DELHI FARMING AND CONSTRUCTION (P) LTD. A

v.

COMMISSIONER OF INCOME TAX, DELHI

MARCH 26, 2003

[RUMA PAL AND B.N. SRIKRISHNA, JJ.] B

Income Tax Act, 1961:

Sections 2(24)(vi) and (45), 45, 47(viii), 104 and 109(1)—Levy of Super Tax on undistributed income of investment company—Capital gain to assessee-company prior to 1.3.1970 by compulsory acquisition of agricultural land—Decision by Directors of the assessee-company not to use the money for payment of dividend due to past losses and meagreness of the profit for the current years—Income tax officer holding the company liable to additional income tax—Propriety of levy—Held : The Capital gain could not have been subjected to tax as it was wholly exempted from 'capital gains' and was not part of the 'gross income' or 'distributable income' for the purpose of Section 104—Whether capital gains are commercial or business profits on which dividends could be distributed would depend on the facts and circumstances of each case based upon commercial decision of Directors of the company—Decision of the Directors was not unreasonable and hence the income tax officer was not justified in sitting in appeal over the business decision of the Directors of the Company. C D E

Section 104—Jurisdiction of income tax officer—Scope of—Held, income tax officer can only consider whether the Board of Directors acted reasonably—Cannot arrive at conclusion that payment of dividend or larger dividend than that declared would be unreasonable in view of losses incurred or due to smallness of the profits in the current years since it is business consideration. F

Appellant-assessee, an investment company got compensation prior to 1.3.1970, by reason of compulsory acquisition of agricultural land. The Directors of the company decided not to fritter away the money of compensation by payment of dividend due to past losses and the smallness of the profit for the current year and they transferred the amount to capital reserve. Assessee was subjected to levy of income tax under Section 104 of Income Tax Act, 1961 for the assessment years 1974-75, 1975-76 G H

A and 1976-77 for its failure to distribute the required statutory percentage of dividend during the concerned previous years ending on 31.3.1973, 31.3.1974 and 31.3.1975 respectively. Income Tax Officer held that there was sufficient money in the hands of the appellant which could and ought to have been declared as dividend and thus held the Company liable to additional income tax for the years 1974-75 and 1975-76. The order was B upeheld by Appellate Commissioner in appeal. In further appeal Income Tax Appellate Tribunal held that provisions of Section 104 of the Act could not be invoked in both the assessment years and gave full relief to the appellant-Company. On reference with respect to the three assessment years, High Court decided in favour of Revenue.

C

In appeal to this Court appellant contended that the sale proceeds of agricultural land are totally exempt from the charge of tax under Section 45 of the Act by reason of Section 47(viii), hence, the capital gains accruing as a result of the compensation paid could never have formed part of the "total income" of the appellant-assessee; that capital gains are D not commercial or business profits, nor are they income in the true sense of the term, although by legislative fiction they have been included within the scope of 'income' and made subject to tax; and that the income-tax officer cannot sit in appeal over the business decision taken by the Board of Directors of the appellant company.

E

Allowing the appeals, the Court

HELD: 1 The entire amount of capital gains which accrued as a result of acquisition (and hence compulsory transfer) of the agricultural land could not have been subjected to tax under Section 104 of the Income F Tax Act, 1961 as it was wholly exempted from capital gains and not part of the 'gross income' or the 'distributable income' for the purpose of Section 104 of the Act. Even assuming that compulsory acquisition of land is transfer of a capital asset within the meaning of Section 45 of the Act, Section 47(viii) specifically exempts any transfer of agricultural land in India effected before the 1st day of March, 1970 from the scope of Section G 45 of the Act. Thus, the compensation which became payable to the appellant as a result of the acquisition of its agricultural land in 1962, was totally exempt from Section 45. Consequently, it did not amount to 'income' within the meaning of Section 2(24)(vi) as there was no 'capital gain' within the meaning of Section 45. It was also not to be included while computing the total income of the appellant as defined in Section 2(45) of H

the Act. Thus, the amount of compensation received by the appellant could not have formed part of the "gross total income" within the meaning of clause (iv) of Section 109 of the Act. Consequently, there was no question of its becoming part of "distributable income" as defined in Section 109(1). [43-B, E]

Cardamom Marketting company (TRAV), Ltd. v. *Commissioner of Income Tax,* (1986) 158 ITR 621 and *Commissioner of Income Tax* v. *South India Corporation Ltd.,* (1990) 183 ITR 361 (Ker.), referred to.

2. There cannot be a hard and fast rule that capital gains ought or ought not to be treated as commercial or business profits on which dividends could be distributed. It would ultimately depend on the facts and circumstances of each case based upon which the Board of Directors take a commercial decision as to whether dividend should be distributed thereupon or not. [45-E]

CIT v. *Gannon Dunkerley and Co. Ltd.,* (1971) 79 ITR 637; *CIT* v. *N. Guin and Co. (P) Ltd.,* I (1979) 116 ITR 475 and *Factors (P) Ltd.* v. *Commissioner of Income Tax, Madras,* (1975) 98 ITR 105, referred to.

3.1. The jurisdiction of the Income-tax Officer under Section 104 of the Act is hedged in by two prerequisite satisfactions on his part. First, that profits and gains are distributed at less than the statutory percentage of distributable income; second, that having regard to the losses incurred by the company in earlier years, or due to the smallness of the profits made in the previous year, the payment of dividend or a larger dividend than that declared would be unreasonable. The second satisfaction brings in business considerations. [45-G, H; 46-A]

Commissioner of Income-Tax (Central) Calcutta v. *Asiatic Textiles Ltd.,* (1971) 82 ITR 816; *CIT* v. *Bipinchandra Maganlal & Co.,* (1961) 41 ITR 290 and *CIT* v. *Gangadhar Banerjee and Co.,* (1965) 57 ITR 176, referred to.

3.2. The words "having regard to" used in the Section 104 of the Act do not restrict the consideration only to two matters indicated in the Section as it is impossible to arrive at a conclusion as to reasonableness by considering only the two matters mentioned isolated from other relevant factors. It is neither possible nor advisable to lay down any decisive tests for the guidance of the Income-tax Officer. The satisfaction

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. [46-G, H; 47-A]

3.3. Taken against the background of the accumulated losses of the company over several financial years, together with the loss of the only asset of the company, there was nothing unreasonable in the decision of the Board of Directors not to distribute dividends from the compensation awarded but to capitalize it in a reserve account. The second statutorily required satisfaction could not have been arrived at by the Income-tax Officer so as to exercise jurisdiction under Section 104 of the Act.

[47-B, C]

CIVIL APPELLATE JURISDICTION : Civil Appeal Nos. 7525-7527 of 2001.

From the Judgment and Order dated 25.5.2001 of the Delhi High Court in I.T.R. Nos. 301 and 302 of 1981.

Ranjit Kumar and Ms. Anu Mohla,, for the Appellant.

T.L.V. Iyer, P.S. Narasimha and P. Sridhar, for the Respondent.

The Judgment of the Court was delivered by

SRIKRISHNA, J. The assessee is a company registered under the provisions of the Companies Act and carrying on business in agricultural activities and dairy farming. The assessee was subjected to levy of income-tax under section 104 of the Income Tax Act, 1961 ('the Act') for the assessment years 1974-75, 1975-76 and 1976-77, for its failure to distribute the required statutory percentage of dividend during the concerned previous years ending on 31st March 1973. 31st March 1974 and 31st March 1975, respectively.

The figures of total income-tax assessed and the distributable surplus as computed by the Income-tax Officer for the assessment years 1974-75 and 1975-76, are as under:

	Assessment year	1974-75	1975-76
1	Total income assessed	Rs. 3,22,580	Rs. 72,130

2	Less taxes payable thereon	Rs. 2,20,160	Rs. 49,228
3	Distributable surplus	Rs. 1,02,420	Rs.22,902
4	Dividends that ought to have been declared by the company, i.e. 90%	Rs. 92,223	Rs. 20,612
5	Dividend declared by the assessee company	Nil	Nil
6	Debit balance in profit and loss account	Rs. 91,472	Rs.20,508
7	Capital reserve shown in the balance-sheet	Rs.7,45,109	Rs.7,45,109

The petitioner's business of agricultural activities had resulted in losses year after year and the accumulated losses at the commencement of the year 1974-75 was Rs. 3,93,610 and for the year 1975-76 the loss was Rs. 91,472.

During the year 1962 certain agricultural land belonging to the appellant company was compulsorily acquired. There was a long drawn litigation with regard to the compensation payable to the appellant. The appellant was awarded a sum of Rs. 7,64,787 as compensation towards the acquired land on which an amount of Rs. 2,94,844 became payable as interest. This amount of interest was paid on different dates during February 1973. Since the compensation was payable immediately upon acquisition of the land, the appellant-assessee took the view that the interest earned on the compensation had to be apportioned over the years 1962 to 1972. A sum of Rs. 20,357.91 only was credited as interest for the period ending 31st March, 1973 and the balance was credited towards the earlier periods. The compensation amount of Rs. 7,45,109.72, being capital gain on the land compulsorily acquired by the Government, was transferred to capital reserve and shown as such in the balance sheet.

The Directors of the appellant company took the view that there was no possibility of distributing dividend in the concerned three accounting years on account of the past losses including the loss of the only asset of the company i.e. agricultural land. It was, therefore, thought prudent to capitalize the compensation amount in a capital reserve account and not fritter it away

A by distribution of dividend.

For the financial year ending 30.6.1973 the Income-tax Officer assessed the income as Rs. 3,22,580 and for the financial year ending 30th June, 1974 the total income was assessed at Rs.72,130. Since the appellant had not declared any dividend during the aforesaid accounting years, the Income-tax B Officer issued notices to the appellant under section 104 of the Act for the assessment years 1974-75 and 1975-76. The appellant contended that, because of the past accumulated losses and the smallness of the profit for the current year payment of any dividend would have been unreasonable, and, therefore, it had decided not to fritter away the money available in its hand as C compensation. The Income-tax Officer, however, disagreed and took the view that there was sufficient money in the hands of the appellant which could and ought to have been declared as dividend. He was also of view that the appellant was an investment company and there was substantial capital available as reflected in the capital reserve of Rs. 7,45,109. He also held that such a huge capital reserve was not required by the company for the purpose of any D business requirement. Consequently, the Income-tax Officer held that the appellant was liable to additional income-tax of 50% of the profit available, which was fixed at Rs.51,210 for the year 1974-75 and Rs. 11,451 for the year 1975-76.

The appeals filed by the appellant before the Appellate Commissioner E of the Income Tax were rejected by upholding the orders of the Income-tax Officer. Further appeals to the Income Tax Appellate Tribunal resulted in full relief to the appellant as the Tribunal agreed with the contentions of the appellant and held that the provisions of section 104 of the Act could not be invoked by the Income-tax Officer in both the assessment years i.e. 1974-75 F and 1975-76. At the instance of Revenue a reference was made under section 256(1) of the Income Tax Act, 1961 to the High Court of the following questions of law :

"1. Whether on the facts, and in the circumstances of the case, the Tribunal was right in law in holding that the capital gains of Rs G 7,45,109 could not be considered for purposes of computing the distributable income of the assessee-company for the purposes of section 104 of the Income Tax Act, 1961, and

(2) If the answer to the first question is in the negative, whether the Tribunal was right in cancelling the orders passed by the Income-H Tax Officer, u/s 104 of the Act for the two assessment years

1974-75 and 1975-76 ?"

By a common judgment dated 25.5.2001 the High Court answered both the questions against the assessee and in favour of the Revenue and also disposed of another reference pertaining to assessment year 1976-77, by taking the same view.

Hence, these three appeals.

Section 104 of the Act at the material time read as under:

"S.104. Super—tax on undistributed income of certain companies:-

(1) Subject to the provisions of sub-section (2) and of Sections 105, 106 and 107, 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 distributable income of the company of that previous year, the Income-tax Officer shall make an order in writing that the company shall, apart from the sum determined as payable by it on the basis of the assessment under Section 143 or Section 144, be liable to pay super-tax at the rate of—

(a) fifty per cent, in the case of an investment company.

(b) thirty-seven per cent, in the case of a trading company, and

(c) twenty-five per cent, in the case of any other company.

(2) The Income-tax Officer shall not make an order under sub-section (1), if 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 within the period of twelve months referred to in sub-section (1), would be unreasonable; or

(ii) that the payment of a dividend or a larger dividend than that declared within the period of twelve months referred to in sub-section (1) would not have resulted in a benefit to the revenue; or

A (iii) that at least seventy- five per cent of the share capital of the company is throughout the previous year beneficially held by an institution or fund established in India for a charitable purpose the income from dividend whereof is exempt under Section 11."

The statutory percent of dividend distributable, is prescribed at different B rates in the clause (iii) of Section 109 of the Act. The expression 'gross total income' is defined in clause (iv) of section 109 as "total income as computed in accordance with provisions of the Act". Section 2(45) of the Act defines 'total income' as the total amount of income referred to in Section 5, computed in the manner laid down in the Act. There is no doubt that capital gains C falling within section 45 of the Act would be chargeable to income-tax under the head "capital gains" and in the manner indicated in the fasciculus of sections 45 to 55A.

The learned counsel for the appellant urged the following contentions in support of the appeal :

D

(a) That the sale proceeds of agricultural land are totally exempt from the charge of tax under section 45 of the Act by reason of section 47(viii); hence, the capital gains accruing as a result of the compensation paid could never have formed part of the "total income" of the appellant-assessee;

E

(b) That capital gains are not commercial or business profits, nor are they income in the true sense of the term, although by legislative fiction they have been included within the scope of 'income' and made subject to tax;

F

(c) In any event, the Income-tax Officer cannot act as a super director and sit in appeal over the business decision taken by the Board of Directors of the appellant company not to distribute dividend during the relevant assessment years having regard to the past losses, the meagerness of the profits made in the relevant years and the necessity to stabilize the finances of the company.

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For the Revenue, the learned counsel joins issue on all the three contentions and supports the view taken by the High Court as fully justified on principle and precedents.

Dealing with the first contention urged by learned senior advocate for H the appellant, it appears to us that both the Revenue authorities and the High

Court have missed the thrust of the argument. The capital gains arose prior to 1st day of March, 1970, and, they arose not because of any transfer voluntarily made by the appellant-company, but by reason of the compulsory acquisition of agricultural land belonging to the assessee. Even assuming that compulsory acquisition of land is a transfer of a capital asset within the meaning of section 45 of the Act, section 47 (viii) specifically exempts any transfer of agricultural land in India effected before the 1st day of March, 1970 from the scope of section 45 of the Act. Thus, the compensation which became payable to the appellant as a result of the acquisition of its agricultural land in 1962, was totally exempt from section 45. Consequently, it did not amount to 'income' within the scope of section 2(24)(vi) as there was no 'capital gain' within the meaning of section 45. It was also not to be included while computing the total income of the appellant as defined in section 2(45) of the Act. Thus, the amount of compensation received by the appellant could not have formed part of the "gross total income" within the meaning of clause (iv) of Section 109 of the Act. Consequently, there was no question of its becoming part of "distributable income" as defined in section 109(1). We are hence, of the view that the appellant must succeed on its first contention that the entire amount of capital gains which accrued as a result of acquisition (and hence compulsory transfer) of the agricultural land could not have been subjected to tax under section 104 of the Act as it was wholly exempted from capital gains and not part of the 'gross income' or the distributable income for the purpose of section 104 of the Act.

The High Court rejected the contention of the appellant-assessee by emphasising that the capital gain was part of assessable income of the assessee, following the view taken by other High Courts as in *Cardamom Marketing company (TRAV), Ltd.* v. *Commissioner of Income Tax,* (1986) 158 ITR 621 and *Commissioner of Income Tax* v. *South India Corporation Ltd.,* (1990) 183 ITR 361 (Ker). The High Court was persuaded to hold that if such losses as are referred to in clause (d) are deductible from the gross total income, there is no scope for entertaining a doubt that capital gains form part of the gross total income of the company within the meaning of section 109 of the Act.

We are afraid that the point has been entirely missed. In neither judgment of the Kerala High Court relied upon was there advertence as to what would happen if the capital asset transferred was agricultural land. In *Cardamom* case (supra) the only argument urged was that capital gains were not part of the business profits, and therefore, could not be taken into account in reckoning

A the distributable income. This contention was rejected by the Kerala High Court by pointing out that section 109(i), while defining "distributable income", specifically takes in and includes the gross total income of the company as reduced by, *inter alia*, losses under the head "capital gains" relating to the capital assets, other than short term capital assets.

B On the second contention, as to whether capital gains, not being commercial profits in the strict sense, could be treated as part of the gross total income for the purpose of distribution of dividends, there is apparent divergence of opinion amongst the High Courts.

C In *CIT* v. *Gannon Dunkerley and Co. Ltd.*, (1971) 79 ITR 637 the Bombay High Court was of the view that capital gains are made only accidentally and occasionally and in making such gains an assessee cannot be described as indulging in business activity and commerce. In inflationary market and/or rising market old and worn out capital assets required to be disposed of may on sale fetch better values and yet are required to be replaced D by similar kinds of capital assets. Under normal circumstances, therefore, the High Court found it difficult to accept the submission that according to the commercial principles the amount received as capital gains are profits intended to be distributed amongst the share-holders. In ordinary circumstances, directors of business experience would never distribute amounts received by way of capital gains. These amounts would ordinarily be reserved for the E purpose of replacement of the assets sold so as to carry on the business of the concerned company in normal manner. For the same reason, amount earned as capital gain was considered to be notional profits. The availability of these gains in the hands of a company did not render these gains commercial profits.

F The Calcutta High Court in *CIT* v. *N. Guin and Co. (P) Ltd.*, (1979) 116 ITR 475, while deciding the case under section 23A of the Income Tax Act, 1922, held :

> "In our view, when a company disposes of any of its capital asset G and realises a price higher than its cost price resulting in a surplus then it will be for the directors to decide if such surplus would be treated as part of the profit of the company and included in distributable surplus. If the directors of the company decide to treat the capital gains as part of the profits of the company and the amount is put back in the profit and loss account, and thereafter if only a part of such H gains is distributed as dividend, it would be open to the ITO to go

into the question whether a greater proportion of such gains should have been distributed. This would be an exceptional case, But where the entire surplus is channelled into reserves it is not for the ITO to lay down that it should have been treated as profits."

In Factors (P) Ltd. v. *Commissioner of Income-Tax, Madras,* (1975) 98 ITR 105, a case arising under section 23A of the Act of 1922, it was held by the Madras High Court that whether the capital gain in a particular case is to be treated as profit available for distribution under section 23A or a capital return would depend on the facts and circumstances of each case. In certain cases capital gain would be in the nature of 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, it was held that the Revenue 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 under section 23A of the 1922 Act.

In our view, there is really no conflict of opinion amongst the decisions of the High Courts. The consensus appears to be that there cannot be a hard and fast rule that capital gains ought or ought not to be treated as commercial or business profits on which dividends could be distributed. It would ultimately depend on the facts and circumstances of each case based upon which the Board of Directors take a commercial decision as to whether dividend should be distributed thereupon or not. In any event, it appears to us that nothing turns on the second contention as far as the present appeals are concerned.

The third contention urged by the appellant-assessee is equally formidable. The High Court in the impugned judgment seems to have assumed that the moment the Income-tax Officer is satisfied in respect of any previous year that the profits and gains distributed as dividends by any company within 12 months immediately following the expiry of that previous year are less than the statutory percentage of the distributable income of the company of that previous year, an order in terms of section 104 must necessarily be passed. In our view, the jurisdiction of the Income-tax Officer under Section 104 is hedged in by two prerequisite satisfaction on his part. First, that profits and gains are distributed at less than the statutory percentage of distributable income; second, that having regard to the losses incurred by the company in earlier years, or due to the smallness of the profits made in the previous year, the payment of dividend or a larger dividend than that declared would be unreasonable. The second satisfaction, in our view, brings in business

considerations. As this Court observed in *Commissioner of Income-Tax (Central), Calcutta* v. *Asiatic Textiles Ltd.*, (1971) 82 ITR 816, while discussing a case under section 23A of the 1922 Act, it is not open for the Income-tax Officer to constitute himself as a 'super-director' in this regard.

In *CIT* v. *Bipinchandra Maganlal & Co.*, (1961) 41 ITR 290 this Court pointed out that the legislature has deliberately used the expression "smallness of profits" and not "smallness of the assessable income" and there is nothing in the context which would require equation of the expression "profit" with "assessable income". 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. It was also pointed out that a company normally distributes dividends out of its business profits and not out its assessable income. There is no definable relation between the assessable income and the profits of a business concern in a commercial sense.

In *CIT* v. *Gangadhar Banerjee and Co.* (1965) 57 ITR 176 this Court, while dealing with the corresponding provision under the 1922 Act, held :

> "The Income-tax Officer, acting under this section is not assessing any income to tax: that will be assessed in the hands of the shareholder. 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".

The words "having regard to" used in the section do not restrict the consideration only to two matters indicated in the section as it is impossible to arrive at a conclusion as to reasonableness by considering only the two matters mentioned isolated from other relevant factors. It is neither possible nor advisable to lay down any decisive tests for the guidance of the Income-Tax Officer. The satisfaction 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.

The question which the Income-tax Officer was to ask himself was: Whether the Board of Directors of the appellant company, in deciding to transfer to capital reserve the entire amount of the awarded compensation and not distributing dividends therefrom, had acted unreasonably or as unreasonable businessman? Taken against the background of the accumulated losses of the company over several financial years, together with the loss of the only asset of the company, we are of the view that there was nothing unreasonable in the decision of the Board of Directors not to distribute dividends from the compensation awarded but to capitalize it in a reserve account. In our judgment, the second statutorily required satisfaction could not have been arrived at by the Income-tax Officer so as to exercise jurisdiction under Section 104 of the Act. The third contention also succeeds.

In the result, we set aside the judgment of the High Court and uphold the order of the Income Tax Appellate Tribunal for the years 1974-75, 1975-76 and 1976-77 and answer the questions raised in favour of the assessee and against the Revenue. There shall be no order as to costs.

K.K.T. Appeals allowed.