INCOME-TAX REFERENCE

Before Mr. M. C. Chagla, Chief Justice and Mr. Justice Tendolkar.

1951 April 2

THE BOMBAY MUTUAL LIFE ASSURANCE CO., LTD. ASSESSEE-APPLICANT *v.* THE COMMISSIONER OF INCOME-TAX, BOMBAY CITY, RESPONDENT.*

Indian Income-tax Act (XI of 1922), s. 6c, Sch. rr. 2 and 3—Mutual Life Assurance Co.—All policy-holders members of the Co.—Surplus of the Co.—Whether it is income and liable to tax—Investment Reserve Fund—Appreciation of Securities—Such appreciation forms part of surplus and liable to tax—Items of expenses which are allowed as deduction from the surplus.

The life assurance fund of the assessee Company at the end of the actuarial period, January 1, 1934 to December 31, 1937 amounted to Rs. 101,53,809. The nett liability of the Company on the current policies was worked out at Rs. 78,57,741. This resulted in a surplus of Rs. 22,96,068.

Held, that this surplus which accrued to the Company from its insurance transactions and which was arrived at as a result of the actuarial valuation of the Company and which surplus was distributable amongst the participating members of the Company was "income" which was liable to tax under rule 2 (*b*) of the Schedule to the Income-tax Act read with s. 6c of the Act.

The Balance Sheets of the Company as of December 31, 1937 and December 31, 1940 contained two items of Rs. 2,72,946 and Rs. 100,000 respectively as investment reserve funds. These two sums represented appreciation of securities. They were, however, not taken to the revenue account but were taken credit for in the accounts in the balance sheets of the Company.

Held, that as credit for these two sums was taken by the Company for appreciation of securities, they formed part of the surplus on a proper actuarial valuation even though these amounts had not been taken in the revenue account. These amounts, therefore, were liable to tax.

Under rule 3 (*a*) of the Schedule to the Income-tax Act a deduction is permitted to the assessee of half of the amounts paid to or reserved for or expended on behalf of the policy-holders.

Held, that the item of income-tax deducted at source by the Company and item of provision made for payment of income-tax, were payable by the Company on its own behalf and not on behalf of the policy-holders and, therefore, these sums could not be claimed as a deduction from the surplus.

Held, also that amounts of depreciation, building expenses and miscellaneous expenses having been paid by the Company on behalf of policy-holders could be claimed as a deduction from the surplus under rule 3 (*a*) above.

* Income-tax Ref. No. 40 of 1950.

Styles Case[1]; *Inland Revenue Commissioners* v. *The Ayrshire Employers Mutual Assurance Association Ltd,*[2] distinguished.

The assessee company, the Bombay Mutual Life Assurance Society Ltd., was a mutual assurance society governed by s. 27 of the Indian Companies Act. All policy-holders were members of the company and there were no shareholders. The Company had issued policies some of which were profit-sharing policies while others were non-profit-sharing policies. It was conceded that the computation of the company's profits i.e., profits of any business of insurance carried on by a Mutual assurance company had to be made in accordance with rule 2 (*b*) of the Rules in the Schedule to the Indian Income-tax Act. Rule 2 (*b*) in terms provided for the taxation of the surplus arrived at as a result of the actuarial valuation.

The surplus was arrived at in the following manner :—

A consolidated revenue account was prepared which showed on one side the amount of life assurance fund at the end of the period for which the consolidated revenue account was prepared. The actuary then found out the nett liability of the company on the current policies. He then deducted the nett liability from the life assurance fund and the result was the surplus.

It was contended by the company that this surplus was not liable to tax at all. It was pointed out that the profits of the company in respect of its profit-sharing policies were not subjected to any tax prior to the assessment years 1939-40. Reliance was also placed on English cases in which the view consistently taken by the English Judges had been that the surplus resulting from mutual activities of persons joining to form an insurance company was not income or profits subject to tax.

There were two items of Rs. 2,72,946 and Rs. 1,00,000 which represented the amounts of appreciation of securities held by the company. These amounts were not shown in the revenue account but credit was given to the company for these sums in the accounts and shown in the balance sheets.

The Department acting under rule 3 (*b*) added these two sums to the amount of the surplus which was liable to tax. The Company contended that these amounts not forming part of the consolidated revenue account could not be added to the surplus.

The third question related to the items for which deduction was claimed from the surplus under r. 3 (*a*) which provided

[1] (1889) 14 App. Cas. 381. [2] (1948) 16 I. T. R. (Supp.) 80.

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for giving a deduction of half the amounts paid to or reserved for or expended on behalf of the policy-holders. The Department negatived all the contentions of the company and referred the following questions of law to the High Court:—

(1) "Whether the surplus accruing to the assessee Company from insurance transactions of a mutual character, is assessable to tax under the Indian Income-tax Act?

(2) Whether the appreciation in the value of securities which is not taken credit for in the revenue account or in the actuarial valuation balance sheet, but is only shown in the balance sheet, should be included in the 'surplus' for the purpose of computing profits of the assessee Company, having regard to r. 3 (b) of the Schedule of the Indian Income-tax Act?"

(3) Whether under r. 3 (a) of the Schedule of the Indian Income-tax Act relief should be given to the assessee Company in the laws of half the adjusted surplus determined under r. 2 (b) or half of the actual surplus as computed by the Income-tax Officer?"

Sir Jamshedji Kanga with *N. A. Palkhiwala* for the applicant.

C. K. Daphtary Advocate-General with *G. N. Joshi* for the respondent.

CHAGLA C. J. The assessee in this reference is the Bombay Mutual Life Assurance Co., Ltd. It is an incorporated company limited by guarantee and all the policy-holders are members of this company. Some policy-holders participate in the profits and some do not, and the very important question that arises on this reference is whether the profits made by the participating members is income liable to tax at all. Sir Jamshedji contends that the participating policy-holders make contributions in order to meet certain contingent liabilities. It turns out that the liabilities are less than what they contemplate and although the word "profits" is used in substance and in reality what the participating members receive is not profits but the return of their own contributions which were more than sufficient to meet the liabilities contemplated. I think Sir Jamshedji's definition of the profits received by the participating members is perfectly correct. But the question that we have to determine is whether under the Indian Income-tax Act, such surplus which is returned to the participating members is made liable to tax. If what was taxed was profits or income in the ordinary sense, then undoubtedly the surplus which was returned to the participating members would not be liable to tax and prior to the amendment of s. 6c of the Income-Tax Act, it is common ground that these profits were not

subject to taxation. The question really is whether in view of s. 6c and the scheme of our Act, this surplus received by the participating members is subject to tax or not.

Now the charging section, as is well known, is s. 3 which charges to tax the total income of every assessee. "Income" is defined by s. 6c. It is an inclusive definition and in the inclusive definition is the profits of any business of insurance carried out by mutual association computed in accordance with r. 9 of the schedule. When we turn to r. 9 of the schedule it says that the rules contained in the schedule apply to the assessment of the profits of any business of insurance carried on by a mutual insurance association. Rule 2 of the rules provides that the profits and gains of life insurance business shall be taken to be either (*a*) the gross external incomings of the preceding year from that business less the management expenses of that year, or (*b*) the annual average of the surplus arrived at by adjusting the surplus or deficit disclosed by the actuarial valuation made for the last intervaluation period ending before the year for which the assessment is to be made. Therefore cl. (*b*) in terms provides for the taxation of the surplus arrived at as a result of the actuarial valuation. Sir Jamshedji's contention is that the schedule as its heading itself indicates is intended for the computation of the profits and gains of insurance business. The schedule is referred to in s. 10 (7) of the Act which provides that notwithstanding anything to the contrary contained in ss. 8, 9, 10, 12 or 18 the profits and gains of any business of insurance and the tax payable thereon shall be computed in accordance with the rules contained in the schedule to the Act. Sir Jamshedji's argument is that ss. 8, 9, 10, 12 or 18 are not charging sections. They merely deal with the mode of computing the profits of insurance companies. Therefore, according to Sir Jamshedji if the surplus does not constitute profits, the schedule cannot be requisitioned to make what is not profits, profits. According to Sir Jamshedji in the first instance the taxing authorities must establish that the surplus is profits before they can rely on the schedule in order to find out how these profits can be computed. There would be considerable force in the argument of Sir Jamshedji if s. 6c had not been enacted. But s. 6c imports into the definition of "income" which is to be found in the charging s. 3 these profits which may not be profits in the ordinary sense of the term but which are made profits by reason of r. 2, because r. 2 really gives an artificial extension to the meaning of the word "profits", when it says that "profits and gains shall be taken to

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be." Therefore a new class of artificial income is created by this rule and that artificial income is included in the meaning of s. 3 by reason of this rule. Sir Jamshedji relied on English authorities to point out that ever since *Styles* case (*New York Life Insurance Company* v. *Styles*),[1] the view consistently taken by the Judges in England has been that the surplus resulting from mutual activities of persons joining to form an insurance company is not income or profits subject to tax. Sir Jamshedji points out that as recently as in 1948 the House of Lords has rejected an attempt made by the Parliament to include that surplus in the profits which are subjected to tax. The decision is *Inl. Rev. Commrs.* v. *Employers Mutual Ins. Asson. Ltd.*[2] What the learned Law Lords there had to consider was the effect of s. 31 of the Finance Act of 1933 and the question that fell to be determined was whether the attempt made by the Legislature to tax the surplus was successful. Lord Macmillan pointed out that the Legislature had plainly misfired and the reason why it had misfired was that they had misapprehended the nature of the surplus which it had attempted to tax. The view it took was that it was membership or non-membership in the company which determined immunity from or liability to tax whereas, as the House of Lords pointed out, what determined the immunity or liability was the real nature of the transaction. Lord Macmillan was happy that the far-from-praiseworthy attempt to tax the surplus which was not profits at all had not succeeded. We might sympathise with Sir Jamshedji that here also the Legislature showed what cannot be described as a very laudable intention, but what we have to consider is whether our Legislature like the Parliament in England has plainly misfired. Looking to the scheme of our Act and according to the clear language used in s. 6c it is difficult to accept Sir Jamshedji's contention that the Legislature while intending to bring the surplus within the ambit of the taxing law has failed to express its intention in sufficiently clear language which would compel us to hold that the surplus to which the participating members are entitled is not subject to tax.

The second question raised on this reference is with regard to two sums of Rs. 2,72,946 which is shown in the balance sheet as of December 31, 1937, under the head investment reserve fund and a sum of Rs. 1,00,000 shown in the balance sheet as of December 31, 1940, also under the head investment reserve fund.

[1] (1889) 14 App. Cas. 381. [2] (1948) 16 I. T. R. (Supp.) 80.

Now in order to understand the contention of the assessee it is necessary to understand how the actuarial valuation is made by the actuary on behalf of the company. A consolidated revenue account is prepared which would show on one side the amount of life assurance fund at the end of the period for which the consolidated revenue account is prepared. Then the actuary finds out what is the nett liability of the company under the current policies and he fixes the liability on the basis of a rate of interest on the investment of the company which he expects the company to realise in coming years. After fixing the nett liability of the company on the current policies he deducts the liability from the life assurance fund and the result is the surplus. If the liability is more than the life assurance fund, then there is a deficit. Now in the case of the assessee company the life assurance fund at the end of the actuarial period January 1, 1934, to December 31, 1937, was Rs. 1,01,53,809 and the nett liability was worked out at Rs. 78,57,741. This resulted in a surplus of Rs. 22,96,068. Now the sum of Rs. 2,72,946 was not added to the life assurance fund. If it had been added, it would have resulted in the surplus being increased by that amount. It was not so added in the life assurance fund because the company did not take this amount to the revenue account in which case it would have increased the life assurance fund, but they took this amount direct to the balance sheet and showed it as investment reserve fund. Now the question is whether although the company has not shown it in the revenue account this sum of Rs. 2,72,946 still forms part of the surplus or not. For that purpose we must look at r. 3 (*b*) which provides that any sums taken credit for in the accounts or actuarial valuation balance sheet on account of appreciation of or gains on the realisation of the securities or other assets shall be included in the surplus. Now it is not disputed that Rs. 2,72,946 does constitute appreciation of securities, but what is contended is that this was not taken credit for in the accounts, the argument being that "accounts" in this sub-rule must be read to mean "revenue account". Now there is no warrant for qualifying the expression "accounts" used by the Legislature by characterising these accounts as revenue account. The only question is that if credit is taken by an assessee in his accounts for appreciation of securities, then that credit must form part of the surplus and it cannot be disputed that the assessee has taken credit for appreciation of these securities. Whether that credit is taken in the balance sheet

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or the revenue account makes no difference. The balance sheet is as much a part of the accounts of the assessee as the revenue account and the Legislature has not chosen to indicate any particular account in which credit should be taken.

It is then argued that this sum of Rs. 2,72,946 never formed part of the surplus as it was not taken into the revenue account and was merely shown in the balance sheet as the investment reserve fund. But surely it cannot be left to the volition of the assessee to determine what the surplus should be in respect of any particular actuarial valuation. The surplus contemplated by r. 2 (*b*) is the surplus which is the result of the annual average of the surplus arrived at by adjusting the surplus or deficit disclosed by the acturial valuation and, therefore, if in fact the sum of Rs. 2,72,946 should have formed part of the surplus on a proper actuarial valuation the mere fact that the assessee did not choose to take it to the revenue account can make no difference to his liability to tax on this amount. It is contended that if this sum of Rs. 2,72,946 had formed part of the life assurance fund it may be that the rate accepted by the actuary for working out the yield on the investment of the company might have been different and the result might have been that the surplus might have been less than what it would be by the addition of this sum of Rs. 2,72,946 to the life assurance fund. We cannot speculate on the possibility of the actuary reducing the rate of interest with the result that the surplus may not have been the same by the addition of Rs. 2,72,946 as the surplus now shown in the valuation.

The same considerations apply to the sum of Rs. 1,00,000 which is shown in the balance sheet as of December 31, 1940.

With regard to these two sums we would like to add that as we are holding that these two amounts form part of the surplus and therefore liable to tax although in the accounts of the company they have not been shown as forming part of the surplus. Sir Jamshedji apprehends that when in fact these amounts are shown as part of the surplus in future the taxing authority will tax this amount over again. Now it is clear that when you determine the surplus for the purposes of r. 2 (*b*) you have to deduct from it any surplus or deficit included therein which was made in any earlier intervaluation period. Therefore if the Department proposes to tax this sum of Rs. 2,72,946 and also the sum of Rs. 1,00,000, it can only be on the basis that these two amounts formed part of the surplus. Therefore, in future

if these two amounts are shown in the actuarial valuation as part of the surplus, they would not be liable to tax over again as the position in law is clear and we have no doubt that the Department will act in accordance with the directions we are giving in this reference.

With regard to the third question under r. 3 (*a*) a deduction is permitted to the assessee of half of the amounts paid to or reserved for or expended on behalf of the policy-holders. Now a surplus is arrived at under r. 2 (*b*) by taking an actuarial surplus excluding from it any surplus included in an earlier valuation and adding to it all expenditure which is not allowable under s. 10 of the Act and from this surplus is to be further deducted under r. 3 (*a*) half of the amounts paid to or reserved for or expended on behalf of the policy-holders, and tax is to be paid on the balance left after this deduction is made. Now when we turn to the assessment made for the year 1939-40 we find that what the income tax authorities have done is that they have taken the surplus as shown in the valuation report, viz. Rs. 22,96,068; then they have added to it Rs. 87,816 for interim bonus paid; then they have deducted from this amount the surplus which was already shown in the previous valuation, viz., Rs. 1,70,139. This resulted in a sum of Rs. 22,13,745. To this has been added the sum of Rs. 2,72,946 which is the amount which we have considered when considering the second question bringing the total surplus to the figure of Rs. 24,86,711. To this amount they have added a sum of Rs. 2,51,196. This is made up of Rs. 96,496 for income-tax deducted at source, Rs. 51,859 for depreciation and Rs. 77,799 set apart as provision for income-tax; then there are three items debited to the building expenses account amounting in all to Rs. 18,273 ; then there are various small items of expenditure totalling up to Rs. 6,769. The total comes to Rs. 27,37,907 which is taken as the surplus for the purpose of r. 2 (*b*). But for the purpose of r. 3 (*a*) the amount taken into consideration is Rs. 22,96,068, the surplus shown in the valuation report. Now Sir Jamshedji's contention is that although for the purpose of arriving at the surplus under r. 2 (*b*) certain expenses may be added to it, for the purpose of deduction under r. 3 (*a*) every expenditure incurred by the assessee must be deemed to be expenditure on behalf of the policy-holders. Sir Jamshedji says that here we have not a company where there are shareholders in which case it might be stated that some expenditure was on behalf of the shareholders and the other on behalf of the policy-holders, and

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the expenditure on behalf of the shareholders would not have fallen under r. 3 (*a*). But where we have a company where all members are policy-holders and there is no share capital at all, then the expenditure incurred by the company can be on behalf of no one else but the policy-holders. I should like to point out that question 3 as raised by the Tribunal does not really bring out the effect of the contention put forward by Sir Jamshedji. We are not concerned with the surplus as shown by the company or the surplus adjusted by the taxing authorities; surplus has to be adjusted in order to bring it within the compass of r. 2 (*b*). What we are concerned with is not r. 2 (*b*) but r. 3 (*a*) which deals with deductions on the basis of the amounts paid to or reserved for or expended on behalf of the policy-holders. The real question is which are the items which the taxing authorities consider as part of the surplus which can be deducted as having been paid to, or reserved for, or expended on behalf of the policy-holders. Therefore it is necessary to deal with these items to which reference has been made separately. There is no dispute as to the items of Rs. 87,816 and Rs. 1,70,139.

Coming then to income-tax deducted at source, it was the company as an entity that was assessed to tax; it was the company as an entity that was liable to pay tax; and it was the company as an entity that in fact paid the tax. It cannot possibly be stated that the tax was paid by the company on behalf of the policy-holders. The policy-holders were not liable to pay tax either individually or as a body. Under the Income-tax Act a company is recognised as a separate entity and as that separate entity its liability to pay tax arose. The assessee is therefore not entitled to claim a deduction with regard to the item of income-tax deducted at source. The same arguments apply with regard to the item of Rs. 77,799 reserved as provision for income-tax.

With regard to depreciation it is not contended by the Department that the sum of Rs. 51,859 has not been reserved on behalf of the policy-holders and credit has already been given to the assessee for it by the tribunal.

Coming to the building expenses and miscellaneous expenses, although these amounts have been paid by the company, they have been and could only have been paid on behalf of the policy-holders and therefore they are entitled to claim this item as deduction under r. 3 (*a*).

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With regard to the sum of Rs. 2,72,946 which has been added to the surplus, the assessee is entitled to a deduction in respect of this item also under r. 3 (*a*) because this amount must be considered to have been reserved for and on behalf of the policy-holders. It stands on the same footing as the sum of Rs. 22,96,068 shown as surplus under the valuation report. The same applies to the sum of Rs. 1,00,000 also added to the surplus.

We would therefore answer questions referred to us as follows : No. 1 in the affirmative. No. 2 in the affirmative. We would re-frame the third question as follows :—

Whether the amounts paid to or reserved for or expended on behalf of the policy-holders within the meaning of r. 3 (*a*) of the schedule to the Income-tax Act include the expenses incurred by the company for payment of income-tax or provision for income-tax?

Having re-framed the question thus we would answer the third question in the negative.

No order for the costs of the reference.

Attorneys for applicant: *Manilal, Kher, Ambalal & Co.*

Attorney for respondent: *N. K. Petigara.*

Answer accordingly.

A. J. P.

INCOME-TAX REFERENCE

Before Mr. M. C. Chagla, Chief Justice and Mr. Justice Tendolkar.

HIMATLAL MOTILAL APPLICANT (ASSESSEE) *v.* THE COMMISSIONER OF INCOME-TAX AND EXCESS PROFITS TAX BOMBAY NORTH, RESPONDENT.*

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Indian Income-tax Act (XI of 1922), s. 25 (4)—Assessment in case of a discontinued business—Relief when there is succession of business—Relief only in respect of the business succeeded to by another person and not in respect of the total income from all sources of the assessee.

The policy of the Legislature in enacting s. 25, sub-ss. (3) and (4) is to prevent double taxation and the relief which is intended to be given is to a particular business that has paid tax under the Act of 1918 and which has paid a further tax under the new Act. Having paid tax relief is intended to be given to that business when that business is succeeded to by another person. But no relief is intended to be given by the Legis-

* Income Tax Ref. No. 41 of 1950.