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Court : Income Tax Appellate Tribunal ITAT Mumbai

Decided On : Apr-04-1994

Reported in : (1994)50ITD301(Mum.)

Judge : T Natarajachandran, Vice-, K Thangal, J Member

Appellant : Assistant Commissioner of

Respondent : N.S. Guzder and Co. (P.) Ltd.

Judgement :

1. This is an appeal by the Revenue, which is directed against the order of the CIT (Appeals) relating to assessment year 1984-85 for which the accounting year ended on 31-3-1984.

2. The assessee is an investment company. It carries on the business of clearing and forwarding, supply of cotton bales to textile mills and also new line of leasing. For the assessment year 1984-85 income returned was Rs. 7,45,316 as per the revised return filed but the total income was determined at Rs. 8,23,940 as per assessment order dated 30-12-1986. In this background, the Assessing Officer noted that the assessee has not distributed dividends of Rs. 2,53,907. Hence, he issued show-cause notice on 16-12-1987 and after considering the assessee's counsel's letter, the Assessing Officer imposed additional tax of Rs. 1,54,860 under Section 104 of the I.T. Act, 1961. In short, the case of the Assessing Officer was that the assessee has not distributed any dividend and hence additional tax was levied. The case of the assessee was that it had no positive distributable

income for declaring dividend. Assessee's computation of distributable income was modified after claiming deduction of six fold items of expenditure enumerated in the impugned order. The Assessing Officer rejected with reasons, the claims of deduction made by the assessee. The main plank of the assessee's case was based on the fact that the long-term capital gains which amounted to Rs. 7,00,000 should be excluded from the gross total income assessed for computing the distributable income as long-term capital gains were taken to the profit & loss account.

Reliance was placed on the decision of the Bombay High Court, in the case of CIT v. Gannon Dunkerley & Co. Ltd. [1971] 79 ITR 637.

3. On appeal, the CIT (Appeals) noted that the assessee has acquired ownership property worth Rs. 3.75 lakhs in Pune and it was later on leased out. She has also noted that the assessee has purchased ownership premise at Bombay for Rs. 7,16,005 and also spent Rs. 20,148 for office premise at Vashi, New Bombay. The assessee's counsel relied on the decision of the Calcutta High Court in the case of CIT v. N.Guin & Co. (P.) Ltd. [1979] 116 ITR 475 which laid down that the choice is left to the company concerned either to transfer the capital gains to the profit and loss account and thereafter deal with the amount as profits or to transfer the amount to reserve account and treat it as a reserve and where the entire surplus is channelled into reserve, it is not for the Assessing Officer to lay down that it should be treated as commercial profits. In para 4 of the appellate order, the CIT (Appeals) stated that the assessee has transferred the long-term capital gains to reserve and also acquired assets out of the capital gains. When once it has been treated as a reserve and it has been utilised for acquiring assets, the question of treatment of the capital gains as commercial profits did not arise. The CIT (Appeals) also held that the statute barred debts should have been taken into account for the purpose of computation of distributable income. She has also stated that the capital expenditure incurred in the flat which was used for business purposes was also to be taken into consideration. In short, the CIT (Appeals) concluded that the Assessing Officer has not rightly computed the distributable income under Section 109 and ignored the judicial decision pointed out by the assessee. For all these reasons, she held that the provisions of Section 104 were

not applicable and the additional tax levied was accordingly cancelled.

4. At the time of hearing, the learned D.R. heavily relied on the decision of the Madras High Court, in the case of Factors (P.) Ltd. v.CIT [1975] 98 ITR 105 wherein it was held that the issue whether the capital gains arising on transfer of capital assets are to be included for the purpose of determining distributable income for declaring dividend would depend upon the Articles & Memorandum of Association of the company and also the fact whether the capital gain received is part of capital return or capital gains. He also relied on the decision of the Assessing Officer levying additional tax.

5. The learned Counsel for the assessee, on the other hand, referred to page 31 of the paper compilation containing profit & loss account for the year ended 31-3-1984. The profit & loss account shows surplus on sale of assets of Rs. 7,37,171.88. He also referred to Gross Block Statement forming part of the balance sheet in Schedule 'G' wherein ownership flats were sold for Rs. 9 lakhs against which vehicles, air-conditioning unit and ownership premises under construction were purchased by the assessee. At page 31, lease income of Rs. 7,39,605 was shown. Referring to Schedule 'B containing notes forming part of the account item 10 at page 39 of the paper compilation, the estimated liability towards contractual obligation has been stated. Reference was also made to page 28 of the paper compilation wherein statute barred debts have been shown as current assets, loans and advances. Finally, reference to the decision of the Supreme Court, in the case of CIT v.Bipinchandra Maganlal & Co. Ltd. [1961] 41 ITR 290 was made for the proposition that terminal profits cannot be taken into account for the purpose of Section 23Aof the Act. It was also stated that the source from which dividend should be distributed should be taken into account and the phrase "smallness of profits" was relevant and not "smallness of total income". The point to be noted was that the profits on the basis of commercial principles should be computed. Accordingly, it was argued that the capital gains arising in the case of the assessee should not be taken into account by relying on the judgment of the Bombay High Court in the case of Gannon Dunkerley & Co. Ltd. (supra).

In reply, the learned D.R. relied on the decision of the Madras High Court in the case of Factors (P.) Ltd. (supra).

6. We have duly considered the rival submissions, record and the paper compilation filed. At the outset, we have to point out that there is no quarrel over the rationale of the judgment of the Supreme Court contained in the case of Bipinchandra Maganlal & Co. Ltd. (supra). The terminal profits under Section 10(2)(utf) is due to statutory fiction contained in the Act and it has not reached the assessee as his profits but it reaches him as part of capital invested by him. This decision is not applicable to the facts of the assessee's case. In the case of Gannon Dunkerley & Co. Ltd. (supra), the Bombay High Court held that the ITO cannot proceed on the footing of assessable profits or notional profits but he must base his order upon calculation and computation of commercial and/or accounting profits. Therefore, in exceptional cases, the ITO would not be justified in considering amounts received byway of capital return and capital gains as forming part of profits of an assessee-company while exercising his powers under Section 23A of the Act, 1922. In that case, the Bombay High Court, inter alia, held as under : 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 purpose of replacement of assets sold so as to carry on the busines of the concerned company in the normal manner.

The Supreme Court in the case of Bipinchandra Maganlal & Co. Ltd. (supra) held that the difference between the sale price and cost price was notional profit and for the same reason, the Bombay High Court in the case of Gannon Dunkerley & Co. Ltd. (supra) held that the amount earned as capital gains must be held to be notional profits and concluded that availability of these gains in the hands of the company does not render these gains as commercial profits. In other words, except in exceptional cases, the Assessing Officer would not be justified in considering the amounts received by way of capital returns and capital gains as forming part of the profits. In other words, only in exceptional circumstances, the capital return as well as the capital gains could be treated as commercial profits.

In the case of N. Guin & Co. (P.) Ltd. (supra) the principle that smallness of profit has to be adjudged in the light of commercial principles and not in the light of total receipts, actual or fictional has been reiterated. The decision also laid down that 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 gains is distributed as dividends, it would be open to the ITO to go into the question whether a greater proportion of such gains should have been distributed as dividend. This would be an exceptional case. However, where the entire surplus is channelled into reserves it is not for the ITO to lay down that it should be treated as part of the business profit of the assessee-company in order to determine the reasonableness of the dividend declared by it.

7. After taking into account the decision of the Madras High Court in the case of Factors (P.) Ltd. (supra) and Calcutta High Court in the case of N. Guin & Co. (P.) Ltd. (supra), it is clear that the issue should be approached from the point of view of directors of the company because the directors of experience would normally credit the capital gains to the reserve account for the purpose of utilising for replacement of assets and in exceptional circumstances, it can be credited to the profit & loss account also. In the instant case, there is evidence on record to show, as rightly pointed out by the CIT (Appeals), that the capital gains arising on the transfer of capital assets have been credited to the reserve and it is also borne on record that the assessee has in fact effected replacement of assets sold in the assessment year 1984-85. We have already indicated above the judicial dicta to the proposition that the capital gains arising on sale of capital assets could not be regarded as commercial profits. On these facts, we have to agree with the reasons and conclusion of the CIT (Appeals) in cancelling the additional tax levied by the Assessing Officer.

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