
(1974) 07 MAD CK 0025

In the Madras High Court

Case No : Tax Case No. 123 of 1968 (Reference No. 52 of 1968)

Factors (P.) Ltd.

APPELLANT

Vs

Commissioner of Income Tax

RESPONDENT

Date of Decision : 11-07-1974

Acts Referred:

Income Tax Act, 1922 — Section 23A

Citation : (1975) 98 ITR 105

Hon'ble Judges : V. Ramaswami, J;G. Ramanujam, J

Bench : Division Bench

Advocate : S.V. Subramaniam, for Subbaraya Aiyar, Sethuraman and Padmanabhan, for the Appellant; V. Balasubrahmanyam and J. Jayaraman, for the Respondent

Judgement

Ramaswami, J.—The assessee is a private limited company. It carries on various activities like insurance agents, transport contractors, etc.

Its share capital is 50 ordinary shares of 1,000 each and paid up capital is Rs. 500 per share amounting to Rs. 25,000. For the assessment year

1961-62 corresponding to the year ending 30th June, 1960, the company suffered a loss on transport contracts in the sum of Rs. 8,519. During

this period it had sold certain shares held by it in other companies which resulted in a profit of Rs. 35,826. This was transferred to the profit and

loss account of the company and the net profit was arrived at Rs. 29,177"97. After providing for taxation, a sum of Rs. 20,000 was transferred to

the general reserve. This account stood at Rs. 30,000 as on 30th June, 1960. Cash and bank balance as on that date was Rs. 16,770.19. No

dividend was declared by the assessee. The Income Tax Officer did not accept the assessee's working of capital gain. He computed it at Rs.

37,688 and assessed the total income at Rs. 38,965 ; the tax thereon came to Rs. 11,881 leaving a distributable surplus of Rs. 27,084. As no

dividend had been declared the assessee was called upon to show cause why the provisions of Section 23 A of the Indian Income Tax Act, 1922,

should not be invoked. In its reply dated June 15, 1964, the assessee contended that the entire income consisted of capital gains, that according to

commercial principles they did not form part of the revenue profits and that, therefore, the company did not declare any dividend. It was further

contended that the Companies Act, 1956, prohibited declaration of dividend out of capital gains. The Income Tax Officer rejected all these

contentions and levied a sum of Rs. 10,021.08 as additional super-tax u/s 23A of the Indian Income Tax Act, 1922. In the appeal before the

Appellate Assistant Commissioner the assessee also contended in addition to the point raised by him before the Income Tax Officer that the

realised accretion in one item of the capital asset could not be treated as profit available for distribution. The Appellate Assistant Commissioner did

not accept these contentions of the assessee and upheld the order of the Income Tax Officer, In support of his decision he relied on the decision of

the Supreme Court in Commissioner of Income Tax, West Bengal Vs. Gangadhar Banerjee and Co. (Private) Ltd., . The assessee appealed to the

Tribunal. The Tribunal referred to the capital position as well as the reserve built up by the assessee-company as shown in its balance-sheet as on

30th June, 1960, and the cash position on that date and considered that any declaration of dividend would not be out of capital. Ultimately, the

Tribunal also held that having regard to the commercial profits of the assessee it would not have been unreasonable to have declared a dividend

and that, therefore, the provisions of Section 23A were rightly invoked in this case. At the instance of the assessee the following question of law

has been referred :

Whether, on the facts and in the circumstances of the case, the provisions of Section 23A were applicable to the assessee-company ?

The learned counsel for the assessee submitted that under article 97 of Table "A" of the First Schedule to the Companies Act, 1913, no dividend

shall be paid otherwise than out of the profits of the year or any other undistributed profits. The capital gains realised from the sale of shares is in

the nature of accretion of one item of capital asset which could not be treated as profits available for distribution. The distribution of such capital

gain would be contrary to the provisions of the Companies Act. In support of this argument, he relied on certain English decisions. Before dealing

with these decisions, it is necessary to note certain general principles relating to declaration of dividend. The manner in which the company's profits

are to be divided among the shareholders must be determined in accordance with the memorandum or articles of association of the company. How

profits available for distribution as dividend are to be reckoned would also depend upon the nature of the particular company and its memorandum

and articles. Profits arising from the ordinary business of the company are ordinarily distributable as dividend. The availability of the profits realised

by dealing with fixed capital and forming accretions to capital would depend upon the articles. Where the articles do not restrict the distribution of

the same, they might also be distributed. However, the dividend shall not be paid out of capital even if the memorandum or articles of association

authorise such payment, as that would amount to a reduction of the capital itself, which is not authorised by law. These general principles may be

found stated in some of the text books. In 6 Halsbury (third edition), paragraph 774, at pages 399-400, we find the following passage I

There is nothing in the Act determining how profits available for distribution as dividends are to be reckoned. It is a question left for decision by

the commercial world. Profits for this purpose may in some cases be amounts differing from what are regarded as profits for other purposes. The

profits of a company are of two kinds. First, there are the profits ascertained, as already mentioned, representing the credit balance on revenue

account arising from the ordinary business of the company. Secondly, there may be profits realised by dealing with the fixed capital and forming

accretions to capital, as, for instance, where part of the undertaking of the company is sold, for an amount in excess of that which was paid for it,

or where an asset acquired by the company which has never appeared in the balance sheets as an asset and has hitherto been regarded as

valueless unexpectedly realises a substantial amount. Where the articles provide that only the profits arising out of the business of a company may

be distributed, only profits of the first kind may be distributed ; but where no restriction is imposed by the articles, profits of the second kind may

be distributed. When this is proposed to be done, the whole of the accounts must be looked at and only the excess of the value of the assets over

the sum total of the liabilities and issued capital may be distributed so that the subscribed capital of the company remains intact.

Again, at page 73 of the same book, we find a statement that the company must not pay any dividend whereby its capital stock will be in any way

reduced. In the note to this statement, it is stated that this provision relates to the paid up capital of the company and not to its capital assets

generally, and so a company may pay a dividend out of a realised profit on its capital assets. In Cower's Principles of Modern Company Law

(third edition), at page 118, we find the following statement:

A realised profit on the sale of fixed assets may be treated as a profit available for dividend, at any rate if there is an overall surplus of fixed and

circulating assets over liabilities.

Gore Browne, in his Handbook of Joint Stock Companies (41st edition), at page 499, has stated the law thus :

But a realised accretion to the value of one item of the capital assets cannot be deemed to be profit without reference to the result of the whole

account fairly taken. On this principle it has been held that where a company formed on the trust principle (i.e., keeping capital and revenue

accounts distinct) made a profit by redeeming debentures at less than par, it could not divide this profit without making good a loss on capital

account. "Profit for this purpose" (i.e., for division) " is not constituted by one individual gain, but by a surplus of gains of all kinds over losses of all

kinds during some definite period..... I am clear that the gain involved in the reduction of the liability on the debenture stock was a gain in respect

of capital or on capital account". On the other hand, where a railway company's capital was said to be lost, but it was entitled to an annuity for the

use of the railway terminable in a few years, it was held that it might distribute the annuity in dividends without making provision for replacing the

lost capital. Where sufficient assets would be left to answer the paid-up capital a realised profit on capital assets can be divided unless forbidden

by the constitution of the company.

It would be seen from the foregoing passages that there is no prohibition for distribution of capital gains as dividend except when it is forbidden by

the memorandum and articles of association. Now, let us deal with the decisions relied on by the learned counsel for the assessee.

2. The earliest case that is referred to in this connection is the one in *Wall v. London and Provincial Trust Ltd.*, [1920] 1 Ch 45 (Ch D). The

question for consideration in that case was whether the profit made by the company in the redemption of its debenture stock at a discount could be

distributed as dividend to the shareholders. The company was a trust investment company. The objects as defined by clause 3 of its memorandum

of association were (a) "to acquire and hold stocks, shares and securities of the classes therein specified and from time to time change such

investments for others of the like nature, and (b) to borrow on debenture stock and to redeem or pay off any moneys so borrowed. The company

was formed on the double account system and the business accounts were conducted and kept as required by the articles of association on the

footing that profit or loss on a change of investment was carried to capital account and net receipts over expenditure were carried to revenue

account and became available for payment of dividends without regard to any depreciation in the market value of the company's investments. In

1900 the company issued certain debentures at par. In 1918, owing to the general fall in the value of securities, the company was able to redeem

some of its debentures at a discount. The investments forming the assets of the company had also fallen to an extent approximately equivalent to

the discount at which the debenture stock had been redeemed. The directors claimed the right to carry the whole of the amount of this discount to

revenue account. The plaintiff, on behalf of himself and other preferential shareholders in the company, sued for a declaration that it was beyond

the powers of the directors and in contravention of the articles of association to transfer to the revenue account the sums representing the discounts

arising upon redemption of the company's debentures. While disposing of a motion for interlocutory injunction, Younger J. considered the issues in

detail. Rejecting the contention of the company, the learned Lord Justice held that clause 3(b) of the memorandum of association did not authorise

a separate and independent business, but was a subsidiary to the main purpose in clause 3(a) and that the amount of discount at which the

debenture stock had been redeemed was not net profit of the company or profit arising from its business and that no part thereof could be

distributed as dividend. It should be noted that the company is a trust investment company which means that the capital and revenue accounts shall be kept separate. The articles of the company, which were extracted in the reports, provided that :

No dividend, instalment of dividend, or bonus, shall be payable except out of any profit arising out of the business of the company", and

All profits and losses resulting from any change of investment shall be carried to capital reserve account and any such profits or losses shall be

disregarded in estimating the net profits of the company.....

It is with reference to these provisions and the nature of the company, it was held that the amount of discount was not profit distributable as

dividend. The following passages which deal with this question may also be quoted:

It is true, as I have said, that in the case of such a company as we have here capital and revenue accounts are distinct accounts and you may

operate upon a credit balance on the second account irrespective of loss on the first. But the accounts are distinct. There is a gulf set between them

not spanned by any bridge. You must not carry any asset from one to the other. The price of being entitled to distribute as dividend a revenue

balance regardless of a capital loss is that you may not supplement a deficiency of revenue by carrying to the credit of that account a gain on capital

however realised.....

The truth is that in accounts kept as this company is required to keep its accounts, an appreciation in capital assets can never increase the dividend

fund. If for the purpose of dividend a company like this desires to gain the benefit of an appreciation in capital values, it must adopt the single

account system and, as a consequence, value its entire assets for the purpose of every dividend distribution. That is not in accordance with the

constitution of this company as it stands, and the present value of its assets offers no inducement to effect any immediate change in that direction.

In my judgment, therefore, this discount is, in no sense, either net profit of the company or net profit arising from its business.

When the matter came on for final disposal it was heard by a different learned judge and this view was affirmed, and the decision is reported in

[1920] 2 Ch. 582. These decisions, therefore, do not, in any way, support the

contention of the learned counsel for the assessee. On the other hand, we have two other direct decisions dealing with this point which is against the assessee's contention. The first case is *Lubbock v. British Bank of South America*, [1892] 2 Ch 198 (Ch D). Shortly stated, the facts in that case were as follows : A banking company sold part of its undertaking and made a net profit of ₹205,000. Under the articles of association of the company, the directors shall be at liberty to appropriate out of the profits of the bank in any year such an amount as in their discretion they shall think proper and add the same to the reserve fund and the reserve fund may be applied for equalising dividends. The directors passed a resolution that the profits derived from the sale of the part of its undertaking be treated as profit and be carried to the profit and loss account and dealt with accordingly. An action was brought against the company for restraining them from distributing the amounts as dividend. It was contended that what was sold was part of the capital of the company and that what was received over and above the value of the asset was an accretion to the capital and therefore it must be kept intact as part of the capital. Repelling this argument, it was held that the profit was profit on capital and not part of the capital itself and that the directors were justified in carrying this sum to the profit and loss account and distributing the same as dividend. The ratio of this decision was applied in *Cross v. Imperial Continental Gas Association*, [1923] 2 Ch 533. In that case, the compensation payable for compulsory acquisition of a part of the undertaking of the company resulted in the realisation of a very considerable profit on book value of the portion acquired. A portion of the profits, the directors proposed to treat as profits available for paying dividend to the members, On the question whether they are distributable surplus profits it was held that the company could, in the absence of a special provision to the contrary, distribute a realised profit on its capital asset. It was argued in that case that Section 121 of the Companies Clauses Consolidation Act, 1845, prohibited the distribution of this profit. That section read :

The company shall not make any dividend whereby their capital stock will be, in any degree, reduced.

It was held that ""capital stock"" there means paid up capital of the company and

that provision did not prohibit a company paying a dividend out of a realised profit on its total capital assets. In *Verner v. General and Commercial Investment Trust*, [1894] 2 Ch 239 (CA) also, a passage (at page 265) to the same effect is found, which reads I

Moreover, when it is said, and said truly, that dividends are not to be paid out of capital, the word "capital" means the money subscribed pursuant to the memorandum of association, or what is represented by that money. Accretions to that capital may be realised and turned into money, which may be divided amongst the shareholders as was decided in *Lubbock v. British Bank of South America*, [1892] 2 Ch 198 (Ch D)

In *Palmer's Company Law* (20th edition), we find the following passage at page 645 :

As was pointed out earlier (rule 5, on page 640, ante) it is clearly established by the authorities that an accretion to fixed assets, when realised, may be brought into the profit and loss account and may be divisible profits, unless prohibited by the articles of the company ; a prohibitive article of that character would, e.g., be an article providing that dividend shall be paid out of trading profits.

The learned counsel for the assessee could not refer to any provision in the memorandum and articles of association prohibiting the declaration of dividend from the profit arising from the sale of these shares. We also find from the balance sheet as on 30th June, 1960, that the value of the other assets and the reserves are kept at their full value and there was no depreciation in the value of the other assets. In other words, as rightly pointed out by the Tribunal, the financial position as is evident from the balance sheet of the company is such that it cannot be said that any distribution of dividend from its profits as shown in the profit and loss account would eat into its capital. What the law requires is only to keep the capital intact and that is satisfied. We do not, therefore, agree with the contention of the learned counsel that there is anything in law or the articles which prohibits the declaration of dividend out of the capital gains of the assessee.

3. It is next contended by the learned counsel for the assessee that while considering the question of applicability of Section 23A, capital gains shall not be taken into account. According to the learned counsel, though the capital gain may be an assessable profit, it is only a notional or deemed

income and in arriving at the commercial or accounting profits, which alone is material for the purpose of applicability of Section 23A, capital gains

shall not be taken into account. If the capital gain is to be excluded, it is not in dispute that the income of the company is too small and does not

warrant the distribution of any dividend. Therefore, the question of applying Section 23A would solely rest on whether capital gains can be taken

to form part of the commercial or accounting profits of the company. In support of this contention, the learned counsel relied on certain decisions

which generally dealt with the scope of Section 23A and the principles stated therein.

4. The relevant part of Section 23A reads as follows :

Where the Income Tax Officer is satisfied that in respect of any previous year the profits and gains distributed as dividends by any company within

the twelve months immediately following the expiry of that previous year are less than the statutory percentage of the total income of the company

of that previous year the Income Tax Officer shall, unless he is satisfied

(i) that, having regard to the losses incurred by the company in earlier years or to the smallness of the profits, made in the previous year, the

payment of a dividend or a larger dividend than that declared would be unreasonable or make an order in writing

In Commissioner of Income Tax, Bombay City Vs. Bipinchandra Maganlal and Co. Ltd., with reference to the meaning to be attached to the

words "'smallness of the profits'" in Section 23A, as it then stood, it was observed:

Smallness of the profit in Section 23A has to be adjudged in the light of commercial principles and not in the light of total receipts, actual or

fictional.

Quoting this passage with approval, the Supreme Court, again in Commissioner of Income Tax v. Gangadhar Banerjee and Co. observed :

These two concepts, "accounting profits" and "assessable profits" are distinct. In arriving at the assessable profits the Income Tax Officer may

disallow many expenses actually incurred by the assessee; and in computing his income, he may include many items on notional basis, But the

commercial or accounting profits are the actual profits earned by an assessee calculated on commercial principles. Therefore, the words,

"smallness of profit" in the section refer to actual accounting profits in comparison with the assessable profits of the year.

The learned counsel for the assessee contended that the capital gains were only notional profits and the availability of these gains in the hands of the

company does not render these gains commercial profits. In support of this argument, the learned counsel relied on Commissioner of Income Tax

(Central), Bombay Vs. Gannon Dunkerley and Co. Ltd., . The facts in that case are as follows ; The assessee was a limited liability company.

During the previous year relevant to the assessment year 1947-48, the company sold the business of its Madras branch and the capital gain on

such sale came to Rs, 4,62,974. The company had not declared any dividend to its shareholders. The question for consideration was whether the

capital gains were includible in the commercial profits for the purpose of considering the "smallness of profits" made in terms of Section 23A of the

Income Tax Act. It was held that except in certain exceptional cases, the Income Tax Officer would not be justified in considering the amounts

received by way of capital return and capital gains as forming part of profits of an assessee-company while exercising powers u/s 23A of the Act.

The reasoning on which this conclusion was arrived at may now be considered. The words "income" and "profit" in different Sections of the

Income Tax Act had not been used to mean and connote the same thing. In some Sections or provisions it had been used in a restricted sense.

Prior to 1946, capital gain was not chargeable to Income Tax. The levy of capital gain which was introduced for the 1946-47 assessment was

removed within two years of its imposition and later reimposed from 1956. Capital gains were never held to be included within the head "profits

and gains of business, profession or vocation". Having regard to this legislative history of "capital gain", it is difficult to hold that the capital gains also

could be considered as part of the profits in connection with the exercise of the powers u/s 23A. In this connection, the learned judge also relied

on the position that the rate of tax on capital gains was different from the rate of tax levied under the heads of income, and that super-tax also was

not payable in respect of capital gains. With great respect to the learned judges, we are unable to see how the fact that capital gains was not

included for the purposes of Income Tax prior to 1946 or the legislative history of the same or the rate of tax being different or the non-liability to

super-tax have any bearing on the ascertainment of commercial profits of the company. If a particular income is exempt from tax, certainly it could

not be said that it would not form part of the commercial profits of the company. In the later part of the judgment, the learned judges have mixed

up the question whether such capital gains could be distributed with the question whether they are required for replacement of the assets and the

non-declaration of dividend on the ground that they are required for replacement of capital assets. If the directors had decided not to declare the

dividend on the ground that such capital gains are required for the purposes of replacement of the assets sold so as to carry on the business in

normal manner, that is a very relevant circumstance which the Income Tax Officer had to take into account in considering whether a larger dividend

than that declared would be unreasonable. But that is not to say that, even in the absence of evidence to that effect, capital gains could not be

treated as forming part of the profits available for division. The learned judges purported to derive support in the conclusion that the capital gains

are notional profits and the availability of these gains in the hands of the company does not make it commercial profit, from a decision of the

Supreme Court in *Commissioner of Income Tax, Bombay City Vs. Bipinchandra Maganlal and Co. Ltd.*, . In that case, the assessee company

sold certain depreciable assets and the difference between the written down value and the price at which they were sold was included in the total

assessable income. The question for consideration was whether this income determined u/s 10(2)(vii) of the Act could be included in the

company's profits for the purpose of determining whether the payment of a larger dividend than that declared by it would be unreasonable. The

price for which depreciable asset was sold, though higher than the written down value, was not in excess of the original cost. With reference to this

income assessable u/s 10(2)(vii), the Supreme Court held that the difference is included in the income as a result of a fiction introduced by the Act.

What, in truth, is a capital return is, by a fiction, regarded, for the purpose of the Act, as income. Though the difference is made chargeable to

Income Tax, its character is not altered and it is not converted into the assessee's business profit. It does not reach the assessee as his profit; it

reached him as part of the capital invested by him, notwithstanding the fiction created by Section 10(2)(vii). It will be seen, on the facts, that since

the price realised was less than the cost price, it was held to be a capital return. The same analogy could not be invoked in considering capital gain realised on sale of an investment. Whether the capital gain in a particular case is to be treated as profits available for distribution u/s 23A or a capital return would depend on the facts and circumstances of each case. We have already seen that unless there is an express or implied prohibition under the constitution of the company either under the memorandum or the articles, capital gains are distributable income. The profits realised on sale of such an investment or an asset is a real profit and not a fictional profit or a notional profit. The Supreme Court's decision in Commissioner of Income Tax v. BipinChandra Maganlal & Co. (already referred to) is no authority for the position that even in cases where the sale price is more than the cost price and the amount, in fact, was realised and available in the hands of the assessee, it is only notional profit and not commercial profit. It is true that in certain cases capital gain would be in the nature of a return of capital itself and in those cases they would not be considered for the purpose of applicability of Section 23A. Barring such exceptional cases, we are of the view that the Income Tax Officer would be justified in considering the amounts received by way of capital gains as forming part of the profits of an assessee while exercising the powers u/s 23A of the Act. We have already held that, on the facts and circumstances of this case, it was not a capital a return, but capital gain. There is no evidence to show that the directors did not declare the dividend for the reason that the same is required for replacement of the assets sold. In fact, the question referred to us does not warrant any consideration as to whether the distribution of the capital gain was a prudent action of the directors and, therefore, the non-declaration could not be said to be unreasonable.

5. For the foregoing reasons, we answer the reference in the affirmative and against the assessee, with costs. Counsel's fee, Rs. 250.