company from an industrial undertaking on which no tax is payable by the company under the Act or in respect of which the company is entitled to deduction under section 80J. The expression 'or in respect of which the company is entitled to a deduction under section 80J introduces a new concept. There is no legal requirement of a de-facto deduction of the amount in question in the particular assessment year. As against actual deduction the company's entitlement to deduction in the relevant year is enough to answer the requirement of section 80J. Necessarily, therefore, the dividend earner will also be entitled to invoke section 80K and obtain pari passu the benefit of the provision".

Under the scheme of section 80J as explained by the Supreme Court by a bench of 3 judges (Bhagwati, J., Tulzapurkar, J and Pathak J) in CIT v. Patiala Flour Mills Co(Pvt) Ltd., "the entitlement is available under section 80J(1) only if there are assessable profits and gains and not otherwise. The same meaning must be reflected in the provisions of section 80K...".

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48. Ibid, 546, comparing the provisions of section 15C with the provisions of sections 80K and 80J of the 1961 Act, Goswami, J., speaking for the Supreme Court in Coromandel Fertilizers observed: "A perusal of sections 80J(3) and 15C would clearly show the difference in the scheme of the two provisions. Broadly speaking, there was no question of 'carry forward' from one accounting year to the succeeding year or years, the sums allowable under section 15C. That feature is now prominent in section 80J in clearly providing that where there are no such profits and gains, an amount equal to the relevant amount of capital employed during the previous year (viz. 6% of the capital employed) shall be carried forward and set off against profits and gains referred to in subsection(1)...".

49. (1978) 115 ITR 640(SC)
50. Ahmedabad Mfg. Calico Printing Co. v. ITO(1979)118 ITR 544,554 (Guj). The Gujarat High Court has followed Patiala Flour Mill's case of the Supreme Court and further observed: "It is thus clear that there must be profits and gains derived from an Industrial undertaking to which section 80J applies and these profits and gains derived from a new
In CIT v. Patiala Flour Mills Co (Pvt) Ltd, the Supreme Court interpreted the provisions of section 80J of the 1961 Act, and it was held:

"For the purpose of deduction under section 80J of the Income Tax Act, 1961, the profits and gains of a new industrial undertaking must be computed in accordance with the provisions of the Act in the same manner as they would be in determining the total income chargeable to tax, and it must follow a fortiori that if the losses, depreciation allowance and development rebate in respect of the new industrial undertaking for the past assessment years have been fully set off against the profit of the assessee from other businesses or for the matter of that, against the income of the assessee under any other head by reason of sections 70 and 71 read with sub-section (2) of section 32 and sub-section (2) of section 32A, no part of such losses, depreciation allowance or development rebate would be liable to be adjusted over again in computing the profits or gains of the new industrial undertaking for applying the provision contained in sub-section (1) of section 80J. The same mode of computation must prevail also in applying the provision contained in sub-section(3) of section 80J because that sub-section provides for setting off the carried forward amount of deficiency of the past assessment years against the profits and gains referred to in sub-section (1) of section 80J, as computed after allowing, interalia, the deduction admissible under that sub-section and therefore, if, for the purpose of sub-section (1) of section 80J, the profits or gains of the new industrial undertaking are to be computed in accordance with the provisions of the Act and no part of the losses, depreciation allowance or development rebate for the past assessment years which has been fully set off against the profit from other businesses or income under any other head is liable to be adjusted over again in computing the profits or gains of the new industrial undertaking, no such adjustment would equally be permissible in applying the provision contained in sub-section (3) of section 80J."

Another much more important aspect under section 80J having relevance with section 80K too, is the concept of 'capital employed'. Rule 19A of the Income Tax Rules, 1962, provided for

50 contd. industrial undertaking must be included in the gross total income of an assessee".

51. (1978) 115 ITR 640 (SC)

52. The quantum of deduction under section 80J is 'six percent per annum on the capital employed' in the industrial undertaking, and it is 7½% per annum on the 'capital employed' for those industrial undertakings which began production after 31st March, 1976.
computing the 'capital employed'. Tracing down the history of rule 19A, rule 3(3) of the Indian Income Tax (Computation of capital of Industrial Undertakings) Rules, 1949, which corresponded to rule 19A of the Income Tax Rules, 1962, provided for the deduction of any borrowed money and debt due by the person carrying on the business in the computation of capital for the purposes of section 15C of the 1922 Act. That rule was not challenged and was in operation till the coming into force of the 1961 Act and the making of the 1962 Rules. Rule 19A(3) followed the same pattern as rule 3(3) of the 1949 Rules.

Rule 19A(3) of the 1962 rules was challenged for the first time in Century Enke Ltd. v. ITO. The question for consideration before the Calcutta High Court was:

Whether for the purposes of computation of 'capital employed', should it be the capital on the first day of the accounting period including the long-term borrowing in it.

The Calcutta High Court held rule 19A ultra vires of the legislature. Immediately thereafter, some High Courts followed this decision, the latest is Warner Hindustan Ltd. v. ITO, where the Andhra Pradesh High Court has held:

"If the rule 19A(3) of the Income Tax Rules, 1962, were given effect to it would defeat the very purpose of the enactment especially in these days when the 'capital employed' in an industrial undertaking is largely raised by way of borrowings and debts by the assessee from various financial institutions. It would also work out very inequitably on different types of entrepreneurs".

Giving the following reasoning that when section 80J directs that the capital employed in an industrial undertaking should be computed in the prescribed manner "in respect of the previous year" relevant to the assessment year, the Andhra Pradesh High Court observed:

53. (1977) 107 ITR 909 (Cal)
54. Madras Industrial Linings Ltd. v. ITO (1977) 110 ITR 256 (Mad), Kota Box Mfg. Co. v. ITO (1980) 123 ITR 638 (All)
55. (1982) 134 ITR 158 (AP)
56. Ibid, Headnote
57. Ibid, 160
"When the computation is with reference to the first day of the computation period, it necessarily ignores the capital employed in the rest of the 364 days of the previous year. If the computation were to be restricted to the Capital employed on the first day of the computation period it would defeat the very purpose of section 80J and would lead to incoherent and anomalous results..."

As a matter of fact, it was only the operative parts of sub-rule (2) reading as "on the first day of the computation period" and of sub-rule (3) reading as "of borrowed monies" under rule 19A, which added much to the controversies and legal squabbles. Howsoever, the mechanics of computing the capital as enumerated in Rule 19 was held to be intravires of the legislature, either with regard to the nominal amount of the debts or with regard to the written down value of the depreciable assets.

58. In CIT v. Simmonds Marshall Ltd (1977) 106 ITR 374 (Bom) the assessee-company was a new Industrial Undertaking and under section 84 (now section 80J) of the Income-Tax Act, 1961, was entitled to a rebate of tax on profits not exceeding 6% per annum of the Capital employed in the Undertaking. The question arose, as to whether the nominal value or the average value of the debts is to be taken into consideration.

The material part of rule 19(1) stated that for the purposes of Section 84 (now section 80J), the Capital employed shall be taken to be... "(C) In the case of Assets being debts due to the person carrying on the business, the nominal amounts of those debts; (D) In the case of any other assets, the value of the assets when they become assets of the business; Provided that if any such asset has been acquired within the computation period, only the average of such value shall be taken in the same manner as average cost is to be computed". The Bombay High Court held that the Proviso at the end of Rule 19(1) can govern only clause (d) and, therefore, it is the nominal amount of the debts due to the assessee, and not their average value, that is to be taken into consideration.

59. In as much as Computation of Capital with regard to depreciable assets, Rule 19A(2)(1) of the Income Tax Rules, 1962, was held to be intravires of Section 80J of the Act in the case of Warner Hindustan Ltd, v. ITO(1982) 134 ITR 158 (AP). The Andhra Pradesh High Court said: "Depreciation deducted on assets is only a notional expenditure and not an actual expenditure. Even after it is allowed as a deduction, it still remains in cash with the assessee by way of depreciation reserve account. By allowing depreciation, the profits and gains are already reduced. The amount so retained or invested is not a fresh capital employed. If such depreciation which is reinvested is computed as Capital employed then there would be double computation of the same.
On the other hand, in a recent case **CIT v. Anand Mahri Steel & Wire Products**, the Madhya Pradesh High Court has expressly dissented from **Century Enka Ltd v. ITO**. Making reference to Sutherland's statutory construction, the Madhya Pradesh High Court observed:

"Where contemporaneous and practical interpretation has stood unchanged for a considerable length of time, it is regarded as of great importance in arriving at the proper construction of a statute. Further, such an interpretation gains greater weight when the statute as interpreted is re-enacted and is regarded presumptively the correct interpretation of the law. The rule is based upon the theory that the legislature is acquainted with the contemporaneous interpretation of a statute, especially when made by an administrative body or executive officers charged with the duty of administering or enforcing the law, and, therefore, impliedly adopts the interpretation upon re-enactment".

Further, it was forcefully contended for the assessee that the construction adopted by the court would be discriminating the indigent assessee who have to borrow funds for their undertakings and that Parliament could not have possibly intended to create this discrimination. On this, the High Court held:

"The indigent assessee who have to borrow capital are given relief by Section 36(1)(iii) of the Act which permits deduction of interest on borrowed capital in the computation of income...

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60. (1982) 133 ITR 365 (MP)
61. Ibid.
62. 3rd Edn 510, 521, 523, 524.
63. Ibid, 371. The Madhya Pradesh High Court declaring Rule 19A(3) intra vires of the Rule making power conferred by Section 80J held:

"When Parliament enacted Section 80J, it must have known as to how section 15C of the 1922 Act was interpreted by the Central Board of Revenue and applied by the Income Tax authorities. The fact that section 80J was enacted in similar terms without showing any disapproval of the interpretation put by the Central Board of Revenue that the amount of borrowings and debts is to be deducted in computing the Capital employed, showed that Parliament approved of that interpretation. Therefore, Rule 19A(3) which followed the same pattern as Rule 3(3) of the 1949 Rules is valid and is in line with the intention of Parliament in enacting Section 80J"

64. Ibid, 372.
Perhaps the aforementioned reasoning advanced by the Madhya Pradesh High Court might have been motivated by this fact that by virtue of an amendment by the Finance Act, 1968, it extended the definition of "Capital employed", so as to include long-term borrowings. But this position remained short-lived and reversed again in 1971 to revert to the era of 1948 to 1968. The reasoning advanced was that the interest paid on such borrowings was already allowed as a deduction in computing the taxable income.

The Finance Act, 1980 has sought to clinch the ambivalent approach to the concept of "Capital employed" by introducing the provisions of the relevant rules of the Income Tax Rules, 1962 in the machinery of Section 80J itself, thus inserting the mechanics for computing the "Capital employed" on a substantive footing.

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SET OFF AND CARRY FORWARD OF LOSSES

A provision of great importance, Section 70(1), has been inserted by the Act of 1961 filling the lacuna existing hitherto. It authorised "intra-head adjustments", to achieve which, resort had previously to be made to general principles of construction and a strained interpretation of the language of some of the Sections of the old Act dealing with computation of income. This precept of "intra-head" adjustment is itself based on one of the foremost principles of tax-laws that income tax being only one tax it is levied on a sum total of the income classified under various heads, and that it is not a collection of different taxes levied separately on each head of income.

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65. A new sub-section (1A) has been inserted by Finance Act, 1980 with effect from 1.4.1972 thus doing away with a long-drawn criticism that the subordinate legislation cannot be said to be valid unless it is within the scope of the rule-making power provided in the statute.

66. CIT, Madras v. Arunachalam Chettiar AIR 1924, Mad 47 4; 1 ITC 278

67. In re Kamdar (1946) 14 ITR 10
Another important feature of the 1961 Act is section 80 which deals with submission of return for losses. Though the assessee was entitled under the 1922 Act to carry forward a loss even though he had not submitted a return for the year in which the loss had been incurred, but by virtue of an amendment of Section 22 of the 1922 Act it was made obligatory upon the assessee to file such a return showing losses. The present Section 80, like Section 22(2A) of the 1922 Act lays down a condition precedent to the carry-forward and set off of the loss, that if a return showing losses has not been filed by the assessee, he would not be entitled to carry forward the loss.

Obviously, if such a return must be filed, either in pursuance of a notice from the ITO or voluntarily under Section 139, the loss would be determined in pursuance of this return. This very point has been in focus in some of the cases, the leading pronouncement in this regard remains the Supreme Court's decision in CIT v. Kulu Valley Transport Co (Pvt) Ltd. Though this decision was based on the relevant provisions of the 1922 Act, which are slightly different from those of Sections 70 to 80 and 139 of the 1961 Act, even then the principle is very much applicable under the 1961 Act. In Kulu Valley, the Supreme Court held that in order to avail the benefit of set-off and carry forward of losses, the assessee must file the return of loss voluntarily and that too, within the time limit prescribed for the filing of voluntary return unless the case is one where the ITO has served a notice on the assessee directing him to file the return under Section 139(2) or the corresponding provisions of Section 22(2A) of the 1922 Act.

The Supreme Court did not in Kulu Valley had to consider, that the taxpayer is entitled to file a belated return of loss before the assessment is made. This question came up before the Calcutta High Court in Presidency Medical Centre (Pvt) Ltd v. CIT, where it was held:

68. The amendment by virtue of Section 22(2A) of the 1922 Act came into effect from 1st April, 1952.

69. (1970) 77 ITR 518 (SC)

70. (1977) 108 ITR 838
"If it is filed belatedly under Section 139 (4), it must be deemed to be in accordance with the law and the loss must be determined and carried forward as a matter of course under Section 72(1) read with Section 80 of the Income Tax Act."

On the other hand, Calcutta High Court held in *Katihar Match Works Pvt Ltd v. CIT* that a belated return filed after the expiry of the prescribed period is not a valid return, and if on receipt of a belated return of loss, the ITO merely dropped the proceedings for assessment, it does not have the same effect as determining the loss of the assessee as nil, and consequently no appeal would lie to the appellate authorities.

The Patna High Court in *Bihar State Electricity Board v. CIT* had to consider the question, whether the nil assessment order passed by the ITO was appealable to the appellate authorities. The Patna High Court held:

"The orders of the ITO determining the income as nil and rejecting the computation of loss as a result of the return of income filed belatedly being ignored was appealable and it constituted an order of assessment."

It is clear from the aforementioned position of case-law, and particularly on a perusal of Supreme Court's judgment in *Kulu Valley* and Calcutta High Court's in *Presidency Medical Centre*, that even in the case of a belated return it is obligatory upon the assessee to predetermine the loss, while making the assessment order.

It is submitted that it would be most appropriate to amend the statutory provisions relating to the filing of return of loss under section 139 read with section 80 in order to secure that in every case where a belated return is filed, it would be obligatory upon the ITO to treat the return as valid, and consequently to predetermine the loss before making the assessment order. It is also submitted that the three separate time-limits enumerated in Section 139(4)(b) dependent upon the assessment year, does not gather much credence for the simple reason that

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71. (1975) 99 ITR 251 (Cal)
72. (1975) 101 ITR 740 (Patna)
the words "before the assessment is made" already takes care of all such situations. Thus only one time limit of four years may be provided, whichever the assessment year may be.

Another very important aspect pertaining to carry forward and set off of losses is the meaning and scope of 'depreciation actually allowed'. In view of the definition of the term 'written-down value' in section 43(6)(b), in the case of assets acquired before the previous year, the actual cost to the assessee less all 'depreciation actually allowed' to him shall be deemed to be the written down value.

Explanation 3 to section 43(6)(b) lays down:

"Explanation 3: Any allowance in respect of any depreciation carried forward under sub-section (2) of section 32 shall be deemed to be depreciation "actually allowed".

The net result comes to this that the unabsorbed depreciation allowance allowed to be carried forward, subject to the provisions of section 72(2) and section 73(3) is deemed to be 'actually allowed' for this limited purpose, even though such an unabsorbed depreciation allowance may be deductible actually from the income in any other succeeding year. Thus in this continual process in each succeeding year the depreciation actually allowed in the preceding year would be deducted causing yearly diminution of the written-down value with consequent decrease in the depreciation allowed on that basis—inevitably increasing the taxable amount of income for every such year.

Comparing the position under 1922 Act, the decisions in regard to the question whether brought forward unabsorbed depreciation allowance could be treated as having been 'actually allowed' Rampur Distillery and Chemical Works Ltd. v. CIT and CIT v. Kamla Mills Ltd., are only of academic importance.

The question as to what constitutes 'depreciation actually allowed' and when can depreciation be regarded as having been

73. (1965) 55 ITR 338 (All)
74. (1949) 17 ITR 130 (Cal)
allowed to the taxpayer has been examined by the Supreme Court in CIT v. Straw Products Ltd, and CIT v. Dharatnour Leather Co.Ltd. In both these cases it was pointed out that any notional allowance by way of depreciation cannot be treated as actually allowed.

The bench of five learned judges had to consider this question, as to when depreciation may be regarded as being 'actually allowed', in Madava Upendra Sinha v. Union of India, Sarkaria, J., delivering the majority judgment of the Supreme Court held:

"The pivot of the definition of "written-down value" is the 'actual cost' of the assets. Where the asset was acquired and also used for the business in the previous year, such value would be its full actual cost and depreciation for that year would be allowed at the prescribed rate on such cost. In subsequent year, depreciation would be calculated on the basis of actual cost less depreciation actually allowed. The key word in clause (b) is 'actually'. It is the anti-thesis of that which is merely speculative, theoretical or imaginary. "Actually" Contra-indicates a deeming construction of the word "allowed" which it qualifies. The connotation of the phrase "actually allowed" is thus limited to depreciation 'actually taken into account or granted and given effect to', i.e., debited by the Income Tax Officer against the incomes of the business in computing the taxable income of the assessee; it cannot be stretched to mean "notionally allowed" or merely allowable on a notional basis.

Of course, any depreciation carried forward under section 32(2) proviso, in view of Explanation 3 to section 43(6) considered as depreciation "actually allowed".

Therefore, it is submitted, that if the losses are ignored altogether in the sense that carry forward of unabsorbed depreciation allowance would be deemed to be depreciation "actually allowed", an absurd situation could arise whereby only profits to the exclusion of losses would be brought to tax leading to

75. (1966) 60 ITR 156 (SC)
76. (1966) 60 ITR 165(SC). Some High Courts followed this view, for example, Ratna Naranbhai Mills Colltd. v. CIT (1950) 18 ITR 122 (Bom), Anglo French Textiles Ltd. v. ITO (1976) 103 ITR 262 (Mad), and CIT v. L.G. Bala Krishnan & Bros Pvt. Ltd (1974) 95 ITR 284 (Mad)
78. (1975) 98 ITR 209
undeserved hardship to the assessee. Such a situation in any case would be against the basic tenets of equity. Explanation 3 to section 43(6), therefore, does not deserve to remain there.

Another aspect pertaining directly to the mechanism of 'carry forward and set off' relates to the purchase and sale of shares by a company other than an investment company. An Explanation was added to section 73 by virtue of Taxation Laws (Amendment) Act, 1975, the effect of which is that the transactions by non-investment companies, for example, industrial or trading companies, when they deal in purchase and sale of shares would be deemed to be speculative transactions, as a result of which the losses, if any, would be set off only against the profits of speculation business.

The well-established principle is that speculative business shall be deemed to be distinct and separate from any other business. Under the 1922 Act, the losses arising out of speculative business could be set off against any other business income. Indubitably, there are certain transactions in which neither delivery nor transfer is contemplated and yet they are excepted from the category of 'speculative transactions'. Such contracts are mere "hedges". The Report of the Direct Taxes Administration Enquiry Committee, 1958-59, clearly brings out this fact that the genesis of introducing the 'speculative' norm is to safeguard those transactions which are genuine or do not enhance or propagate the abnormalities in price fluctuations in the open market. The relevant part of the Report reads as follows:

*An important criticism made by a large number of witnesses who appeared before us, had been that the

79. Explanation 2 to section 28.
80. The idea in entering into a "hedge" is primarily to provide an insurance medium against the risk of adverse price fluctuations.
assurance given by Shri C.D. Deshmukh, with regard to the treatment of 'bonafide' hedging transactions in ordinary business, was not being duly implemented. It was stated that the spirit of the amendment had been lost sight of by the Department in the course of administration of the proviso and that sometimes even genuine hedging losses were being treated as speculative losses.

The Report goes on to mention:

"It may be remarked that by reason of the very nature of the trade, business or manufacture, hedging has necessarily to be entered into for the purpose of 'stability of prices and other objectives which are recognised by economists'. The object of the legislature is not to strike against such hedges, but only to counter the practice of some assesses to buy up losses so as to reduce their profit. Consequently, wherever it is found that a hedging transaction is genuine, it should be excluded from the purview of speculation."

It is, therefore, submitted that even for non-investment companies the purchase and sale of shares is an incidental activity in the ordinary course of business, and by the very nature of business or manufacture activities, it could not have been at all desirable to differentiate a non-investment company with an investment company. Rather such a step is retrograde which encourages an investment company as compared to a manufacturing or industrial company. Explanation to section 73, therefore, hampers the normal business incidents of non-investment companies, and could be omitted.

The concept of 'Charitable Purpose' has been one of the most baffling concepts in tax jurisprudence. In essence, 'charity' or 'charitable purpose' carry the same meaning. In U.K. the statute of Elizabeth I which was not directed so much to the definition of charity as to the correction of abuses which had grown up in the administration of trust of a charitable nature, had a preamble containing an illustrative list of charitable objects which was never treated as exhaustive. It, however, became the practice of courts 'to refer to the preamble as a sort of index or chart in order to determine whether or not a given purpose was charitable'. Thus, a purpose was considered in the eye of law, to be charitable only if it came within the letter or the spirit and intendment of preamble of the statute of Elizabeth.

Thus the English concept of charity included the four categories of objects: i) Relief of poverty; ii) advancement of education; iii) advancement of religion; iv) other purposes beneficial to the community not falling under any of the preceding heads.

The Indian Income Tax Act, 1922, borrowed the aforementioned concept in clause (3) of section 4, which laid down:

"'charitable purpose' includes relief of the poor, education, medical relief and the advancement of any other object of general public utility, but nothing contained in clause (i) or clause (ii) shall operate to exempt from the provisions of this Act that part of the income from property held under a trust or other legal obligation for private religious purposes which does not ensure for the benefit of the public."

83. Cf., Per Beg,J., in Sole Trustee of Shikshana Trust v. CIT, Mysore (1975) 101 ITR 234 (SC)
84. This four-fold classification of charitable purposes was put forward for the first time in the course of an argument by Sir Samuel Romilly in Moricev. Bishop of Durham in the year 1805.
85. The trend of judicial pronouncements was to construe the words 'general public utility' in section 4(3) of 1922 Act very widely. The only serious limitation put on the character of 'general public utility' was that it clearly excluded the object of private profit-making. This test was applied in the Tribune Press Case (1939) 66 IA, 241; 7 ITR 415. The Privy Council held that the production of the newspaper, 'Tribune' under the conditions fixed by the testator's will did not...
Tracing the historical retrospect of 'charity' and 'charitable purpose', with particular reference to the English, American and Indian practice, Bijawat States:

"Thus we find that 'charity' and 'charitable purpose' have a similar meaning in these three countries, but it is only in India, that the words 'charitable purpose' have been defined in the Income Tax Act, itself".

In essence, the terms 'charity' or 'charitable purpose' carry the same meaning, but the following words of Venkatarani, J., in CIT v. Federation of Indian Chambers of Commerce and Industries reveal the inherent normity of this situation.

"There can be no objection to a person spending his money on charity. But can he be charitable at the expense of others?"

On the hand, the law acknowledges that exemption to tax must prevail in the name of charity, and on the other hand it tries to plug the 'allergy to taxation masquerading as charity'. Does the law really strike a balance between the protection of the 'interests of those individuals who are to run 'charity' or law merely protects the interests of an activity of business which is of general public utility? This is the main question, which goes to the root of the problem. Section 11(4) of the Income Tax Act, 1961 read together with section 2(15) becomes responsible for most of the case-law. "Lawyers and legislators must stop confusing each other and start talking to their real audience—the people so that communication problems may not lead to prolific forensic battles."

85 contd., paper was the object of supplying the province of Punjab with an organ of educated public opinion.

86. Bijawat, M.C., "charitable purpose—'not involving the carrying of any activity for profit'-retrospect and prospect”—an article read at the All-India Seminar on ‘current tax problems and Tax Reforms held at Poona University, November 1983.


88. Per Sen, A.P.J., dissenting judgment in Addl Commissioner of IT, Guj v. Surat Art Silk Cloth Manufacturer's Association (1980) 121 ITR 1 (SC)

89. Per Krishna Iyer, J., in Indian Chamber of Commerce v. CIT Calcutta (1975) 101 ITR 796(SC); affirming CIT v. Indian Chamber of Commerce (1971) 81 ITR 147 (Cal)
Krishna Iyer, V.R.J., while delivering the judgment of the Supreme Court in Indian Chamber of Commerce v. CIT, Calcutta observed as under:

"...You create a charity, land exemption from the taxing provision and run big industries virtually enjoying the profits with a seeming veneer of charity or situation which exsuscititated Parliament and constrained it to engraft a clause deprivatory of the exemption, if the institution fulfilling charitable purposes undertook activities for profit and thus sought to hoodwink the statute...".

The aforementioned position at law signifies the predicament by virtue of the ten mischievous words "not involving the carrying on of any activity for profit" added at the time of introducing the current Income Tax Act, 1961, in the definition of the term 'charitable purpose'. The Finance Minister in his speech in the Parliament explicated the reason for the restrictive condition, adding these ten words, as under:

"The definition of 'charitable purpose' in that clause is at present so widely worded that it can be taken advantage of even by commercial concerns which, while ostensibly serving a public purpose, get fully paid for the benefits provided by them...".

It is important to note that in England, the Radcliffe Commission on Taxation of Profits and Income recommended in 1955 that for purposes of taxation, charity should be restricted to relief of poverty, advancement of education and advancement of religion and that the fourth category mentioned in the dictum of Lord Macnaghten, namely, "trusts for other purposes beneficial to the community" should be cut out entirely. What was recommended in 1955 in U.K. could be taken up only in 1983 in India by virtue of the Finance Act, 1983, and that too, in a Covert manner, by omitting those ten words -"not involving the carrying on of any activity for profit".

Questions of intricate importance arise in this regard:

1) What is the parameter of the legal concept of charitable

90. Ibid
91. Lok Sabha Debates, Vol. LVT# 1951, 3073
92. Royal Commission on Taxation of Profits and Income (Cmd 9474, 1955) Part I, Ch.7
ii) What is the controlling distinction between activities which fell on one side or the other of 'charitable purposes'?

iii) What are the measures by which misuse of funds belonging to 'charities' can be effectively checked?

The first question was answered by Krishna Iyer J., in Indian Chamber of Commerce v. CIT, Calcutta. The facts in brief were that the Indian Chamber of Commerce was a company registered under the Indian Companies Act, 1913. Its memorandum and articles of association spelled out the broad objects and "briefly put, they are primarily promotional and protective of Indian trade interests and other allied service operations... It is clear from clauses 4 and 8 of the Memorandum of Association that the Members of the Chamber do not and cannot stand to gain personally, since no portion of income and property of the assessee shall be paid...directly or indirectly, by way of dividend or bonus or otherwise, howsoever, by way of profit...". The assessee, the Indian Chamber of Commerce, was assessed for the accounting year 1963-64 on the income which arose from the three heads of arbitration fees, fees for certificates of origin and the share of profits in a firm M/s Calcutta licensed Measurers, which issued weighment and measurement certificates charging a fee therefor. It is important to note that all these services were extended to Members and non-members or, rather to the trade generally.

Answering in favour of the revenue, Krishna Iyer J., enumerated the 'parameter' of the legal concept of 'charitable purpose', as under:

"This expression defined in section 2(15), is a term of wit and embraces objects of general public utility. But, under cover of charitable purposes, a crop of camouflaged organisations sprung up. The mask was charitable, but the heart was hunger for tax-free profit. When Parliament found this dubious growth of charitable chameleons, the definition in section 2(15) was altered to suppress the mischief by qualifying the broad object of 'general public utility' with the additive 'not involving the carrying
on of any activity for profit". On 'controlling distinction' between activities which fall on one side or the other of 'charitable purposes', counsel for the revenue said in Indian Chamber of Commerce case:

"...The linkage is not between object of public utility and the challenged activity but between the 'methodology' adopted for the advancement of such objects and proneness for profit flowing from such method of activity...".

Discarding this reasoning, that it will render the ten words illusory or ineffectual, the Supreme Court held:

"...Notwithstanding the possibility of obscurity and of dual meanings when the emphasis is shifted from 'advancement to object', used in section 2(15), we are clear in our minds that by the new definition the benefit of exclusion from total income is taken away where in accomplishing a charitable purpose the institution engages itself in activities for profit...".

In effect, the question is as to when it could be said that the linkage between the objects of public utility and the activity carried on results into a profit-making trading activity. Krishna Iyer, J., observed:

"...Take the case of a blood bank which collects blood on payment and supplies blood for a higher price thereby making profit. Undoubtedly, the blood bank may be said to be a general public utility but if it advances its public utility by sale of blood as an activity for(making) profit, it is difficult to call its purpose charitable. It is just blood business".

94. An earlier judgment of the same court CIT v. Dharmodayam Co. (1974) 94 ITR 113 was not followed in this Indian Chamber's case. In Dharmodayam's case the assessee-company was conducting a profitable business of running chit funds and its memorandum of association had as one of its objects "to do the needful for the promotion of charity, education and industry". It was decided in favour of the assessee, on which Krishna Iyer, J., commented: "The court found it possible on these facts to grant the benefit of section 2(15) by a recondite reasoning. If this ratio were to hold good, businessmen have a highroad to tax avoidance, Dharmodayam shows how dangerous the consequence can be if the provision were misconstrued".

95. (1975) 101 ITR 796 (SC)
96. Ibid
97. Ibid
In *Sole Trustee of Shikshana Trust v. CIT, Mysore* the profits from the business of publishing newspaper and magazines accounted for the manifold increase in the value of the assets of the trust. Although the 'original trustee' was not 'to take any remuneration' for discharging his duties as a trustee, yet he was not precluded "from being paid out of the trust...".

While Khanna J., speaking for himself and Gupta J., gave emphasis on the maxim of 'ejusdem generis', that "in order to bring a case within the fourth category of charitable purpose, it would be necessary to show that, 1. the purpose of the trust is the advancement of any other object of general public utility, and 2. the above purpose does not involve the carrying on of any activity for profit. Both the above conditions must be fulfilled before the purpose of the trust can be held to be charitable purpose".

On the other hand, Beg J., in his concurring judgment held:

"...All profits making even as a mere by-product, would have been covered by the word 'involving', which is of wide import, if this word had stood by itself without further qualifications by the context. The use of the words 'for profit', however, shows that the involvement of profit-making should be of such a degree or to such an extent as to enable us to infer it to be the real object...".

The aforementioned 'controlling distinction' enunciated by Beg J., in *Sole Trustee of Shikshana Trust case* was approved by the majority judgment in *Additional CIT v. Surat Art Silk Manufacturer's Association*. The Supreme Court relied heavily on

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98. (1975) 101 ITR 234 (SC). In the instant case the trust had been carrying on the business of publishing newspaper and weekly and monthly magazines in order to 'supplying the Kannada speaking people with an organ or organs of educating public opinion...and for the ventilation of public opinion on matters of general public utility'. Khanna, H.R. J., spoke for himself and Gupta, A.C. J., but Beg, M.H.J., gave a concurring judgment.

99. (1980) 121 ITR 1 (SC). Bhagwati, J., delivered the majority judgment (Untwalia, N.L. Tulzapurkar, V.D. JJ agreeing) of the Supreme Court in the instant case, while Pathak, R.S. J., gave a concurring judgment, and Sen, A.P. J., gave a dissenting one. It is obvious that this judgment overruled the earlier two decisions of the Supreme Court in *Sole Trustee of Shikshana Trust v. CIT, Mysore* and *Indian Chamber of Commerce v. CIT Calcutta*. 
the following test enunciated by Beg.J., in Sole Trustee of Shikshana Trust case:

"The test introduced by the amendment is: Does the purpose of a trust restrict spending the income of a profitable activity exclusively or primarily upon what is 'charity' in law?

The test now is, more clearly than in the past, the genuineness of the purpose tested by the obligation created to spend the money exclusively or essentially on 'charity'. If that obligation is there, the income becomes entitled to exemption..."

In other words, the theory of dominant or primary object of the trust was treated to be the determining factor, even in regard to the fourth head of charity, viz., the advancement of any other object of general public utility, so as to make the carrying on of business activity merely ancillary or incidental to the main object.

Sen, J., in his minority judgment in Surat Art remarked:

"When the government did not accept the recommendation of the Direct Tax Laws Committee, 1977, for the deletion of the words 'not involving the carrying on of any activity for profit' occurring in section 2(15) of the Act, the court has by a process of judicial construction achieved the same result".

The Supreme Court did follow Surat Art Silk in one of its subsequent judgments, CIT v. Federation of Indian Chambers of Commerce & Industries, but with a candid note of radicalism. Venkataramiah, J., observed:

1. Direct Tax Laws Committee Report (Interim Report, Dec. 1977) Chapter 2. This report is popularly known as Chokshi Committee Report, after the name of the chairman of the Committee.

2. In this instant case, FICCI, New Delhi was an existing company under the companies Act, 1956. It had neither any share capital nor does it distribute any dividends to its members. The assessee carried on during the assessment year 1962-63 the holding of the Indian Trade Fair and of sponsoring the conference of the Afro-Asian organisation for Economic Cooperation and derived receipts totaling Rs 75,18,548 from rent for space allotted, Rs 20,750 by sale of season tickets, Rs 26,550 share of profits on sale of book on company law etc. Besides this FICCI received Rs 3,00,000 from Government of India as Grant-in-aid for organising the conference.

3. Ibid, 51
"...Whatever may have been the position in those days when
the state was just a police state performing minimum
functions of government, today when the state is a
welfare state, would it be right either morally or
constitutionally to allow amounts which should legitimately
form part of the revenue of the state to be dealt with by
non-governmental agencies administering trusts is a
question which requires examination in an appropriate case.
This, however, is a larger question which, if logically
pursued may justify total deletion of the exemption accorded
in the case of charitable and religious trusts".

To all this legal conundrum, Sen, J., suggests as under:

"In retrospect, it seems that it would have been better
for Parliament to have deleted the fourth head of charity
"any other object of general public utility" from the
ambit of the definition of 'charitable purpose', while
enacting section 2(15) of the Act rather than inserted
the words 'not involving the carrying on of any other
activity for profit', thereby creating all this legal
comundrum".

As mentioned above, these ten words, 'not involving the
carrying on of any other activity for profit' have been omitted
by the Finance Act, 1983 but retaining the words 'the advancement
of any other object of general public utility'. Does this
amendment imply that only those trusts will carry exemption now
which have a built-in prescription in the constitution of a
trust-deed against making a profit? In other words, if such a
self-imposed and innate restriction on making profits in the
carrying on a business are missing, then the exemption of
section 2(15) would not be given.

At the same time "ready-made nostrums like 'dominant
intent', 'incidental profits', 'real object'as against 'ostensible
purpose', 'entangled', 'wrapped-in', 'inter-twined' and the like
fail as Criteria in critical cases, although they have been
liberally used in judicial vocabulary. In this branch of law
verbal labels are convenient but not infallible...".

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4. (1980) 121 ITR 1 (SC)
5. Per Krishna Iyer, J., in Indian Chamber of Commerce v.
   CIT, Calcutta (1975) 101 ITR 796 (SC)
Perhaps, "it is wrong to think that all springs of charity in India will dry up if true effect is given to section 2(15) of the Act in accordance with the minority judgment in the Surat Art Silk case...one need not go in search of charitable persons amongst the tax payers only".6

It is, therefore, submitted that the fourth classification 'advancement of any other object of general public utility' may be omitted. The measure adopted by Finance Act, 1983 omitting the ten words 'not involving the carrying on of any activity for profit' would not circumvent the forensic syndrome and it is likely to be as green a forensic battle as ever before.

It is further submitted that the Parliament could foresee the implications of deletion of these ten words only to the extent of saving the business of 'printing and publishing' of religious books, or any trust carrying on a business wholly for religious purposes, or a business being 'mainly' run by the beneficiaries themselves of such a trust.

Perhaps this sub-clause (b) to sub-section (4A) of section 11, coming by virtue of Finance Act, 1983 has been inserted to supersede the Madras High Court Judgment in CIT v. Workshop Trust decided on April 1, 1982. The brief facts of this case were, an inmate of Sri Aurobindo Ashram started a carpentry workshop with borrowed money. It was run on commercial scale, but was held under a trust styled as 'workshop trust'. The trust deed stipulated that the inmate had no manner of personal interest either in its corpus or income which was held exclusively for the benefit of Aurobindo Ashram. The inmate claimed exemption under section 11 in respect of profit of Rs 10,000 made by the workshop on the plea that the trust was a Charitable Trust.


7. (1983) 12 Taxmann 239 (Mad)
The Madras High Court held (Headnote)

"The Trust deed of the assessee-trust was a plain speaking document...The ashram's locus standi under the trust was only as a beneficiary and it, therefore, separated the trust and the ashram as two distinct entities.

There is no law of charitable trusts which says that the objects avowed by the beneficiaries are at once the objects of the trust itself...While self-denial has no positive purpose, charity involves affirmative action and is by no means a negative virtue; •••Supreme acts of self-sacrifice are good in their own way but they are not charitable acts...".

Thus sub-clause (b) of sub-section (4A) which reads:

"(b) the business is carried on by an institution wholly for charitable purposes and the work in connection with the business is mainly carried on by the beneficiaries of the institution..."

The aforementioned sub-clause is likely to create more controversies. The Madras High Court observed in CIT v. Workshop Trust:

"...It might look odd that the virtues of self-abnegation and self-effacement should be regarded as non-charitable. While hospitals and schools run on affluent lines should pass muster as charitable bodies. That, however, must be understood as the law, both under the statute and on the authorities".

It is submitted that in CIT v. Workshop Trust the only 'inmate' was the only beneficiary. Would it imply that the term 'mainly' used in sub-clause (b) would imply one beneficiary. If not so, would the word 'imply' mean 'substantially'. It is submitted that these amendments by virtue of inserting sub-section (4A) once again makes an outlet to tax avoidance. It is submitted that sub-section (4A) inserted by Finance Act 1983 deserves to be omitted.

The 'Chameleon' of 'public utility' could get prominence again by virtue of the words in sub clause (a) of sub section (4A) as under:

"...or is of a kind notified by the Central Government in this behalf in the official gazette...".

8. Ibid
'ZERO-TAX COMPANIES'

The Finance Act, 1983 has introduced by virtue of section 80WA, in the Income Tax Act, 1961 a very bold concept of compulsorily taxing a portion of the income of the companies, notwithstanding that the statutory allowances or deductions absorb such profits. As a matter of fact, the genesis of this measures lies in the observations made by the Public Accounts Committee, while presenting its 143rd report to the Lok Sabha, as under:

"There has been a steady fall in the actual collection of corporate tax compared to the budget estimates during 1976-77 to 1980-81. This has been despite the fact that the number of companies and company assessments have increased as also the pre-tax profits of the 20 big industrial houses in the country. This shortfall has been due to liberal allowance of tax incentives as well as tax evasion, or avoidance by more and more companies."

The Profit tax of the top 20 companies had increased from Rs 400.7 crore in 1978 to Rs 515.52 crore in 1979 and Rs 544.24 crore in 1980. Yet, under the cover of liberal statutory provisions, they have been paying no tax at all or paying only a nominal tax. Even during 1981-82, as many as 42 out of 76 high-profitable companies did not pay any tax or paid only a nominal tax. Even in absolute terms, the contribution made by the private sector companies to the national exchequer in the form of corporation tax is much less than that made by public sector. A sample study conducted by the Directorate of Inspection (Special Investigation) last year has revealed that "substantial incentives are enjoyed by companies particularly large expanding companies which alone can take advantage of concessions by regular expansion and floating new undertakings which necessarily result in the substantial claims of depreciation, development rebate and investment allowance, etc., and such companies by and large are owned by the monopoly houses".

While introducing the Finance Bill, 1983 in the Lok Sabha, the Finance Minister observed as under:

"With a view to securing that the various deductions in respect of tax concessions admissible under the Income Tax Act do not result in reducing the taxable income of companies to the extent that no tax or only a negligible tax is paid by profit-making companies, it is proposed to make a provision in the Income Tax Act so the effect that where in the case of companies the aggregate amount of deductions"

Admissible under certain specified provisions of the Income Tax Act exceeds 70% of the amount of total income computed before making such deductions, the amount to be deducted under those provisions will be restricted to 70% of the total income as computed before making such deductions.

This section 80WVA has listed 28 items of tax incentives. After the company has worked out 'pre-incentive' income after allowing all such deductions and incentives which do not fall within this restricted category of 28 items, then the aggregate of these 28 items by way of deductions and incentives would be restricted to 70% of such 'pre-incentive' income. In other words, the company would have to pay income tax on a minimum of 30% of the 'pre-incentive' income. Such deductions or incentives which could not be completely absorbed would be allowed to be carried forward to the succeeding years.

It is worth-mentioning that certain deductions, for example, section 80G dealing with donations to certain funds, charitable institutions etc., section 80HH dealing in respect of profits from new undertakings set-up in backward areas etc., which were previously not eligible for carry forward, can be carried forward now, due to the necessary implications of section 80 WVA. In precise, the total sum is the postponement of the benefits flowing out of the various tax incentives.

The real pinch of this new measure would be felt under the provisions of the companies (profits) surtax Act, 1964, for the simple reason that the basis of charge of surtax is the 'chargeable profits'.

3. The list of 28 items of tax incentives has thrust, inter alia, on the following deductions:

1. Donations or expenditure made for promotion of research (section 35(1)(iii), section 35(2)(ia), section 35(2A), 35(2B).

2. Expenditure for agricultural development or rural development or conservation of natural resources (section 35C, section 35CC, 35CC(vi), 35 CCB).

3. Development rebate, development allowance or investment allowance of earlier years (sections 33(2)(ii), 33A (2)(ii), 33A(2)(i), 32A(2)(i), 32A(3)(i).

4. Expenditure incurred for industry in backward areas or rural areas (section 80HH, 80HHA)

5. Inter-corporate dividend (section 80M) etc.
Section 2(5) of the Companies (Profits) Surtax Act, 1964 defines the expression 'chargeable profits' as under:

"2(5): 'chargeable profits' means the total income of an assessee computed under the Income Tax Act, 1961, for any previous year or years, as the case may be, and adjusted in accordance with the provisions of the First Schedule."

In other words, surtax would necessarily operate with respect to 30% of the profits of the company, thus entailing the tax liability to a further extent.