INCOME-TAX REFERENCE

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

1956 Feb. 22

KANTILAL MANILAL AND OTHERS, APPLICANTS *v.* THE COMMISSIONER OF INCOME-TAX, BOMBAY NORTH, KUTCH AND SAURASHTRA, AHMEDABAD, RESPONDENT*

Indian Income-Tax Act (XI of 1922), s. 2 (6A)—Dividend—Release by Company in favour of its share-holders right to receive shares out of new issue of shares by another company of which such company was share-holder—Whether distribution of such right among share-holders amounted to distribution of dividend?—Non-compliance with formalities necessary for declaration of dividend does not affect liability to pay tax if real nature of transaction is receipt of profits of company by share-holders.

K. M., assessees, held 570 shares out of the total 800 shares of N. Mills, Ltd. In May 1948, the Bank of India, Ltd., offered new shares to its share-holders in the proportion of one new share for every three shares held by them on payment of Rs. 100 per share. The said Mills being holders of 5000 shares of the said Bank became entitled to receive 1666 shares of the new issue. The directors of the Mills invested the funds of the Mills for the purchase of 66 shares only and distributed the right to receive the balance of 1600 shares among its 800 share-holders in the proportion of two shares of the Bank for one share of the Mills. The assessees as holders of 570 shares of the Mills thus became entitled to receive 1140 shares of the Bank. The right to the new issue of shares of the Bank had a market value of Rs. 100 per share. The contention of the Taxing Department that the release of the right to receive the new shares of the Bank by the Mills in favour of the assessees amounted to distribution of dividend by the Mills and was as such liable to tax was affirmed by the Income-tax Appellate Tribunal. On reference,

Held, that the definition of the word 'dividend' in the Indian Income-Tax Act, 1922, is inclusive and not exhaustive and therefore the receipt by the share-holder as such of the profits of the company would fall within that definition.

If the real nature of the transaction is the receipt by the share-holder of the profits of the company, then he is liable to tax on that income as dividend notwithstanding the failure of the company to comply with the procedure laid down by the Indian Companies Act, 1913, for the declaration of a dividend.

Held, therefore, affirming the decision of the Tribunal, that the distribution of the right to apply for the shares of the Bank by the Mills in favour of the assessees amounted to distribution of dividend.

The Commissioners of Inland Revenue v. *Fisher's Executors*,[1] *The Commissioner of Income-Tax* v. *M. P. Vishwanath Rao*[2] and *Bacha F. Guzdar* v. *The Commissioner of Income-Tax, Bombay City*,[3] referred to.

A dividend need not be declared in cash; it may be declared in specie.

Facts material to this report are set out in the Judgment.

At the instance of the Applicants the following question was referred to the High Court of Judicature at Bombay :—

*Income-Tax Reference No. 31 of 1955.

1. [1926] 10 T. C. 302. 2. [1950] 18 I. T. R. 68.
3. [1953] Bom. 525.

Whether on the facts and circumstances of the case the distribution of the right to apply for the shares of the Bank of India by Navjivan Mills Ltd., in favour of the assessees amounted to a distribution of "dividend" within the meaning of s. 2 (6-A) of the Indian Income-tax Act?

The High Court re-framed the question as follows :—

Whether on the facts and circumstances of the case the distribution of the right to apply for the shares of the Bank of India by Navjivan Mills Ltd., in favour of the assessees amounted to a distribution of "dividend"?

N. A. Palkhiwala with *Sir Jamshedji B. Kanga* for the applicants.

M. P. Amin, Advocate General with *G. N. Joshi* for the Respondent.

Chagla C. J.—The facts giving rise to this reference are rather unusual and because they are unusual the question that we have to answer seems to be a little difficult. The assessees were shareholders of the Navjivan Mills and the Navjivan Mills had invested its profits in the purchase of 5,000 shares of the Bank of India. On May 25, 1948 the Bank of India offered to its shareholders one share for every three shares held on payment of Rs. 100 per share, and the directors of the Navjivan Mills passed a resolution that they would invest the funds of the company in the purchase of 66 shares out of 1666 shares to which they were entitled and the right to the remaining 1600 shares was distributed among the 800 shareholders of the company in the proportion of right to two shares of the Bank for one ordinary share held in the company. The assessees between them held 570 shares of these Mills and the assessees requested the Mills to renounce their right with regard to 1,140 shares to which they were entitled in favour of Jesingbhai Investment Co., and the question that arose for decision by the tribunal was whether the assessees were liable to tax on the right acquired by them to the shares of the Bank of India on the basis that that right constituted dividend for the purpose of the Indian Income-tax Act.

There are certain important facts to which attention must be drawn. It is found as a fact that this right which a shareholder of the Bank of India acquired to obtain one share for three shares had a market value and that market value was Rs. 100 per share. It was therefore open to the Navjivan Mills to sell this right and obtain for it a cash consideration. Therefore, it is clear that what the Navjivan Mills were disposing of was an asset of the Mills, an asset which the Mills had acquired by reason of its holding 5,000 shares of the Bank of India, an asset which was a valuable asset and had a cash equivalent value. It may be accepted as a general proposition that when a shareholder of a company, by reason of his being a shareholder and by virtue of being a shareholder, receives a part of the assets belonging to the company of which he is a shareholder, or part

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of the funds of the company of which he is a shareholder, he can only receive it in one of two capacities. He either receives it as income, the asset or the fund coming to him from the company out of profits made by the company, in which case the income in the hands of the shareholder is dividend which he has received from the company. A shareholder may also receive part of the asset or the funds in another capacity. The company of which he is a shareholder may decide to increase the capital or it may decide to capitalize its accumulated profits, and instead of distributing these profits it may issue to its shareholders bonus shares or a right to receive fresh shares for payment of a certain consideration. In that case the shareholder does not receive a dividend from the company but he receives a right to participate in the additional capital raised by the company. In this case it cannot be disputed that the right which the Mills acquired did not constitute a part of its capital. Whether the right remained unrealised or was realised, it could only constitute its income or its profits in contradistinction to the subscribed capital. A very important consequence follows from this that it was open and competent to the Mills to distribute either this right or the proceeds of this right as dividend. In law there is a prohibition against any company distributing its capital as dividend, but the law permits a company to distribute its income or its profits, which does not form part of this capital, as dividend.

The question that has been agitated at the bar and which we have to consider is whether the receipt of a shareholder, by reason of the fact that he is a shareholder, of part of the profits of the company distributed *pro rata* among all the shareholders, can be considered to be dividend for the purpose of the taxing law although the formalities required by the Companies Act for the distribution of dividend have not been complied with. Mr. Palkhivala is perfectly right when he says that from the point of view of Company law the resolution of the directors cannot possibly be looked upon as a declaration of dividend. It is well established and the law is quite clear that a dividend can only be declared by the shareholders of the company. The only right that the directors have is to recommend a dividend to the meeting of the shareholders. In this case there is neither a formal recommendation by the directors that a dividend should be paid, nor is there any acceptance, formal or otherwise, by the company of that recommendation. But would it be true to say that because the company has not complied with the procedure required for the declaration of dividend under the Companies Act, it is competent to a shareholder who has received a part of the profit from the company distributed among all the shareholders to tell the taxing authorities that he is not liable to pay tax on that income as dividend because his company has failed

to carry out the formalities and the procedure required by law? In our opinion, if the true nature of the transaction which we must consider is the receipt by the shareholder of dividend in the sense of his receiving a part of the profits of the company, then he is liable to tax on that income as dividend, notwithstanding the failure of the company to comply with the necessary procedure. The failure of the company to comply with the procedure may entail serious consequences as far as the company is concerned. It may render the directors liable to misfeasance proceedings; it may even render the shareholder liable to refund the income that he has received. But those are considerations with which we are not concerned. The only question that we have to consider is that when in the year of account a shareholder receives a part of the profits or income of the company of which he is a shareholder and that receipt is not attributable to the capital of the company in the sense that the capital is increased, then is or is not the shareholder liable to pay tax in that year on that income as dividend.

If we are right in the view that we take, apart from authorities which we will presently consider, then there cannot be the slightest doubt in this case as to the true nature of the transaction. In this case the directors could have gone to the market, cashed their rights, obtained the money, and recommended to the general body of the shareholders that that particular amount should be distributed among the shareholders as dividend and the general body would have had the authority to sanction the recommendation made by the directors. What the directors have done—and that is the shape that the transaction has taken—is that instead of going through that formality they have passed a resolution transferring this right to the shareholders and stopped at that. Can the mere fact that a particular transaction takes a particular shape defeat the right of the taxing authority to claim tax when according to the true nature of the transaction the assessee is liable on the receipt obtained by him as a result of that transaction? This is not a case where the directors would have been prevented from recommending this particular amount to be distributed as dividend, or the general meeting of the company would have been prevented from doing so. Instead of going through that formality which the directors and the general body could have gone through, the directors adopted a device by which it could be said technically and formally that there was no declaration of dividend. Can that technicality and that want of formality come in the way of our considering the true nature of the transaction? In our opinion, if we emphasised the real and true nature of the transaction and ignored the want of formality, then it is clear that what the directors did was to give to the shareholders a part of the assets of the company, and once it is established, as it is clearly established in this case,

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that that part of the assets did not constitute the capital of the company, then what the shareholders received was income in the naure of dividend.

The Tribunal addressed itself only to one aspect of the definition of dividend given in the Income Tax Act. It will be remembered that the definition of dividend in the Income-tax Act is an inclusive and not an exhaustive definition and the Tribunal took the view that the case of the assessees fell under that definition. The definition of dividend is contained in s. 2 (*6-A*) and the view of the Tribunal was that this particular income received by the assessees was dividend within the meaning of s. 2 (*6-A*) (*a*). Clause (*a*) is to the following effect:

> "(*a*) any distribution by a company of accumulated profits whether capitalised or not, if such contribution entails the release by the company to its shareholders of all or any part of the assets of the company."

In our opinion, there cannot be much doubt that there was in this case a release to the shareholders by the company of part of its assets, but what Mr. Palkhivala has urged and with some force is that the distribution was not of accumulated profits. What is urged is that the right which was distributed by the company was, if at all, current profits, and one cannot speak of accumulated profits till after the profits of the year have been ascertained and it is only in the following year after necessary distribution and allocation some profits are left which can be called accumulated profits. In the view that we take it is unnecessary to consider this aspect of the case and to decide whether Mr. Palkhivala is right in the contention he has put forward. If the definition of dividend is inclusive and not exhaustive, there is nothing to prevent us from considering whether the present case does not fall within the ordinary definition of dividend and not the extended definition given by the Legislature in s. 2 (*6-A*) (*a*). The real question that we have to consider is not which section of the Income-tax Act is applicable or which particular part of s. 2 (*6-A*) applies, but whether there is a liability upon the assessees to tax on the ground that their income is dividend within the meaning of the Indian Income-tax Act. The ordinary meaning of dividend is, as we have already suggested earlier in the judgment, the receipt by the shareholder by reason of his being a shareholder of part of the profits of the company of which he is a shareholder. The formalities and technicalities attached to the declaration of a dividend cannot detract from the ordinary and normal meaning to be attached to that expression. It may be said in a particular case that the dividend received by the shareholder was not properly declared or that the necessary procedure was not followed, but in its plain natural meaning the receipt by the shareholder under the circumstances just referred

to must be described as dividend and must have the characteristics of a dividend. Therefore, in our opinion, whether the extended definition under s. 2 (6-*A*) (*a*) is or is not attracted, this is a clear case where the case falls under the ordinary meaning of dividend which is not excluded by the definition given by the Legislature in s. 2 (*6A*).

Turning to the authorities relied upon by Mr. Palkhivala, he has relied first on an English case, *the Commissioners of Inland Revenue* v. *Fisher's Executors.*[4] That case logically followed from the earlier English case reported in *Blott's case,*[5] and the facts show that what the company did was that it capitalised its undivided profits and in respect of those profits which were capitalised it created an issue of 5 per cent debenture stock to its ordinary shareholders, and the question that arose for the decision of the House of Lords was whether the issue of this debenture stock was a distribution of profits and the House of Lords held that it was not and did not constitute income in the hands of the shareholders for the purposes of tax. Lord Chancellor Viscount Cave at p. 333 says:

"My Lords, if the tests which are to be found in these judgments are applied to the transactions now in question, I think that it will be found impossible to escape from the conclusion that the issue of debenture stock in the present case falls within the same category as the issue of shares in *Blott's case.* Here, as in that case, the fund representing reserve and accumulated profits was at the disposal of the company, which could determine as against the whole world whether that fund should be distributed to the shareholders as income or should be retained and applied to capital purposes."

What the company did in that case was that it did not distribute to the shareholders the profits as income, but applied that income to capital purposes and issued debenture stock. Mr. Palkhivala relied on certain observations of Lord Sumner appearing at p. 339, and Lord Sumner as a general proposition lays down:

"The proposition, that the substance of a transaction must be looked to and not merely the form, is generally invoked against those who have carried it out. I think it is unusual, where the form of a transaction is against those whose transaction it is, to invoke the substance in their favour, in order to eke out what they have left defective in form."

The conflict before us is not between the substance and the form of any resolution passed by the company. The form is clear and nobody suggests that that form should be ignored. But what we have looked at is the real nature of the transaction which is something very different from ignoring the form and trying to go behind the form to find out what the intention of the company or the shareholders or the directors was. But the real ratio of the judgment of Lord Sumner is to be found at p. 340 and this is what the learned Law Lord says:

4. [1926] 10 T. C. 302.

5. [1925] 8 T. C. I. 101.

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"The fact is that money's worth is not a material circumstance until the bonus distribution has been shown, when still in the company's hands and at the time of distribution, to be impressed with the character of income of the company."

Therefore, whether the right had money's worth or not and what money's worth it had, the relevant and material question to consider is what was the nature of the right which the company had acquired at the time when it decided to transfer it to the shareholders. If the right was impressed with the character of income of the company, then it would be dividend; otherwise it will not be dividend. Mr. Palkhivala's contention was that as far as the company was concerned, this particular right which it acquired would constitute a capital gain and it would not be income and the company would not be liable to tax in respect of this right. We are not concerned in this reference with the liability of the company to tax with regard to the right which it acquired from the Bank of India, and Lord Sumner does not use the expression "income of the company" in the sense in which Mr. Palkhivala suggests. He uses the expression "income of the company" in contradistinction to its capital, and what Lord Sumner is emphasising is that if at the date of the distribution the asset of the company is an asset which could be distributed as dividend and which did not constitute the capital of the company which could not be distributed, then the distribution to the shareholders in law would be dividend.

Mr. Palkhivala also relied on a judgment of the Madras High Court in *Commissioner of Income-tax* v. *M. P. Viswanatha Rao*.[6] In that case the Tata Iron & Steel Co., instead of paying dividend to the shareholder in cash, issued bearer deposit certificates which were payable on or before a certain date with interest, and the question that the Madras High Court had to consider was whether the sum represented by the deposit certificates could be considered dividend and the High Court held that there had not been a release of assets of the company and that the deposit certificate was something like a post-dated cheque or a promissory note or a promise in the form of a negotiable instrument and that the sum represented by the deposit certificates was therefore not liable to be taxed as dividend. It will be noticed that the Madras High Court was only considering the definition of dividend as appears in s. 2 (*6-A*), it was not considering the general definition which we have considered in this case, and the reason why the Madras High Court came to this conclusion was that there was no release of assets by the company because it had paid nothing to the shareholder but merely issued a deposit certificate and all the funds and the assets of the company continued to remain

6. [1950] 18 I. T. R. 68.

with the company. The learned Judges make it clear at p. 71 when they say:

"Looking at the matter from the point of view of the company itself no portion of the sum of Rs. 5,750 (that was the sum in question in that reference) left the coffers of the company and no portion of this sum reached the pocket of the shareholder. The money remains where it was in the hands of the company and there has been no release of the assets of the company so far as this sum is concerned."

The position here is entirely different. The coffers of the company have been depleted by a large amount by reason of the transfer of its right to the shareholders. Therefore, there has undoubtedly been, as we already pointed out, a release of the assets of the company and so the ratio of this decision cannot help Mr. Palkhivala.

Mr. Palkhivala also relied on a decision of this Court in *Mrs. Bacha F. Guzdar* v. *Commissioner of Income-tax*[7] where we have considered what the technical meaning of declaration of dividend is. As we have already said, Mr. Palkhivala is right in his contention that there is no technical declaration of dividend in this case. If that point is conclusive of the matter, undoubtedly Mr. Palkhivala is entitled to succeed.

There is only one final aspect of the matter that we might consider. Authorities have laid down that a dividend need not be declared in cash, it may be in specie, and therefore the fact that the company decided to transfer the right which it had acquired from the Bank of India to its shareholders need not necessarily militate against the contention that the transfer of such right in specie was the payment of dividend to the shareholders. In law there is no difference whatever between the company cashing this right and declaring a dividend in respect of the amount received by the company, and the company transferring this right itself which had a money value and which could have been cashed by the shareholders.

The question that has been submitted to us does not really bring out the real controversy between the parties. As we have all the facts before us we propose to re-frame the question which will read as follows:

"Whether on the facts and circumstances of the case the distribution of the right to apply for the shares of the Bank of India by Navjivan Mills Ltd., in favour of the assessees amounted to a distribution of "dividend?"

To the question so re-framed our answer will be in the affirmative. No order as to costs.

Attorneys for Appellant : *Manilal Kher Ambalal & Co.*

Attorneys for Respondent : *N. K. Petigara.*

Answer accordingly.

P. M. P.

7. [1953] Bom. 525.