Chapter IV

BASE EROSION FROM EXCLUSION: THE PRINCIPLE OF REALIZATION
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Limitations of the income tax arising from the prac-
tice of taxing income only on 'realization' are well-known.
Postponement of recognition of a gain, till it is 'realized'
secures an advantage to wealth-owners for which there is no
completely satisfactory remedy. Taxation of capital gain
would be less objectionable had income been recognized on
accretion for then there would have been no question of bunch-
ing. Preferential treatment of capital gains with its atten-
dant complications is the product of taxation on the basis of
realization. Exclusion of imputed income also is essentially
a consequence of this practice. Avoidance through use of the
corporate cover and manipulation of loss-offset facilities
would scarcely have been possible under a system of taxation
which goes by accretion. In a severe indictment of the prac-
tice of relying on the realization principle in income reco-
gnition - which he described as a 'professional conspiracy
against truth', Simons said -

They (the consequences of the arbitra-
riness in time-allocation of income resulting
from the application of the realization principle)
frustrate the central purpose of income taxation,
namely equitable progression ... They discrimi-
nate grossly between property incomes and salary

1 Henry Simons quoted in "A Comprehensive Tax Base
as a Goal of Income Tax Reform" by Boris Bittker
incomes; between wealthy and less wealthy persons, between real business enterprisers and stock-market 'operators', between these relatively useful operators and the passive, diversifying 'rentier stockholder'; and notably, between shareholders and partners or single proprietors.\textsuperscript{2} (Italics supplied)

Through so critical of its application in taxation Simons did not think it possible however to discard the principle of realization altogether. The Carter Commission too, while holding up the net accretion concept as the ideal, resiled from the idea of taxation on accretion, and merely recommended imputation of realization on the occurrence of certain events like gift or bequest or migration of the taxpayer to another country. This dilemma of the advocates of the comprehensive income concept invited the taunt of Bittker and provided ground for his fierce attack on the entire approach underlying the CTB. There can be little doubt that credibility of the income tax as an instrument of progressive taxation hinges a great deal on the extent to which the net accretion concept can be approximated by the tax base in practice or, if taxation on accretion is impracticable, on whether logically consistent alternative principles can be evolved

\begin{itemize}
\item \textsuperscript{2} Henry Simons, \textit{Federal Tax Reform} (1950), p. 61.
\item \textsuperscript{3} Simons rejected the proposals for adoption of accretion principle advanced in the Twentieth Century Fund publication, \textit{Facing the Tax Problem} (1937) as impracticable (Henry Simons, \textit{op. cit.})
\item \textsuperscript{4} \textit{Report of the (Canadian) Royal Commission on Taxation} (1966), Vol. 3, pp. 50-51.
\item \textsuperscript{5} Bittker, \textit{op. cit.}
\end{itemize}
for income recognition.

Before proceeding to consider whether and, if so, to what extent the reliance on the realization principle can be reduced, it is necessary to see what are its attributes and why they are thought so indispensable.

Attributes of 'realization' in accounting practice

The reason usually advanced against recognising income on mere accretion is that in periodic income assessment that would call for valuation of all assets of each taxpayer at the beginning and the end of every accounting year without going through an actual sale. This apparently involves the exercise of subjective judgement. The test of realization is thus required in the interests of objectivity and administrative convenience. Taxation of gains before they are 'realized' is considered unacceptable also because of the liquidity problem it entails for the taxpayers. The tests of income recognition as applied in practice however do not seem to be based on a consistent application of either objectivity or liquidity.

'Realization' in accounting practice

In accountancy, the essential ingredients of realization are, consummation of a transaction and receipt of a measurable, liquid asset. A statement of the Accounting Principles Board (APB) of the American Institute of Certified Public Accountants (AICPA) issued in 1970 said -
Revenue is generally recognized when both of the following conditions are met: (1) the earning process is complete or virtually complete; and (2) an exchange has taken place.\(^6\)

Numerous instances can however be cited to show that these tests are not always adhered to in practice. For instance, the earnings of a sinking fund or accumulation of discount on purchase bonds are customarily treated as realized income even though they do not satisfy the tests. As one authority on accounting theory points out, this suggests that objective measurability of the asset received rather than its liquidity is more crucial in the recording of realized revenue.

The value established through a bargained exchange is believed to be completely objective. Examination of accountancy practices however shows that the concept of objectivity, as applied, lacks 'homogeneity of substance'; different standards of objectivity are applied for different purposes, one for recording assets, another for liabilities and still another for recognition of revenue. Rigorous application of objectivity test would preclude recording of

\(^6\) APB Statement No. 4 (1970).


depreciation, use of the lower-of-cost-or-market rule in inventory valuation and many other facts which are usually taken note of in financial statements. It appears that in practice 'measurability' is given a broad connotation so that an item is considered to be measurable if it can be estimated with a reasonable degree of accuracy. Depreciation of fixed assets for example is taken to be measurable even though it represents merely a notional estimate and necessarily involves the accountant's judgement. In deciding whether a change in an asset has become definite — that is irreversible — also calls for exercise of judgement by the accountant. Recognition of costs — bad debts, for example — is often based on such judgement. If this is granted, the insistence on a bargained transaction as a condition precedent for realization of income seems quite untenable.

That the presence of a market transaction is also not essential is evident from the practice followed in the evaluation of income from agricultural and mining activities where income is recognized long before a sale takes place. Could it be said that the crucial test is the completion of an activity or rendering of a service? It does not seem so. The extent-of-services-performed test is not easy to apply as evidence of realization, for income is often recognized well before the service is rendered in full. Sometimes the receipt represents

payment for services rendered over more than one period and this calls for notional allocation. Some would like realization to be conditional on the performance of the 'critical function'. But what is 'critical' can be a matter of judgement.

After examining the various criteria used in accountancy to determine the timing of income recognition, one author comes to the conclusion that -

...income is recognized at several different times and upon different evidences, and that no specific standard has been set as to when the different times or different evidences should be used.\textsuperscript{11}

In their study on the basic postulates of accountancy, Sprouse and Moonitz the noted authorities on accountancy said, "We cannot accept it (realization) as an essential feature of accounting because the concept lacks analytical precision".\textsuperscript{12}

Of late the relevance of the realization principle in the measurement of business income for assessing entrepreneurial success or for corporate dividend policy has been questioned by many in the accountancy profession. Sidney


\textsuperscript{12} R. T. Sprouse and M. Moonitz, "A Tentative Set of Broad Accounting Principles for Business Enterprises", \textit{Accounting Research Study No. 3} (AICPA, 1962).
Alexander pointed out the irrationality of judging managerial performance by looking merely at accounting profit based on a part of tangible equity while ignoring changes in net worth (including goodwill) resulting from the decisions of the managers. "Objectivity without relevance is not much of a virtue", another professor of accountancy has commented. Dissatisfaction with the accountancy measure of income based on a rigid application of the realization principle has led to suggestions for introducing new measures of business profits, the most notable of which is the suggestion for measuring 'money income' in terms of 'current operating profit' and 'holding gain'. Another concept suggested for measuring enterprise success is that of 'variable income'.

'Realization' in taxation

Similar ambiguity marks the use of the term 'realization' in law for purposes of taxation. As in accountancy, the two qualities usually considered necessary for income to be recognized in law are liquidity and objective measurability.


16 S. S. Alexander, *op. cit.*
But a great deal of flexibility is allowed in the application of the tests in practice. This flexibility has resulted from several factors.

In the case of income from business and profession the statute permits the taxpayer to rely on his own method of accounting if it is regularly employed, unless the method is such that true profit or loss cannot be deduced therefrom. This allows considerable latitude to taxpayers deriving income from business and profession in the matter of income recognition. The method of accounting followed by most businesses - known in India as the 'mercantile system' - permits taxpayers to bring into their accounts income not received in cash as well as expenditure or loss before any payment is actually made. Of course the law does not leave the timing of income recognition entirely to the convention of accountancy even where the taxpayer follows the mercantile or accrual system of accounting. But the tests of realization as formulated by courts themselves are not free from ambiguity.

In a definitive ruling, the Supreme Court said that income can be recognized only when the assessee acquires a

18 As the Supreme Court put it, this method "brings into credit what is legally due before it is actually received, and brings into debit expenditure for which a legal liability has been incurred before it is actually disbursed." /Keshav Mills Ltd. v. CIT (1953) 23 ITR 230 (S.C.)/
right to receive the same. For this there must be a debt owed to him by somebody. Implicit in this proposition is the requirement that there must be a bargain, that is, external transaction. Also implicit is the quality of separability. Mere appreciation in the value of wealth fails to satisfy these requirements and is therefore excluded from the tax base. It is by virtue of these tests that bonus shares are declared 'not income'. This viewpoint found its clearest expression in the decision of the U.S. Supreme Court in the celebrated case Eisner v. Macomber whereby 'stock-dividend' (or bonus shares as they are called in that country) in the hands of shareholders was declared 'not income'. "Enrichment through increases in value of capital investment is not income in any proper meaning of the term", the Court observed. Subsequently, however, there have been cases both in USA as in India where income was recognized even in the absence of an external transaction. While stock dividend is still not

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19 E. D. Sassoon & Co. Ltd. v. CIT (1954) 26 ITR 27 (S.C.) cf: "Generally under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy" \Regulation 1.446 (c)(i)(ii) of the U.S. Treasury/.  

20 252 U.S. 189 (1920).  

21 See F.W. Windal, "Legal Background for the Accounting Concept of Realization", AR (1963) for an account of how judicial opinion in USA moved away from the Eisner decision in individual cases even though that (footnote contd.)
recognized as income, receipt of debenture bonds was held to be the equivalent of cash. In another case it was held that dividend paid on a preferred equity in stock of any degree of preference satisfies the realization test.

In India also, numerous instances can be cited where the requirement of an external transaction was dispensed with as a test of realization. In activities taking more than a year to complete, like a contract job or other activity of production, courts have held that profits accrue from year to year. It is recognized that income may accrue not just at a particular point like sale but at points anterior to a terminating act denoted by sale as is evident from the following observation -

It is not necessary ... for income to accrue (i.e. for income to be recognized) that there must be a sale of commodity. (italics added)

The possibility that profit may arise at different stages of the manufacturing process is also not denied by the courts. Thus the Supreme Court decided in one case that

decision was not actually reversed. The account of U.S. law on the point presented here is based on Windal's article. See also in this connection Russell Bowers, "Tests of Income Realization", AR, 1941.

22 298 U.S. 441. This seems to be the position in Indian law also [See Kanga & Pkhivala, The Law and Practice of Income Tax (1969), p. 427.


income did arise when a steel manufacturing company which also owned iron ore mines transferred ore from the mine to the foundry. Attribution of income or profits to any stage prior to arm's length sale necessarily implies valuation on a notional basis which obviously goes against the canon of objectivity. Apparently, that did not stand in the way of recognizing income.

The tests of liquidity and objective measurability have also been considerably undermined through the development of the doctrines of 'constructive receipt' and 'cash equivalent'. These doctrines are relied upon to include the right to future payment in the recipient's gross income in the year in which the contract of sale is executed. Application of these doctrines in India can be seen in one of the decisions of the Privy Council where it was held that a mortgagee who purchased at auction under a court-decree the property which was the subject-matter of the mortgage can be said to have received the equivalent of the interest due on his mortgage.


27 Raja Raghunandan Prasad v. CIT (1933) ITR 113 (P.C.).
Equivalent of cash can of course take many forms and often involves notional valuation. But that does not deter the courts from recognizing income in such receipts. Receipt of even real estate in satisfaction of debt is regarded as giving rise to income. In one case the Indian Supreme Court held that when realization takes place in money's worth the market value of the asset taken should be ascertained and income computed accordingly.

Application of the principle of 'constructive receipt' was however denied when a company sold plots of land developed by it for a price of which only a part was paid in cash and the balance was payable in instalments with interest, and it was secured by a charge created on the land. The amounts which were treated as loan and for which the lands were mortgaged could not, according to the Supreme Court's ruling, be treated as 'constructive receipt'. In a similar situation the House of Lords ruled that the estimated present value of the unpaid price of real estate sold by a taxpayer on deferred payment basis should be taken as receipt at the time of sale.

28 See Kanga & Palkhivala, op. cit., p. 93, footnote 14, for references on decided cases on the point.
31 Absalom v. Talbot, 26 TC 166.
It might appear that what the courts look for in addition to a completed transaction in the presence of the taxpayer's wherewithal or ready cash to pay. This, according to some, is the crucial element in the legal tests of income realization. The principal difference between timing of income recognition in accountancy and in taxation is also ascribed to the primacy of the wherewithal-to-pay concept in taxation (e.g. as reflected in the recognition of pre-paid income as realized for taxation while postponing recognition of unpaid instalments of sale price).

Though not clearly articulated, the anxiety to avoid imposing any liability for income not received is also reflected in the principle of 'real income' evolved by the Indian courts to deny recognition of income in situations where the income is foregone on business considerations even though the right to receive it has accrued to the taxpayer. Where an

32 Sommerfeld, Anderson & Brock, An Introduction to Taxation (1972), Ch. 18.

33 It was held by the U.S. Supreme Court in Schlude v. Commissioner that income was taxable in the year of cash receipt even though the accrual basis taxpayer had not performed the services to which the receipt related. This, according to one author, widened the gulf separating accounting income and taxable income (D.L. Crumbley, "How Long Will the Commissioner and the Courts Ignore Accounting Standards on the Accrual of Prepaid Income?", NLI, December 1969).

34 The principle of 'real income' was first applied in this context by the Bombay High Court in Kashi Parekh (footnote contd.)
assessee gave up 75 per cent of the managing agency commission due to it in order to get the agency transferred to two private companies, Supreme Court held that no income had arisen.

There are cases however where this principle was departed from. Thus in one case, the Court refused to exclude managing agency commission forgone by a taxpayer from its income, saying, "The accrual of income is not to be equated with the receipt of income."

The principle of wherewithal-to-pay is even more clearly contradicted in the rule evolved by the courts in the matter of cost recognition. Here the main criterion is that there should be a definite liability on the part of the taxpayer to pay. Contingent liabilities are, by this test, not

(previous footnote contd.)

& Co. Ltd. v. CIT (1960) 39 ITR 706. It was however first enunciated in an entirely different context by Lord Macmillan in Privy Council judgement Raja Bijoy Singh Dhudhuria v. CIT (1933) 1 ITR 135. There the question was whether tax could be levied on that portion of the income of a taxpayer on which there was a prior charge.


36 Morvi Industries Ltd. v. CIT (1971) 82 ITR 835 (S.C.). The reasoning advanced in support of this decision was: that the act of forgoing was not dictated by commercial expediency.

37 This is the principle laid down by the Supreme Court in Indian Molasses Co. (P) Ltd., v. CIT (1959) 37 ITR 66 (S.C.).
recognized as cost and provision for such liabilities cannot be deducted from income. In the subsequent cases however the Indian courts seem to have moved away from this position. In a notable decision the Supreme Court said that provision for a contingent liability can be taken into account in income computation provided it is sufficiently certain to be capable of valuation and its discounted value is ascertainable. If the wherewithal-to-pay was the decisive test, such provisions could hardly be recognized as cost. The inconsistency of recognizing estimated amount of liability as cost while refusing to recognize the estimated value of the unpaid sale price as income is too obvious to need comment. The wherewithal-to-pay principle is also violated in the decisions which permit liability on account of sales tax etc. to be recognized even when the taxpayer disputes the liability and withholds payment.

Enough has been said to show that though income must be 'realized' before it can be recognized for taxation, the tests applied by the courts in deciding disputed cases

38 Metal Box Company of India Ltd. v. Their Workmen (1969), 73 ITR 53 (S.C.) This principle has been followed in Madho Mahesh Sugar Mills Pvt. Ltd. v. CIT (1973) 92 ITR 503; Delhi Flour Mills Co. Ltd. v. CIT (1974) 95 ITR 151.

39 In Calcutta Co. Ltd. v. CIT (1959) 37 ITR 1, expenditure likely to be incurred was allowed to be deducted on estimate.

do not add up to a consistent set of rules. While an external transaction is often thought essential for income to be realized, in several situations income is recognized even in the absence of such a transaction. The claim that 'realization' is needed for certainty and objectivity appears untenable as costs are often recognized and allowed to be deducted on estimate. Besides, the fact that an external transaction may not reveal the true value of the articles transacted in has led the legislature to empower the tax authorities to estimate the fair market value in several situations. The income tax law abounds in such provisions (vide Ch. XXA of the Act for instance). That courts are not adverse to recognizing income on a notional basis and on imputation is evident from the decision of the U.S. Tax Court in the much discussed American case of Sol Diamond in which it was held that receipt of interest in the share of profits of a firm amounts to realization. This decision has been assailed for violating the universally applied principle that a taxpayer realizes income only when he engages in an 'exchange transaction'. But it clearly shows the dilemma which a mechanical adherence to the external transaction test leads to.

41 N. H. Lane, "Sol Diamond: The Tax Court Upsets the Service Partner", 46 Southern California Law Review 232 (1973). Lane is of the view that the proper course would have been to tax the value of the interest, when sold, as ordinary income.
The wherewithal concept too, we have seen, is not followed consistently as is evident in the recognition of costs before actual payment is made.

**Future of 'realization' as a test of income recognition**

Despite the inconsistencies in its application and difficulties in defining its attributes, the realization test is unlikely to be given up either in accountancy or in taxation. In accountancy, as noted already, relevance of realization for purposes which financial statements are meant to serve has been widely questioned. The three Concepts and Standards Committees appointed by the American Accounting Association - on 'Inventory Measurement', on 'Long-lived Assets' and on the 'Realization Concept' - all agreed that holding gains and losses (that is, gains etc. which result from changes in asset values) should be recognized. But opinion was split on the question whether such gains and losses, when not validated by disposition, should enter into the calculation of net income. The main argument for excluding holding gains and losses again was, as one accountancy expert put it, that "retention of a realization concept enhances objectivity."

The dilemma caused by the accountant's anxiety to avoid the charge of subjectivity or bias in income measurement is

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42 S. Davidson, *op. cit.*

43 C. T. Horngren, quoted in S. Davidson, *op. cit.*
unlikely to be resolved soon. For valuation cannot be avoided in income measurement. By its very nature profit hinges on revaluation which are essentially based on expectations. Given the fact of uncertainty such evaluation cannot be entirely objective. Doubts about the relevance of 'objectivity' in the practical uses of income may help break the barriers imposed by the realization concept and as Solomons (1961) predicted, the next few years may well be the twilight of the income concept as envisaged in conventional accounting. Various suggestions have been forthcoming for narrowing the gap between accounting income and economic income. But so long as uncertainty remains, it is difficult to see how the gap can be completely bridged. Granting that some arbitrary rules are unavoidable for income recognition for practical purposes, the question is, how should the tax system adopt itself to these rules to minimise inequity? One response has been to permit


45 One suggestion is that a liberal attitude toward recognition but a strict attitude toward realization might help the transition to versions of net income which incorporate holding gains and allied concepts (Horngren, op. cit.) Another view is that economic income and accounting income can be brought together if formulated more carefully and critically. (Russell Bowers, op. cit.).
deduction from the income base for the exclusions which follow from the application of the realization rule. However, as argued earlier, in a progressive tax system this would be self-defeating. Therefore, the endeavour should be to see that the exclusions so resulting are kept down to a minimum or alternative ways of tackling the exclusions must be evolved within the constraints of the realization criterion, which cause the least damage to the base. With this aim in view we propose to examine the practice obtaining in three important areas of income taxation where the realization rule has a significant bearing and explore the scope for reform. These are: (1) the rule for stock valuation; (2) treatment of imputed income and (3) taxation of bonus shares. So far as problem of capital gains is concerned - and it is in this area that the impact of the realization principle is felt most - alternative solutions have been considered in the previous chapter.

RULE FOR STOCK VALUATION*

In any business enterprise, unless the articles traded in are all bought and sold within a year, the size of the profit earned by it during the year is obviously affected by the value put on the stocks at the terminal points of the accounting period. Though it is well recognized that in periodic income determination account must be taken of the

* This section of the present chapter was published in the EPW, vol. IX, No. 35, Review of Management, August 1974.
stock at the beginning and at the end of the period, the law does not lay down any specific rule for the purpose. The Income-tax Act being silent on the point, the principle which has come to be established through judicial rulings is that valuation of stock-in-trade should be made in accordance with ordinary principles of accountancy.

Consistent application of the realization principle, which is one of the basic postulates on which accountancy practices are said to be founded, would require all unsold stocks to be valued only at cost. The rule of stock valuation generally followed by accountants is, 'cost or market value whichever is lower'. All losses likely to arise from a decline in the price of closing stock are thus duly taken into account even before their 'realization' but profits resulting from price rise are kept out. In order that no 'unrealized' profit is included in income, when there are several items in the stock, taxpayers are even allowed to follow a method called the 'pick and choose' method, whereby the lower of cost or market is taken separately for each item so that items for which the market price has gone up are valued only the cost is taken while those which have depreciated are valued at market price. Sometimes downward revision of stock

46 CIT v. Krishnaswami Mudaliar (1964) 53 ITR 122. (S.C.)
47 Whimster & Co. v. IRC (1925) 12 TC 813.
48 CIT, EPT v. Chari & Ram (1949) 17 ITR 1.
values on anticipation goes even beyond that. Thus a dealer in the parts of motor cars, import of which was banned, was allowed to value his stock notionally at 50 per cent and even 100 per cent less than cost even though the same stock was valued at a higher price for purposes of obtaining overdraft from the bank. When the stock is considered unsaleable for lack of demand the cost is allowed to be taken even at nil. The value of the opening stock, it might be supposed, would merely reflect the carried forward figure of closing stock of the preceding period. This however is not always the case. Thus when a dealer in silk goods died, leaving a sizeable stock that had cost Rs. 2,78,000 and his daughters resumed the business, the opening stock was allowed to be valued at Rs. 3,53,000 which happened to be the market value of the stock on the date of death of the dealer.

It is not as if the courts permit the accountancy practice to be followed in all situations and whatever be the results. In a case involving the valuation of work-in-progress

49 India Motor Parts & Accessories (P) Ltd., v. CIT (1966) 60 ITR 531.
50 K. Mohammad Ádam Sahib v. CIT (1965) 56 ITR 360.
51 CIT v. Appu Chettiar (1962) 45 ITR 152.
the House of Lords refused to accept the plea advanced on behalf of the Revenue for applying the 'on-cost' method whereby indirect costs (that is, proportionate part of the overheads) are added to the cost of materials and other expenses as against the direct cost method (which takes account of only the variable costs) followed by the taxpayer regularly even though the on-cost method is well recognized in accountancy. The result obviously went in favour of the taxpayer. The Last-in-First-Out (LIFO) method which is recognized for tax purposes in USA was rejected by the Privy Council in a well-known case. Similarly a plea for upholding the 'base stock' method of valuation was turned down by the Court of Appeal in a case even though it is a recognized method of accounting.

52 Duple Motor Bodies Ltd. v. Ostime (1961) 43 ITR 65.


The case related to a company of cotton spinners who consistently followed this system for a long time whereby raw cotton on the machines - called 'fixed process stock' - was not shown in the trading account although it appeared in the balance sheet "while an agreed weight of the cotton standing by the machines (spare process stock) was included in the trading account at a fixed or arbitrary figure." Expert evidence of chartered accountants was taken; but it was conflicting. One expert however admitted that, though a good method, it had the effect of showing lower profits than accounts prepared on cost-or-market basis.
Broadly, however, the position is that accountancy practice is allowed to prevail unless there is an obvious inconsistency with the law. After examining the various alternatives the Taxation Enquiry Commission supported the present system and so did the U.K. Committee on Taxation on Trading Profits (Tucker Committee). For several reasons however this approach does not seem to be either rational or satisfactory. First of all there is hardly any uniformity in accountancy practice or opinion on the question. This was sharply revealed in a case decided some time ago by the House of Lords in England. The point at issue was the meaning of the word, 'market value' in the context of the valuation rule - 'lower-of-cost-or-market'. The taxpayer, a dealer in shoes, wanted to value the stock of shoes which had gone out of fashion at its 'replacement cost' and not at its realizable value which was higher (but, presumably, less than the original cost). The Revenue authorities refused to accept the 'replacement cost' valuation and the House of Lords upheld the Crown's plea as it tended to produce a less inaccurate result. Expert opinion of accountants tendered before the court in this case was sharply divergent and the court interpreted the expression 'market value' in


its natural meaning to connote "the price which can be obtained for the article in question in the market which offers the best price." The bitter controversy among accounting theorists over the merits of the LIFO method of valuation also testifies to the fact that there is no agreed set of principles in accountancy for stock valuation.

More important, the rule 'lower-of-cost-or-market' though widely applied has no sanction even in accountancy theory. If, on the assumption that the business is a going concern, the idea is to segregate assets used for business (circulating assets) from those used in business (fixed assets) and to regard changes in the value of the latter as of no consequence in yearly income measurement, then the logical course would be to adopt cost as the basis for valuation of the latter and market as that of the former. Application of realization principle on the other hand would require valuation of all assets at cost. The lower of cost or market is, as one critic observed, the result of "an illogical and one-sided application" of the going concern convention.

57 Cross J. in Freeman, Hardy & Willis v. Ridgway (1970) 75 ITR 632.


The history of stock-valuation rule shows that it was born out of the conservatism which is innate among the accountants which was but natural in the environment in which the English accounting profession was bred. Relevance of this rule for purposes for which financial statements are prepared - stewardship reporting or providing information for investors to help planning and control - is increasingly called into question by accountants. For measuring business profit for managerial purposes, Parker and Harcourt have advocated, following Solomon, the adoption of 'replacement cost' as the valuation rule except where it is greater than the present value of the receipts expected from its use or its net realizable value (NRV). For measuring ex-post income, however, as has been pointed out by Gray and Wells, there is no reason why anything other than NRV should be taken.

It will not do to say that adopting the NRV would introduce a large element of subjectivity in financial results. For the operation of the lower-of-cost-or-market rule also involves an element of subjectivity. Even historical cost


61 Parker & Harcourt, op. cit., Introduction.

is not always more objective than market value. As Parker and Harcourt point out, depreciation based on historical cost is but an estimate and the "so-called historical cost of a manufactured article depends on a number of rather arbitrary decisions about which overheads are 'inventoriable' and how they should be allocated between jobs or processes, while many assets have easily verifiable market values". The sharp criticism levelled in U.K. against decision of the House of Lords in the shoe dealer's case referred to earlier (where the realizable value was upheld as appropriate in preference to replacement cost) also does not seem to be tenable. It is argued that the rule 'cost, net realizable value or replacement price whichever is the lowest' ensures that no element of profit is anticipated before it is earned. But this reasoning appears to be unsound, since, once a firm's liquidity is restored, any new commitment in inventory must be made primarily because management expects net realizable value to be equal to or greater than cost. To allow taxpayers to

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63 Parker & Harcourt, op. cit., p. 16.
65 C. E. Johnson, op. cit. This is essentially the ground on which Musgrave questions the logic of not recognizing income on the appreciation of assets. (R. A. Musgrave, "The Carter Commission Report", Canadian Journal of Economics, Supplement, February 1968.)
anticipate losses on inventory valuation but not gains may be prudent on the part of accountants but does not stand to reason in income measurement for taxation. It almost amounts to presenting Revenue with a heads-I-win-tails-you-lose alternative. In the context of an inflationary situation, the lower-of-cost-or-market rule operates to negate one of the important objectives of progressive taxation by allowing postponement of taxes on the gains of price rise and thus helping to support inventory accumulation. Such postponement is advantageous in more than one way in conditions where credit is scarce. RBI study of company finances shows that the proportion of inventories in the assets of medium and large public limited companies has increased from 31.9 per cent in 1970-71 to 33.5 per cent in 1972-73. In the case of 350 large public limited companies the proportion of inventories has increased from 28.8 per cent in 1970-71 to 31.1 per cent in 1972-73. The conservative rule of stock-valuation directly contributes to the capacity for stock holding. A rough calculation shows that the amount involved in tax-postponement facilitated by the current role of inventory valuation is by no means negligible and may amount to an interest-free loan of Rs.300 crores for the organized sector alone on which interest at the rate of 15 per cent works out

67 "Finances of Large Public Limited Companies 1972-73", RBI, February 1974, Table 7.
Rs. 45 crores per annum.

Considering everything, continuance of the lower of cost and market rule seems totally indefensible and quite unnecessary. This is conceded by many among the accountants themselves yet the rule continues to be followed. As Parker (1969) comments after tracing the history of the rule, "The astonishing thing about the lower of cost and market rule is its ability to survive attack." It may be, as Parker laments, that an agreement on inventory valuation is unlikely so long as the more general problem of asset valuation remains.

RBI study of company finances referred to in note 66 shows that the net sales of large and medium public limited companies was Rs.8,635 crores during the year 1972-73. Assuming that the ratio of inventories to sales of large and medium companies is around 31 per cent (as revealed by the same study), the value of inventories of these companies works out to about Rs.2700 crores (inventory at the year-end was valued at Rs.2672 crores). With an average price rise of 20 per cent per annum in the last few years, the value of price gain on these inventories comes to Rs.540 crores and the amount of tax postponed as a result of valuation at lower-of-market-or-cost approximately to Rs.297 or Rs.300 crores (@ 55 per cent). The interest on this amount @ 15 per cent per annum is about Rs.45 crores. If the unorganized sector too is included the amount of tax postponed would appear to be around Rs.500 crores, and the interest on it about Rs.75 crores per annum. This estimate however might be on the high side as the average holding period of goods may not be more than three or four months. Hence a more realistic estimate of tax postponed would be about 250 crores and Rs.25-30 crores may be taken to be the interest gain from such postponement.
unresolved. But, for tax purposes, there is no reason why valuation at market should not be imposed for stocks for which market values are available regardless of what accountants say. The decision of the House of Lords to take 'market value' in its natural meaning has paved the way for such a change in the rule. Conservatism in this regard may be in the interest of business proprietors but is incompatible with the aims of progressive taxation. Among the alternative market values again, it is the Net Realizable Value which is more relevant for purposes of ex post income calculation than replacement cost and present value of future benefits realizable from the use of the assets. The practical difficulties of ascertaining NRV of stock-in-trade are surely much less formidable than in the case of other business assets. Viewed in the light of preceding discussion, the recent measure in U.K. to provide tax relief to companies on the basis of increase in the value of closing stock cannot but be regarded as detrimental to the aims of progressive taxation. There might be some justification for such a measure in a country like U.K. where income-tax is paid by a large number of people, but such considerations cannot apply to India at present.

69 Gray & Wells, op. cit.
TREATMENT OF IMPUTED INCOME

One of the major consequences of the application of the realization test is the exclusion of all imputed incomes from the tax base. In the sense in which it is generally used in tax literature imputed income connotes a "flow of satisfactions from durable goods owned and used by the taxpayer or from goods or services out of the personal exertions of taxpayer on his own behalf." That the principle of equity requires the inclusion of imputed incomes in the tax base is not generally contested. Considerations of practicality centering primarily around the problem of valuation and enforcement however rule out the possibility of any thoroughgoing reform of the tax base to include all imputed incomes. Thus while advocating the comprehensive approach the Carter Commission shied away from the idea of recommending the inclusion of imputed income from home-owning even though the Chairman of the Commission admitted later that this was not "entirely logical."

70 D. B. Marsh, "Taxation of Imputed Income", Political Science Quarterly, December 1943. Some prefer to include in this definition value of various privileges that are sometimes provided by employers to their employees, which are not substitute for money wages. (Haskell & Kauffman, "Taxation of Imputed Income", NLI, 1964). This modification however seems unnecessary as all such benefit can be easily converted into money terms; more important, it obscures the essential issues arising in the taxation of imputed incomes associated with problems of valuation of services which are not marketed or marketable.

In India no imputed income is included in the tax base except the value of the enjoyment of owner-occupied houses. This has resulted from the application of the principle laid down by the courts that "no man can trade with himself." Although the context in which it was first enunciated was quite different, in essence the principle is nothing but an offshoot of the realization criterion which requires a gain or benefit to be received through an external transaction in the form of money or something convertible into money before it can be recognized as income.

Exclusion of imputed income from the base affects the equity and efficacy of the income tax in many ways. Apart from offending horizontal (and also vertical) equity, it tends to distort the choice between working at home and taking up employment outside, and encourage investment in consumer capital in preference to other assets. Failure to tax imputed income represented by housewives' domestic services is at the root of some of the difficulties encountered.

72 In the case in which this principle was first spelled out the question was whether profit earned by a city corporation by supplying water outside the city limits was taxable (Dublin Corporation v. M. Adam 2 TC 387).

in the taxation of personal incomes on the marital unit basis though as will be seen later (Chapter IX) workable solutions can be found to this problem. The harmful effects of the exclusion of income enjoyed from home owning have received a good deal of attention from economists in USA where the inequity is compounded by the deduction permitted in respect of interest on mortgages on owner-occupied houses. Subsidy given in this form is criticized as bad from the welfare angle and also because it encourages housing of a type that does little to help the poor. In India notional income from home-owning is taxable but the scope of the provision is so narrow that it may be regarded as virtually non-existent. Though no corroborating data are available, it


75 Laidler has argued that even granting that housing carries external economies (and house-owning makes for social stability) a subsidy in this form increases in size as one goes up the income-scale because of higher marginal rates and the income elasticity of demand for housing, and is ill-suited to capture the social economies associated with housing (Laidler, op. cit.)

76 Notional income from homeowning cannot exceed 10 per cent of other incomes (Sec. 23 of the Act). From (footnote contd.)
can be safely asserted that the strikingly rapid growth of the investment in luxury housing and consumer durables that has taken place in India in recent years is greatly facilitated by the absence of adequate arrangement for the inclusion of imputed income in the income tax base.

**Quantitative significance**

For an idea of revenue effect of the virtual exclusion of imputed income from home-owning, one needs to know how much would be assessed to tax if imputed income has allowed to be included in the loan without any restriction and the amount actually assessed as income from 'self-occupied' houses. No information on these points is readily available. Some idea of the dimensions of the revenue loss caused by this exclusion can however be derived indirectly.

(Previous footnote contd.)

Looking at the data relating to 1961-62 Krishnan felt that only about 25 per cent of property income is assessed to tax. Imputed rent alone would be around Rs.150 crores. He did not however make any attempt to estimate how much of this was enjoyed by income-tax payers (T. N. Krishnan, "Taxation of Property and Net Wealth in India: A Note", EPW, January 1, 1972, Note 25).
According to CSO's estimate of Net Domestic Product for 1970-71, income from 'real estate and ownership of dwellings and business services' was of the order of Rs. 696.78 crores. Break-up of these figures to show how much of it was on account of imputed rent is not available. However, earlier years' figures show that income from urban dwellings formed about 45 per cent of the total net product under the head 'real estate etc.' Hence about Rs. 300 crores may be taken as the income from urban dwellings for the year 1970-71. Since ownership of urban properties is highly skewed - according to Mahalanobis Committee's findings, top 10 per cent of the urban home-owning households accounted for 57 per cent of urban dwellings - it may perhaps be assumed that 50 per cent of the rental incomes (actual and notional) went to the income-tax payers. That comes to about Rs. 150 crores. As against this figure, income from property assessed in the year 1971-72 amounted to Rs. 93.2 crores. Although it is difficult to furnish any direct evidence in support, the difference of about Rs. 50 crores may well be accounted for by the underassessment of imputed rent. Imputed income from durables

79 Brochure on Revised Series of National Product for 1960-61 to 1964-65 (CSO, 1967), Ch. XIII.
80 Report of the Committee on Distribution of Income and Levels of Living (1964), Part I, p. 21, para 50.
like cars also may not be altogether negligible.

Another way of estimating the loss to revenue caused by the underassessment of notional rent is to work out how much would be tax if such rent was assessed properly. Proceeding on the assumption that 50 per cent of the urban households live in their own houses (as found by NSS), we may impute notional house rent to 50 per cent of the 'individuals' paying income tax in each income range at the rate of 10 per cent of their gross income and then work out the tax payable thereon after allowing for expenses at the rate of 30 per cent. It will be seen that income from imputed rent estimated on this basis comes to a little over Rs. 80 crores and the tax leviable to Rs. 27 crores (approximately) at the 1971-72 rates (Table 4.1). If the restriction of 10 per cent was not applied the tax leviable would have come to a larger figure. The tax actually levied on property incomes of individuals for that year was no more than Rs. 12.5 crores. Allowing for some margin of error, the revenue loss from the virtual exclusion of imputed rent may perhaps be put at Rs. 15-20 crores.

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82 Owners of newly constructed houses get some concession in tax in that a deduction of up to Rs. 1200 is allowed in the computation of rental income of such houses [Sec. 23(1)]. But that cannot account for the gap.
## Table 4.1

<table>
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<th>No. of Individual taxpayers</th>
<th>50% of Col. (2)</th>
<th>Mean Income of the Range (Rs.)</th>
<th>10% of mean income (Rs.)</th>
<th>70% of Col. (5)</th>
<th>Income from imputed rent (Rs.)</th>
<th>Marginal Tax rate (as of 1971-72) (%)</th>
<th>Tax on net imputed income from dwelling house (Rs.)</th>
<th>Total tax on imputed income (Rs.)</th>
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### Note 1

Figures in column (2) are based on All India Income-tax Statistics 1971-72.

Regarding Col. (5), 10% of the mean income is taken to represent the notional income from home-owning in conformity with the statutory requirement that such income cannot exceed 10% of the other incomes of the assesses.

Col. (6) shows the net income from home-owning on the assumption that 30% of the gross income takes care of the outgo by way of repairs, etc.
a year. Imputed income from durables like cars also may not be altogether negligible.

Another effect of the non-inclusion of imputed income in the tax base is that by not taxing such income the tax system discriminates in favour of persons whose professional skill is of direct use to their household and 'penalizes specialization'. It also provides opportunities for avoidance, if not evasion, through such devices as 'bargain-purchase' and consuming one's own produce e.g. farmers consuming grains raised from their own field or a trader withdrawing from one's own trading stock for personal consumption. Since opportunities of avoidance or tax reduction through these methods are not open equally to all this can be a source of inequity. Quantitatively, the effect of ignoring the benefits from bargain - purchases may not be significant but the same cannot be said about the exclusion of farmers' consumption of their own produce.


84 Since agricultural income is not taxed in India under the Central income tax, this result might be of little consequence. With the introduction of the system of partial integration of agricultural and non-agricultural income however, this is no longer true. Besides it affects the incidence of agricultural income tax levied by the States. Treatment of imputed income would also be of significance if incomes from activities like dairying and livestock breeding are again brought under taxation, as is indeed contemplated under the Finance Act, 1975.
Suggestions towards a rational treatment of imputed incomes

As stated earlier problems of valuing such things as leisure time militate against the inclusion of all imputed incomes in the income tax base. To mitigate the effects of total exclusion however, two sets of remedies are generally proposed, viz., (1) taxation of certain conspicuous items of income like the notional rent of owner occupied house and; (2) a suitable deduction out of employment income. Much of the ill-effects on equity and distortion of choice between work and leisure caused by the omission of imputed value of homeownership and enjoyment of leisure, it is believed, can be neutralized in this way.

Considerations of both equity as well as growth (the need to curb investment in luxury housing and other durables) call for an earnest attempt to tax imputed incomes. This is particularly true of imputed rent of owner-occupied houses, for it forms a substantial element of the aggregate net gains accrued by individuals. The second-best solution

proposed for the inequity of omitting imputed rent from taxable income, viz. deduction of house rent paid by rent payers, is not satisfactory because in trying to achieve horizontal equity it seriously compromises the progressivity of the tax system and thereby the aim of vertical equity and redistribution. The ground usually put forward for not including imputed income in the tax base, viz., valuation and administrative problems (it was on this ground that Carter Commission felt hesitant to recommend inclusion of imputed income and the practice was given up in U.K. a few years ago) is not very convincing in the case of imputed rent since urban houses at least admit of a standardized approach. It may be worthwhile to make an effort to tax the imputed rent of not only houses but of other major durables like motor cars, refrigerators and TVs.

Problems of selective approach

One difficulty with such a selective approach to the treatment of imputed income as implied in taxing a few items while leaving out others (or, alternatively, in providing for compensatory deduction for the non-inclusion of some) is that it requires exercising some judgement about which items to take notice of and which are to be ignored. Absence of any clear principle in this regard causes dilemma and confusion.

86 Bossons, op. cit.
The conflict in the view taken by the highest judicial authorities in U.K. and India on the question whether any income should be recognized when a trader withdraws some articles from his trading stock for personal consumption illustrates how acute the dilemma can be at times. The House of Lords thinks income does arise on such withdrawal while the Indian Supreme Court thinks otherwise. 87

Similar conflict marks the decisions of tax courts in USA too. In a case where a partner of a firm doing real estate brokerage business purchased some properties through the firm on his individual account, the commission received

[87] In their material aspects, the facts in the two cases were identical. In the Indian case, the taxpayer was the sole owner of a firm dealing in silver and company shares. During the relevant year he had withdrawn some silver bars and shares for personal use. Reversing the decision of the High Court, the Supreme Court held (with one judge dissenting) that no income was realized by the taxpayer through such withdrawal. \(\text{Sir Kikabhai Premchand v. CIT (1953) 24 ITR 506 (S.C.)}\)

In the British case, the taxpayer ran a stud farm, profits of which were taxable, and also maintained a racing establishment for recreational activity. In the year in question five horses were transferred from the stud farm to the racing establishment, that is, for personal purposes. The House of Lords decided (with one Lord dissenting), reversing the decision of the court below, that the accounts of the business must be credited with the market value of the animals and not their cost on such transfer. \(\text{Shawkey v. Wernher (1956) 29 ITR 962 (H.L.)}\)
by him from the firm in respect of the purchase was treated as taxable income by the Board of Tax Appeals. But in another case where a partner of a firm paid some commission to the firm on transactions done on his account the commission was held to be non-taxable as "the partner was paying it to himself."

Recognizing income in such situations (as diversion of stock from trade to personal use) might appear to be more in accord with commonsense and sound in economics as well as administratively welcome. But in strict logic there is no valid ground for recognizing such income unless imputed incomes are recognized as taxable in all situations. The Indian Supreme Court's decision is therefore less vulnerable.

88 Haskell & Kauffman, op. cit.

89 Haskell and Kauffman (op. cit.) seem to regard this approach as more satisfactory in logic and economics.

90 This is because it blocks the scope for avoidance. Following the decision of the House of Lords, Inland Revenue in U.K. has been valuing trading stocks withdrawn from business for personal use at the market value but the decision is not taken to apply "to services rendered to the trader personally or to expenditure on the construction of a fixed asset used in the trade." (Simon's Taxes, Bl.926).

91 It must be mentioned however that the Supreme Court did not adhere to this logic when an investor in shares turned a dealer and a question arose as to how to compute the profits on the share sales. The Court held that the cost relevant for this purpose is the market value of the shares on the date of their conversion into business stock and not the (footnote contd.)
To bring only this particular variety of imputed income under taxation that is, to make an exception in the case of withdrawal of stock from business for personal use, a case must be made out for such treatment on more persuasive grounds than is implied by the argument advanced by the House of Lords, viz., that a business asset must be disposed of in a business way. In other words, if the area of exemption of imputed income is to be curtailed, the delimitation should proceed on straightforward and rational lines instead of coming through rulings based on fallacious logic or irrelevant considerations.

Though it is not possible to find a formula for distinguishing between different kinds of imputed incomes in order to select only some for taxation while leaving out others without avoiding some arbitrariness, one way of going about it would be to treat imputed income from labour on a different footing from that derived from capital. In respect of imputed income from working for oneself a presumption may be built into the law to the effect that any gain made by a taxpayer from the exercise of his vocational position,

(previous footnote contd.)

original cost. Thus the cost was allowed to be computed on a notional basis on this occasion although the gain reflected in such valuation would, probably, not be allowed to be taxed as capital gain. The point however did not come up before the Court for a decision. CIT v. Bai Shirinbai Kooka (1962) 46 ITR 86/.
skill or calling whether in profession or in business or employment is taxable, being income from an economic activity and not from sacrifice of leisure. To allow for the fact that not all imputed incomes from labour which would be taxable by this criterion can be located (e.g. when doctor treats his own family) some deduction may be allowed against such incomes before including it in the tax base.

Treatment of imputed income from capital may be rationalized by stipulating that all investment in consumer durables beyond a certain value (and lasting say for more than one accounting year) must be reported and income imputed to it at the going market rate of rent for similar article or, alternatively, market rate of interest by imputing a return on the amount invested in such durable at the current interest rates. Any capital gain on sale of such assets must also be included in taxable income. The incongruity of excluding capital gain from sale of personal assets like motor cars would then disappear.

The two rules suggested above might appear to be a little complicated. In actual operation, however, they would not involve any more complexity than the taxation of imputed income from assets like residential houses and cars, while the underlying logic will help indicate the correct solution in borderline cases. At the same time it will remove the bias in favour of consumer durables which total exemption of imputed income creates.
TREATMENT OF BONUS SHARES

Perhaps nothing illustrates better the dilemma and confusion that the application of the realization principle creates in practice than the manner in which bonus shares are treated in the assessment of shareholders. Consistently with the requirements of the realization principle, the income tax law in India has refused to recognize any distribution of profits by a company as dividend unless it is accompanied with release of some asset of the company. The judicial view about bonus shares was expressed most succinctly by the U.S. Supreme Court in the case of Eisner v. Macomber to which reference has been made already. In this decision the U.S. Supreme Court refused to recognize 'stock dividend' (that is, bonus shares) as income by arguing that enrichment through mere increments in the value of one's wealth is not income. The position taken by the judicial authorities in U.K. and India is also similar. The reasoning underlying the decision of the House of Lords in the leading case on the subject was slightly different viz. that issue of bonus shares

92 252 U.S. 189 (1920).

93 I. R. v. Blott, 8 T.C. 101. This principle was followed by the Supreme Court in the case of CIT v. Dalmia Investment Co. Ltd. (1964) 521 ITR 567 (S.C.). The Courts have refused to recognize bonus shares as income even when there is a cash option to the shareholders, unless the option is actually exercised. (In Re v. Coke 11 T.C. 181).
makes no difference to the shareholders' economic circumstance. Even if the bonus shares are sold by the shareholders, it was argued, "he would be realizing a capital asset producing income and the proceeds would not be income in his hands". In other words, the sale proceeds would be a capital receipt.

Accepting the judicial view income tax statute in India has refrained from treating bonus shares as income when they are received by equity shareholders. As indicated in Chapter II, the definition of dividend set out in the Act encompasses distribution out of accumulated profits but not unless it is accompanied with release of assets. Bonus shares are however treated as dividend when they are received by preference shareholders. The only time when bonus shares issued to ordinary shareholders have been treated as income in India was during the brief period 1964-66. Value of bonus shares as on date of issue was taken as income during these two years. The provision however ceased to operate after 1966. At present bonus shares give rise to income in the form of capital gain only when they are transferred (here 'transfer' means only those types of dispositions which are included in the definition of the term in the Act and does not include gifts and bequests). The mode of computation of capital gain on transfer of bonus shares has been the 

94 Sec. 2(22).
subject-matter of quite a few Supreme Court cases. The practice which has come to be established is to spread the cost of acquisition of the original shares over the entire shareholdings of the taxpayer in the company (comprising original as well as bonus issues) and take the average as the cost. The view that bonus shares are not income has found support from economists like Kaldor and expert bodies like the TEC and the Royal Commission (1955).

For various reasons however exclusion of bonus shares from taxable income has caused misgivings as is evident from the attention given to the question in discussions on the income tax. The amount of tax saved through these issues is not negligible. It is probably around Rs. 18-20 crores a year on the average. Though capitalization of


97 On an average about Rs. 50 crores of company profits are capitalized in this way every year (Table 4.2). According to RBI survey of share ownership (RBB, Feb. 1968) 66 per cent of the shares was held by less than 1 per cent of the shareholders. It may therefore be assumed that 75% of the distribution of company profits goes to income tax payers mostly in brackets exposed to a marginal tax rate of 50 per cent and above, even making allowance for the fact that a sizable portion of the holdings would be with companies and financial institutions. The tax on 50 crores if distributed as dividend would amount to Rs. 50 crores \times \frac{1}{2} \times \frac{1}{2} \times \frac{1}{2} = 19 crores.
company profits through issue of bonus shares makes no apparent difference to the shareholders, it cannot be maintained that the shareholders' tax advantage is no consideration in the issue of bonus shares. The fact that bonus issues in India practically ceased during the two years (1964-66) when they attracted tax in the hands of shareholders and reappeared with a record Rs.147 crore issue in 1966 (Table 4.2) the moment the tax was lifted, should be enough to dispel any doubt on the point. Even the courts have at times recognized that these shares are "received in lieu of dividends which might otherwise have been obtained."

To say that bonus shares are not income because they are capital receipt also cannot do for in that case capital gain should be recognized as soon as they are issued. However, if bonus shares are to be subjected to income tax when received by the equity owners whether as ordinary income or as capital gain, it must be established that they confer an economic gain to the shareholders. For the basic objection to their taxation has been that issue of these shares confers no benefit on the equity owners of companies. Recently L. C. Gupta has claimed to have found statistical support for this view.

It is to be noted however that neither Kaldor nor the

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98 CIT v. Athi Ramachandra Chettiar (1964) 52 ITR 96.
Table 4.2.

Company profits permitted to be capitalized through bonus issues

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount (Rs. crores)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1958</td>
<td>9.9</td>
</tr>
<tr>
<td>1959</td>
<td>2.9</td>
</tr>
<tr>
<td>1960</td>
<td>1.4</td>
</tr>
<tr>
<td>1961</td>
<td>10.40</td>
</tr>
<tr>
<td>1962</td>
<td>13.50</td>
</tr>
<tr>
<td>1963</td>
<td>10.86</td>
</tr>
<tr>
<td>1964</td>
<td>4.08</td>
</tr>
<tr>
<td>1965</td>
<td>4.93</td>
</tr>
<tr>
<td>1966</td>
<td>147.00</td>
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<tr>
<td>1967</td>
<td>47.85</td>
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<td>1968</td>
<td>33.55</td>
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<tr>
<td>1969</td>
<td>39.08</td>
</tr>
<tr>
<td>1970</td>
<td>40.57</td>
</tr>
<tr>
<td>1971</td>
<td>41.19</td>
</tr>
<tr>
<td>1972</td>
<td>33.86</td>
</tr>
<tr>
<td>1973</td>
<td>60.00</td>
</tr>
</tbody>
</table>


Note: The above figures relate to permission given for capitalisation. The amounts actually capitalized are sometimes a little less than that for which permission is obtained.
Royal Commission (1955) ruled out the possibility that bonus shares might embody some advantage to the shareholders. While agreeing that bonus shares should not be treated as taxable income the Royal Commission (1955) recognized that "whatever a strict analysis shows, the announcement of a capitalisation is generally greeted as an advantage or at any rate as an encouragement to the shareholders affected."

Kaldor's view that bonus shares should not be taxed like ordinary income was based mainly on the consideration that the capital gain from appreciation of the market valuation of a company consequent on a bonus issue is not measured by the issue itself and that such appreciation should be treated on the same footing as appreciation which is not due to this cause. It would thus appear that Kaldor's objection against taxation of bonus shares is not so much that they do not improve the economic position of the shareholders as that the element of gain cannot be identified.

Gupta seeks to support his conclusion primarily on two statistical findings. These are, first, that share prices do not necessarily appreciate on the announcement of a bonus
issue and post-bonus prices of shares, apart from being unstable, change in an unpredictable way, there being wide diversity in the movement of prices over the first one year after the announcement as compared to the pre-announcement price. (The percentage change in the prices ranges from 94.1 to -23.1). Secondly, bonus issues do not always lead to an increase in the total dividend distribution and it is the quantum of dividend which ultimate determines the price gain on the shares. Almost two-thirds of the companies examined by Gupta reduced the nominal dividend rate after the bonus issue and about one-third showed no increase in the quantum of dividend after the issue of the bonus shares. The latter finding is however open to question since while working out the quantum and also the nominal rate of dividend Gupta made adjustment for each successive issue separately whereas the proper comparison should perhaps be with the rate which would obtain if the total amount of the dividend was taken as the return on the original investment. If all the issues are considered together in all probability the quantum as also the rate of dividend would turn out to be much larger.

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**Bonus Shares**


104 Ibid., p. 24.

105 This can be demonstrated with the following example. Suppose a company started with a paid up equity capital of Rs.1 lakh. Assume further that at first the company paid dividend @ 10 per cent or Rs.10,000 in aggregate. Now assuming that it

(footnote contd.)
Thus the argument that bonus shares are of no advantage to the shareholders is not very convincing. Even Gupta does not deny that bonus shares confer some gain but he thinks that in most cases the gain is only a fraction of the amount of bonus shares received except when the ratio of bonus issues is very low. The case against taxation of bonus shares looks less vulnerable when premised on the argument that the gain to shareholders resulting from their issue is not easily ascertainable than on the belief that they make no difference to the taxable capacity of the taxpayers. Here again certain misconceptions seem to inhibit clear thinking. One is that the gain accruing from bonus issues must be reduced by the decline in the share values which usually takes place following their issue consequent on their allotment. But this argument is hardly legitimate. For taking cognizance of depreciation in share values when appreciation (which usually follows the announcement of the issue) is not recognized as a gain is obviously illogical. Indeed, if income was recognized on the accretion principle (that is,

(previous footnote contd.)

issued bonus shares in the ratio of 1:1 twice in the course of five years, at the end of the said five years, a dividend of 5 per cent would mean a distribution of ₹20,000, which if taken as a return on the original investment works out to 20 per cent. With Gupta's adjustments, it seems, the rate would be taken as only 10 per cent.

106 Gupta, op. cit., p. 90.
on the valuation of wealth including all share holdings of the taxpayer at the beginning and the end of each period) bonus issues would pose no problem at all. Even if one does not go so far as to accept the accretion basis in taxation, any attempt to integrate corporate with personal taxation would call for recognition of bonus shares as income. Thus the Carter Commission had no hesitation in recognizing bonus issues as a form of distribution of company profits even though they did not think it wise to adopt the accretion basis without reservation. The Australian Study Group on tax reform also thought it necessary to regard bonus issue as dividend in their scheme which was based strictly on the realization principle. In fact bonus shares are treated as dividend in Australian income tax since long.

Whether tax on corporate profits should be integrated with personal income taxation is examined in some more detail in Ch. X. Even without such integration there are reasons to justify taxation of bonus shares as ordinary income because of the avoidance opportunities which preferential treatment of such issues makes room for. In USA 'stock dividends' were generally not taxable till 1969 so long as


they were made in the same class of stock unless there was a cash option or unless the issue was in discharge of a preference dividend. It was however found that under this arrangement one could achieve substantial tax saving by suitably timing stock redemption or by carefully delineating the rights of different classes of stock. The law was accordingly amended in 1969 and several kinds of previously non-taxable stock dividends were made taxable. But this has complicated the law so much that it is difficult now to be sure which issue is taxable and which is not. Therefore it would seem unwise to make any attempt to tax bonus shares like ordinary income except in a straightforward manner as suggested by the Carter Commission.

It must be conceded however that the advantage embodied in bonus share is not necessarily equivalent to their nominal value and that a precise valuation of gain represented by them raises many difficult problems. The best way to bring them under taxation is therefore to go via capital gains, as suggested by Kaldor. Gupta (1973) suggested that an exception may be made in the case of bonus issues in very low ratios (up to 1:6) and such distribution may be treated as dividend while distribution in high ratios should be regarded as a kind of stock-split. This suggestion however does not seem to be workable. For such a line of demarcation would be

109 Sommerfeld et al., op. cit., p. 432.
too arbitrary to be justifiable, and such a rule can be easily circumvented by varying the bonus ratio beyond the critical limit while increasing the frequency.

For purposes of computing the capital gain on transfer of bonus shares the rule evolved by the Supreme Court viz., that the cost of original shares should be spread over all the share holdings offers an equitable and simple method although it is advantageous to the taxpayers. But, to yield fair results the rule should be applied with some consistency. It appears that the courts do not always adhere to this principle and departures are made for reasons which do not seem to be valid. One such instance is provided by the decision of the Supreme Court in a recent case in which the taxpayer had sold bonus shares some of which were received before 1954 and some, after 1954. According to the principle laid down by the Supreme Court, in computing the gain on the sale, ordinarily, the cost of bonus shares should have been worked out by spreading the cost of acquisition of the original shares over the total equity holdings of the assessee in the company (assuming he did not purchase any shares later) at the time of the sale (after of course adjusting for any share sold out earlier). Where

an asset happens to be acquired before 1954, in the computation of capital gain on the transfer of such an asset the income tax law in India allows an option to the taxpayer to substitute the fair market value of the asset as on 1. 1. 1954. The assessee in this case had exercised this option. Even so in assessing the capital gain the cost as decided in the light of this option should have been spread over the shares of the taxpayer in the company at the time of sale. The Supreme Court refused to permit this on the ground that "for the ascertainment of the fair market value of the shares in question on January 1, 1954, any event prior or subsequent to the said date was wholly extraneous and irrelevant". That may be so with respect to the fair market market value of the shares as on January 1, 1954, but it is difficult to see how it stood in the way of spreading that value over the shares that subsisted (i.e., including the fresh issues) when the sale took place. It must be submitted with respect that the Court failed to appreciate the implications of its own rule.

In choosing the mode of taxation of bonus shares however one has to keep in view the pattern of corporate taxation and the policy taken in regard to retention of profit by companies. If retention is disfavoured and undistributed profits are sought to be taxed then the surpluses capitalised

111 Ibid., p. 793.
through bonus issues should be regarded as part of undistributed profits and taxed accordingly. If however retention is to be encouraged then issue of bonus shares should be looked upon as distribution and taxed in the hands of shareholders at their face value. The value so brought under taxation should form the cost basis for determining any capital gain in future as the Carter Commission suggested. If on the other hand the present system of not recognizing any gain to shareholders on the receipt of bonus shares is continued, then in computing capital gain arising from their transfer, the cost should be determined by spreading the original cost over the total number of shares both original as well as bonus. But the cost so determined should apply to original shares too when the capital gain from these shares is required to be ascertained. Where bonus shares are left to be tackled through the capital gain route it is essential to impute realization at the time of gifts and bequests. Realization should be presumed also when shares are transferred from investment to stock-in-trade or withdrawn from stock-in-trade for transfer to investment portfolio.

It is doubtful if the gain arising on such transfers or withdrawals can be taxed at present in view of the Supreme Court ruling in Bai Shirinbhai Koka's case referred to earlier (see note 91 ante); of course this question did not arise for decision in that case and the issue seems to be open.
It is also necessary to stipulate in the law that any cash option whether exercised or not will amount to realization.

In short, there is no need to disturb the present arrangement for taxing bonus shares via capital gain unless integration of corporation and personal taxation is decided upon. Considerable tightening up of the existing law governing the taxation of bonus shares is however called for to make sure that all capital gains derived through these shares are taxed and that indefinite postponement is not possible.