

## SHREE KRISHNA AGENCY LTD.

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v.

## COMMISSIONER OF INCOME TAX CENTRAL, CALCUTTA

August 24, 1971

[K. S. HEGDE AND A. N. GROVER, JJ.]

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*Income-tax Act, 1922, s. 23A(9)—Explanation (1) cl. (ii)—Free transferability of shares—Directors having absolute discretion to refuse to register transfer of shares without giving any reasons—Shares whether freely transferable—Public whether substantially interested in company.*

The assessee was a public limited company. Under Art. 37 of its Articles of Association the Directors could at any time in their discretion and without assigning any reason decline to register any proposed transfer of shares. The question in Income-tax proceedings relating to the assessment years 1952-53 and 1954-55 was whether on a true interpretation of Art. 37 the assessee company could be regarded as one in which the public were substantially interested within the meaning of the third proviso to s. 23A(1) of the Income-tax Act, 1922. In reference the High Court answered the question in favour of the revenue on the view that the shares of the company were not freely transferable and therefore it was not a company in which the public were substantially interested. In the assessee's appeal by special leave,

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HELD : Article 37 could not by any stretch of reasoning be regarded by itself to be a restriction on the transfer of shares by one shareholder to another. Free transferability of shares is a normal and common feature of limited companies. Indeed there would hardly be any public company in the memorandum of articles of which an article similar to Art. 37 will not be found. This article appears even in the standard Articles of Association prescribed under the Companies Act itself. The purpose is only to give power to the Directors for declining to register the transfer of a share when the paramount interest of the company so require. There may be cases where it can be shown that the Directors have been exercising the power very freely and have virtually eliminated the element of free transferability. In such cases it may be possible to hold that in fact the shares were not freely transferable. But in the present case there was no evidence of the Directors having acted in the aforesaid manner nor was there any restriction in the other Articles of Association interfering with the free transfer of shares by one shareholder to another. The High Court was therefore in error in holding that the mere existence of an article like Art. 37 would affect the free transferability of the shares within the meaning of the Explanation (1) to s. 23A(9) of the Act. [372 C—F]

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*East India Corporation Ltd. v. Commissioner of Income-tax, Madras, 61 I.T.R. 16 and Raghuvanshi Mills Ltd. v. Commissioner of Income-tax, Bombay, 74 I.T.R. 823, approved.*

*Commissioner of Income-tax, West Bengal v. Tona Jute Co. Ltd. 48 I.T.R. 902, disapproved.*

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CIVIL APPELLATE JURISDICTION : Civil Appeals Nos. 1837 and 1838 of 1968.

**A** Appeals from the judgment and order dated February 10, 1965 and July 17, 1967 of the Calcutta High Court in Income-tax Reference Nos. 274 of 1961 and 114 of 1963 respectively.

*D. Pal, R. K. Choudhry, N. R. Khaitan, Krishna Sen and B. P. Maheshwari*, for the appellant (in both the appeals).

**B** *B. Sen, R. N. Sachthey and B. D. Sharma*, for the respondent (in both the appeals).

The Judgment of the Court was delivered by

**C** **Grover, J.** These appeals by certificate from a judgment of the Calcutta High Court arise out of Income Tax References in which the main point involved was whether the assessee company could be regarded as one in which the public are substantially interested within the meaning of the Explanation in s. 23A of the Indian Income Tax Act, 1922, hereinafter called the "Act".

**D** The appeals relate to the assessment years 1952-53 and 1954-55. The assessee is a public company incorporated under the Indian Companies Act, 1913. Article 37 of its Articles of Association provided as follows :—

**E** "The Directors may at any time in their absolute and uncontrolled discretion and without assigning any reason decline to register any proposed transfer of shares."

**F** The Income Tax Officer held that the assessee was a company in which the public were not substantially interested within the meaning of the Explanation in s. 23A of the Act. Accordingly he applied the provisions of that section. The assessee appealed to the Appellate Assistant Commissioner. The appeal relating to the assessment year 1952-53 was dismissed but with regard to the subsequent year it was allowed. The Appellate Tribunal upheld the contention that Article 37 of its Articles of Association did not operate as a bar to the free transferability of the shares and therefore it was a company in which the public were substantially interested within the meaning of the Explanation in s. 23A of the Act. Thereupon the Tribunal was moved by the Commissioner of Income tax for stating the case and referring the following question of law which was referred by it to the High Court in the case relating to the assessment year 1952-53 :

**H** "Whether on a true interpretation of Article 37 of the Articles of Association, the assessee Company can be regarded as one in which the public are substantially interested within the meaning of the third proviso to section 23A(1)".

A similar question was referred in the case relating to the assessment year 1954-55. The High Court following a judgment of the same court in *Commissioner of Income tax, West Bengal v. Tona Jute Co. Ltd.*,<sup>(1)</sup> answered the questions referred against the assessee and in favour of the Revenue. In that case the Calcutta High Court had expressed the view that a public company whose Directors had absolute discretion to refuse to register the transfer of any share to any person whom it shall in their opinion be undesirable in the interest of the company to admit to membership and were not obliged to give any reason for refusal to register was not a company the shares of which were freely transferable to other members of the public within the meaning of the Explanation in s. 23A of the Act.

Section 23A of the Act confers power to assess companies to super tax on undistributed income in certain cases. Sub-section (9) *inter alia* provides that nothing contained in the section shall apply to any company in which the public are substantially interested. Explanation (1) which was so renumbered by s. 7 of the Finance Act of 1957 to the extent it is material is as follows :

“For the purposes of this section, a company shall be deemed to be a company in which the public are substantially interested.”

- (a) .....
- (b) if it is not a private company as defined in the Indian Companies Act, 1913, (VII of 1913), and
  - (i) .....
  - (ii) the said shares were at any time during the previous year the subject of dealing in any recognised stock exchange in India or were freely transferable by the holder to other members of the public; and
  - (iii) .....

The Calcutta High Court referred to the relevant provisions of the Indian Companies Act 1913 according to which unless the Article provided otherwise the shareholder had a free right to transfer his shares to whomsoever he liked. But it was considered that where the Articles contained a power under which the Directors could decline to register any transfer of shares the right of free transfer was cut down by that Article and this affected the question of free transferability of the shares. Moreover the

(1) 48 I.T.R. 902.

- A** transfer of shares was not complete until the registration of the name of the transferee and if such a registration could not be insisted on as a matter of right it could not be said that the shares were freely transferable. The Madras High Court in *East India Corporation Ltd. v. Commissioner of Income-tax, Madras*<sup>(1)</sup> and the Bombay High Court in *Raghuvanshi Mills Ltd., v. Commissioner of Income-tax, Bombay*<sup>(2)</sup> took the contrary view and dissented from the opinion expressed in the Calcutta case that in the presence of an Article similar to Article 37 of the Articles of Association of the assessee the shares would not be freely transferable within the meaning of clause (ii) to Explanation 1 in s. 23A (9) of the Act. It may be mentioned that before its amendment by the Finance Act 1955 the corresponding provision appeared in the Explanation in s. 23A(1) after the third proviso. But instead of the word "were" the word "are" was employed. The question, therefore, which has to be examined is whether the shares could be regarded as freely transferable to other members of the public. In our opinion the following observations in the *East India Corporation* case represent the correct view about the meaning of the word "transferable" :

**E** "Transferable", ex facie, is not to be equated to "transferred". The word imports a quality, a legal effect arising out of or inherent in the character and nature of the shares themselves. This quality does not stand by itself, for the section says "are in fact freely transferable". We have to give effect to each of these words, and if we did so, transferability is qualified by the fact which in the context, to our minds, means a factual tendency which is unrestricted and which ensures transferability. In other words, we understand by the words "are in fact freely transferable" not that there should necessarily be actual transfers of shares, but a factual tendency towards free transfer of shares, subject, of course, to reasonable restrictions by holders to other members of the public."

- G** The Directors have certainly been given a discretion by Article 37 to decline to register any proposed transfer of shares but that does not mean that the shares cease to be transferable. The said Article does not confer any uncontrolled or unrestricted discretion upon the Directors to refuse to register the transfer of shares in a given case. In other words the Directors cannot act arbitrarily or capriciously. It is well known that the power conferred by such an Article is of a fiduciary nature which has to be exercised by the

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(1) 61 I.T.R. 16.

(2) 74 I.T.R. 823.

Directors in the best interests of the company for preventing any undesirable person becoming a member if that is likely to be prejudicial to the company. It is a power which has to be reasonably exercised for protecting the interests of the company. It cannot be assumed that the discretion conferred on the Directors will be abused for ulterior purposes. The discretion which has been conferred for being exercised in the interest of the company cannot take away the tendency of the free transferability of the shares in the absence of cogent material or other factors from which it can be inferred that the shares were not capable of being freely transferred. Article 37 can by no stretch of reasoning be regarded by itself to be a restriction on the transfer of shares by one shareholder to another. Free transferability of shares is a normal and common feature of limited companies. Indeed there would hardly be any public company in the memorandum of articles of which an article similar to Article 37 will not be found. This article appears even in the standard Articles of Association prescribed under the Companies Act itself. The purposes, as has been noticed before, is only to give power to the Directors for declining to register the transfer of a share when the paramount interests of the company so require. There may be cases where it can be shown that the Directors have been exercising that power very freely and have virtually eliminated the element of free transferability. In such cases it may be possible to hold that in fact the shares were not freely transferable. But in the present case there is no evidence of the Directors having acted in the aforesaid manner nor is there any restriction in the other Articles of Association interfering with the free transfer of shares by one shareholder to another. We are unable, therefore, to uphold the judgment of the Calcutta High Court that the mere existence of an article like Article 37 would affect the free transferability of the shares within the meaning of the Explanation.

In the result the appeals are allowed and the decision of the High Court is set aside. The question referred in each case is answered in favour of the assessee and against the Revenue. The assessee shall be entitled to one set of costs in this Court.

G.C.

*Appeal allowed.*