

PETITIONER:
COMMISSIONER OF INCOME-TAX, WEST BENGAL, CALCUTTA

Vs.

RESPONDENT:
GUNGADHAR BANERJEE AND CO. (P) LTD.

DATE OF JUDGMENT:
22/03/1965

BENCH:
SUBBARAO, K.
BENCH:
SUBBARAO, K.
SHAH, J.C.
SIKRI, S.M.

CITATION:
1965 AIR 1977 1965 SCR (3) 439
CITATOR INFO :
E 1968 SC 883 (6)
R 1973 SC2323 (9)
RF 1976 SC 255 (21)
R 1990 SC1277 (29)

ACT:
Indian Income-tax Act, 1922 (11 of 1922), s. 23A-Dividend-Distribution-Burden of showing whether low-Circumstances to be considered--"Smallness of profit"-Meaning of-"Accounting profits" and "assessable profits", distinction between.

HEADNOTE:

As the dividend declared to be distributed by the respondent company at its General Body Meeting was below 60 per cent of the profits available for distribution, the Income-Tax Officer, with the previous approval of the Inspecting Assistant Commissioner, passed an order under s. 23-A of the Income-Tax Act directing that a certain higher amount shall be deemed to have been distributed as dividends as on the date of the annual general meeting of the Company. He found that, having regard to the profits earned in the earlier years and the capital and taxation reserves, payment of larger dividend would not be unreasonable. This was affirmed, on assessee's appeals by the Appellate Assistant Commissioner, and the Income-tax Appellate Tribunal. The Tribunal referred the question to the High Court under sec. 66(1) of the Act, which concluded that having regard to the smallness of the profits, the order of the Income-tax Officer was not justified and answered the question in the assessee's favour. In appeal by certificate.

HELD: Section 23A of the Income-tax Act is in the nature of a penal provision. In the circumstances mentioned therein, the entire undistributed portion of the assessable income of the company is deemed to be distributed as dividends. Therefore, the Revenue has strictly to comply with the conditions laid down thereunder. The burden therefore, was upon the Revenue to prove that the conditions laid down thereunder were satisfied, before the order was made.

Thomas Fattorini (Lancashire) Ltd. v. Inland Revenue Commission L.R. [1942] A.C. 643 applied.

In the present case the Revenue failed to discharge the said burden: indeed, the facts established stamp the order of the Income-tax Officer as unreasonable.. [446F, G]

Though the object of the section is to prevent evasion of tax, the provision must be worked not from the stand Point of the tax collector but from that of a businessman. The reasonableness or the unreasonableness of the amount distributed as dividends is judged by business considerations, such as the previous losses, the present profits, the availability of surplus money and the reasonable requirements of the future and similar others. It is neither possible nor advisable to lay down any decisive tests for the guidance of the Income-tax Officer. It depends upon the facts of each case. The only guidance is his capacity to put himself in the position of a prudent businessman. It is difficult to say that the Income-tax Officer cannot take into consideration any circumstances other than losses and smallness of profits. This argument ignores the expression "having regard to" that precedes the said words in s. 23A of the Act. [444B-E]

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Commissioner of Income-tax v. Williamson Diamond Ltd. L.R. [1958] A.C. 41, applied.

Sir Kasturchand Ltd. v. Commissioner of Income-tax, Bombay City, (1949) 17 I.T.R. 493, referred to.

The words "smallness of profit" in s. 23A of the Act refer to actual accounting profits in comparison with the assessable profits of the year. The 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. [445F-H.]

Commissioner of Income-tax, Bombay City v. Bipinchandra Maganlal and Co. Ltd. (1961)41 I.T.R. 296, followed.

In a case where an Income-tax Officer takes action under s. 23A of the Act before the tax for the relevant period is assessed, only the estimated tax can be deducted; but, there is no reason why, when the tax had already been assessed before he takes action under this section. the estimated tax and not the real tax shall be deducted therefrom. [445H-446B]

There is no provision in the Income-tax Act which makes the Balance Sheet final for the purpose of s. 23A of the Act or even for the assessment. It no doubt affords a prima facie proof of the financial position of the company on the date when the dividend was declared. But nothing prevents the parties in a suitable case to establish by cogent evidence that certain items were, either by mistake or by design, inflated or deflated or that there were some omissions. [446B-D]

JUDGMENT:

CIVIL APPELLATE JURISDICTION: Civil Appeal No. 807 of 1963. Appeal from the judgment and order dated September 4, 1961 of the Calcutta High Court Income-tax Reference No. 85 of 1956.

C.K. Daphtary, Attorney General, R. Ganapathy Iyer and R. N. Sachthey, for the appellant.

A. V. Viswanatha Sastri and S. C. Muzumdar, for the respondent.

The Judgment of the Court was delivered by Subba Rao, J. This appeal by certificate raises the question of the construction of the provisions of s. 23A of the Indian Income-tax Act, 1922, hereinafter called the Act, before it was amended by the Finance Act, 1955.

The relevant and undisputed facts may be briefly stated. Messrs. Gungadhar Banerjee & Co. (Private) Ltd., the respondent herein, is a private limited company. At the General Body Meeting of the Company held on December 6, 1948, the Directors declared a dividend at the rate of 5 1/2 per cent. per share. The said distribution of dividends related to the accounting year 1947-48 which ended on April 13, 1948. According to the balance-sheet of the Company for that year the net profit for the said year was Rs. 1,28,112/7/5. The taxation reserve was Rs. 56,000. The profit

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left was Rs. 72,000. The Directors declared a dividend at the rate of 51 per cent. per share thus making a total distribution of Rs. 44,000. On that basis the profit that was available for further distribution was Rs. 28,000. Though under the balance-sheet the estimated tax was Rs. 66,000, the tax assessed for the year was Rs. 79,400. If the difference between the tax assessed and the estimated tax was also deducted from the profits, there would only be a sum of Rs. 4,000 that would remain as undistributed profits.

The Income-tax Officer assessed the total income of the assessee for the year 1948-49 at Rs. 2,66,766. After deducting the tax payable under the two heads, namely, I.T. of Rs. 81,517/13/0 and C.T. of Rs. 33,345/12/0, he held that a sum of Rs. 1,51,902/7/0 was available for distribution to the shareholders as dividends. As the amount distributed by the Company was below 60 per cent. of the profits available for distribution, the Income-tax Officer, with the previous approval of the Inspecting Assistant Commissioner of Income-tax, passed an order under s. 23-A of the Act directing that the amount of Rs 1,07,902 (i.e., Rs. 1,51,902 minus Rs. 44,000 = Rs. 1,07,902) shall be deemed to have been distributed as dividends as on the date of the annual general meeting of the Company. He found that, having regard to the profits earned in the earlier years and the capital and taxation reserves, payment of larger dividends would not be unreasonable.

The assessee preferred an appeal to the Appellate Assistant Commissioner against the order made by the Income-tax Officer under s. 23A of the Act. By the time the appeal came to be disposed of, in an appeal against the order of assessment the assessed income was reduced by a sum of Rs. 80,926. Notwithstanding the said deduction, as the amount of Rs. 44,000 distributed by the Company was less than 60 per cent. of the balance of Rs. 1,64,440 arrived at on the basis of the revised calculation, the Appellate Assistant Commissioner held that an action under s. 23A of the Act was justified. He further held that the assessee incurred no losses in the previous years, that in almost all the past assessments the assessee showed substantial profits, that the profits disclosed in the year of account were not small and that, therefore, the direction to pay a higher dividend was not unreasonable.

On a further appeal, the Income-tax Appellate Tribunal held that the amount of profits should be judged only from the balancesheet and that judged by the figures given thereunder a dividend to the extent of Rs. 64,000 being 60 per cent. of the assessed profits less income-tax. could be distributed

and that such distribution was not unreasonable.

The Tribunal referred the following question under s. 66(1) of the Act for the decision of the High Court of Calcutta:

"Whether on the facts and in the circumstances of the case any larger dividend than that declared by the company could reasonably be distributed within the meaning

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of Section 23A of the Indian Income-tax Act and the application of Section 23A of the Indian Income-tax Act was in accordance with law."

The High Court held that the Tribunal went wrong in taking into consideration the past profits instead of the past losses, the taxation reserves without considering the past liabilities for taxation, and the profits for the year in question disclosed in the balance-sheet, ignoring the actual tax assessed for that year. It came to the conclusion that, having regard to the smallness of the profits, the order of the Income-tax Officer was not justified. In the result, it answered both parts of the question referred to it in the negative. Hence the appeal.

Learned Attorney-General, appearing for the Revenue, contended that the balance-sheet of a company on the basis of which dividends were declared was final and the profits disclosed thereunder would be the correct basis for the Income-tax Officer acting under s. 23A of the Act; and, as the balance-sheet of the company for the relevant year showed a sum of Rs. 1,05,950 as "capital reserve brought forward", a sum of Rs. 5,73,161 as taxation reserve, and a sum of Rs. 56,000 as estimated tax, the Income-tax Officer rightly held that the financial condition of the Company was sufficiently sound to warrant an order under s. 23A of the Act. Alternatively he contended that if the respondent could be permitted to go behind the balance-sheet to ascertain the real profit, the Department should also be likewise allowed to go behind the balance-sheet to show that the commercial profit was larger and the reserves were in excess of the past liabilities and that in that event to remand the case for ascertaining the true state of facts.

Mr. A.V. Viswanatha Sastri, appearing for the assessee-Company, contended that the burden lies on the Revenue to establish that the dividend declared was not a reasonable one and that in the present case it had not discharged that burden. He further argued that for the purpose of "testing the smallness of the profit" the Income-tax Officer had to take into consideration not the assessable Income but the commercial profit of the Company and that in the present case, having regard to the commercial profit, a declaration of a higher dividend would be unreasonable. He pleaded that, should this Court hold that the Income-tax Officer could establish that the reserves were more than the liabilities, the assessee should also be permitted to prove what were its real, commercial profits and that the reserves were far less than the demands.

The contentions of learned counsel turn upon the provisions of s. 23A of the Act, before it was amended by the Finance Act of 1955. The material part of that section reads:

"(1) Where the Income-tax Officer is satisfied that in respect of any previous year the profits and gains distributed as dividends by any company up to the end of the

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sixth month after its accounts for that

previous year are laid before the company in general meeting are less than sixty per cent of the assessable income of the company of that previous year, as reduced by the amount of incometax and super-tax payable by the company in respect thereof he shall, unless he is satisfied that having regard to losses incurred by the company in earlier years or to the smallness of the profit made, the payment of a dividend or a larger dividend than that declared would be unreasonable, make with the previous approval of the Inspecting Assistant Commissioner an order in writing that the undistributed portion of the assessable income of the company of that previous year as computed for income-tax purposes and reduced by the amount of income-tax and super-tax payable by the company in respect thereof shall be deemed to have been distributed as dividends amongst the shareholders as at the date of the general meeting aforesaid, and thereupon the proportionate share thereof of each shareholder shall be included in the total income of such shareholder for the purpose of assessing his total income."

The section is in three parts: the first part defines the scope of the jurisdiction of the Income-tax Officer to act under s. 23A of the Act; the second part provides for the exercise of the jurisdiction in the manner prescribed thereunder-, and the third part provides for the assessment of the statutory dividends in the hands of the shareholders. This section was introduced to prevent exploitation of juristic personality of a private company by the members thereof for the purpose of evading higher taxation. To act under this, section the Income-tax Officer has to be satisfied that the dividends distributed by the Company during the prescribed period are less than the statutory percentage, i.e., 60 per cent., of the assessable income of the Company of the previous year less the amount of Income-tax and super-tax payable by the Company in respect thereof. Unless there is a deficiency in the statutory percentage, the Income-tax Officer has no jurisdiction to take further action thereunder. If that condition is complied with, he shall make an order declaring that the undistributed portion of the assessable income less the said taxes shall be deemed to have been distributed as dividends amongst the shareholders. But before doing so, a duty is cast on him to satisfy himself that, having regard to the losses incurred by the company in earlier years or "the smallness of the profit made," the payment of a dividend or a larger dividend than that declared would be reasonable. The argument mainly centered on this part of the section. Would the satisfaction of the Income-tax Officer depend only on the two circumstances, namely, losses and smallness of profit? Can he take into consideration other relevant circumstances? What does the expression "profit" mean? Does it mean only the assessable income or does it mean commercial or

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accounting profits? If the scope of the section is properly appreciated the answer to the said questions would be apparent. The Incometax Officer, acting under this section, is not assessing any income to tax: that will be assessed in the hands of the shareholders. He only does what the directors should have done. He puts himself in the place of

the directors. Though the object of the section is to prevent evasion of tax, the provision must be worked not from the standpoint of the tax collector but from that of a businessman. The yardstick is that of a prudent businessman. The reasonableness or the unreasonableness of the amount distributed as dividends is judged by business considerations, such as the previous losses, the present profits, the availability of surplus money and the reasonable requirements of the future and similar others. He must take an overall picture of the financial position of the business. It is neither possible nor advisable to lay down any decisive tests for the guidance of the Income-tax Officer. It depends upon the facts of each case. The only guidance is his capacity to put himself in the position of a prudent businessman or the director of a company and his sympathetic and objective approach to the difficult problem that arises in each case. We find it difficult to accept the argument that the Income-tax Officer cannot take into consideration any circumstances other than losses and smallness of profits. This argument ignores the expression "having regard to" that precedes the said words.

On the interpretation of the words "having regard to" in s. 23A of the Act, the decision of a Division Bench of the Bombay High Court, consisting of Chagla C. J., and Tendolkar J., in *Sir Kasturchand Ltd. v. Commissioner of Income-tax, Bombay City*(1) was relied upon by the appellant. Chagla C.J., speaking for the Court, held in that case that "the reasonableness or unreasonableness of the payment of a dividend or a larger dividend has to be judged only with reference to the two facts mentioned in the section, viz., losses incurred by the company in earlier years and the smallness of the profit." To put the contrary construction, the learned Chief Justice said, "would be to import into it words which the Legislature did not think fit to insert in that section and to expand the ambit of the discretion exercised by the Income-tax Officer." But the learned Chief of Justice did not expressly consider the scope of the expression "having regard to" found in the section. The Judicial Committee in *Commissioner of Income-tax v. Williamson Diamond Ltd.*(2) had to consider the scope of s. 21(1) of the Tanganyika Income-tax (Consolidation) Ordinance, 27 of 1950, which was *pari materia* with s. 23A of the Act. Adverting to the argument based upon the words "having regard to", their Lordships observed:

"The form of words used no doubt lends itself to the suggestion that regard should be paid only to the two matters mentioned, but it appears to their Lordships that it is

(1) [1949] 17 I.T.R. 493.

(2) L.R. [1958] A.C. 41.49.

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impossible to arrive at a conclusion as to reasonableness by considering the two matters mentioned isolated from other relevant factors. Moreover, the statute does not say "having regard only" to losses previously incurred by the company and to the smallness of the profits made. No answer, which can be said to be in any measure adequate, can be given to the question of "unreasonableness" by considering these two matters alone. Their Lordships are of the opinion that the statute by the words used, while making sure that "losses and smallness of profits" are never lost sight of, requires all matters relevant

to the question of unreasonableness to be considered. Capital losses, if established, would be one of them."

With great respect, we entirely agree with this view. The contrary view unduly restricts the discretion of the Income-tax Officer and compels him to hold a particular dividend reasonable though in fact it may be unreasonable.

The expression "smallness of profit" came under the judicial scrutiny of this Court in Commissioner of Income-tax, Bombay City v. Bipinchandra Maganlal & Co. Ltd.(1) Therein, Shah, J., speaking for the Court observed thus:

"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. This view appears to have been taken by the High Courts in India without any dissentient opinion."

The learned Judge laid down the following test: "Whether it would be unreasonable to distribute a larger dividend is to be judged in the light of the profits of the year in question." If the assessable income was the test and if the commercial profits are small, the learned Judge pointed out, the company would have to fall back either upon its reserves or upon its capital which in law it could not do. This decision is binding on us and no further citation in this regard is called for. 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.

Another incidental question is whether for the purpose of ascertaining the net commercial profits the tax estimated or the tax actually assessed shall be deducted. In a case where an Income-tax Officer takes action under s. 23A of the Act before the tax for the relevant period is assessed, only the estimated tax can be deduct-

(1) (1961) 41 T.T.R. 290, 296,

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ed but, there is no reason why, when the tax had already been assessed before he takes action under this section, the estimated tax and not the real tax shall be deducted therefrom. In this view, in the present case to ascertain the commercial profits what should be deducted is not the tax shown in the balance-sheet but the actual tax assessed, on the income of the Company.

Another question raised is whether the balance-sheet is final and both the parties are precluded from questioning its correctness in any respect. There is no provision in the Income-tax Act which makes the balance-sheet final for the purpose of s. 23A of the Act or even for the assessment. It no doubt affords a prima facie proof of the financial position of the company on the date when the dividend was declared. But nothing prevents the parties in a suitable case to establish by cogent evidence that certain items were, either by mistake or by design, inflated or deflated or that there were some omissions. It does not also preclude the assessee from proving that the estimate in

regard to certain items has turned out to be wrong and placing the actual figures before the Income-tax Officer. But in this case no attempt was made before the Tribunal to canvass the correctness of the figures either on the debit side or on the credit side and we do not think we are justified to give another opportunity to either of the parties in this regard. Before the Tribunal there was no dispute that the actual tax assessed for the relevant year was much higher than the estimated tax shown in the balance-sheet.

Section 23A of the Act is in the nature of a penal provision. In the circumstances mentioned therein the entire undistributed portion of the assessable income of the Company is deemed to be distributed as dividends. Therefore, the Revenue has strictly to comply with the conditions laid down thereunder. The burden, therefore, lies upon the Revenue to prove that the conditions laid down thereunder were satisfied before the order was made: see *Thomas Fattorini (Lancashire) Ltd. v. Inland Revenue Commissioners*(1). In the present case the Revenue failed to discharge the said burden: indeed, the facts established stamp the order of the Income-tax Officer as unreasonable.

The assessment orders passed by the Income-tax Officer are not before the Court. The balance-sheet shows a net profit of Rs. 1,28,112/7/5 whereas the Income-tax Officer has computed the assessable income at Rs. 2,66,766, which was later reduced in appeal by Rs. 80,925. There is no evidence on the record that the real commercial profits were artificially reduced in the balance sheet. Nor is there evidence to show what part of the income assessed represents commercial profits, and what part the notional income. In the circumstances it must be assumed that the amount mentioned in the balance-sheet correctly represented the commercial profits.

(1) L.R. [1942] A.C.643.

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From the figures already extracted at an earlier stage it is manifest that the net commercial profit was barely Rs. 4,000 and it is not possible to hold that it was not unreasonable for the Income-tax Officer to make an order to the effect that the additional sum of Rs. 64,000 should be deemed, to have been distributed as dividends amongst the shareholders. In the result we hold that the order of the High Court is correct and dismiss the appeal with costs.

Appeal dismissed.

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